

19 September 2017

Committee Secretary
Senate Standing Committees on Environment and Communications
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Parliament House
CANBERRA ACT 2601

To the Committee Secretary

The AER welcomes the opportunity to respond to the Senate Environment and Communications Legislation Committee regarding the Competition and Consumer Amendment (Abolition of Limited Merits Review) Bill 2017.

In our view, limited merits review is detrimental to the long term interests of consumers and should be removed as soon as possible. We set out detailed reasons for this view in our October 2016 submission to the COAG Energy Council's review of limited merits review process. We have attached that submission in full for your reference. The key views we set out in that submission are that:

- the limited merits review regime has failed to meet policymakers' intentions— in particular, appeal has been routine and outcomes have been consistently to the detriment of consumers. For example:
 - Appeals from 2008–2013 resulted in revenue increases of approximately \$3.5 billion (nominal)
 - Since 2014, networks have sought appeals totalling approximately \$7.2 billion (nominal).¹ The final outcomes of these reviews are not yet finalised.
- this in turn compromises the regulatory process—as the bar to seek appeal is low, the limited merits review process has become the ultimate focus of the regime. This does not support the achievement of the best initial decision, nor balanced outcomes that represent the interests of all stakeholders.

¹ The initial appeal values were higher but some matters were withdrawn prior to completion of the LMR processes.

- removal of limited merits review will support an appropriate accountability framework and a robust regulatory process in which consumers and other stakeholders may readily participate, as opposed to the legalistic and costly limited merits review regime in which network revenues have been increased in all but one of over thirty appeals to date.

We would like to take this opportunity to add to our initial submission to reflect our experiences over the past year. In short, they reinforce our views that limited merits review has compromised the initial regulatory decision-making process to the long-term detriment of consumers. Without LMR we expect the focus to shift to effective engagement with consumers and the regulatory process and we are starting to see some evidence of such a shift following the CoAG Energy Council's review of LMR.

Our submission

Our attached submission to COAG EC provides analysis and evidence to support the positions outlined above.

In attachment A to this letter we briefly update our submission with:

- the implications of the Full Federal Court decision for the role of limited merits review—in our view, the Court's decision confirms that the Tribunal has much wider scope to intervene than was intended by policy makers. This in turn makes appeal more attractive.
- recent experience of cascading reviews—due to the long and complex review processes, we are commonly forced to make decisions where previous appeals are outstanding and we do not yet have access to the outcomes of the appeal process. This creates significant uncertainty and has contributed to divergent outcomes on substantially similar decisions.
- engagement since commencement of the COAG review of limited merits review— since COAG EC moved forward its review of the limited merits review framework, we have observed perceptible and positive changes in the engagement between networks, consumers, other stakeholders and the AER.

In attachment B to this letter, we enclose our October 2016 submission to the COAG Energy Council's review of limited merits review.

We look forward to working with the Committee as it undertakes its deliberations. If you would like to discuss any aspect of this submission, please contact me or Warwick Anderson on

Yours sincerely

Paula Conboy
Chair

Attachment A— Updates since the AER's submission to COAG Energy Council's review of limited merits review

The implications of the Full Federal Court decision for the role of limited merits review

In March 2016, we sought review of the Australian Competition Tribunal's decision in relation to our determinations for Ausgrid, Endeavour, Essential, ActewAGL and Jemena Gas Networks.

A key purpose of our appeal was also to have the Court's guidance on the scope and role of LMR. We now have that guidance, and it indicates that LMR allows the Tribunal broad scope to intervene in the decision making process, despite the legislative limitations implemented by the COAG Energy Council in 2013.

In our view, the FFC decision reinforces the conclusion reached by the COAG Energy Council in December that limited merits review is compromising the regulatory process and failing to achieve its policy intent. In particular:

- It establishes the Tribunal as a second regulator without equipping it properly to undertake the complex tasks involved in proper network regulation.
- As a result, the potential for limited merits review becomes the focus of the primary decision-making process
- This compromises engagement between service providers and the AER and excludes consumers from meaningful participation.

We reach those views with based on the following key findings of the Court:

- First, the Court concluded it would not have been the intention of the legislature that there are classes of error that may be discerned by the Tribunal but would ultimately be beyond the Tribunal's reach.² In our view, the implication of this finding is that the Court does not accept that the grounds of review, introduced to limit the scope of merits review, actually limit the Tribunal's ability to intervene in the regulatory process. In contrast, our understanding of the policy objective is precisely that the Tribunal's powers are intended to be limited by the grounds of review.
- The Court also took a very wide interpretation of the requirement that a matter should be 'raised and maintained' in order for an issue to be raised on appeal.³ In our view, the critical policy objective of this requirement is to ensure that consumers and other

² For example: [149]— "To conclude that there were some findings of fact or exercises of discretion which were not susceptible to review by the Tribunal for material error seems to us to be unlikely as a matter of the intention of the legislature."

³ For example [151]—" We do not accept the submission on behalf of the AER that the correct approach is to ask whether a service provider has engaged with the regulator or that service providers must engage with the regulator (and other interested parties) throughout the primary decision-making process. In our opinion, that is to raise a distracting or potentially distracting test. Similarly, we do not accept the submission on behalf of the Minister that what was required was genuine engagement with the regulator on the issues for determination and that "parties must be incentivised to engage fully in the regulatory process at first instance." . Also see [484-485].

stakeholders will have an opportunity to engage with all relevant material and arguments during the primary decision making process. If an issue has not been clearly raised and maintained during the long determination making process, it should not be entertained by the Tribunal. However, the Court's decision now means that there is no strict requirement for businesses to engage in detail during the AER's primary process because the Tribunal is free to consider almost any arguments on review, as long as they relate broadly to an issue concerning the AER's determination. We see this as a significant driver in compromising the integrity of the primary process and in denying consumers and other stakeholders the proper opportunity to engage with revenue proposals.

- Finally, the Court indicated that the Tribunal can give effect to the materially preferable test by requiring the AER to undertake that assessment on remittal.⁴ This test was a key feature of the 2013 reforms to limited merits review and was designed to ensure that the Tribunal was positively satisfied of a preferable overall decision before intervening to increase or decrease revenue. However, based on the Court's finding, as long as the Tribunal remits a decision to the AER, it appears there is no need for the Tribunal to reach a conclusion about the materially preferable decision before setting a decision aside.

Taking account of these conclusions, the Full Federal Court decision strengthens our view that the LMR framework cannot be reformed to enable meaningful consumer participation in the regulatory process. Network businesses have a clear financial incentive to submit material in a form that is amenable to the highly legalistic LMR process and to pursue higher revenues through appeals. This focus on appeals has generated vast volumes of material. Without LMR we expect the focus to shift to effective engagement with consumers and the regulatory process and we are starting to see some evidence of such a shift following the CoAG Energy Council's review of LMR.

Recent experience of cascading reviews

In our view, the limited merits review regime has contributed to substantial uncertainty through the current regulatory period. Due to the long and complex review processes, it is common that we release final determinations while other limited merits review processes are outstanding. In turn, this commonly contributes to further reviews of subsequent decisions since the networks, stakeholders and indeed we are unable to engage with what might be the Tribunal's potential findings on those outstanding matters. Further, when the Tribunal hands down a decision, that decision may be released at a stage that does not allow it to be factored into decisions nearing release. Affected networks and stakeholders are in turn unable to make timely submissions about the relevance of a Tribunal decision to their own situation and we are unable to undertake our own analysis in a timely manner, often leading to delays or further reviews.

⁴ See [156]— “...whether there will be, or would be likely to be, a materially preferable decision to the decision in fact made by the regulator depends on an assessment of the decision as a whole, and a comparison of that decision with a putative alternative decision, either by the Tribunal or by the AER on remitter: it does not depend simply on an assessment of errors in individual components of the decision under review.”

A further consequence is that different Tribunal panels have considered substantially the same arguments and come to different conclusions. For example, focussing on electricity distribution network service providers during the current regulatory cycle:

- We released final determinations for the NSW and ACT electricity distribution service providers and Jemena Gas Networks in April 2015
- In May 2015, the Ausgrid, Endeavour Energy, Essential Energy, ActewAGL and Jemena Gas Networks applied to the Australian Competition Tribunal for merits review and the Federal Court for judicial review of the AER's final 2014-19 distribution determination. The Tribunal had in excess of 1 million pages of material before it.
- In the interim, we published final decisions for the Queensland and South Australian electricity distributors in October 2015.
- In November 2015, South Australia Power Networks sought review of the AER's decision on substantially similar matters to NSW/ACT. At this stage, the Tribunal had not yet made a decision on the same issues for NSW/ACT.
- The Tribunal made its decision for the NSW/ACT distributors and JGN in February 2016. It upheld some aspects of the AER's decision, including the return on equity and return on debt data series. It overturned other parts of our decisions and remitted the decisions back to the AER to be remade in accordance with its orders as to the value of imputation credits (gamma), return on debt and operating expenditure (opex).
- In March 2016 the AER applied to the Federal Court for judicial review of the Australian Competition Tribunal decisions to set aside its revenue determination for the NSW and ACT distributors and JGN.
- In May 2016, we released final determinations for the five Victorian electricity distributors and ActewAGL (gas). All six service providers sought appeal of aspects of these determinations. The Tribunal has recently delayed its decisions on these reviews until October 2017 in order to take into account submissions on the other Full Federal Court processes.
- In October 2016, the Tribunal affirmed the AER's decision for SAPN in full, despite similar arguments being put to many of the matters in the NSW/ACT/JGN reviews, creating further uncertainty and scope for further reviews.
- In November 2016, SAPN sought Full Federal Court judicial review of the Tribunal's decision. The same bench of the Full Federal Court that heard the NSW/ACT/JGN reviews heard the SAPN judicial review but has not yet handed down its decision on these matters.
- In May 2017, the Full Federal Court handed down its decision on the AER's appeal of the Tribunal decision for NSW/ACT and JGN. The Court upheld the AER's appeal in respect of the Tribunal's construction of the rules regarding gamma.
- We are currently about to commence work on the remittal for the NSW/ACT and JGN decisions, released in 2015, but do not yet have the guidance of either the Full Court's consideration of SAPN's appeals or the Australian Competition Tribunal's decision in the Victorian appeal.

These outcomes are, in our view, a direct result of the complex and wide-reaching nature of appeals under the LMR framework. We consider the cascading uncertainty is not in the long-term interests of consumers and that it compromises the price signals sent to users of and investors in energy networks. In particular, we note that we are about to undertake the next revenue determination process for the NSW and ACT electricity distributors (commencing January 2018) despite substantial proportions of the previous revenue allowance not being finalised.

Engagement since commencement of the COAG review of limited merits review

Finally, we would like to note the positive impacts that we have already seen arising from the expectation across the sector that limited merits review would be either removed or significantly restricted.

Since COAG EC moved forward its review of the limited merits review framework, we have observed perceptible and positive changes in the engagement between some networks and their consumers and the AER. Of three decisions released in 2017, only one appeal was lodged and that appeal was ultimately dropped before it proceeded to a hearing. The trend continued since the Minister's announcement on 20 July 2017 about the Government's intention to remove access to limited merits review. In general terms, we have observed a growing acceptance that, with restricted or removed access to limited merits review, the primary decision process regains primary significance. In our view, this has contributed to improvements in the way networks engage consumers and ourselves. This is consistent with our view that the availability of the Australian Competition Tribunal as a second and ultimate regulator has fundamentally affected the regulatory process.

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4 October 2016

Mr Rob Heferen
Chair
COAG Energy Council Senior Committee of Officials
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Dear Mr Heferen

The AER welcomes the opportunity to respond to the COAG Energy Council Senior Committee of Officials' (SCO) Review of the Limited Merits Review Regime Consultation Paper (Consultation Paper).

The AER is committed to the maintenance of a robust regulatory framework that meets the objectives that were originally identified by the Ministerial Council on Energy (MCE) in 2006 and refined following the 2012 Expert Panel's review. Namely these are to:

- provide a balanced outcome between competing interests and protecting the property rights of all stakeholders
- maximise accountability
- maximise regulatory certainty
- maximise the conditions for the decision-maker to make a correct initial decision
- achieve the best decisions possible
- minimise the risk of "gaming"
- minimise time delays and cost.

Our attached submission examines from a first principles basis whether the current limited merits review framework supports the achievement of these objectives. Based on this analysis, we conclude that the regulatory framework would be strengthened by the removal of limited merits review of regulatory determinations.

Threshold for review has been met and reform is required

We recognise there is a threshold question for policy makers as to whether sufficient time has elapsed to be considering reforms to a framework that was amended in 2013.

In addition, as noted in the consultation paper, in October the Full Federal Court will hear the AER's application for a review of a recent Australian Competition Tribunal (Tribunal) decision which may have implications for the conduct of future reviews.

However, in our view, the 2013 changes have not addressed the underlying problems with the limited merits review regime and further reform is required. The availability of limited merits review compromises the initial decision making process and the long-term interests of consumers and this impact is unlikely to be addressed by the Full Federal Court decision.

Our submission describes the role of the regulator in determining revenues for service providers. Regulatory decisions are complex, technical and are based on forecast data and subject to contested estimation theories. Our role is to consider all relevant information and correctly exercise our discretion to determine an answer out of range of possible answers that best meets either the national electricity or gas objectives.

The reforms made in 2013 were intended to ensure that decisions were only amended by the Tribunal if a materially preferable decision exists that better achieved the long-term interests of consumers. As set out in this submission there is already sufficient evidence to suggest that the 2013 changes have been unsuccessful in achieving that aim.

