

3rd October 2016

COAG Energy Council Secretariat



To whom it may concern,

**Submission on Review of the Limited Merits Review
Regime**

The Energy Users Association of Australia (EUAA) is the peak body representing Australian energy users. Our membership covers a broad cross-section of the Australian economy including significant retail, manufacturing and materials processing industries. The annual energy bills paid by our members collectively amounts to many billions of dollars and constitutes a significant input cost to their business. Even small movements in energy prices can make a big difference to the financial stability of our members and greatly affects their ability to create employment and shareholder returns.

It is pleasing to see recent announcements regarding reduced network revenue caps leading to relatively lower network costs for consumers into the future. It is equally pleasing that network service providers involved have indicated they will not challenge these determinations, which appear to have come about through collaboration between the Australian Energy Regulator (AER), network service providers and consumer groups. We welcome this and applaud those parties involved. Unfortunately this has proven to be the exception rather than the rule, which has caused considerable concern amongst energy users.

Therefore the EUAA is very pleased to see this COAG review of the Limited Merits Review (LMR) regime. One of the key drivers of recent increases in electricity prices has been an unprecedented escalation in network tariffs. While some increases may be justified, it is our view that the increases have been significantly above what should have been the result of efficient monopoly network regulation. The flaws in the current regulatory regime have resulted in a Weighted Average Cost of Capital (WACC) higher than is required for investors given the risk allocation between networks and consumers, higher than efficient levels of new and replacement investment along with higher than efficient levels of operating and maintenance costs.

Given energy users end up paying the final bill they should be able to actively participate in both the AER revenue cap process and any appeals from the AER decisions. Unfortunately, information asymmetry and lack of resources creates large barriers to effective consumer participation, particularly the LMR regime given its judicial process. Initiatives such as the Consumer Challenge Panel and funding from Energy Consumers Australia are welcome developments. However they pale when compared with the resources available to the networks that are able to recover their regulatory and LMR appeal costs from consumers.

What this means is that the monopoly network regulation regime has failed to achieve the National Electricity/National Gas Objectives, being to deliver outcomes in the "long term interests of consumers".

The EUAA does support a merits review process for AER decisions as part of good regulatory practice and central to achieving the NEO/NGO objectives. A review process gives all stakeholders (networks, consumers, investors) confidence in the regulatory regime's accountability and transparency. It should be able to assess relevant matters and make judgements that are "reasonable" balancing the complex array of economic, technical and public policy issues around the long-term interests of consumers.

A best practice regulatory regime should not just be about finding the lowest price. It should be about getting a price and service quality combination that reflects the efficient risk allocation in the provision of long life monopoly assets. In doing so we believe the long-term interests of consumers will be met. This has not occurred to date and consumers have lost trust in the regulatory system to deliver this outcome

The 2012 LMR review (Yarrow Review) identified many reasons for the failure of the LMR process to meet the NEL/NGO. Its key recommendation was the establishment of an independent non-judicial body to replace the Australian Competition Tribunal (ACT). COAG decided instead to proceed in 2013 with amendments to the operation of the ACT.

Like the COAG Energy Council and the AER, we believe these amendments have failed to deliver their policy intent to provide better outcomes in the long-term interests of consumers.

The EUAA believes these failures cannot be addressed by a repeat of the 2013 approach of legislative changes to the existing LMR structure. While improvements are certainly possible and recent suggestions, such as reducing barriers to entry for consumers to participate in the LMR process, are welcomed, it would still retain the fundamental problem of having a judicial review process. This adversarial judicial process is not suited to the evaluation of a complex array of issues involved in achieving the NEO/NGO. An adversarial approach almost certainly requires significant legal representation which brings with it significant time and financial resource requirements. These are significant barriers to both consumer participation and procedural fairness.

The EUAA believes that these failures can only be addressed by the establishment of a new administrative investigatory body consisting of a panel of economic and technical experts – Option 3 in the Consultation Paper.

