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Consultation on Limited Merits Review regime

Introduction

I have been commissioned by the Energy Networks Association (ENA) to provide an independent view of the Council of Australian Governments (COAG) Energy Council's consultation into potential changes to the Limited Merits Review (LMR) Regime and to provide my views. I am therefore writing to you in order to place on the record my views on the consultation into potential changes to LMR Regime. Whilst I have an ongoing relationship with Frontier Economics as an Associate, I am not an employee of Frontier Economics. The views set out in this letter are my own independent thoughts, drawing on extensive direct experience of operating and advising on appeal regimes.

From 1998-2004 I was Chairman of the Competition Commission (formerly the Monopolies and Mergers Commission and now the Competition and Markets Authority) in the United Kingdom, the primary review body applying to utility regulation regimes in the UK. This followed three years as a member of the Commission and three years as Deputy Chairman. Until 2013 I was also a Member of the Committee for Standards in Public Life. Until 2013 I was Provost of Oriel College, University of Oxford. I have published widely on economics and have advised both the UK and Chinese governments on the design and implementation of appeal arrangements.

The role of merits reviews

Energy networks are critical to the success of any nation. They offer citizens an essential service and provide an engine for economic growth and prosperity. In circumstances where energy

networks are regulated, a necessary condition for a healthy energy sector is effective and stable economic regulation. This will provide companies with the confidence to invest, innovate and deliver welfare-enhancing services to society. Regulatory authorities must take robust, timely decisions setting out the ground rules for how they will operate, and must enforce these rules effectively.

The right of firms to seek a merits review of regulatory decisions is central to ensuring that economic regulation is effective and stable. Appeal rights make regulators accountable for their decisions by providing independent scrutiny of those decisions. Where firms are affected materially by regulatory decisions, they should have an effective right of challenge if they consider that the regulator has made a mistake or has not acted reasonably. The right to seek a review of the merits of a regulatory decision offers protection to the property rights of investors. Likewise, consumers should also have the opportunity to test the merits of the regulator's decisions by seeking review, to guard against regulatory capture or error.

Given the importance of the merits review regime, it is clearly important that the COAG Energy Council undertake this review of the LMR regime in a thorough manner, in full cognisance of the consequences of the various reform options it is considering.

Observations on issues raised in consultation paper

Incomplete evidence

The consultation paper reports that since 2013, twelve of the twenty decisions taken by AER have been subject to applications by network businesses for review by the Tribunal. I understand that a further four applications for review have been made by consumer groups. The high number of appeals does suggest that there is a problem with the present system of regulation in Australia. In my experience a well-functioning merits review regime has a far lower proportion of decisions subject to appeal.

However, the paper fails to provide the evidence that is necessary to diagnose properly the nature of the problem. Whilst there is much discussion in the consultation paper about the volume of appeals, the cost, the time, access of consumers, legal focus etc. there is no discussion on the actual quality of either the regulator's decisions or those of the Tribunal.

This must be a critical aspect of how the LMR regime has performed in the past, and I find an omission of any discussion of these issues to be puzzling.

The COAG Energy Council has not set out in the consultation paper whether the problem it is seeking to address is:[1]

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[1] There may be other explanations too.

- too many poor decisions by the regulator — it may be that the regulator has been too extreme, or erred repeatedly, and the review body has simply fulfilled its role by correcting those errors. This might, for example, arise because of too few resources and/or time properly to address the undoubted complexities of energy price regulation, or an undue bias towards lower prices today, at the expense of adequate funding of long term investment (external pressures in this direction are a familiar characteristic of regulatory regimes).
- too lax an approach by the review body, encouraging excessive applications to review. This might arise, for example, because of energy companies' superior resources compared to consumers, or inadequate resources assigned to the review body. or
- a flawed decision-making framework that the review body is obliged to follow, for example, imprecise objectives, scope for energy companies to focus in on errors against them, or too narrow and overly legalistic an approach

Clearly, the policy solution will differ depending on which of these is the root cause of the problem.

The only way to select the correct policy prescription is to look closely at the regulator's and review body's decisions since 2013 and diagnose properly which of the above applies. But the public review undertaken by the COAG Energy Council has not done this and consequently it is simply unclear whether any of the remedies proposed will address the underlying problem(s), or simply make matters worse.

To be more precise, the regulator should be setting prices that are the lowest possible sufficient to adequately fund (but no more) the investment necessary to ensure long term adequacy and security of supply. If that is what most or all of the regulator's decisions achieved, then this focuses remedial attention on the review body and/or the process. But if, in a substantial proportion of cases, the regulator did not achieve this then the review process may be working very well, with the problem lying at the earlier stage of the regulatory decisions themselves. If the answer to this is not known, then there cannot, in my view, be a sound reconsideration of the limited merits review system. Owing to this missing evidence it seems to me that the COAG Energy Council consultation process is not structured appropriately; and not supported by the full body of necessary evidence.