In addition to the problems identified by the Expert Panel in 2012, this submission sets out how the limited merits regime is compromising the initial decision making process. Our experience has been that the Tribunal, operating as a second regulator, has in general become the primary audience for the regulated businesses. This affects how they engage in the regulatory determination process initially with negative impacts on the process and other stakeholders.

Taking into account the nature of the regulatory task and the compromising of the initial regulatory decision, we have formed a view that the limited merits review regime has failed to meet the objectives set out by the Ministerial Council and Expert Panel, and should be removed. In our view, judicial review provides an appropriate accountability framework in ensuring that our decisions are lawful and that we have reasonably exercised our discretion.

The regime has not met policy makers' intentions

In 2012, the MCE formed an Expert Panel to review the performance of the limited merits review regime. The Panel identified a range of issues with the regime:¹

- the scope of the Tribunal's reviews tended to be unduly narrow, with the complex interlinkages between decisions and the merits of the overall decision on revenue or prices never assessed

¹ Expert Panel, Review of the Limited Merits Review Regime, Stage 2 Report, 30 September 2012.

- insufficient attention was given by the Tribunal to the National Gas Objective and National Electricity Objective and, in particular, the long-term interests of consumers through the review process
- an overly legalistic approach to reviews had been adopted, which discouraged consumer and user groups from participating in the process
- the regime was more resource intensive and costly than expected and cases took longer to complete than anticipated, and
- contrary to expectations, reviews were commonplace and were not confined to issues with a material consequence on the operation of the business.

Based on our experiences since the 2013 reforms, it does not appear that the Expert Panel's concerns have been addressed. For example, the Panel concluded that by looking at matters in isolation, the Tribunal was failing to take into account the highly complex interlinkages and contentious nature of the issues being reviewed. Yet, in the reviews since 2013, the focus of the Tribunal's hearings remains on the narrow issues raised by service providers.

The conduct of the Tribunal's hearings also remains formal with submissions almost exclusively being made by Senior Counsel. The time and cost involved in Tribunal reviews has increased since the 2013 reforms. Reviews remain routine, with 12 of the AER's 19 decisions made since 2013 being subject to an application for review.

It is also unclear whether the Tribunal has given greater consideration to the long-term interests of consumers in its decisions and whether the extra focus on consultation has had a meaningful effect in making the review process more accessible to consumers.

Merits review is compromising the regulatory process

In addition to the problems identified by the Expert Panel in 2012, in our view the limited merits review regime has compromised the initial regulatory determination process. Limited merits reviews of AER decisions have been considered "part of the process" since its inception in 2008. This negatively impacts the incentives on participants as the regulator is not seen as the primary audience for material presented by service providers.

Rather than meeting the objective of providing for an outcome that ensures all stakeholders' views are taken into account, the regime has incentivised service providers to be strategic in the timing and scope of information submitted to us. The regime also fostered a guarded and at times adversarial, relationship between the regulator and service providers.

For example, some service providers routinely submit a significant volume of new material to us very late in the process. Often, this occurs just prior to the time we are legislatively required to issue our decision. This leaves us limited opportunity to appropriately consider or consult on the material. This behaviour is not isolated and has a materially negative effect on the regulatory process. The compromised process

makes it difficult not only for us but for consumers and other stakeholders to meaningfully engage. It does not support the achievement of the best initial decision possible, nor improvements over time. If businesses were incentivised to consider us to be the target audience and decision maker, such gaming would be avoided.

The additional costs and uncertainty that can be imposed on stakeholders through overlapping reviews of sector wide issues has also become apparent through the most recent round of reviews. Where appeals from earlier determinations are not yet resolved this creates uncertainty for all stakeholders in subsequent AER determinations. This is most prevalent in rate of return issues and can be addressed through a change to the electricity and gas rules to bind the rate of return guideline, as discussed below.

Appropriate accountability with a robust regulatory process

The Tribunal is a respected body that plays an important role in the economy. It has important roles in considering competition and market structure issues under the Competition and Consumer Act (CCA). Its role in considering coverage decisions under the National Gas Law also aligns with its role in third party access under the CCA. These are very different from the type of consideration required in the limited merits review of electricity and gas revenue determinations. We consider that the current form of the limited merits review and the review body itself are not well suited to provide an additional layer of scrutiny to energy regulatory decisions. In the context of the technical, complex and contested nature of the empirical forecasts, economic and financial theories involved, a merits review body should be constituted and resourced to undertake a comprehensive inquisitorial (as opposed to adversarial) process.

In contrast to the initial regulatory process, the Tribunal is afforded far less time and resources for considering the relevant material in arriving at its decision. For example, in the recent NSW/ACT appeals, the Tribunal was supplied with over one million pages of material. That review process had only limited input from stakeholders other than the networks and was formal, legalistic and adversarial. It is also unclear how the long-term interests of consumers were presented and meaningfully considered in the Tribunal's decision making process.

The Consultation Paper includes the option of creating a new investigatory body. We are not certain that this option could sufficiently address the issues that arise from the availability of limited merits review. It follows from the above sections that we consider that even if a comprehensive inquisitorial review process could be developed, a new investigatory body risks becoming the primary audience for material from the service providers and compromising the initial regulatory decision making process.

Designing a new framework for merits reviews (limited or otherwise) for energy decisions is a complex exercise, as illustrated by the failure of limited merits review to achieve its policy objectives in its initial form, or after a subsequent round of review. We consider there is risk that any new merits review framework would also fail to achieve its policy objectives.

Also, a new framework may not address the objectives of certainty and timeliness of decision making and would involve duplication of effort and additional cost. In that context, the Commonwealth Administrative Review Council identifies that "decisions that are the product of processes that would be time-consuming and costly to repeat on review"² may justify exclusion from merits review.

We consider that judicial review is the appropriate accountability measure to address the reasonableness and lawfulness of regulatory decisions, this being a key concern for all stakeholders. We acknowledge the different role played by the courts under judicial review. The scope of judicial review is narrower but nonetheless robust and appropriate. Because of its more limited scope, judicial review is less likely to be perceived by the service providers as a routine part of the regulatory process. In turn, this is likely to improve the service providers' focus and conduct during the AER's decision making process, providing for more genuine engagement and better access for all stakeholders. Such an outcome would support the attainment of the original regulatory framework policy objectives.

We consider that removal of limited merits review would result in service providers focusing on the initial regulatory process (including proper engagement with their customers), rather than the Tribunal, as the decision maker. Shifting the focus back to the primary decision making process would provide the incentive for service providers to more meaningfully engage in the initial regulatory process and lead to greater accessibility for consumer involvement. This would minimise gaming and better support the objectives of achieving the best decision possible, balancing the interests of all stakeholders.

Other improvements can be made to the regulatory process

Our submission sets out three areas where further improvements to the regulatory process could be considered as part of this review.

First, the current national electricity and gas laws explicitly afford standing to consumer representative organisations to participate in limited merits review processes. Such standing is not precluded in judicial review. However, to remove any doubt, legislation could guarantee standing for consumer groups in judicial review.

Second, where judicial review action was taken, consumer representatives may become subject to cost orders. The current limited merits review affords consumers protection against cost orders. Further consideration should be given to how these protections can be preserved for judicial review hearings.

Thirdly, as judicial review will be part of the accountability framework, the uncertainty created for stakeholders because of overlapping issues could continue. Issues overlap when they are under review and are also under consideration in on going regulatory

² Administrative Review Council, 1999, "What decisions should be subject to merit review?" Section 4.53

determination processes. This is most significant in respect of rate of return where many issues are generic across the industry.

To address these issues we recommend amending the electricity and gas rules to make the rate of return guideline binding. It would remove the need for stakeholders to invest in duplicated development and review processes for each service provider. This is particularly important for resource constrained consumer groups. At the completion of the guideline development process, judicial review would be available as an appropriate check on the reasonable exercise of our discretion and that the guideline was developed lawfully.

We issued a guideline in 2013 that sets out how we would determine the benchmark rate of return. The guideline was developed through extensive consultation with stakeholders, including service providers and involved the consideration of a significant amount of complex and technical expert advice.

However, as the guideline is not binding, our experience is that the same arguments are required to be considered in each regulatory determination process and then the Tribunal is required to consider the same arguments again. The Tribunal consideration is done in a compressed timeline, without the benefit of hearing from the experts and without the support of additional resources. The arguments are heard through counsel. While highly capable, counsel is not a substitute from hearing arguments directly from the experts, with the benefit of time to analyse and consider the issues and with the support of staff.

Our submission

Our submission is in two parts. Part A provides analysis and evidence to support the positions outlined above. Part B contains summary responses to each of the questions posed in the SCO consultation paper.

We look forward to working with SCO as it prepares its final advice to the COAG Energy Council. If you or any of your team would like to discuss any aspect of this submission, please contact me or Warwick Anderson on 02 6243 1240.

Yours sincerely

Paula Conboy
Chair



AER Submission Review of the limited merits review framework

October 2016

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Part A: Analysis of limited merits reviews of energy decisions

Limited merits reviews of decisions under the national energy frameworks have been the subject of extensive analysis and reform. Policy makers began considering the appropriate accountability mechanisms for energy decisions in 2005 and reviewed the effectiveness of these arrangements in 2012.

On 19 August 2016, the COAG Energy Council agreed to initiate a review of the limited merits review framework. The terms of reference for the review require its Senior Committee of Officials (SCO) to review the effectiveness of the merits review regime and consider options for reform that will best advance the interests of consumers, including removal of merits review altogether.

SCO published a consultation paper on 6 September 2016 that provided some specific issues, questions and options for reform to assist in the development of stakeholder submissions for the review.

As part of public consultation for the review, consumers, network service providers and other interested stakeholders were invited to submit written feedback in response to the issues raised in the paper, the specific questions raised and on any additional matters stakeholders consider are relevant factors for contributing to achieving the policy intent of the 2013 reforms.

Starting from first principles, Part A of this submission sets out:

- the role of merits review in the broader regulatory and accountability frameworks applying in the energy sector
- an analysis of the performance, and implications, of limited merits reviews to date in light of the policy principles and objectives articulated over time
- what it would mean to remove access to limited merits review for regulatory determinations and access arrangements, and
- an alternative to strengthen the range of accountability measures within the regulatory process.

Part B contains summary responses to each of the questions posed in the SCO consultation paper.

1 The accountability framework

Like the COAG Energy Council, we are committed to the maintenance of a robust regulatory framework that promotes efficient investment in, operation and use of, energy infrastructure, for the long-term interests of consumers. In keeping with the objectives that were originally identified by the Ministerial Council of Energy (MCE)³ and were subsequently refined following the 2012 Expert Panel review, the regulatory framework should:

- provide a balanced outcome between competing interests and protecting the property rights of all stakeholders
- maximise accountability
- maximise regulatory certainty
- maximise the conditions for the decision-maker to make a correct initial decision
- achieve the best decisions possible
- minimise the risk of “gaming”
- minimise time delays and cost.

Accountability is a critical element of the national energy regulatory framework. It provides stakeholders with the confidence that when exercising our powers we will operate in an impartial manner. Further, it provides assurance that our decisions are made in accordance with the administrative law principles of lawfulness, fairness, rationality, openness and transparency, and efficiency.⁴

Limited merits review is, just one element of a broader accountability framework that we are subject to. We are subject to a range of mechanisms that hold us accountable to service providers, users, consumers, the COAG Energy Council, the general public and a range of other stakeholders.

Further detail on our accountability frameworks and how it compares with those applied in other regulated industries is provided in the remainder of this section.

1.1 Economic regulatory functions and powers

The AER was established as an independent regulator in mid-2005 under the *Competition and Consumer Act 2010* (CCA)⁵ and has an independent Board, comprising two state/territory appointed members and a Commonwealth appointed member. Our functions and powers are set out in Part IIIAA of the CCA, the *Australian Energy Market Agreement 2004*, the National Gas Law (NGL), the National Electricity Law (NEL) and the National Energy Retail Law.

³ See MCE (2006), *Review of Decision-Making in the Gas and Electricity Regulatory Frameworks*, May 2006, p. 3 and SCER (2012), *Statement of Policy Intent*, December 2012, p. 2.

⁴ Administrative Review Council (1996), *Submission to the Senate Legal and Constitutional Legislation Committee*, 1996.

⁵ Until 2010 this was previously known as the *Trade Practices Act 1996*.

Of particular relevance to this review are the economic regulatory functions and powers set out in the NGL, NEL, the National Gas Rules (NGR) and National Electricity Rules (NER). This includes, but is not limited to:⁶

- For gas: approval of access arrangements proposals, arbitration of access disputes, making of ring fencing determinations, granting of ring fencing exemptions and approval of associate contracts
- For electricity: making distribution and transmission network determinations and assessing cost pass through applications.

In exercising these functions and powers, we are required by the NGL and NEL to, amongst other things:^{7,8}

- do so in a manner that will, or is likely to, contribute to the achievement of the National Gas Objective (NGO) and the National Electricity Objective (NEO) including choosing between two or more possible reviewable regulatory decisions to contribute to the objective to the greatest degree
- take into account the revenue and pricing principles⁹ when exercising a discretion in the making of a determination, or when performing or exercising any other economic regulatory function or power, if we consider it appropriate to do so
- ensure that when making a distribution or transmission determination in electricity, or an access arrangement decision in gas, that stakeholders that may have an interest in the matter are informed of material issues under consideration and given a reasonable opportunity to make submissions before a decision is made
- specify the manner in which the constituent components of the decision relate to each other and the manner in which that interrelationship has been taken into account in the making of the decision.