In support of this position, our submission presents the EUAA's views on:

- Why we support a merits review process as a central part of good regulatory practice – hence why we do not support Option 4 in the Consultation Paper
- Why the 2013 amendments to the operation of the LMR structure have not met the NEO/NGO – hence why we do not support Option 1 in the Consultation Paper
- Why further amendments to the existing structure will not address the fundamental problem of a judicial process being ill-suited to a LMR review of economic regulation – hence why we do not support Option 2 in the Consultation Paper
- Why we support Option 3 in the Consultation Paper – a new investigatory body with a charter to investigate and assess (not in a legal or adversarial way) all the arguments put by stakeholders as the best chance of getting the most efficient, balanced and reasonable outcome in terms of the NEO/NGO.
- Our general support for elements of Option 3 outlined in the consultation paper and some additional comments on structure and why we see the risks of Option 3 as very manageable.
- Additional comments on improving the initial AER price cap determination process with a view to avoiding the need for costly appeals or interventions.

With regards to our preferred approach, we believe option 3 is the only way to ensure the LMR process has the required focus on the NEO/NGO. We also believe this approach will have great benefits to the AER in its evaluation process and the role of stakeholders in that process.

If Option 3 were adopted the AER will no longer be writing 1,500 page decisions in anticipation of the inevitable forensic legal review of every word as part of an ACT appeal. Instead it will write shorter, more reasoned decisions, that reflect the complexity of the issues it evaluates knowing that if appealed it will be subject to review by its peers in a non-judicial LMR. In doing so it will ensure it is the most efficient, balanced, reasonable and materially preferable outcome in terms of the NEO/NGO.

Consumers are fast losing faith in the network regulatory system. It has failed to deliver on the NEO/NGO. It has failed to give them procedural fairness. We are of a strong view that simply tinkering with a broken model runs the risk that consumers will turn to a political solution with the risk of decisions being ad hoc and short term in nature. This response is not in the interests of either consumers or investors.

We look forward to further discussions with the Review Team on matters raised in this submission.

Yours sincerely

Andrew Richards

CEO – EUAA

Review of The Limited Merits Regime – EUAA Submission

This submission sets out the EUAA's views on the four options proposed in the Consultation Paper ("Paper"). Answers to the relevant questions asked in the Paper are provided at the beginning of each section.

1. We support the concept of a limited merits review as part of good regulatory practice

Question 23. Removing access to merits review would profoundly and adversely impact on the confidence of stakeholders in the accountability and transparency of monopoly network regulation to achieve the long-term interests of consumers. There are no complementary changes that could provide a substitute for a properly constituted merits review system.

Question 24. We do not support merits review through a judicial process as is used in the Australian Competition Tribunal ("ACT"). However, we support judicial review of an administrative merits review process through the Federal Court on the grounds set out on p.18 of the Paper e.g. points of law.

Question 25. Access to merits review should continue for both electricity and gas utilities.

The EUAA supports the concept of a merits review process to review AER network revenue decisions as part of good regulatory practice for the following reasons:

- Merits reviews provide an incentive to the AER to exercise its discretionary powers responsibly,
- Merits reviews give all stakeholders confidence around the accountability and transparency of the AER process and ensures errors can be addressed.
- Merits reviews serve to give confidence that the final decision is the best available to achieve materially preferable decisions in the "long term interests of consumers".

A robust merits review process would have the following characteristics:

- Is limited to matters that were brought before the AER as it made its original decision
- Has a reasonably high threshold test of materiality before an appeal is heard
- Provides "procedural fairness" i.e. equal access for all potential parties to utilise the review process and to have their views heard and considered
- Has no barriers to participation e.g. cost of participation into the process that disadvantages any stakeholder
- Does not allow gaming or rent seeking by the appellant e.g. does not allow "cherry picking" of issues that are then dealt with in isolation
- Has an investigative rather than adversarial approach to examining the matters under review; this enables comprehensive evaluation of the inter-relationships and uncertainties in the economic, technical and public policy issues examined to reach a decision that is materially preferable in the long term interests of consumers
- Minimised the time taken to get to a final decision

For these reasons we do not support Option 4. We support the retention of the right to appeal LMR decisions to the Federal Court on the grounds set out on p.18 of the Paper e.g. error of law.

2. The changes made to the LMR process in 2013 have failed to reflect good regulatory practice and so failed to meet the intention of Energy Ministers at the time

Question 4. The current LMR process acts against preferable decisions being made in the long-term interests of consumers.

Question 5. There are many issues in the current LMR regime that adversely impact on the ability to achieve the best outcome in the long-term interests of consumers. These include the judicial process used in the Tribunal, the necessity to use lawyers, the immense evidence trail presented by the networks and the networks' ability to recover the costs of the appeal in their network charges meaning there is little financial disincentive to appeal.

