Consumer Utilities Advocacy Centre

Level 2, 172 Flinders St
Melbourne VIC 3000
Phone: 03 9639 7600
Fax: 03 9639 8966
ACN 100 188 752

13 April 2012

Review of Limited Merits review Secretariat
Energy and Environment Division
Department of Resources Energy and Tourism

By email: LMR.Secretariat@ret.gov.au

Dear Professor Yarrow, Dr Tamblyn and the Hon. Mr Egan

Response to consultation paper on the Review of the Limited Merits Review Regime

The Consumer Utilities Advocacy Centre Ltd. (CUAC) would like to thank the Expert Review Panel (the Panel) for the opportunity to respond to your initial consultation paper on the review of the Limited merits review. As you may be aware, CUAC, along with the Consumer Action Law Centre (Consumer Action), have had recent experience of the merits review process in electricity distribution in Victoria. This has shaped many of the perspectives in this submission. At the outset, CUAC would like to express its support for the decision of the Standing Council on Energy and Resources to bring forward this review process. In our view, such a review is necessary and timely to correct some clear problems with the current appeals mechanism in the national electricity and gas laws.

CUAC would also like to apologise for the brevity of this submission. It is, unfortunately, a consequence of limited resources, short timeframes and competing priorities. Nonetheless, we hope that this is only the first contribution of several to your deliberations in the coming year. We should also highlight that our knowledge of the limited merits review process primarily relates to its application to the economic regulatory decisions of the Australian Energy Regulator (AER) in electricity distribution. However, many of our observations are applicable to the broad merits review regime in energy.

Background

CUAC has some substantial recent experience with the regime that governs the monopoly regulation of Victorian electricity distribution network service providers (DNSPs) under the National Electricity Law (NEL) and Chapter 6 of the National Electricity Rules. We actively engaged with the AER throughout the current price determination process (2011-2015). CUAC was a member of the consultative forum that was established to provide a consumer perspective to support the AER's decision making process. As a result of this engagement, we gained insight into the price determination process, the AER's approach and the substantial complexities involved in regulatory price setting under the NEL. It was also during this time that we learned from a variety of stakeholders that there was a high likelihood that some aspects of

the AER's final decision would be subject to a limited merits review appeal lodged by the DNSPs to seek an upward revision of the approved revenue in the AER's final decision. In our preliminary enquiries as to why this was the case we learnt more about the limited merits review process and how it seemed to provide incentives for DNSPs to appeal aspects of the decision as it offered the potential for substantial gains with little chance of incurring costs.

At this juncture, it should be noted that CUAC is of the view that the conduct of the AER throughout the Victorian 2011 – 2015 determination process, within the constraints of the Rules, was fair. The AER actively sought a diversity of views on its activities and seemed to give DNSPs every opportunity to provide information to guide their final decision. The substantial upward revision of the AER's draft determination upon receipt of new information from the DNSPs was testament to this. Consequently, we were concerned, though not surprised, when all five Victorian DNSPs elected to appeal the AER's final decision to the Australian Competition Tribunal through the limited merits review process.

Given our concern at the decision of the DNSPs to appeal, CUAC along with Consumer Action started to investigate ways in which the consumer interest could continue to be represented through any appeals process. To this end we engaged a law firm, who fortunately agreed to provide *pro bono* assistance, and began to investigate the possibility of intervening in the appeals process as allowed under section 71L of the National Electricity Law. In the short time frames allowed, we notified the Australian Competition Tribunal (ACT) of our intention to intervene in the appeals process as a user or consumer intervener. We subsequently commenced work with our legal team to identify grounds for our intervention.

Through this process, we learned that, in effect, there are some very significant barriers to consumer participation in the appeals process. Despite a significant effort by CUAC and Consumer Action and *pro bono* legal support, our ultimate decision was to withdraw from the process on the basis of legal advice. However, as a result, we identified the following barriers to our intervention that would also be likely applicable to any end user involvement in the merits review regime.

- The substantial finances required to adequately resource an intervention to have a chance of success (in particular to support sufficient technical expertise).
- The short timelines for developing applications for leave to intervene in the process.
- The practical limits of the NEL to allow for consumer access to the merits review regime.
- The risks associated with cost orders against end user organisations.
- The Christmas holiday timing of the AER's pricing decision (in Victoria).
- Significant information asymmetries between DNSPs and end user organisations.

Having indentified these issues, we resolved to undertake some analysis of the merits review regime with a view to identifying options for reform. To this end, we engaged a consultant to prepare the report *Barriers to fair network prices,* which we have included as part of this first

submission for consideration by the Panel. This research report highlights not only the barriers to consumer participation in the review process but also some of the flaws in the merits review regime that should be corrected as part of this review.

This report builds upon work previously commissioned by CUAC at the time the merits review regime was being developed entitled *Grounds for appeal*. This report by Catriona Lowe and Denis Nelthorpe also examined the advantages and disadvantages of prospective appeals models for economic regulatory decisions and concluded that judicial review was preferable to the limited merits review that was eventually adopted. We have included this report with this submission for consideration by the Panel.