The NGR and NER provide further prescription on how we perform these functions and powers and the decisions we are required to make. The NGR and NER also:

- set out the procedures we are to follow and the consultation process we are required to carry out when making its decisions¹⁰
- prescribe the methodologies, principles, tests and other matters we are to have regard to when making decisions
- specify the level of discretion we have when making decisions, with some provisions providing full discretion, while others provide no discretion or otherwise limit discretion¹¹

⁶ This is not an exhaustive list of our economic regulatory functions and powers. See, for example, section 27 of the NGL and section 15 of the NEL.

⁷ See section 28 of the NGL and section 16 of the NEL.

⁸ See section 27 -28 of the NGL and section 15-16 of the NEL.

⁹ The revenue and pricing principles are set out in section 24 of the NGL and section 7A of the NEL.

¹⁰ See for example, rules 8, 9, 9A and 9B of the NGR and Part G in Chapter 6 of the NER.

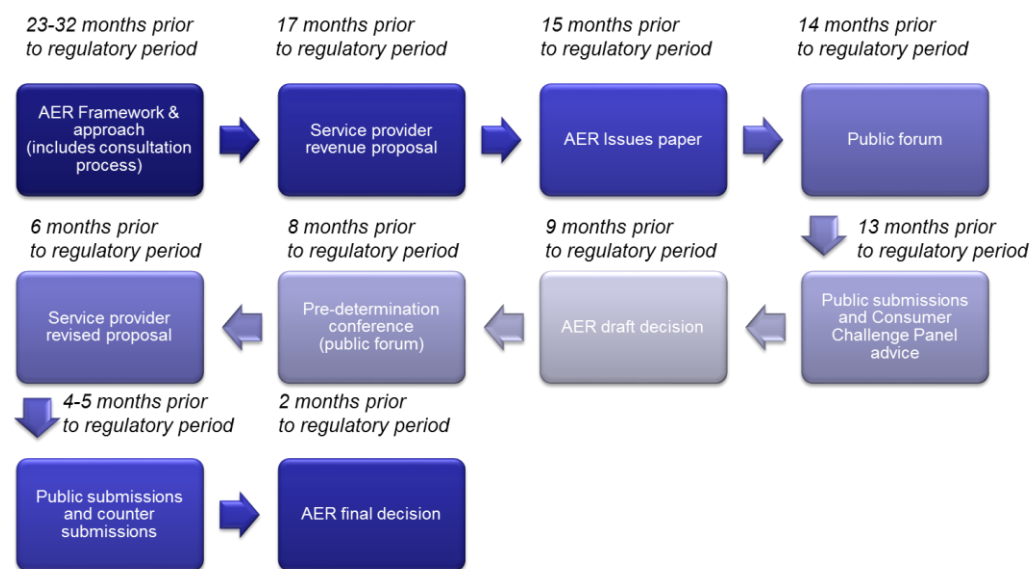
¹¹ For example, under the NGR, the AER has no discretion if the service provider proposes an access arrangement period of five years and has limited discretion when approving capital expenditure, operating expenditure, depreciation, distribution tariffs and transmission tariffs. Similarly, under Chapter 6 of the NER the AER has no discretion if the service provider

- require us to develop, in consultation with stakeholders, guidelines that set out the approach we intend to take in relation to specific issues (e.g. rate of return and incentive schemes); which in some cases are binding¹²
- publish draft decisions for public comment before making final decisions¹³
- provide reasons for decisions.¹⁴

Box 1.1 provides an overview of how the above regulatory framework is applied in a typical electricity distribution regulatory determination process.

Box 1.1: Typical regulatory determination process

The figure below sets out the standard electricity distribution network determination process, which can take up to 32 months to complete as it often includes a framework and approach stage.



The framework and approach stage allows us to set out our proposed approach to service classification, control mechanisms, the treatment of depreciation and the application of incentive schemes before the service provider submits its regulatory proposal for the following period. This stage can be triggered by either us or the service provider. If its triggered, it will typically take seven months to complete and involves:

- the publication of an issues paper
- a round of consultation with the service provider, users, consumer representatives and other stakeholders (jointly 'stakeholders')
- consultation with the Consumer Challenge Panel

proposes a five-year regulatory period and has limited discretion when approving capital expenditure, operating expenditure and a range of other matters set out in rule 6.12.3.

¹² For example, under Chapter 6 of the NER the cost allocation and confidentiality guidelines are binding, while the rate of return, expenditure incentive, expenditure forecast assessment guidelines and shared asset guideline are not.

¹³ See for example, rule 6.10.2 of the NER

¹⁴ See for example, rules 6.10.2(a)(3) and 6.11.2(3)

- the publication of a final framework and approach paper.

The rules require the framework and approach stage to be completed 23 months prior to the commencement of the regulatory period. The service provider then has six months to submit its regulatory proposal and tariff structure statement to us.

Our review of the regulatory proposal usually takes 15 months to complete and involves:

- the publication of an issues paper and a public forum
- an initial round of consultation with stakeholders
- consultation with the Consumer Challenge Panel
- engaging experts (e.g. engineers, economists and finance experts) to provide advice on certain aspects of the proposal
- a team of skilled analysts within the AER examining the issues raised in the regulatory proposal
- the Board making draft decisions on all the constituent decisions it must make under the NER
- the publication of the draft determination and a predetermination conference to explain the determination
- the receipt of a revised proposal by the service provider, which under the rules should only address the matters we raised in the draft determination
- a further round of consultation with stakeholders (including the potential for a cross submission stage on specific matters) and the Consumer Challenge Panel
- the examination of the revised regulatory determination by analysts within the AER and, where relevant, expert advisors
- the Board making final decisions on each of the constituent decisions
- the publication of our final determination.

The length of time taken to complete the framework and approach and regulatory determination processes provides some insight into the scale of our task and the complexity of issues and range of views we consider when making our decision.

Some insight into the scale of our task can be found in the following observations:

- In a standard electricity distribution regulatory determination, we must make 26 constituent decisions (e.g. decisions on the classification of services, the allowed rate of return and other building block values).
- In the May/June 2014 regulatory proposals, eight service providers submitted approximately 9,000 documents spanning 110,000 pages for consideration.
- Our final decisions for each of the NSW distribution network service providers exceeded 1,400 pages, excluding reports from prior decisions and the guideline processes.

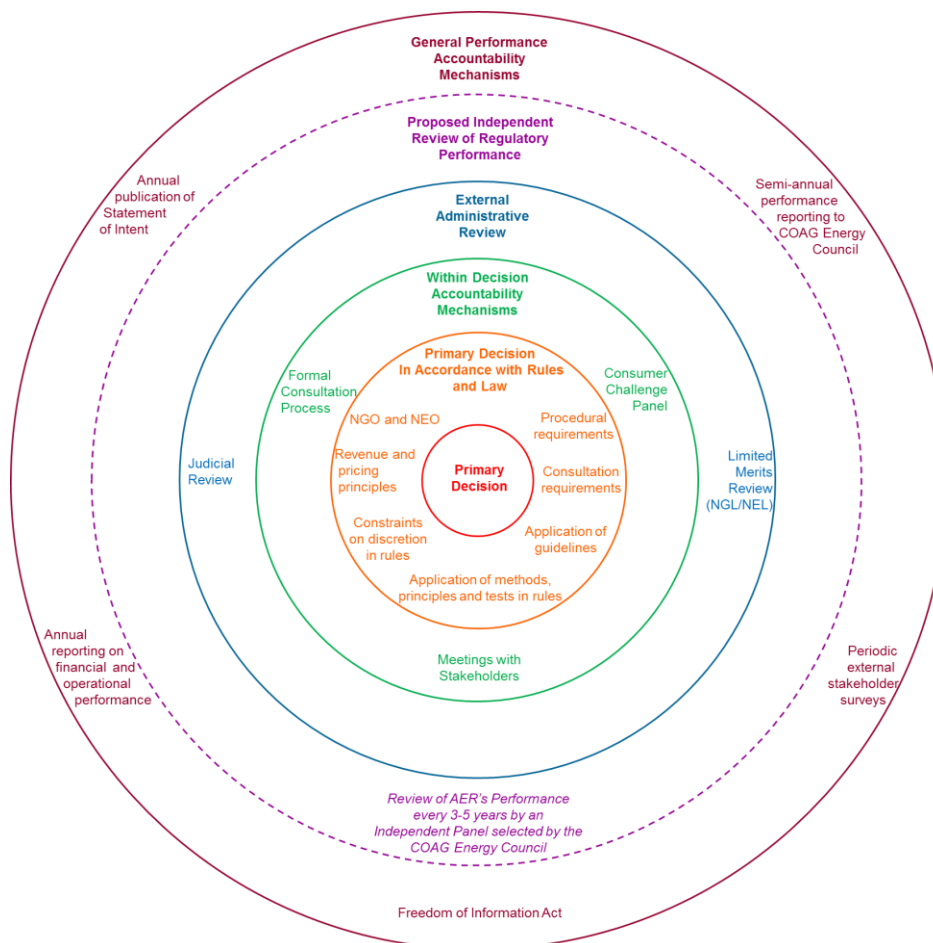
Together these features of the regulatory framework provide for a transparent, consultative, predictable yet adaptable regulatory process. The framework provides clearly defined constraints on how we exercise our powers and the level of discretion we have when making decisions. The separation of the rule making and economic regulatory functions and the ability of stakeholders to propose rule changes to the Australian Energy Market Commission (AEMC), poses additional discipline on our interpretation and application of the rules.

The constraints imposed on our decision making are unique to the national energy frameworks. Other regimes accord regulators greater discretion to determine how they will exercise their powers and regulate services (see section 1.3). While we have less discretion than most regulators, we are still subject to rigorous regulatory and accountability frameworks.

1.2 Accountability Framework

Figure 1.1 sets out the key elements of our accountability framework. As this figure shows, we are held accountable for our regulatory decisions through a range of mechanisms. Some of these relate to specific regulatory decisions, while others apply to our regulatory decision making and other operational activities more generally.

Figure 1.1: AER Accountability Framework



This accountability framework has been added to and strengthened over time through changes to the NGL, NEL, NGR and the NER. It has also been reinforced through a number of self-initiated measures. For example, the Better Regulation Program resulted in the creation of the Consumer Challenge Panel and improvements to the way in which consumers are consulted by us and service providers. Further detail on how we are currently held accountable for our regulatory decisions is provided below.

1.2.1 Accountability for regulatory decisions

We are currently held directly accountable for our regulatory decisions through:

- the consultation process that is carried out as part of the decision making process
- the administrative review mechanisms that can be triggered once a decision is made.

Consultation process

During the decision making process, we are held accountable for our decisions through the stakeholder consultation process that we are required to conduct under NGL, NEL, NGR and NER. In a regulatory determination process, stakeholders have at least two opportunities to express their views about the proposal, to engage with the AER and other stakeholders and to inform the AER's position on various issues. Through the framework and approach stage and guideline development process, stakeholders have further opportunities to make submissions to inform the AER's approaches and views.

The degree of our accountability in this stage of the decision-making processes has been strengthened by the establishment of the Consumer Challenge Panel. This panel was established through our Better Regulation Program in 2013 to act in an advisory capacity and inform our decisions, particularly in relation to consumer interests. In this capacity, the Consumer Challenge Panel provides an independent critique of our decisions and service providers' proposals, which is published on our website to ensure transparency and inform other stakeholders participating in our processes.

External administrative review mechanisms

Once we have made our decision, it may be subject to limited merits review under the NGL or NEL if the decision constitutes a 'reviewable regulatory decision'¹⁵ and/or judicial review. Further detail on these review mechanisms is provided in Box 1.2.

Box 1.2: Administrative reviews

Judicial Review¹⁶

Judicial review by a court can be sought by a person with standing. This will include anyone with a particular interest in the decision or a person who is deemed to have standing under legislation.

The grounds for such a review include that we:¹⁷

- did not have jurisdiction to make the decision
- breached the rules of procedural fairness in connection with the making of the decision

¹⁵ Under the NGL, the AER related 'reviewable regulatory decisions' include: an applicable access arrangement decision; a ring fencing determination; a decision to grant a ring fencing exemption; an associate contract decision; and any other decision prescribed by the Regulations. The Regulations do not currently specify any additional reviewable decisions. Under the NEL, 'reviewable regulatory decisions' include network revenue or pricing determination that sets a regulatory period, and any other decision prescribed in the Regulations. The only additional decisions that are currently prescribed in the Regulations as reviewable decisions are cost pass-through determinations.

¹⁶ See for example sections 5 and 16 of the ADJR Act and section 39 of the *Judiciary Act 1903*.

¹⁷ See for example section 5 of the ADJR Act.

- has not observed procedures that were required by law
- improperly exercised its powers (e.g. by taking an irrelevant consideration into account or exercising a power in an unreasonable manner)
- made an error of law
- made a decision that was induced or affected by fraud, not supported by evidence or other material, or otherwise contrary to law.