Question 6. The current grounds for review are flawed and reflect the judicial process in the Tribunal. A focus on small issues, cherry picked and lacking materiality, is diverting the focus from the long-term interests of consumers.

Question 7. A major problem with the existing Tribunal is the scale of material presented e.g. one million pages for the NSW/ACT distributors appeal. It must be recognised that this is inevitable in a judicial system and creates significant barriers to participation by users.

Question 9. While we are not aware of barriers to the Tribunal getting additional expert advice to that provided by the parties, we question its usefulness. Simply adding yet another "expert opinion" to those already received still faces the constraint of having to evaluate any number of expert opinions in a judicial framework. Expert opinions often involve value judgements and experts can have reasonable grounds for disagreement.

Question 10. Participation in the current process is not possible without legal representation. This creates an enormous barrier to consumer participation given the costs, complexity and time taken to prepare. Neither Energy Consumers Australia (ECA) nor EUAA members have access to sufficient funding to redress this imbalance. It should be remembered that a fundamental aspect of the judicial system is that in the interest of due process both parties have the right to legal representation, even if that means a court appointed lawyer is provided. This is not available in the current LMR process where the deepest pockets dominate proceedings.

Question 11. The EUAA has regularly reviewed the option of participation in a particular merits review and each time concluded that the expense and time required to prepare and participate in the process is too great. For network service providers the upside value of this resource expenditure to its business is far greater than that for a consumer or consumer group. This creates a significant imbalance in benefits derived from effort expended.

Compounding this is the ability of network service providers to pass on the cost incurred in the LMR process as these costs can be recovered as part of the original price cap application. Unfortunately there doesn't seem to be a cost deterrent for network service providers in the same way it is a deterrent for consumers. We consider this a gross inequity and fundamental flaw of the current regime.

Question 12. Given the tribunal was a judicial body using the rules of evidence, we considered that it would see consumer input through this judicial prism. It would be very difficult, if not impossible to get the Tribunal to consider the way consumers would present their input as a complex balancing of various factors for the long-term interest of consumers.

Question 13. There will always be an information asymmetry between consumers and the network service providers. It is their whole business and consumers cannot hope to understand the details. With the existing LMR, network service providers have an incentive to flood the Tribunal with information that simply overwhelms consumers as they attempt to respond. Due to the complexity of the issues and expert time required to digest and interpret information there will always be some evidence that consumers miss and, given the judicial process, can mean an easy "win" for the networks.

Question 14. The extended timetable for review can be simply addressed by having a non-judicial merits review process with set timetables and limits on the volume of material than can be presented.

Question 15. Maintaining the current regime would entrench an inefficient, costly and time-consuming approach that restricts participation by consumers and is therefore fundamentally flawed. We must get back to the basic goal of providing a means to deliver outcomes that are in the long-term interests of consumers and the policy intent of the 2013 reforms.

The concerns consumer expressed about the failure of the original merits review system were well expressed by the Yarrow Committee in 2012 – particularly around its failure to fully consider the long-term interests of consumers and the barriers consumers faced in the LMR process.

The EUAA had first-hand experience of this system. We undertook considerable research in 2009 to evaluate whether to intervene in a particular ACT appeal. Following advice from a QC, we declined to proceed given the estimated cost, the anticipated protracted process and low likelihood of success.

While the Yarrow Committee recommended a new administrative appeals body, COAG Energy Ministers decided to make amendments to the then existing Australian Competition Tribunal structure to address stakeholder concerns. The Paper (p.4) notes that:

“These 2013 reforms were intended to ensure that the regulatory decisions promote efficient investment, operation and use of energy infrastructure in ways that best serve the long-term interests of consumers. This included avoiding the lengthy and excessively legalistic hearings that make it difficult for all stakeholders to participate”

The EUAA believes the 2013 reforms have failed to achieve these objectives and in fact worsened the situation for consumers by allowing an overly legalistic process to become entrenched. It is our view that the current regulatory regime has resulted in a WACC that is higher than required for investors given the risk allocation between networks and consumers, higher than efficient levels of new and replacement investment, higher than efficient levels of operating and maintenance costs and very limited procedural fairness with huge barriers to consumer participation in the regulatory process.