Outcomes of the limited merits review appeals

In the latest *State of the Energy Market* Report, the AER highlights the fact that at the time of the report's release, merits review outcomes had resulted in increased network revenues to the tune of $2.9 billion.[1] The subsequent outcomes of the merits review of the Victorian electricity distribution businesses would have raised that figure above $3 billion. CUAC is not convinced that end user outcomes have been enhanced by this additional $3billion that they have paid for their energy networks. We are also concerned at the one way nature of these outcomes. As far as we are aware, there has not been a single merits review under the current rules that has resulted in a decrease in network revenues. Is it possible that any errors in AER decision-making are only ever against the DNSPs interest? The merits review outcomes would suggest that this is the case even though common sense would suggest otherwise.

The AER has also indicated in the same report that "the current Rules framework has increasingly made [merits] reviews of AER decisions an extension of the determination process."[2] Nearly all of the network pricing decisions made by the AER under the current Rules have been appealed. CUAC does not see this as a transitory anomaly whereby the extent of the regulator's powers are tested through review to establish precedent. Instead, we see this as result of clear incentives for DNSPs to appeal. We have no doubt that appeals will continue with such regularity until the review regime is reformed. Any regulatory regime that is appealed with such regularity to the judicial umpire is clearly not working as effectively as it should and is in need of reform.

Policy objectives

The original criteria established by the Ministerial Council on Energy (MCE) for the development of an appropriate review scheme are still relevant. However, to achieve these objectives, the design of the overall regulatory scheme will also be important. We should not, for example, rely on the review scheme alone to "achieve the best decisions possible" or to "maximise the conditions for the decision maker to make a correct initial decision." In fact, the primary burden for achieving these outcomes should be on the overall regulatory design and not the review scheme. Nonetheless, we can still see the value of trying to contribute to these objectives in the reform of the review scheme. CUAC has serious reservations about the ability of the current review model to achieve:

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1 Australian Energy Regulator (2011) *State of the energy market 2011*, Commonwealth of Australia, pp 8-9

2 *Ibid*

- maximum accountability;
- the representation of all stakeholder interests in the process;
- a minimum risk "gaming" or strategic behaviour on behalf of the regulated entities; and
- minimum delays and costs.

In fact, we are of the view that the current review model in practice works against these objectives. Our reasoning as to why this is the case will now be examined in brief. Further detail can be found in our two attached reports to this submission.

Strategic behaviour by regulated businesses

Under the current limited merits review regime businesses can "appeal specified individual elements of a price control decision, without affecting other elements of the decision"[3]. This results in the phenomenon of 'cherry picking' the areas of a decision where there is the greatest likelihood of a ruling in favour of the DNSP while areas of the decision that may be result in a ruling to the detriment of the DNSP escape the attention of the ACT. This phenomenon was highlighted by the Victorian Minister for Energy and Resources, the Hon. Michael O'Brien MP when he said: "At the moment the power companies can take the decision of the regulator and they can cherry pick and decide which bits of it they want to appeal."[4]

This was also predicted in the *Grounds for Appeal* report:

> *It is the nature of a lengthy and detailed regulatory determination process that involves the exercise of significant discretion that there will be an element of bargaining amongst the various stakeholders, such that 'gives' in relation to one issue will be offset by 'takes' in relation to another issue.*
>
> *However setting in place an appeal mechanism that allows only some elements of a determination to be appealed virtually guarantees that only 'takes' will be appealed. Thus, it can be argued that by allowing appeals in relation to 'takes' only, a limited merits review process may in fact deliver greater revenue gains to the regulated businesses than would have occurred had the decisions been reviewed in their entirety. This it must be remembered, takes place in an environment where decision-making is already likely to err in favour of the regulated entities*[5].

Such 'cherry picking' may not present so much of a problem if there was an opposing party with a sufficient stake, interest and expertise to appeal elements of the decision which incorrectly favoured the regulatory entities. However, as the *Barriers to fair network prices* report makes clear such a party does not exist. Disparate end users, who do not have anywhere near the

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3 Mountain, Bruce and Littlechild, Stephen, (2010) 'Comparing electricity distribution revenue and costs in NSW, Great Britain and Victoria', *Energy Policy*

4 Australian Broadcasting Corporation News (2012) *Electricity pricing system unfair: minister*, accessed at http://www.abc.net.au/news/2012-01-20/electrictiy-pricing-system-unfair3a-minister/3784910 on 13 April 2012

5 Lowe, Catriona and Nelthorpe, Denis (2006) Grounds for appeal – representing the public interest in the review of regulatory decision making in the energy market, CUAC p. 43

financial interest in an appeal outcome when compared to the DNSPs, are unlikely to commit resources to scouring the lengthy regulatory documents to find an opportunity to appeal. Even if they did, any outcomes of the costly legal fight that would eventuate would not be worth the effort and costs involved. Furthermore, the only other party relatively well placed to participate in an appeals process, the regulator itself, is hardly likely to appeal its own decision. Therefore, the current limited merits review seems to encourage strategic behaviour or "gaming" and does not live up to the founding objectives expressed by the MCE. An alternative regime needs to be established that overcomes this problem.