The remedies available to the Federal Court include affirming the decision, declaring the rights of the parties, or setting the decision aside with remittal back to us for further consideration, subject to any directions the court thinks fit.¹⁸

Limited Merits Review¹⁹

A limited merits review of a reviewable regulatory decision by the Tribunal can be sought by an affected or interested person or body if they are granted leave by the Tribunal. Provisions in the NGL and NEL state that leave must not be granted unless there is a 'serious issue to be heard' and the applicant has established a prima facie case that one or more of the grounds would be likely to result in a materially preferable NGO or NEO decision. The grounds for review include that:

- we made an error of fact and the error was material to the making of the decision
- we made more than one error of fact and those errors, in combination, were material to the making of the decision
- our exercise of discretion was incorrect, having regard to all the circumstances
- our decision was unreasonable, having regard to all the circumstances.

The Tribunal can affirm a decision, vary the decision, or set the decision aside and remit it back to us. The Tribunal may only make vary or remit the decision if it is satisfied that doing so is likely to result in a materially preferable NGO/NEO decision. When making its determination, the Tribunal is:

- required to take reasonable steps to consult with users and prospective users, user or consumer associations, or user or consumer interest groups
- not allowed to consider any matter other than the application for review, the submissions and material before us, although provision has been made for the Tribunal to obtain additional information or material if it would assist the Tribunal to determine whether a materially preferable decision exists.

1.3 Accountability in other jurisdictions and industries

The table below compares our accountability framework with those applying to our counterparts in New Zealand, the United Kingdom (UK) and Canada and to the Australian Competition and Consumer Commission (ACCC).

As Table 1.1 reveals, the decision making model we operate under is unique in terms of the constraints it imposes on our decision-making. The other access regimes regulated by the ACCC in Australia and other energy regulators in New Zealand, the UK and Canada have greater discretion to set revenues and/or prices for regulated service providers. As a result, we are subject to a more stringent accountability framework than most regulators.

¹⁸ See for example, section 16 of the ADJR Act.

¹⁹ See Part 5 of the NGL and Part 6 Division 3A of the NEL.

Table 1.1: Accountability frameworks employed in other jurisdictions and industries

	AER	NZ Commerce Commission	UK Gas and Electricity Markets Authority (GEMA) (Ofgem's governing body)	Ontario Energy Board (Canada)	ACCC			
	Energy				Telco (Part XIC CCA)	Water Infrastructure Murray Darling Basin (Water Act 2007)	Below Rail Infrastructure (Part IIIA CCA)	Australia Post, Airservices Price Notifications (Part VIIA CCA)
Decision making model								
Responsibility for determining how infrastructure or services should be regulated	Largely prescribed in the rules, with the rules also specifying the level of discretion the AER has when making decisions	Determined by Commerce Commission (specified in input methodologies) subject to the objectives and principles in the <i>Commerce Act 1986</i> .	Determined by Gas and Electricity Markets Authority, subject to the objective and principles in the Gas and Electricity Acts	Determined by Ontario Energy Board subject to objective and principles in the <i>Ontario Energy Board Act</i>	Determined by the ACCC, subject to the objectives and principles set out in Part XIC of the CCA	Commonwealth Minister, based on advice from the ACCC on the water charge (infrastructure) rules	Determined by the ACCC, subject to the objectives and principles set out in Part IIIA of the CCA	Determined by the ACCC, subject to the principles set out in Part VIIA of the CCA
Within Decision Accountability								
Stakeholder Consultation	✓ Supplemented by CCP	✓	✓ Supplemented by Consumer Challenge Group	✓	✓	✓	✓	✓
Internal Review	✗	✗	✗	✓ Stakeholders can file a motion for a review of an OEB decision, which is heard by a newly constituted panel.	✗	✗	✗	✗
External Administrative Review								
Judicial Review	✓	✓	✗	✓	✓	✓	✓	✓
Limited Merits Review	✓ (Tribunal) Limited to reviewable regulatory decisions	✓ (High Court) Limited to input methodologies determinations and a small set of decisions	✓ (Competition and Markets Authority) In the past this mechanism has been described as a full merits review but in recent decisions it has moved to a limited merits review	✗	✗ Removed in 2011	✗	✓ (Tribunal)	✗
Other measures								
Independent Review of Performance	Proposed	✗	✗	✗	✗	✗	✗	✗

It is clear from the table that stakeholder consultation is a key element of all the accountability frameworks. The development of the Consumer Challenge Panel has, however, added an additional layer of accountability to our regulatory decision making process, with Ofgem being the only other regulator currently employing this type of mechanism.

With regard to the external review mechanisms, as Table 1.1 highlights, all of the sampled regulators are subject to some form of external review. However, the type of review differs markedly, with some subject to:

- **Judicial review only** - For example, decisions by the Ontario Energy Board and the ACCC in relation to water, Australia Post, Airservices and telecommunications are only subject to judicial review. As noted in Table 1.1, limited merits review has only been removed from the telecommunications access regime in Australia in the last five years, while the other regimes have never been subject to merits review. The decision to remove the limited merits review option from Part XIC of the CCA occurred in conjunction with a range of other reforms to the telecommunications access regime. At the time the decision was made it was described by the Commonwealth Government as being necessary to "promote regulatory certainty and timely decision making".²⁰
- **Limited merits review only** - For example, in the UK decisions by the Gas and Electricity Markets Authority (Ofgem's governing body), can only be subject to merits review. It is worth noting in this context that while the review mechanism in the UK used to operate on a *de novo* basis, following a number of amendments to the appeals mechanism in 2011, it is now operating in a similar manner to the limited merits review mechanism in the NGL and NEL.²¹
- **Limited merits review on the methodologies** to be used to determine the revenue allowance and/or the price path but not on the application of those methodologies. For example, in New Zealand limited merits review is available on the Commerce Commission's input methodologies²² determinations, but does not extend to the default price-quality path decisions that flow from the implementation of these methodologies.²³ At the time the New Zealand Government introduced this review model, it noted that the "case for having merits review of input methodologies, before a decision on whether and how to regulate is made, is stronger than for review at the end for decisions on control terms".²⁴

²⁰ Parliament of the Commonwealth of Australia House of Representatives (2010), Explanatory Memorandum - Telecommunications Legislation Amendment (Competition and Consumer Safeguards) Bill 2010, p. 5.

²¹ See for example, the discussion in Competition and Markets Authority (2012), *British Gas Trading Ltd v The Gas and Electricity Markets Authority Final Determination*, 29 September 2012, pp. 19-20.

²² Input methodologies are akin in some ways to the rules and the AER's guidelines.

²³ In New Zealand, limited merits review is also available on customised price-quality paths, individual price-quality paths and decisions on how information disclosure and negotiate/arbitrate regulation applies to regulated suppliers, but it does not apply to default price-quality path determinations, which is the form of regulation that applies to the majority of regulated gas and electricity networks in New Zealand. See sections 52Z and 91 of the *Commerce Act 1986* (New Zealand)

²⁴ New Zealand Government (2007), *Review of the Regulatory Control Provisions of the Commerce Act 1986 - Regulatory Impact Statement*, 2007, p. 48.

While not shown in Table 1.1, even where limited merits review is available in other jurisdictions, there are some notable differences between the form that these reviews take and the limited merits review mechanism set out in the NGL and NEL. For example:

- In New Zealand, the High Court is responsible for carrying out the merits review and it can only exercise its power to allow an appeal of the Commerce Commission's input methodologies determination if it is satisfied the amended or substituted decision is (or will be) “materially better” in meeting the purpose of:²⁵
 - Part 4 of the *Commerce Act 1986* (i.e. to promote the long-term benefit of consumers)
 - input methodologies (i.e. to promote certainty for suppliers and consumers in relation to the rules, requirements and processes apply to the regulation of services).
- In the UK, the Competition and Markets Authority (a public administrative body) is responsible for carrying out the merits reviews and must only allow an appeal if it is satisfied the Gas and Electricity Markets Authority's decision was wrong on one or more of the following grounds:²⁶
 - the Gas and Electricity Markets Authority failed to properly have regard to, or give appropriate weight to, the matters to which it must have regard, in the carrying out of its principal objective and certain duties
 - the decision was based, wholly or partly, on an error of fact
 - the licence modifications fail to achieve, in whole or in part, the effect stated by the Gas and Electricity Markets Authority in its decision, and/or
 - the decision was wrong in law.

Perhaps one of the most interesting points to emerge from Table 1.1 is that merits review is not universally (or even generally) applied to energy infrastructure in other jurisdictions,²⁷ or to the industries regulated by the ACCC. Nor is it universally applied at a state and territory level in Australia. For example, water and waste water regulatory decisions by the Independent Pricing and Regulatory Authority Tribunal (IPART) in NSW can only be subject to judicial review, while equivalent decisions by the Independent Competition and Regulatory Authority (ICRC) in the ACT can be subject to a full merits review.²⁸ Put simply, there is no clear answer to what might be regulatory best practice in this area.

²⁵ See section 52Z of the *Commerce Act 1986* (New Zealand).

²⁶ *Gas Act 1986* (United Kingdom) and *Electricity Act 1989* (United Kingdom)

²⁷ While European energy regulators have not been included in this table, we understand that merits review is not universally applied throughout Europe. See Centre on Regulation in Europe, Enforcement and judicial review of decisions of national regulatory authorities, 21 April 2011.

²⁸ See Part 4C of the *Independent Competition and Regulatory Commission Act 1997* (ACT)

2 Performance of limited merits review regime

2.1 Policy context

The MCE introduced a limited merits review regime into the NEL and NGL in 2008. The MCE also inserted a requirement to review the effectiveness of the limited merits review regime to assess how it had operated since commencement.²⁹

In deciding to allow access to limited merits review in 2006, the MCE considered that limited merits review would:

- best facilitate the correction of a range of regulatory errors with significant adverse consequences
- encourage the making of the best administrative decisions in all the circumstances
- encourage investment in gas and electricity and across those sectors by promoting confidence in the regulatory process.³⁰

The reference to encouraging investment is consistent with the direction of public policy discussion at the time. There was a perception that the economic regulatory process was an impediment to further investment in essential infrastructure.³¹ This also fed into the policy debate on the development of the electricity rules for the regulation of transmission service providers. These transmission rules were then used as a base for the rules governing the regulation of distribution network service providers in 2008.

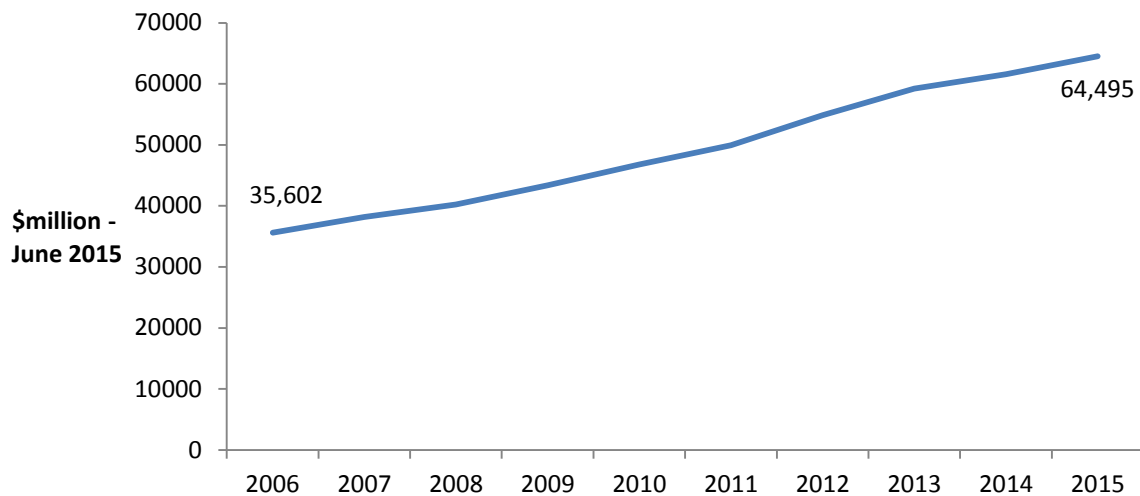
As shown in Figure 2.1, the national energy regulatory framework has been highly successful in promoting investment. Between 2008 and 2015 the total asset base of the distribution networks has increased by 81 per cent in real terms. Substantial augmentation of the networks has taken place and large quantities of aging assets have been replaced or refurbished. At the same time, there was a significant increase in regulated revenues and prices while demand has decreased, resulting in decreased utilisation of the networks, and measures of reliability have increased.

²⁹ The MCE expected this requirement would provide an incentive for stakeholders to only seek limited merits reviews where there was a potentially significant error made by the regulator.

³⁰ Ministerial Council on Energy (2006), *Review of Decision Making in the Gas and Electricity Regulatory Frameworks Decision*, 2006.

³¹ This argument was most strongly run by the Productivity Commission. See Productivity Commission (2001), *Review of the National Access Regime*, Report no. 17, 2001, AusInfo, Canberra; Productivity Commission (2004), *Review of the Gas Access Regime*, Report no. 31, Ausinfo, Canberra; Exports and Infrastructure Taskforce (2005), *Australia's Export Infrastructure*, Report to the Prime Minister, Canberra, May 2005.