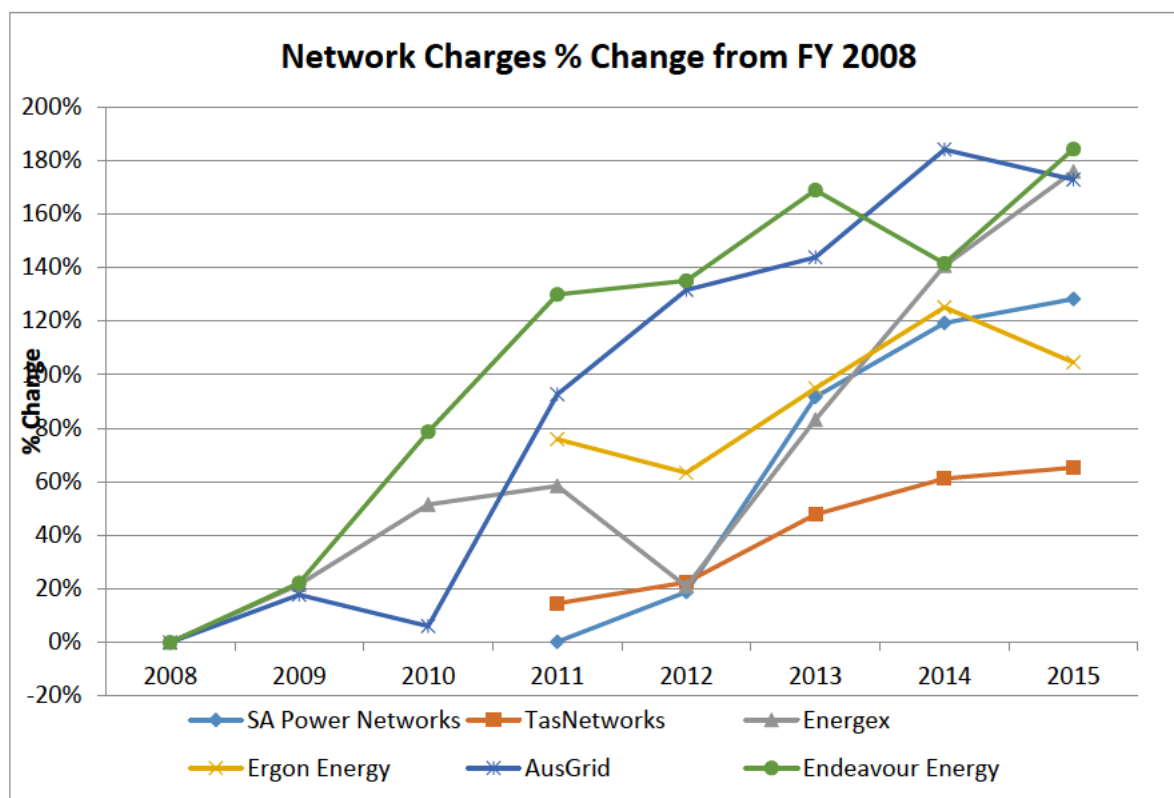
Evidence provided by the AER suggests that network service providers have come to regard the LMR as the primary regulator rather than an appeals process. It appears in many cases that the AER’s final decision is simply a speed bump on the way to some network service providers desired outcome. Not only have the incidence of appeals increased since the 2013 reforms but also has their complexity. It seems that the only constraint on appeals is where a State Government has directed the network not to do so.

Network service providers ability to recover appeal costs in network charges creates perverse incentives when placed in a judicial appeals process. We believe that the current regime has led to network service providers having “captured” the LMR process.

Network rates of return and hence charges levied on consumers are well above what should be the outcome of efficient regulation of monopoly networks with this risk allocation in both electricity¹ and gas². As the Paper notes (p.4):

“Since 2013, twelve of the AER’s twenty decisions on electricity network revenue and gas access arrangements have been subject to applications by network businesses for review by the Tribunal. Taken together, these twelve network businesses asked the Tribunal to increase their revenue by around \$7 billion over a five-year period. Legal challenges mean revenue determinations finalised by the AER more than 16 months ago (April 2015) will likely remain uncertain until at least early 2017.

The chart below clearly highlights the issue of escalating network charges over the last 8 years where, despite some one-off reductions, the trend is undeniably and significantly upward.