Consumer involvement and accountability

As mentioned in the previous section, the likelihood of a consumer group or interested party acting as a sufficient opposing party under the current merits review regime is remote. Even with the finest resourcing, consumer groups would still not be in a position to participate meaningfully in the review process. There are a number of reasons for this. The issue of information, both barriers to access and excess volumes, is chief among these. Economic regulatory decisions are immensely detailed and usually include thousands of pages of technically detailed printed material. When this is multiplied by the 13 electricity distribution networks and 11 gas distribution pipelines the volume of material is startling. If transmission networks are included the volumes of material become even more remarkable. The idea that well resourced consumer groups could actively engage with this material to the extent that they could become an adequately strong opposing party in an appeals process is remote. This possibility becomes even more remote when it is coupled with the fact that considerable swathes of information in regulatory determinations remain confidential. Any consumer agency would need to go through the further process of identifying and challenging the confidentiality of the additional information that they may need for a successful appeal.

The likelihood of consumer involvement is further limited by the fact that no single consumer or groups of consumers has anything like the financial stake in the outcome as that of the DNSPs. Even with greater resourcing, this imbalance is not likely to be corrected.

We note that Professor Alan Fels has written a defence of limited merits review for the Energy Networks Association. In that paper he suggests the provision of greater accessibility to consumer organisations to the appeals process through resources and legislative change is the appropriate avenue for reform to the existing regime. While CUAC supports the view that consumer agencies need to be better resourced and equipped to participate in energy regulatory processes, we do not think this, in itself, is adequate to address the imbalance in the current review regime.

As the *Barriers to fair network prices* report states:

> *There seems little value in tweaking current arrangements to enhance the probability of consumer organisations being able to intervene in the merits reviews as it is likely that the process will continue to present insurmountable barriers to consumer intervention*[6].

[6] Johnston, May Mauseth (2011) *Barriers to fair network prices: An analysis of consumer participation in the merits review of AER EDPR determinations*, CUAC and Consumer Action Law Centre, p. 9

Delays and costs

There is no doubt that the current limited merits review process is imposing costs and delays to regulatory determinations. In the case of the recent merits review appeal of the Victorian electricity price determination, the final decision of the ACT was not delivered until January 2012. This was more than 12 months after the AER's initial decision. To get to this outcome, vast legal resources were required. We assume that each of the five Victorian distribution businesses was represented by a Senior Counsel. Additionally, both the AER and the Minister for Energy Resources were represented in the process by Senior Counsel. When the costs of this heavy weight representation is combined with junior counsel, solicitors and court fees the costs of the merits review process seem even more remarkable.

The cost of this process is ultimately the burden of energy users and tax payers. Given this, the question really has to be asked as to whether the benefit to end users of this process merited the cost involved. It should also be noted that the significant delay in arriving at a final determination reduces certainty for end users. This is particularly the case for large end users for whom distribution charges are a large component of their operating costs.

A note of warning on stakeholder submissions

The MCE initial decision on the limited merits review highlighted the fact that a vast majority of submissions supported the limited merits review. CUAC notes that in public consultation processes the party with the most to gain or lose from a particular outcome will be the most likely to engage in a particular consultation process. It is not sufficient to base a particular policy position on the fact that the majority of stakeholders have advocated for such a course. The reality of a process such as this is that it is the DNSPs who will have the greatest stake in ensuring an outcome in their own self interest. Conversely, many consumer groups with their limited resources will only be able to give passing attention to this process as they grapple with all of the other issues on their agendas including national retail regulation, misleading marketing practices and the proliferation of new technologies in the energy market.

Given this, CUAC urges the Panel to ensure that it seeks evidence beyond that contained in submissions and looks at the best possible academic evidence on the subject of appeals to administrative decisions to ensure the final outcome meets the policy objectives that have been set for this process.

CUAC's initial policy position

CUAC's initial policy position is that the current limited merits review regime has not achieved the objectives set out in the original decision paper. We argue that a well designed judicial review model should replace the limited merits review. Both of the attached papers to this submission highlight the fact that appropriate legislative design can ensure that the judicial review provides adequate certainty and transparency for regulated businesses. We also note that the introduction of a judicial review model should be coupled with best practice regulatory design to ensure the stated objectives are achieved.

We note, however, that we would be willing to entertain other innovative alternatives to limited merits review that may come to light as a result of this review process. We are more than happy to further consult with the panel as your views evolve.

Once again we would like to thank the Panel for this opportunity to comment on this important review. We look forward to further engagement throughout the process. If you have any queries or would like to consult further with us do not hesitate to contact me.

Yours sincerely,

Jo Benvenuti
Executive Officer