Figure 2.1: Regulatory asset bases: Electricity distribution businesses



These trends have led to a growing awareness that prices in excess of efficient cost can adversely affect broader economic efficiency and activity. Consequently, questions have been raised in the community about whether the balance of the policy settings specified in 2006 was correct, including the use of merits review to promote investment per se rather than focussing on efficient and necessary investment. Forums that have canvassed the balance in the policy framework have included:

- 2012 amendments to the NER and NGR. On 29 November 2012, the AEMC made new rules to improve the strength and capacity of the regulator to determine network price increases so consumers do not pay more than necessary for reliable supplies of electricity and gas.³²
- 2012 Energy Market Reform - Putting Consumers First. On 7 December 2012, COAG endorsed a package of reforms developed by the then Standing Council on Energy and Resources (SCER) to ensure consumers were paying no more than necessary for reliable and secure energy supplies. Amongst other things, this included measures to strengthen regulatory outcomes and an appropriate appeals mechanism.³³
- 2012 Expert Panel Review of limited merits review. The Expert Panel noted that where price increases are perceived as wealth transfers from consumers to the service providers without any articulated benefits, it creates risks to the long-term legitimacy of the regulatory regime.³⁴
- 2013 Productivity Commission Inquiry into Electricity Network Regulation. The inquiry found spiralling network costs in most states are the main contributor to the 70 percent increase in electricity retail prices between June 2007 and December 2012. The

³² AEMC (2012), <http://www.aemc.gov.au/Rule-Changes/Economic-Regulation-of-Network-Service-Providers>, accessed 2 October 2016.

³³ COAG (2012), <http://www.coag.gov.au/node/481>, accessed 2 October 2016.

³⁴ Yarrow, Egan and Tamblyn (2012), *Review of Limited Merits Review Regime; Stage Two Report* pp 35-36.

Commission concluded the increases were partly driven by flaws in the regulatory environment.³⁵

On 9 December 2011, SCER brought forward the mandated review of the limited merits review regime in light of increasing concerns relating to the operation of the regime, in particular the increases in regulated revenues since 2009. An Expert Panel was established in 2012 to review the operation of the limited merits review framework since 2008. The Panel concluded that the limited merits review framework had not delivered on the statutory objectives (the NEO and NGO) or the original policy intent.

In its Final Stage Two Report, the Panel identified a number of issues relating to the operation of the limited merits review regime for energy between 2008 and 2012. This included concerns around the degree of accountability, regulatory certainty and minimising time delays and costs.

The Panel also raised questions about whether the review mechanism was resulting in the best possible decisions, having regard for all stakeholders' (in particular consumers') interests. Further the Panel flagged the potential for the regime to result in gaming, given the potential for significant revenue increases well in excess of the costs for seeking review, coupled with the lack of any meaningful risk of losing revenue.

In response to the Panel's findings, SCER published a Statement of Policy Intent that clarified its expectations about how the original criteria were intended to operate in practice. In 2013 SCER amended the NEL and NGL in 2013 to align the role of the AER and Tribunal and explicitly link decision making to the delivery of the long-term interests of consumers.

However, in our view, the 2013 reforms have not been successful in delivering the intentions of policy makers and the operation of merits review continues to create and exacerbate imbalances in the regulatory framework, as explained in the following sections.

2.2 The nature of energy network regulatory decisions

Regulatory determinations are complex and technical decisions that are performed in accordance with the relevant provisions in the NER and NGR (see Box 1.1). There are extensive rules that cover the economic regulation of monopoly service providers under the national energy frameworks. These rules impose a number of stringent obligations on how we conduct the determination process. The information that goes into determinations and the decisions themselves are also extensive, covering hundreds of thousands of pages of material, numerous phone, face-to-face meetings and other targeted stakeholder engagement opportunities. As set out in Box 1.1, this process takes place for up to 32 months.

The electricity and gas rules provide for a high degree of prescription and therefore, transparency and predictability in the regulatory process. Broker reports illustrate that the primary decision making process provides certainty around the approaches that will be adopted through regulatory determination processes. These reports characterise our

³⁵ Productivity Commission (2013), *Inquiry into Electricity Network Regulation*, <http://www.pc.gov.au/inquiries/completed/electricity/report>, accessed 2 October 2016.

approach as highly transparent and predictable.³⁶ This position was also reflected in a survey of financial investors conducted for the Royal Bank of Canada.³⁷

It is important to consider the character of the decisions made through these processes. Energy network economic regulation is based on a large number of calculations, estimations and models to provide an indication of efficient costs. Often these are based on forecasts, drawn from a range of differing expert theories and opinions. In this context, the primary decision maker is tasked with correctly exercising its discretion in determining an answer, in an environment where there is no single precisely correct answer.

Ideally any inquisitorial review process (as proposed by the Expert Panel) would be similar in character to the AER's initial process. This would have flow through implications to the costs of funding and participation in duplicative processes. The scope of such a task on review may of necessity approach de novo, which has previously been recognised by the MCE as unsuitable for regulatory determinations due to the high costs involved in reviewing an entire determination.

2.3 Limited merits review compromises the regulatory process

Regulatory determinations are made up of a large number of interrelated constituent decisions, where changes to these individual decisions can result in significant changes to the overall revenues. Consequently, complex interrelated matters are highly contested.

Limited merits review has resulted in a second decision making process as a means of revisiting these contested matters, with the Tribunal becoming the second decision maker. This has compromised the integrity of the initial decision making process and incentivised reviews being sought on the basis of potential gains in revenues for the business rather than on implications for the delivery of the NEO or NGO.

Since 2008, reviews have been sought on 32 out of 51 regulatory decisions.³⁸ Of the matters that were varied or remitted back to the primary decision maker³⁹, none resulted in a decrease in revenues for the regulated business compared to the original decision. One of the objectives outlined for limited merits review was to provide a balanced outcome for competing interests. This has not been achieved as service providers face very little practical downside from seeking merits review. The legal costs of seeking review are minor compared to the potential upside from successfully reviewing elements of the decision. To date consumers have been unsuccessful in arguing that revenue should be decreased either because of the individual issues that are considered in isolation or because of the outcome of the decision as a whole.

In combination, these outcomes illustrate both that reviews are sought as a commonplace part of the regulatory process and the asymmetrical incentive to appeal to increase revenues

³⁶ These broker reports are proprietary and have been provided to us in confidence. If it assists decision-makers, we can provide further details on specific brokers and reports.

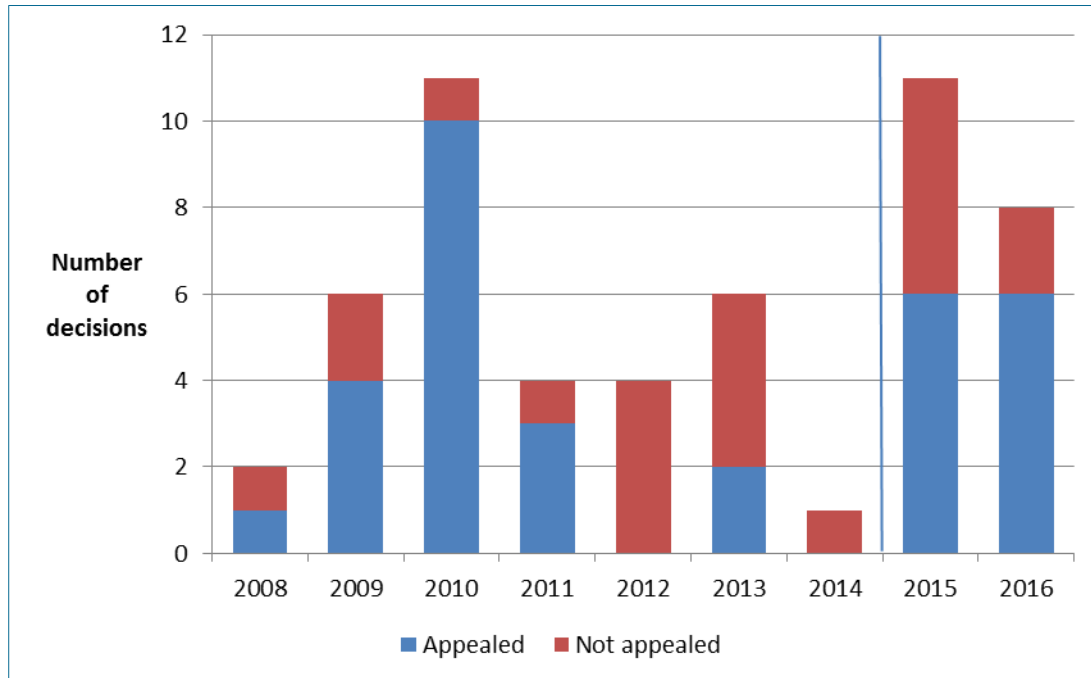
³⁷ See Royal Bank of Canada (2016), *ASX Network Utilities– Investor Survey on Regulation*, August 2016, p. 31.

³⁸ Excluding the ongoing South Australian, Dampier to Bunbury Natural Gas Pipeline and Victorian reviews.

³⁹ Noting this related to reviews of both the Economic Regulation Authority and our decisions over this period.

which encourages reviews being sought routinely. The only downside risk a service provider can face through the currently process is for a consumer representative or government to successfully appeal our decision.

Figure 2.2: Number of reviews sought



The practical lack of downside risk in seeking a review, coupled with the potential for significant increases in revenues, means that service providers pursue limited merits reviews of our decisions as a routine part of the determination process. Figure 2.2 demonstrates that, since limited merits review was introduced into the national energy frameworks by the MCE in 2008, reviews have been sought on 60 per cent of revenue determinations and this pattern has continued following the 2013 reforms.

In practice, appeals to the Tribunal have become an embedded part of the regulatory determination process with the Tribunal the ultimate focus of many of the service providers' submissions. This reflects the relatively low threshold for appeals to be heard and the limited downside risk to businesses' revenue outcomes. As a result, regulatory proposals are commonly drafted in a highly legalistic tone. In some cases, service providers have submitted reports prepared by legal counsel. The focus of the proposals has been diverted from being economically persuasive to being legally defensible on appeal. It also makes it harder for other stakeholders, without access to lawyers, to engage with the arguments in such submissions.

2.3.1 Strategic engagement encouraged by limited merits review

In our experience, many service providers view the Tribunal as the ultimate decision maker and as a result the primary audience for their material. For example, we have observed the following range of indicators:

- On occasion, service providers have told us that we are not their audience, and the information is intended for the Tribunal.
- Large quantities of complex material are provided to us so that it can be included in review related material for reference in subsequent Tribunal hearings. The volume, complexity and legalistic tone of this material have been increasing over time.
- Service providers often provide complex, technical or extensive information late in the regulatory process meaning that other stakeholders and ourselves are precluded from considering and making informed responses. Nonetheless, the material becomes available to the Tribunal and can be drawn upon if limited merits review is sought.⁴⁰
- It is common that, upon being granted leave service providers have either introduced new lines of argument or substantively changed the emphasis on arguments and information compared to their regulatory proposals.
- Service providers have submitted reports prepared and/or commissioned by its legal counsel. In turn, we have asked Counsel to review elements of our decisions prior to publishing.
- Service providers have chosen not to engage with the analysis set out in draft decisions, then sought and were granted leave to appeal on such issues. The length and complexity of our decisions have increased substantially as we have attempted to address the full scope of issues that might be raised with the Tribunal even though those issues have only been raised peripherally with us.
- Some service providers have undertaken lengthy and expensive limited merits review processes, only to have shareholders elect not to recover the revenue.
- Service providers have substantially changed approach between initial and revised proposal in response to arguments advanced in other Tribunal proceedings.

These strategic and tactical behaviours results in a guarded and inefficient process that is less accessible to other stakeholders. Additionally, in anticipation of having decisions reviewed by the Tribunal, we are forced to adopt a more legalistic approach to both conducting regulatory determination processes and in the language used to explain decisions. This can make our processes and documents less accessible for stakeholders to engage with. We do not consider this to be in the long-term interests of consumers.

2.4 Limited merits review and the energy objectives

The primary expressions of the intention of national energy policy are in the statutory objectives. In 2012, SCER clarified that the long-term interests of consumers are the paramount consideration in interpreting the NEO and NGO. This concept was extended through the 2013 reforms, where the Tribunal was required to:

- only grant leave for a review where a prima facie case has been established by the applicant that there is a materially preferable outcome in the long-term interests of consumers

⁴⁰ See sections 28ZB and 71R of the NEL and sections 68C and 260(7) of the NGL.

- demonstrate that its decision is materially preferable to the decision under review in the context of the long-term interests of consumers as set out in the NEO or NGO.

Since then, limited merits reviews have continued to examine issues in isolation with little reference to the NEO or NGO. In particular, there has been little clarity around how regard has been given to the implications for the decision as a whole or the long-term interests of consumers.

In 2012 SCER committed to a suite of energy reform activities that were aimed at ensuring consumers pay no more than necessary for reliable and secure energy supplies.⁴¹ In line with this commitment, the limited merits review arrangements were modified to remove impediments to consumers engaging in limited merits reviews by:

- making reviews less formal and legalistic
- making it clear that legal representation was not required to participate and to remove the range of costs that could be awarded against consumer and user parties
- requiring the Tribunal to consult with consumers during reviews.

While there may be no formal legal requirement for representation by legal counsel, lack of legal representation creates difficulties for stakeholders to engage with the Tribunal in a meaningful way. For all parties, except minister intervenors,⁴² it may be challenging to obtain leave without representation, either as an applicant for review or intervenor, given the legal nature of the process and the legal hurdles of which the Tribunal must be satisfied. Even where leave for a review or intervention is granted, lack of legal representation may make arguments presented to the Tribunal less meaningful or less persuasive.

An obligation on the Tribunal to consult with consumer stakeholders was intended to make limited merits reviews more accessible for consumers. In practice this has been difficult due to a lack of resources, the complexity of the issues and the legal nature of the arguments. It is not clear how the consultation that was undertaken has informed the Tribunal's decisions and, consequently, its long-term usefulness as a meaningful contribution to limited merits reviews is also unclear.