Another key indicator of the overall failure of the current regulatory system is the NSW/ACT case. The million pages of evidence, the costs of the appeal, the time taken to resolve the issues, the resource commitment of networks, consumers and the AER – all suggest a very broken system. Given the further AER appeal to the Federal Court, a final decision may not be available until towards the end of the period the revenue cap is meant to apply to. We now see network service providers involved making a participant derogation to allow recovery of any increase in revenue cap to extend into the next 5-year revenue cap period 2019/20 to 2023/24.

Even with the limited, but very welcome, support of the ECA, consumers can never hope to match the resources available to the network service providers in a judicial process. Given the almost

¹ Hugh Grant “Asserts or Liabilities – the Need to Apply Fair Regulatory Values to Australia’s Electricity Networks” May 2016

² Credit Suisse “APA.AX: APA Group - Quantifying downside risk from regulation” Asia Pacific/Australian Equity Research Gas Utilities 17 March 2016.

impenetrable barriers to participation, the EUAA and its members have little confidence that the current LMR process will produce materially better outcomes in the long-term interests of consumers.

As noted above the regime creates perverse incentives on the network service providers given they can recover their costs of appeal in network charges. This combined with precedent suggested they have a high chance of getting an increase in their allowable revenue from an appeal, tells the networks that there is little or no downside from appealing to the ACT. The AER seems to anticipate that all of its decisions will be appealed and seeks to pre-emptively defend itself through a significant expansion of their reports' length to withstand the inevitable forensic legal review of every word as part of an ACT appeal.

The AER presented data to the LMR Public Consultation session on 21st September 2016 showing an example of how the number of pages in a final regulatory decision has ballooned - ~280 pages (IPART all NSW DBs 2004-9), ~720 pages (AER all NSW DBs 2009-14) to ~1,460 pages (AER Ausgrid only 2014-19). Clearly this adds additional costs and time to the LMR process, a cost that is ultimately borne by taxpayers and energy users.

In the EUAA's view, the fundamental reason for the failure of the ACT structure is that it follows the processes, customs and disciplines of a judicial body. We agree with the Paper's view on the inherently legalistic process of the Tribunal (p.13):

"The 2013 reforms do not appear to have made the LMR more investigatory and less judicial in nature."

This adversarial legalistic nature of the appeals process makes it well suited to resolving disputes over the application of the law, especially where issues can be clearly and narrowly defined, or issues of fact e.g. has the AER made the correct calculation? But we do not consider it to be an appropriate approach for the evaluation of policies and economic concepts under uncertainty nor is it an appropriate approach to enable balancing of complex issues that include broader tests of public interest.

As the Paper remarks (p.6) there is an important difference between a "correct" decision and a "preferable" decision in network regulation. A judicial process is well suited to making a "correct" decision where only one decision is possible on the facts or the law. It is not well suited to making a "preferable" decision, which requires discretion and judgement given information that is subject to uncertainty in complex economic, technical and public policy issues in monopoly network regulation.

Yet LMR decisions are primarily about getting to a "materially preferable" solution that best meets the long-term interests of consumers, which appears to be at odds with the very nature of the LMR judicial process.

The 2013 amendments were designed to bring some regulatory certainty. However, we agree with the Paper's comments (p.12) that instead there has been increased regulatory uncertainty for all stakeholders.

The inevitable result of trying to consider complex issues in a judicial framework are that decision-making is delayed. It appears that the ACT lacks sufficient resources to adequately assess the issues before it in an acceptable timeframe. It is difficult to see how the ACT can deliver a better result for consumers given a relatively narrow approach defined by a judicial review, the limited expert resources it has available and the considerable time pressure it is under. This is in stark contrast to the

many months of investigation, expert economic modelling and consultation undertaken by the AER to develop their position in the first instance.

There is little clarity in the Tribunal decisions around how their decisions were influenced by the long-term interests of consumers. We would observe that “investment certainty” for the network service providers is given substantive weight in decisions. This is understandable but a balance between investors and consumers is needed to achieve the NEO/NGO. The long-term interests of consumers cannot be viewed through the prism of investor certainty, as defined by the investors.

In her presentation to the LMR Public Consultation Session on 21st September, Rosemary Sinclair provided quotes from the ACT decision on the NSW appeals that indicate the Tribunal is giving equal weight to networks and consumer interests and did not provide justification for its decision to set aside and remit back to the AER using the “materially preferable NEO decision criteria”. Certainty of regulatory structure should not trump the long-term interests of consumers.

For these reasons we do not support Option 1.

3. We do not think that the problems with the current LMR structure change are addressed by further incremental legislative amendments

Question 16. No amendments are possible that will achieve the policy intent of the 2006 and 2013 LMR reforms.

Question 17. The current Tribunal review process cannot be made sufficiently investigatory in nature to justify retention of the Tribunal.

Some stakeholders are suggesting changes to the existing regime to address its shortcomings such as:

- More funding to consumer advocates to have a more level playing field
- Getting agreement on key issues like WACC every 5 years and eliminating it as a ground for appeal
- Not allowing networks to recover appeal costs in network charges.

While we welcome these initiatives as a demonstration of intent and good faith by those proposing the changes, the EUAA believes this will fail to meet the requirements of good regulatory practice. The experience since 2013, particularly the NSW/ACT case, shows that we need a circuit breaker, not tinkering at the edges of a flawed model. A “proportionate” response should reflect the fundamental problems with the existing model.

Even if consumers had access to funding at the same level as the networks there are still problems of a judicial process. A review process based on the rules of evidence in an adversarial process are manifestly inadequate to address very complex economic, technical and public policy issues associated with the regulation of energy markets. No amount of legislative amendments can change the inherent review process in the Tribunal.

We do not see the AER changing its approach were this options adopted. If current behaviour continues they will still spend significant resources on trying to anticipate a forensic judicial review.

We see little benefit in having a Federal Court judge presiding in the LMR process. If there is an error in law, this can be resolved in an appeal from the LMR process to the Federal Court.

For these reasons the EUAA does not support the proposed Option 2.

4. We believe that the Review Team should focus on Option 3 – New fit for purpose investigative body

Question 19. Yes it should be straightforward to increase the clarity of grounds for a LMR to be undertaken by a new body that is investigatory rather than judicial.

Question 20. The new body can achieve this balance. Central to this will be sufficient funding for consumers to participate in the original AER revenue cap process so they then have standing in a review; and the investigatory approach of the body as it seeks to balance competing views. Consumers need to have confidence that they are able to present their views, be heard, understood and valued. The decision needs to be set out in a way that shows this balancing and in plain English why it is materially preferred in the long term interests of consumers.

Question 21. We generally support the body's role as set out in the table on pp 15-16 in the Paper – though seek to encourage the body to make final decisions and limit remits back to the AER to prevent a continuing cycle of appeals.

Question 22. The new body should be completely independent of the existing energy regulatory institutions (AER/AEMC/AEMO) with its own small secretariat. This could have links to the Federal Department of energy. Direct funding should come through COAG Energy Ministers.

The principles of good regulatory practice require that the LMR be based on an assessment of a wide range of economic, technical and public policy issues that experience shows are not suited to a judicial context.

The EUAA's preferred option is Option 3 – the establishment of a new fit for purpose investigative body. We see this approach as having the best chance of achieve decisions that are materially preferable to the long-term interests of consumers:

- An purpose built investigatory body is much better suited to the LMR task
- It will reduce the cost, complexity and time delays so that consumers have much more confidence on the overall regulatory process meeting to meet the long term interests of consumers, and
- It will allow the AER to focus on what it does best – reviewing the network revenue proposals, rather than constantly looking over its shoulder in anticipation of what might be raised in a judicial ACT appeal. The AER will focus on weighting the evidence presented by stakeholders and then making an educated judgement that they think will stand up to peer scrutiny of the new body rather than stand up to adversarial judicial scrutiny in the ACT.

While we have not had the opportunity to undertake a detailed review of whether the Australian Information Commissioner is a useful model, we generally agree with the description of this body and its proposed approach set out on p. 15-16 of the Paper. Two particular suggestions:

- Consider some limit on the amount of material allowed to be presented during the appeal process
- Encourage the body to make a final decision itself and limit its remit back to the AER to avoid a continuing cycle of appeals.

The body should not be fettered by any confidentiality constraints and have similar investigatory powers to the ACCC.

Key to the success of the new body will be increased consumer involvement in the AER review process – in addition to the work of the revamped Consumer Challenge Panel – given the limit in the LMR process to issues raised during this AER revenue decision process. This will require increased funding – whether through the ECA or the AER.