Table 2.1 below sets out our assessment of the contribution of limited merits reviews to the objectives of the regime articulated by the MCE in 2006 and the focus of the 2013 reforms.

⁴¹ COAG (2012), <http://www.coag.gov.au/node/481>, accessed 2 October 2016.

⁴² Energy ministers of participating jurisdictions can intervene in reviews as a right and do not need to establish a basis for their participation

Table 2.1: Performance against policy intent

Policy objective	Observation	Conclusions
Provide a balanced outcome for all stakeholders	The Panel concluded the lack of downside risk is an indicator of lack of balance in limited merits reviews. There remain few downside risks for service providers seeking a review.	The balance in reviews remains weighted in favour of the businesses due to a lack of downside risk and the narrow focus of reviews. This lack of downside risk is exacerbated where consumers do not have the capacity to engage in the review process in a meaningful way.
Maximise accountability	<p>SCER were explicit in 2013 that accountability should be maximised by allowing parties 'appropriate' recourse to have decisions reviewed.</p> <p>In our view, an appropriate accountability framework should ensure that decisions have been made lawfully and that we have reasonably exercised our discretion.</p>	<p>Merits review provides a second regulator, which compromises the primary decision.</p> <p>Judicial review already provides robust accountability mechanism consistent with the original policy intent.</p>
Maximise regulatory certainty	The regulatory process provides a high level of predictability. Extensive and consultative decisions encourage participation from all stakeholders, and allow the full consideration of this input in reaching a decision. However, in our experience, strong incentives to appeal and a low threshold for leave encourage a second regulatory process.	Access to limited merits review compromises regulatory certainty.
Maximise conditions for the decision maker to make a 'correct' initial decision	The routineness and low threshold for limited merits review result in the Tribunal becoming the primary decision maker. This encourages strategic provision of information, which compromises the initial decision making process.	Conditions for making the initial decision are compromised by access to limited merits review. Judicial review provides for decisions to be tested for correctness in law.

Achieve the best decisions possible	Recent limited merits reviews are not clear about the contribution to the statutory objectives and continue to look at matters in isolation The initial decision making process is compromised because the Tribunal is seen as the primary decision maker. Decisions are not made on the best possible information. Information is not accessible to stakeholders and not intended to persuade the AER.	Limited merits review decisions are not clear in how they will contribute to the delivery of the NEO/ NGO. As a result, it is not clear in many cases that they are contributing to the best decision possible.
Minimise the risk of 'gaming'	The Panel identified that features of the regime which were intended to address the risks of gaming, in particular the provisions intended to widen the scope of reviews, had not worked as intended. Our experience since 2013 indicates that reviews remain narrow in their focus, and Tribunal decisions are largely confined to specific issues in isolation.	The concerns raised by the Panel around the narrowness of reviews leading to opportunistic behaviour remain relevant.
Minimise time delays and costs	The length of time for reviews has increased since 2013 (9-10 months compared to 5-7 months) and the costs for reviews have remained about the same. Under any form of merits review of complex and extensive regulatory processes, this appears likely to continue. It is unclear how a robust re-evaluation of the merits in a three year decision process could take place in a timely and cost-effective manner.	Limited merits reviews are long and costly processes. This effectively limits the meaningful participation of consumer groups in the process.

* The Panel noted that the concept of 'correct' was not appropriate in the context of regulatory determinations, given it is generally impossible to identify a correct decision (Yarrow et al (2012), Stage One Report, pp 48-49).

** The Panel took gaming to mean conduct that is not constrained by regulation where one party intentionally takes advantage of this lack of restraint to further its own interests by doing things that directly and adversely affect the interests of other parties (Yarrow et al (2012), Stage One Report p 55).

3 A stronger regulatory framework with judicial review

In our view, judicial review provides an appropriate accountability mechanism in light of the primary decision making process. As noted in section 1.3, the level of prescription in relation to performing our economic regulatory functions is unique compared to other independent decision makers in Australia and internationally. This prescription means that regulatory determinations are likely more amenable to judicial review than to limited merits review.

The remainder of this section looks at the practical implications of removing access to limited merits reviews and relying on judicial review.

3.1 The process of judicial review

In Australia, there are two forms of judicial review: common law judicial review, which at the Commonwealth level is entrenched by s 75(v) of the Constitution and s 39B of the *Judiciary Act 1903*, and statutory judicial review, which is available under the *Administrative Decisions (Judicial Review) Act 1977* (ADJR). While technically different, from a practical perspective judicial reviews under ADJR and common law are similar.

3.1.1 Timeframes

Filing an application under ADJR is usually required within 28 days from the publication of the terms of the decision being reviewed. This can be extended at the discretion of the court on the basis of it being required to do justice in the particular case, having regard to the reasons for the delay and the balance of convenience.

It is difficult to determine the length of the judicial review process. The timeframe from commencement of a judicial review proceeding to judgment varies, depending on the complexity of the matter being reviewed. It is possible to have matters listed for hearing more quickly where the court is persuaded that it is appropriate to do so. However, there are no set time limits.

Of the six judicial reviews of energy decisions, the average time attributable to judicial review is about 10 months. In some cases it is difficult to determine the specific time attributable to judicial review because of stays or overlaps with limited merits review proceedings. We have set out below the approximate durations of judicial review proceedings including underlying assumptions where necessary:

- *SPI Electricity Pty Ltd v Australian Competition Tribunal [2012] 208 FCR 151*: approximately 7 months
- *Ergon Energy Corporation Ltd v Australian Energy Regulator [2012] FCA 393*: approximately 16 months⁴³

⁴³ The Ergon Energy judicial review process was stayed while the limited merits review process took place. The stay in effect delayed the commencement of judicial review proceedings from July 2010 until February 2011. As a result, we have recorded the judicial review timeline as taking 16 of the 23 months between the release of the AER's decision and the

- *ActewAGL Distribution v The Australian Energy Regulator [2011] FCA 639*: approximately 9 months
- *United Energy Distribution Pty Ltd v Australian Energy Regulator [2012] FCA 405*: approximately 3 months⁴⁴
- *SPI Electricity Pty Ltd v Australian Energy Regulator [2014] FCA 1012*: approximately 18 months⁴⁵
- *CKI Utilities Development Pty Ltd v Australian Energy Regulator [2016] FCA 17*: approximately 6 months

In comparison, limited merits reviews of electricity distribution decisions have taken approximately eleven months on average. We consider electricity distribution appeals are the most relevant point of comparison.⁴⁶ Having regard to these timelines, there appears to be modest differences in duration between limited merits review proceedings and judicial review proceedings.

3.1.2 Standing and costs

Under sections 5, 6 and 7 of the ADJR Act, a person who is aggrieved by an administrative decision may apply for judicial review in respect of the decision. This may include any of the stakeholders participating in the regulatory determination process. This is similar to limited merits reviews, where an affected party may seek leave for a review.

The NEL and NGL expressly allow consumer groups to intervene in limited merits review applications. This right of intervention could also be provided in judicial review through legislation.

Under the limited merits review regime, consumer groups are currently protected against the potential for cost orders to be made against them. This protection may not exist under judicial review, where the awarding of costs can be used to minimise the risk of vexatious matters being brought before the court. We discuss this difference further in section 3.3.

44 release of the Court's decision.

44 All the Victorian DNSPs sought merits review of the AER's 2011-15 determination. The merits review applications were heard between 22 March 2011 and 5 April 2011. UED concurrently applied for judicial review in the Federal Court of Australia. On 5 April 2012, the Tribunal handed down a decision upholding certain arguments of UED but dismissing others (an initial decision was handed down on 6 January 2012, but some issues remained outstanding). Following the Tribunal decision, UED sought discontinuance of judicial review proceedings in light of decision of tribunal, which was accepted by the Court in April 2012.

45 The SPI limited merits review and judicial review matters were run and heard together with the same judge sitting for both the Tribunal and the federal court. The limited merits review decision was handed down in August 2013, and the judicial review decision was handed down 13 months later.

46 It is largely electricity distribution service providers that have sought judicial review of AER decisions. Secondly, due to their materiality and timing within the regulatory cycle, these decisions have the greatest impact on energy consumers and sectoral precedent.

3.1.3 Ability to sit with experts and remedies

Applications for judicial review are generally determined on the basis of the material before the original decision-maker. However, there is capacity for the court to take evidence on a judicial review matter. For example, in the ActewAGL judicial review in 2011, two economics experts appeared before the Federal Court to provide technical advice.

While there is scope for the court to seek expert advice, its likelihood of doing will be balanced with the requirement for this to come within the scope of admissible evidence. This, in turn, allows the court to access appropriate expertise to inform its decisions, while managing the risks of decisions being made on the basis of evidence that was not in front of the primary decision maker, which has not been tested through affected stakeholders.

Remedies available to the court include affirming a decision, declaring the rights of the parties or setting aside the decision with the matter remitted to the decision maker. In limited circumstances, such as where on the correct application of the law a particular decision is mandated, the court may substitute its own decision on a judicial review application rather than remit the matter for reconsideration, although this is rare in practice.⁴⁷

3.2 Benefits to the regulatory process

A well-functioning regulatory regime and overarching accountability framework provides stakeholders with confidence in the integrity of the process and the reasonableness of decisions. Limited merits review can provide an additional layer of scrutiny, as set out in section 2. However, the operation of the current regime does not deliver on the long term interests of consumers as it compromises the initial regulatory process by creating an adversarial and legalistic process that stakeholders find difficult to access. This section sets out our view as to why judicial review is the appropriate primary check on our exercise of discretion, taking into account the nature of energy network regulatory decisions.

The main differences between limited merits review and judicial review relate to the role of the body conducting the reviews. These differences are reflected in the grounds for reviews (see Box 1.1).

Merits reviews are processes in which the review body stands in the shoes of the primary decision maker to determine whether it agrees with the original decision-maker's reasons and conclusions. For reviews of energy network decisions, reviews are limited by a threshold to be reached before the role of the review body is enlivened. The threshold is that the Tribunal must first reach a finding that the initial regulatory decision contained an error of fact, incorrect exercise of discretion or that the decision was unreasonable. However, as set out earlier in this submission, without the benefit of dedicated resources and in a compressed timeframe, it is very difficult for the Tribunal to engage with the complexity and magnitude of the issues before the AER.

⁴⁷ Section 16 of the ADJR.

In contrast, judicial reviews are processes in which the legal basis of the decisions is the subject of scrutiny. As such, the grounds for judicial review relate to issues of jurisdiction, procedural fairness, consistency with obligations in law, or decisions that were not supported by evidence.

The role of judicial reviews is more constrained than for limited merits reviews. In judicial reviews, courts will look at findings of fact in the context of whether an error of law has occurred, but not to determine whether they are the 'correct' facts. In addition, it is the role of the court to ensure that the original decision maker has not abused a discretionary power conferred by law. In contrast, the Tribunal is able to substitute its own view of whether that exercise of discretion was reasonable. Judicial review will consider whether a decision is within the bounds of legal reasonableness.⁴⁸

We consider that the scope of judicial review provides appropriate avenues for affected stakeholders to test the reasonableness and lawfulness of regulatory determinations. We consider this objective to be of central importance in terms of accountability and stakeholder concerns about the exercise of discretion. While the scope for review is more constrained, it allows for a high degree of accountability in our application of the national energy frameworks for regulatory determinations, without the consequences associated with having a second regulatory process.

A further benefit of judicial review is that it reduces the asymmetrical nature of the appeal process in particular the limited downside risk to business revenues. In contrast with limited merits reviews of energy decisions:

- Obtaining leave for judicial review relies on appellants meeting a relatively higher threshold. This is because the test to obtain leave for review relates to demonstration that the primary decision is incorrect in law, whereas for limited merits reviews of energy decisions being granted leave has not been a substantive hurdle.
- In addition, there are greater downside risks for parties to judicial review than for limited merits review. That is due to the potential for costs to be awarded against parties in judicial review.

In combination, this would reduce the incentive to seek reviews as a routine part of the regulatory determination process. Instead, reviews are likely to be limited to matters where there are risks to contributing to the achievement of the NEO or NGO (consistent with the MCE's original policy intent).

The more narrow approach to judicial review means that the role of the court on review does not overlap with that of the primary decision maker. As a result, the resources required for a robust review are less, and does not risk the court being seen as a second regulator.

As a consequence, removing the limited merits review would reduce the incentives for service providers to strategically withhold information until late in regulatory processes. This is because judicial review does not revisit the primary decision on the basis of the

⁴⁸ That is, any decision or outcome within the area of decisional freedom (that is, where under legislation, the decision-maker has discretion around a number of decisions or outcomes), is within the bounds of legal reasonableness. See *Minister for Immigration and Border Protection v Eden* 2016 FCAFC 28).

information submitted to the original decision maker, rather than the decision is lawful on the basis of the available evidence. In turn, this would improve the accessibility, quality and timeliness of the information in regulatory processes, which benefits all stakeholders and will maximise the conditions for the correct initial decision to be made.

As would be the case under any changed review framework, we anticipate that there may be a transitional period under which regulated service providers would seek judicial review more actively to establish precedents. However, judicial review is a well-established and well-understood framework, so we expect that this transitional period would be neither lengthy nor disruptive to the long-term interests of consumers.

3.3 Consumer involvement

Consumer representatives have automatic standing in limited merits reviews. While these representative organisations are likely to have standing in judicial review, amendments could be made to remove any doubt. While this would address the issue around standing, judicial reviews do not afford the same protection against cost orders being awarded against consumer and user groups that currently exists in limited merits reviews.