Membership of the new body would consist of a panel of experts with skills in the economic, commercial and technical matters considered by the AER in its revenue decision process. There should be no requirement for members to have legal qualifications. We would see the COAG Energy Council as the appropriate body to select this panel.

A three-member Panel would be convened “as required” and those three would appoint a Chairman. There are two options for providing secretarial and research support:

- The body would have its own small independent secretariat; staff would monitor AER decisions so that they can brief Panel members should an appeal arise and then support the Panel during the appeal, or
- By drawing on resources in the Federal Energy Department

We see disadvantages in the body having any formal or informal connection to the AEMC. It should be independent and seen to be independent by all stakeholders. Given the State Government role in appointing AEMC Commissioners and some State Governments’ continued ownership of networks, we see a potential perceived conflict of interest in any association with AEMC. Further the AEMC, as the rule making authority, may be conflicted as it assesses rule changes that will impact on the operation of the new body.

The budget would be provided through the COAG Energy Council.

Parties should retain the right to appeal to the Federal Court on the grounds set out in the table on p.18 of the Paper.

The costs incurred by networks in the appeal process – to the new body and any subsequent Federal Court appeal – should not be recoverable in network charges.

5. We consider the risks from Option 3 to be manageable and considerably less than other options

Question 18. There are the usual risks associated with establishing a new body e.g. it will not operate in the long term interests of consumers, it will be captured by a particular stakeholder, it will not be resourced properly, perceptions of network investors and too low a threshold for review. We consider these are manageable with good organisation design. Examples of other similar bodies currently operating can be drawn on such as Australian Information Commissioner, which is mentioned in the Consultation Paper (p.14). Challenges in implementation include timeliness of establishment particularly if key stakeholders oppose this approach and seek to delay its implementation.

We define risks in terms of the LMR review objective of “the ability to deliver decisions that are materially preferable in the long term interests of consumers”. Our discussion so far has argued that the existing ACT structure has failed to deliver in the 2013 reform objectives and tinkering with this model will only have a marginal impact on achieving this objective. It is a false dichotomy to characterise Option 2 as “low risk” and Option 3 as “high risk”.

The potential risks are around time and resources to set up the new body, sovereign risk to network investors around a change in regulatory structure and whether the new body will have the skills and resources to ensure administrative efficiency in its decision-making processes.

We believe that all these risks can be managed with sufficient goodwill among all stakeholders and COAG resourcing to ensure good organisation design. Yes, there will be considerable work involved in establishing a new body, but the EUAA is prepared to play its part in supporting this work. Key to the timely and efficient establishment of the new body will be:

- Clear and detailed directions from the Energy Council on the structure, objectives and timetable for establishment of the new body – we wish to avoid a situation where opponents of change seek to delay change and re-prosecute their particular views
- Funding available to consumers to ensure their participation in the establishment process

The arguments around regulatory certainty/sovereign risk for debt and equity investors are sometimes easy to make and difficult to refute. Certainly we do not consider these arguments as relevant to networks that are State Government owned. There is no doubt that debt and equity providers in privately owned networks have reaped the benefits of the current LMR process and it is understandable they wish this one-way bet to continue. As noted above there is evidence to suggest that the economic regulation of monopoly networks has resulted in returns significantly above that required by investors in regulated assets with the same risk allocation.

It is not surprising that a recent Rothschilds survey of network investors supported continuation of the existing LMR process. It is also not surprising to see broker reports on listed network companies very focussed on the outcomes of the LMR process as a guide to their investment recommendation.

Domestic investors understand the regulatory risks associated with investing in private network businesses. While overseas debt and equity investors may be less knowledgeable, we would suggest that the move to Option 3 should not impact their willingness to invest. As Spark Infrastructure's recent presentation to UK and European Investors pointed out³:

1. Regulatory policy in Australia continues to protect efficient sunk investments

- ▶ Private ownership of grid assets delivers efficient investment
- ▶ AEMC (rule maker) has consistently rejected proposed optimisation of RAB

2. Revenue cap provides revenue certainty

- ▶ All electricity transmission and distribution networks under AER jurisdiction now under Revenue cap
– sales volume risk removed

³ Spark Infrastructure "UK and Europe Investor Presentation" 14-16 March 2016 slide 11
http://sparkinfrastructure.com/wp-content/uploads/2016/04/09_Mar-2016-UK-and-Europe-investor-presentation-11-Mar-2016.pdf

A similar presentation to US investors in June 2016 highlighted “revenue certainty”, inflation protection” and “cost pass throughs for operating and capital costs”⁴.

Implementing Option 3 will have no impact on this risk allocation.

However, all investors need to recognise there are risks to their investment that are potentially much larger than any change in the LMR process.

The large rise in network charges has put great pressure on small and large businesses cost structures and competitiveness. Some EUAA members have addressed this by improving energy productivity, some by closing operations, and some by expanding offshore where energy is cheaper. Combine this with the increase in distributed generation and the level of grid demand is expected to continue falling. This will have the effect of further increasing network charges as networks move to increase the fixed component of charges and recover their allowable revenue over a smaller customer base.

In this context, the EUAA would argue there is potentially considerable political or sovereign risk associated with a continuation of the existing LMR process. Rising network charges combined with a LMR system that consumers have lost faith in, increases the chances of a political response that shifts volume risk back on to networks and puts pressure on them to write down stranded assets.

Both investors and consumers benefit in the long term with a regulatory regime that appropriately balances their interests. The current regime does not and the longer this persists the greater the chance of ad hoc political intervention that poses greater risks to investors than a move to option 3.

It remains to be seen if the change to Option 3 results in higher funding costs. EUAA members, knowing that existing system has brought rises in network revenue caps of up to \$7b, is willing to take the risk.

6. Consideration of Option 3 in a wider context - Other issues

Question 26. There are a number of areas of reform to the broader regulatory framework that would assist in achieving the policy intent of the 2013 reforms of the LMR and deliver outcomes in the long term interests of consumers.

As the Paper notes (p.19) the Review’s Terms of Reference allow the consideration of wider issues around the economic regulatory framework to better achieve the policy intent of the 2013 reforms with respect to the long term interests of consumers.

To this end the EUAA offers four thoughts for consideration around measures to reduce the frequency and improve the efficiency of LMRs:

(i) Remove any constraints on the AER’s access to network information

This would include giving the AER similar investigatory powers to the ACCC to get behind any confidentiality barriers.

⁴ Spark Infrastructure “Canada and USA Investor Presentation” June 2016 slide 18

http://sparkinfrastructure.com/wp-content/uploads/2016/06/31_North-America-investor-presentation-14-June-2016.pdf

(ii) Provide additional resources to the AER

There is a clear mismatch between the resources available to the AER and that available to the network service providers. This puts the AER at a distinct disadvantage. The resources involved in network appeals have stretched the AER's resources available to undertake the regular revenue cap process. Three particular areas where a resource boost would be welcome by the EUAA are:

- The engineering/technical evaluation of investment and O&M expenditures
- The development of greater process around the information that networks need to present to the AER e.g. benchmarking data templates
- Review of the effectiveness of the greater consumer engagement required under the AER's Better Regulation programme

(iii) Provide additional resources to consumers to participate in the AER process earlier

The development of the Consumer Challenge Panel and the funding available from the ECA are both welcome developments that enable much greater consumer involvement than in the past. However, the resources available to consumers to participate in the AER process e.g. provide detailed submissions on the draft expenditure proposals, are still very limited with comments generally limited to high level issues.

(iv) Develop binding positions on key parameters to reduce the scope of appeals

Currently the AER devotes considerable resources to develop guidelines around key parameters e.g. WACC. It is then up to the networks to decide if they will or will not follow these guidelines in their revenue submissions. Some do and some do not. If they do not and then the AER decision applies the guidelines, then there was a risk of an appeal.

An alternative approach is to have develop the guidelines into binding rulings that network have to apply over a given "cycle" of reviews. Stakeholders would have the option of a LMR (new body and Federal Court), but once it is binding they could not appeal the matter in their individual revenue cap process. While this shifts additional regulatory and administrative effort to the "front" end, hopefully it limits the need to fix the "back" end of LMR.

(v) Negotiated settlements

This is an approach that is gaining ground in some overseas jurisdictions and worth of consideration for its application in Australia. There is a much greater role of consumers throughout the process and a greater chance of the NEO/NGO being met.

EUAA

5 October 2016