In comparing the current framework to a judicial review framework, we consider both limited merits reviews and judicial review require legal representation to engage in the process effectively. As legal representation is costly, participation in the substance of reviews is inaccessible to all but the best resourced consumer groups.

With or without legal representation, consumers are better able to engage in the earlier economic debate of the initial regulatory process rather than the costly, narrowly focussed and highly contested legal debate at the end of the process. Consumer involvement in the initial regulatory process would be enhanced were the initial process to be less adversarial and guarded, as would be the case were merits review to be removed from the framework.

4 A binding rate of return guideline

While addressing many of the issues identified with the current framework, the reforms recommended in the preceding sections would not necessarily eliminate the potential for cascading reviews on the rate of return. Cascading reviews occur when regulatory determinations fall due before issues have been resolved from a previous decision. This creates uncertainty for all stakeholders.

For example, the Tribunal in ACT/NSW/Jemena overturned our decision on the return on debt and remitted the issue back to us. Subsequently, we have been required to make decisions for Qld and SA electricity distribution and Victoria electricity distribution and are currently working towards final decisions for Tasmania, Qld and Victoria electricity transmission. Because the approach to the return on debt has not been settled it has created uncertainty in each of the subsequent processes. Until our approach to the remittal and any subsequent appeals are settled, uncertainty arises for services providers in preparing their proposals, stakeholders in making submissions on the proposal and ourselves in making our decisions.

While there is some risk of cascading reviews across other revenue drivers, it is most pronounced in rate of return parameters. This is because the rate of return is the most material input to revenue,⁴⁹ frequently relies on the exercise of discretion between competing expert opinions and tends to have issues that are common across the industry. As a consequence of these factors, there is often a range of plausible outcomes. The combination of materiality and the inherent contentiousness of discretion result in a persistently strong incentive to appeal.

Since 2008, multiple overlapping appeals on similar rate of return issues have been common. For example, at the time of submission of this document:

- The Tribunal in the New South Wales and ACT electricity distribution and Jemena Gas Network (JGN) hearings found error and remitted (amongst other issues) approach to return on debt transition back to the AER.⁵⁰ This remittal is ongoing, while the AER has sought review of the Tribunal's decision in the Full Federal Court.
- A different Tribunal panel has already conducted hearings on the approach to return on debt transition for SA Power Networks (SAPN),⁵¹ where, SAPN argued for a different approach to debt than the position advanced by Networks New South Wales in the New South Wales and ACT electricity distribution hearings.

⁴⁹ The rate of return multiplied by the regulatory asset base, which is less variable in decisions, commonly accounts for greater than 50 per cent of regulated revenue.

⁵⁰ Australian Competition Tribunal, Applications by Public Interest Advocacy Service Ltd and Ausgrid Distribution [2016] ACompT1; Australian Competition Tribunal, Applications by Public Interest Advocacy Service Ltd and Endeavour Energy [2016] ACompT2; Australian Competition Tribunal, Applications by Public Interest Advocacy Service Ltd and Essential Energy [2016] ACompT3; Australian Competition Tribunal, Applications by Public Interest Advocacy Service Ltd and ActewAGL [2016] ACompT4; Australian Competition Tribunal, Application by Jemena Gas Networks (NSW) Ltd [2016] ACompT 5.

⁵¹ Application by SA Power Networks ACT 11 of 2015;

- A different Tribunal panel again is set to consider the approach to return on debt transition as appealed by some of the Victorian electricity distribution service providers.⁵²
- While a total of 8 service providers have sought reviews of the AER's approach to debt transition, a further 8 service providers did not seek review of the AER's approach to debt transition in revenue determinations.⁵³

These cascading reviews create highly undesirable regulatory outcomes, including:

- the risk of different limited merits review outcomes on decisions that, in our view, should be common across the sector
- stakeholders needing to devote resources to participate in multiple reviews without a settled starting point
- timing uncertainty across the sector, whereby service providers have greater incentive to appeal while awaiting previous limited merits review decisions in order to preserve their position
- excessive resource costs to all parties arising from multiple reviews addressing a common approach.

4.1 Advantages of a binding guideline

The problem of cascading appeals on the rate of return could be mitigated by making the rate of return guideline binding across five year regulatory cycles.

A binding rate of return guideline would mitigate some of the most important consequences of limited merits review by:

- promoting greater certainty between binding guidelines
- avoiding the need for stakeholders to devote intensive resources to reconsiderations of the same rate of return issues within a regulatory cycle⁵⁴
- avoiding the negative outcomes associated with overlapping reviews of the same issues supported by subtly different arguments
- making the binding guideline process a critical focal point for stakeholders, and thus allowing stakeholders to devote their resources to other aspects of the regulatory determination processes
- preserving consideration of a holistic rate of return that meets the allowed rate of return objective.

⁵² Application by United Energy ACT 3 of 2016; Application by Citipower ACT 4 of 2016; Application by Powercor ACT 5 of 2016; Application by ActewAGL ACT 6 of 2016; Application by Jemena ACT 7 of 2016; Application by AusNet ACT 8 of 2016.

⁵³ Specifically: Energex, Ergon Energy, Australian Gas Network, Transgrid, AusNet Services, Citipower, Powercor and United Energy.

⁵⁴ These reconsiderations are often on the basis of subtly different arguments submitted during each AER determination process, despite those issues having been considered in depth during a recent guideline process. As the guideline is not binding the Tribunal will ultimately rehear these economic debates for each service provider where regulatory processes overlap.

The content of the binding guideline would be subject to judicial review when published. Then, the AER's implementation of this binding guideline at each subsequent regulatory decision would then be subject to judicial review. This would test that the AER has undertaken lawful and reasonable decision processes and has properly applied the findings of the guideline. It will also promote a consistent approach for all service providers.

4.2 History of the rate of return guideline

The current non-binding sector-wide rate of return guideline has not always applied under the NER. Previously, chapter 6A of the NER required a binding 5 year WACC review for transmission. When distribution functions transferred to the AER, distribution rules allowed for departures from the WACC statement of regulatory intent where there was "persuasive evidence". In effect, the statement of regulatory intent was a non-binding guideline for all sectors other than electricity transmission.

We adopted consistent approaches and methodologies for rate of return determinations in gas, despite (at the time) relatively less prescriptive rules in the NGR. Electricity distribution and gas service providers routinely sought review of our rate of return decisions, but electricity transmission service had only limited access to review on matters that are now covered by the rate of return guideline.

As part of the 2013 framework changes, the inconsistent approaches between the different sectors were revised and a non-binding periodic rate of return guideline was to apply across all sectors. Most stakeholder feedback, especially from investors and market brokers, was that the rate of return guideline led to a material improvement in transparency and predictability in the way that we have made rate of return decisions. Nonetheless, in proposals since this time and despite the extensive consultation undertaken in the development of the guideline, all service providers have proposed to depart from the guideline in nearly all respects. While there have been a myriad of subtle differences between proposals, the most substantial issues have been common across the sector:

- Return on equity—Nearly all service providers have proposed to depart from the AER's foundation model approach as set out in the rate of return guideline in order to rely more substantively on several additional models.
- Return on debt—Service providers have proposed to depart from the AER's approach to calculating the return on debt, as set out in the guideline, and many have also proposed departures to the AER's approach for transition to a trailing average return on debt.
- Gamma—Most service providers have proposed to depart from the AER's approach to estimating the value of imputation credits (gamma) as set out in the rate of return guideline.

Box 4.1: The 2013 rate of return guideline

During the 2013 better regulation reform program, we established guidelines to set out how we would undertake a suite of our regulatory functions over the forthcoming regulatory cycle. We developed the 2013 rate of return guideline during this process. The guideline set out in a high degree of detail how we would make decisions on rate of return issues and on the value of imputation credits (γ). It was arrived at after an extensive, transparent and consultative process.

In total, the development process for the guideline included:

- approximately 18 months of development
- 30+ new expert reports submitted by service providers
- 7 new expert reports commissioned by the AER
- extensive analysis of existing academic literature and market information
- extensive engagement with the consumer reference group
- large numbers of submissions by service providers, user groups, market participants (investors, finance groups, state treasuries etc)
- draft and final explanatory statements and appendices in the order of 220 (draft) to 400 (final) pages setting out our detailed analysis and positions.

As discussed in section 4.3.1, stakeholders generally expressed highly favourable commentary about the effect of the guideline in promoting certainty and predictability in rate of return determinations.

4.3 The specific importance of a binding rate of return guideline

Rate of return determinations have several characteristics that make them unique amongst building block inputs. Specifically:

- Having regard to its revenue impact and variability over time, the rate of return is the most material driver of building block revenue across the regulated service providers
- The questions relating to the rate of return are 'sector-wide' in nature, and should not rely to a great extent on the specific circumstances of individual service providers. For this reason, the rate of return is especially well-suited to a sector wide process with binding outcomes.
- The reviews of these parameters typically exhibit the most acute consequences of the limited merits review regime against its policy objectives in that:
 - Rate of return methodologies and parameters are the most routinely contested matters under the current limited merits review framework. Further, as discussed in section 4.3.1 below, a recent Royal Bank of Canada survey indicated that 71 per cent of investors either agree or strongly agree with the AER's approach to

cost of equity and the WACC. This suggests that a high proportion of appeals may be driven by potential upside rather than a requirement for change to meet the allowed rate of return objective.

- Limited merits review hearings on the rate of return are highly technical, making it difficult for consumers to participate without costly expert input and difficult for any review body to properly consider all the interrelated issues with expert support.
- Limited merits review decisions on the rate of return have contributed to substantial impacts on consumer prices without clear links to the long-term interests of consumers, beyond generalisations.

4.3.1 The importance of rate of return to investors

A recent Royal Bank of Canada survey provides stakeholders views on the uncertainty and the role of limited merits review in the energy sector. They compared these results with the same responses from 2013.⁵⁵ Several of the results are supportive of the AER's approach to rate of return guidelines. Specifically:

- More investors viewed regulatory uncertainty as moderate or low in 2016 compared to 2013 (71 per cent in 2016, 55 per cent in 2013).
- 71 per cent of investors agree or strongly agree with the AER's methodology for cost of equity and WACC, compared to 35 per cent in 2013. Relatedly, the proportion that strongly disagrees has decreased from 30 per cent to 11 per cent.
- 53 per cent of investors agree or strongly agree that the AER has sufficiently taken into account volatility and uncertainty in financial markets in developing the regulated WACC, compared to 35 per cent in 2013.
- While 85 per cent of investors agree or strongly agree that 'a form of merits review is crucial in terms of ensuring accountable and transparent decision making by the AER', only 14 per cent of investors concluded that removal of the current limited merits review regime would significantly increase the cost of capital. In contrast, 32 per cent concluded that it would either modestly decrease or have little to no impact on the WACC.

To the extent that these results are reflective of investor perspectives, we would conclude that:

- since 2013, investors have substantially more confidence in both the level of regulatory certainty, and in the robustness of the AER's cost of capital methodologies
- a transparent and comprehensive rate of return guideline has been a key driver of this outcome
- while investors view some form of merits review as important, removal of the current limited merits review regime would have little effect on perceptions of regulatory risk as manifested in the required return on capital.

⁵⁵ Royal Bank of Canada, ASX Network Utilities– Investor Survey on Regulation, August 2016.

4.4 Conclusion

On this basis, we consider there are potentially significant benefits in adopting an alternative model with a binding rate of return guideline. This would allow us to improve regulatory certainty and the ability of stakeholders to participate in a single, definitive review process for the most material and contentious driver of regulated revenue.

The guideline would be subject to judicial review which provides an appropriate accountability framework in ensuring that our decisions are lawful and that we have reasonably exercised our discretion. The extensive consultation process we employ in developing the guideline is well suited to being tested through judicial review. We have considered whether a merits review framework could be developed for the rate of return guideline, but have significant concerns with such an approach. In particular, we note the difficulties encountered in developing a merits review framework more generally, the inherent uncertainty and discretion required in assessing rate of return issues and the potential for the review body to be seen as the primary audience perpetuating the issues outlined in the submission around a second decision maker.

Part B: Response to consultation paper questions

The following section sets out the AER's response to the questions raised in the consultation paper. Further additional detail on the issues raised in response to the questions is provided in earlier sections.

1. Are there any specific factors which prevent issues being resolved through the determination process?

- No, our determination process is a robust, transparent and consultative process that affords all stakeholders an opportunity to participate. A number of improvements have been made to this process in the last five years to:
 - Make it more accessible to all stakeholders (e.g. through the Better Regulation process), allow consumers' views to be taken into account more effectively (e.g. through the Consumer Challenge Panel)
 - Provide stakeholders with multiple opportunities to make submissions (e.g. in the case of electricity, stakeholders can make submissions in the framework and approach stage and can also make submissions in response to the service provider's proposal and to our draft decision)
 - Allow some issues to be resolved early and for the determination process to then focus on the substantive issues (e.g. through the introduction of the framework and approach stage in electricity and the guideline development processes).
- In recent regulatory determination processes there have been contentious issues that were resolved through the process without review being sought.
- However, access to limited merits reviews compromises these positive aspects. Specifically, limited merits reviews create a second regulatory process with a second decision maker. As a consequence, many stakeholders engage with the Tribunal, rather than us, as the decision maker.
- In addition, we consider that the rate of return parameters need not be reconsidered through each individual service provider's determination process. As set out in section 4 we consider the rate of return guideline should be made binding.

2. Are reviews generally considered a routine part of the determination process?

- Yes, reviews continue to be a routine part of the determination process
 - Since its introduction in 2008, 20 reviews have been sought from 34 decisions, or roughly 59 per cent of all reviewable regulatory decisions.
 - Since the 2013 reforms, this trend has continued, with 12 reviews from 19 decisions (63 percent) being sought
 - Further, there is evidence that market participants and investors view review as inevitable or routine
- The commonplace nature of limited merits reviews is a consequence of the opportunity for a second regulatory process coupled with little downside risk in seeking reviews.

3. Does the framework enable reviews to focus primarily on the long-term interests of consumers?

- No, reviews continue to examine elements of the regulatory determination in isolation without explanation about how this relates to the decision as a whole in the context of delivering the long-term interests of consumers.
- The differences between the resources, time and number of steps in the primary decision making process and reviews makes it difficult to conceptualise how limited merits reviews can result in decisions that better align with the long-term interest of consumers

4. To what extent does the current framework support materially preferable decisions being made for the long-term interests of consumers?

- The concept of 'materially preferable' is ambiguous, which makes it both difficult to understand and apply for limited merits reviews.
 - The Tribunal gave some thought to the meaning of 'materially preferable' and the long-term interests of consumers in its NSW and ACT decisions, with the same approach was adopted in ATCO Gas in Western Australia.
 - However, in its reasons paper, the Tribunal did not provide clarity around how the concept was applied to either the individual matters or the decision as a whole.
- Demonstrating that a decision would, or would be likely to, result in a materially preferable decision in the long-term interests of consumers is a significant task, approaching the same scale (and need for resourcing) as regulatory determination processes.

5. Are there any other issues which impact on the delivery of regulatory decisions that serve the long-term interests of consumers?

- Limited merits review undermines the substantive improvements to the regulatory frameworks over the last four years. For example:
 - the AEMC's 2012 rule changes, which extended the regulatory determination process to enable more consumer engagement
 - our establishment of the Consumer Challenge Panel and development of the consumer engagement guideline.
- Regulatory determinations are complex, information intensive, large and technically detailed.
- Applying limited merits review to regulatory determinations results in focusing on isolated components of the overall decision.
 - Limited merits reviews are necessarily short and, as such, not informed by the entire regulatory process, from guidelines, through framework and approach to draft and final decisions.
 - The Tribunal does not have the time or resources to conduct a review of the same character as the initial decision making process.

6. Are the current grounds for review sufficiently robust to avoid undue weight being placed on minor matters in merits reviews?

- No, in practice the grounds have continued to result in an undue focus on what SCER has called 'error correction', without regard to whether or not the issues are material
- Further, the threshold for leave appears to be unchanged as a result of the 2013 reforms, meaning that even very minor matters are considered in review processes as long as any one issue under appeal is sufficiently material.

7. Are there any issues with the scale and scope of material that can be brought forward in relation to reviews?

- Yes, the scale of the task performed by us in making a regulatory determination is extensive. It is impractical for the full extent of the AER's consultation process to be examined in a review process.
- The scope and complexity of material and arguments presented to the Tribunal is extensive. For example, the NSW and ACT reviews included:
 - over one million pages of documents
 - fourteen days of substantive hearings
 - hundreds of pages of written submissions
 - one consumer forum lasting two days.

8. Is there a way to minimise the regulatory impost of maintaining a record of decision making as part of any future reforms?

- No, and it would not be appropriate to try to limit the information to be included in the record. That said, we perceive that limited merits review provides incentives for networks to submit encyclopaedic volumes of material so that it can be accessed in the review process. If limited merits review was removed, it is more likely that network businesses would engage more genuinely in the initial decision making process and that information would be provided in a more accessible format to assist in persuading the AER and other stakeholders.
- We consider that maintaining a record of decision making is good regulatory practice.
 - Regulatory determinations are complex and information intensive processes.
 - Reviews of these decisions will always lead to substantial impost in maintaining a large record of decision making.
 - We expect that the same material will be discoverable information for limited merits review as for judicial review
 - As service providers will retain access to judicial review, it will always be necessary to maintain a database of all information provided to us
- However, the record of review related material includes all material provided to us and not only information that informed our decision. Consideration should be given to being able to exclude information provided late in the determination process on the basis that it

could not have been reasonably considered. This would require an amendment to the definition of review related material in the NEL and NGL.

9. Are there any barriers to the Tribunal seeking additional expert advice? If so, how could these barriers be addressed?

- There are no legal barriers, although historically the Tribunal has not done so in a substantive way.
- The Tribunal's approach manages the potential risk of parties not having access to natural justice in contesting information presented to the Tribunal.
- Further, the Tribunal's approach to date is consistent with the objective of the Tribunal only having regard to material that was before us in making the primary decision.
- In two of the judicial reviews undertaken so far, the Federal Court has invited oral evidence from experts. This process appears to have been helpful to the Court.

10. Is participation without legal representation possible? Are there barriers hindering full consumer participation in the review process?

- For consumer and user groups, participation without legal representation is possible, although in practice, without legal representation it may be difficult to demonstrate the case for intervention to the satisfaction of the Tribunal.
- Legal representation is costly and intimidating, which sidelines all but the best resourced consumer groups.
- For example, in the recent NSW and ACT limited merits review hearings, 8 service providers (parties and interveners) were represented by 14 counsel compared to one consumer group (PIAC) represented by 2 counsel. This imbalance compromises the effectiveness of consumer participation.

11. How costly has your participation in the appeal process been and what are the implications of this participation for you?

- Cost of participation for us has been at least \$3 million since the 2013 framework changes (covering the ACT/NSW Jemena and SAPN processes to date).
 - This reflects only the legal costs of participation
 - There are other costs, including staff time
 - It also has implications for performing other duties. For example, it has resulted in delay of Rate of Return guideline review and other development work
 - However, our costs cannot be readily extrapolated for other stakeholders, in particular user and consumer groups who are not necessarily in a position to expend the same amount of money as either the service providers or ourselves.

12. What are/were your expectations of how the Tribunal would consider the input from consumers?

- In order for the Tribunal to evaluate materially preferable decisions that are in the long-term interests of consumers, all review-seekers and interveners (collectively, parties) should be able to participate in reviews on a level playing field:

- regardless of legal representation
- regardless of the type of stakeholder
- In 2013 SCER recognised the need for greater access to views beyond the parties and required the Tribunal to consult with consumers
 - By nature, it could be anticipated there would be a lower threshold for participating in community forums
 - It could be expected the outcomes from that consultation would inform the Tribunal about consumers' views on the long-term interests of consumers. Ultimately, it seems a reasonable proposition that consumers are best placed to speak to the long-term interests of consumers.

13. How can parties provide the Tribunal with sufficient evidence to inform its decision making, while still supporting the Tribunal in its aim to conclude decisions within three months?

- In the context of limited merits reviews of energy decisions, it is not insufficient information that is the issue. Rather, regulatory decisions are made relying on a greater volume and complexity of information than the Tribunal can practically consider.
- These limitations result in parties using extracts of the material in the record to argue about a matter being reviewed in isolation.
- This is not consistent with 'standing in the shoes of the original decision-maker' where all the material is considered in its context. The Tribunal does not have this opportunity.

14. What has been the impact of the extended timeframe of review processes? How could these impacts be addressed?

- The extended timeline for reviews has resulted in substantial pricing uncertainty and practical outcomes that the broader framework in the rules cannot easily accommodate.
- The complexity of regulatory determinations and the amount of information that needs to be considered means that any merits based review of these decisions will be inherently lengthy. This introduces a tension between limited merits reviews considering the fullness of information and decisions being made within a reasonable timeframe.
- Revenue smoothing can partly ameliorate the price impact of these delays.

15. What would be the impact of maintaining the current regime?

- Our view is that regulatory determinations are not amenable to merits review. If the current regime is maintained:
 - There will continue to be a second regulatory process, with reviews remaining routine and the Tribunal engaged as the ultimate decision maker.
 - As a consequence, all of the other policy failures observed by the expert panel in 2012 would remain. That is, narrowness of focus, lack of links to the NEO and NGO and the risk of opportunistic behaviour.
 - Limited merits review will continue to compromise the broader national energy framework.

16. What amendments, if any, would you propose to achieve the policy intent of the 2006 and 2013 LMR reforms?

- A suite of major reforms were made in 2012 and these reforms have not achieved the stated policy objectives.
- Given the complexity and expansiveness of regulatory determinations, it is difficult to conceptualise how limited merits review can sufficiently take into account the views of all stakeholders. Further, the presence of limited merits review compromises the integrity of the initial decision making process.
- For this reason, we think that removal of limited merits review and reliance on judicial review provides an appropriate avenue for affected stakeholders to test the reasonableness and lawfulness of regulatory determinations.

17. Should the existing Tribunal review process be made more investigatory in nature? If so, how could this be achieved?

- This was a policy intent from 2013. In practice it has not happened, and the most recent appeals were highly legalistic and adversarial. All participants (excluding the SA Energy Minister) in the most recent round of appeals relied entirely on legal counsel developing their submissions and presenting their arguments to the Tribunal.
- In Australia both the Administrative Appeals Tribunal and the Australian Competition Tribunal have adopted an approach to proceedings that are similar to courts.

18. What are the risks of establishing a new review body? Are there any challenges associated with implementing this option?

- The key risk of establishing a new body is that it may result in similar shortcomings to the current limited merits review framework. In particular, an investigatory review body might also come to be viewed as a second regulator. We have set out in our submission why this has material consequences for the functioning of the regulatory regime.
- In terms of challenges, designing a new framework for merits reviews (limited or otherwise) for energy decisions is a complex exercise, as illustrated by the failure of limited merits review to achieve its policy objectives in its initial form, or after a subsequent round of review. We consider there is risk that a new framework would fail to achieve its policy objectives.

19. Would it be possible to increase the clarity of grounds for review, and their relevance to the long-term interests of consumers, by establishing a new body?

- No. We consider that further clarifying grounds for error, either in the current limited merits review framework or for a new body would be unlikely to materially change several of the most problematic policy consequences of the limited merits review regime.

20. Could a new review body provide an appropriate balance between access to reviews where necessary and ensuring the long-term interests of consumers are delivered? How would a new investigatory body help achieve this balance?

- No. An alternative review body testing grounds for errors on merit would be unlikely to address several of the most problematic policy consequences of the limited merits

review regime. Due to the complexity and materiality of issues in regulatory determinations, any such option for review will still:

- create a strong incentive for routine appeals
- result in comparatively greater access to review for better resourced parties. This would be likely to exclude all but the best-resourced consumer groups.

21. What role and structure could a new review body have? Are there any examples of a sector specific review body that could be applied to energy?

- For the reasons set out in this submission, we consider a judicial review only framework would substantially improve the achievement of the MCE's policy objectives compared to a limited merits review framework.

22. Do you have any suggestions for how a new investigatory body could be appropriately resourced?

- We do not support the model of investigatory body set out in the consultation paper for the reasons discussed in the preceding questions.

23. What are the likely consequences of removing access to merits review of revenue determinations and access arrangements? If access to LMR was removed, are there any complementary changes to the wider regulatory frameworks, or other legislative changes, that might be considered to provide accountability for regulatory decisions and deliver the long-term interests of consumers?

- For the reasons set out in section 3 of our submission, we are satisfied that robust accountability framework would remain in place after removal of limited merits review.
- Due to the unique characteristics of rate of return determinations in the regulatory framework, we have also proposed a binding rate of return guideline. This will mitigate the problems arising from cascading reviews on common rate of return parameters.
- In combination, we consider these approaches should contribute to a robust accountability framework that better achieves the MCE's 2006 objectives.

24. In circumstances where redress is sought through judicial review processes, what mechanisms could be put in place to better support consumer and user participation?

- If access to limited merits review is removed, we consider that the initial decision making process is likely to become more accessible to consumers and that consumers will be better placed to influence the outcome of that process.
- Our view is that consumer representatives are likely to have standing in judicial review proceedings. However, the risk of cost orders against consumer groups might be problematic in making judicial review proceedings inaccessible for consumers. Mechanisms to limit the risk of cost orders would support better consumer and user participation.
- However, the costs of judicial review—excluding cost orders—are unlikely to be significantly higher than the legal costs incurred in participating in the New South Wales, and ACT electricity distribution, and Jemena Gas Network limited merits reviews, where Energy Consumers Australia (ECA) funded PIAC's participation.

- PIAC has also used ECA funding to determine whether there was grounds for intervening in the judicial review sought by the AER of the NSW, ACT and JGN decisions.

25. Should all access to merits review be removed or only for electricity revenue determinations and gas access arrangement decisions?

- Our view is that the evidence is overwhelming in favour of removing limited merits review for electricity revenue determinations and gas access arrangement decisions. In contrast, we have limited evidence on the necessity to remove limited merits review for other reviewable regulatory decisions.

26. Are there other areas of reform to the broader regulatory framework that would assist in achieving the policy intent of the 2013 reforms to LMR and deliver outcomes in the long-term interests of consumers?

- Yes. In particular, we have proposed in our submission our preferred model of accountability which includes:
 - the removal of limited merits review or redefining reviewable regulatory decisions (if other decisions are determined to be retained) - requiring changes to the NEL and NGL
 - a binding rate of return guideline to apply across electricity and gas, distribution and transmission - requiring changes to the NER and NGR)
- We consider this model would better achieve the policy objectives set out by the MCE in 2006 and reiterated in 2013.