Moreover, it is being conducted in haste, with only a few weeks allowed for parties to submit responses, limiting the ability of any other party to present analysis of the recent decisions taken by the regulator and the review body. Where consultation processes are not informed by all relevant evidence, there will be a material risk that the resulting decision is poor.

Unclear legislative and policy framework

There is repeated reference in the paper to the National Electricity Law and the National Gas Law objective of the 'long term interests of consumers'. However, at no point does the consultation paper discuss how it is anticipated that the AER, or the Tribunal, should balance

price, quality, reliability, security of supply and service levels over different periods of time. Consequently, this repeated reference obfuscates rather than helps the discussion. In my experience much (maybe most) of the tension in utility appeal cases is between:

- consumers, the public, and often policymakers wanting lower energy prices in the short-term;
- as against the needs of companies for sufficient funding and profit incentives to provide security of supply, efficient investment, long-term cost efficiency and innovation (noting that meeting these needs is also in the long-term interests of consumers).

Just repeating the phrase 'long term interests of consumers' does not begin to address the real problem of the appropriate or optimum trade-off between these two components of their long-term interests.

Based on comments made by the Tribunal, it seems clear to me that it has a very sound understanding of the complex set of factors that it is required to trade-off when reaching its decisions, and has known this since at least 2008.

> The national electricity objective provides the overarching economic objective for regulation under the Law: the promotion of efficient investment in the long term interests of consumers. Consumers will benefit in the long run if resources are used efficiently, i.e. resources are allocated to the delivery of goods and services in accordance with consumer preferences at least cost. As reflected in the revenue and pricing principles, this in turn requires prices to reflect the long run cost of supply and to support efficient investment, providing investors with a return which covers the opportunity cost of capital required to deliver the services.[2]

Is it then the view of the COAG Energy Council that the Tribunal has, in the past, not found an appropriate balance between competing concerns? In my view it would be possible to reach this conclusion if and only if there has been a full assessment of the quality of the decisions taken by the regulator and the Tribunal. As I note above, no such assessment is presented.

If there is a lack of consensus over what long term interests of consumers actually means, then this will come home to roost when the review body seeks to determine which of its available decisions will lead to 'materially preferable' outcomes. Tests of this kind are, almost inevitably, intrinsically vague and ambiguous in nature and very hard to codify, involving as they do the need to make judgements as to how to resolve the trade-offs outlined above. If there is no agreement over what the objective should be between policy makers and the Tribunal then dissatisfaction with the application of the materially preferable test will be inevitable, but this does not necessarily imply that it is the test that is flawed.

I understand that the materially preferable test has only been in force since 2013 and many of the cases appealed under the new arrangements have yet to be concluded. It may be that an

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2 Application by ElectraNet Pty Limited (No 3) [2008] ACompT 3, the Tribunal.

appropriate and practical basis for applying this test will be found if the arrangements are allowed sufficient time to bed in, whether clarity is provided over the long term interests of customers or not. However, given the speed with which this review has been called since the new arrangements were introduced, sufficient time may not be provided for this to happen.

Policymakers need to have a much clearer understanding about what 'long term interests of consumers' actually means before undertaking lightly such a major policy shift. I suspect strongly that a profound lack of clarity about how best to balance these short-term and long-term considerations (including how to weigh the interests of existing consumers with future consumers) could be the root cause of much of the dissatisfaction expressed with the present LMR arrangements. Yet this is not explored at all in the consultation paper.

Options for reform

As will be clear from my preceding comments, I would have expected to see a wider range of evidence presented in the consultation paper, to inform a richer set of remedies. It is regrettable that so few options are presented, not least since two – the status quo and abolition of LMR – should, in my view, be dismissed almost out of hand. The fact that at present 60% of regulatory decisions taken by the AER since 2013 are subject to appeal confirms that something must change. But given the critical role of merits reviews in securing business confidence, protection of consumers and companies against regulatory error and economic growth, the removal of LMR in their entirety would be contrary to natural justice and hence damaging to the reputation and interests of Australia.

Therefore, there are only two remaining options from the consultation paper that require further thought, which are to make legislative amendments and/or to replace the existing review body with a more investigative one.

In truth, as I have already commented above, there is simply insufficient information in the consultation paper to determine which of these options is likely to be most apt to solve the problems faced, or indeed if some other options not presented in the consultation paper should be pursued, as it is not clear that the problem has been well identified.

In my view, the sensible course of action would be for the COAG Energy Council to pause, gather the required evidence, and then formulate policy thereafter. This would entail extending what is clearly a very compressed timetable for consideration of issues of fundamental import.

Nevertheless, of the options suggested, I suspect that some combination of Option 2 and Option 3 may be needed, potentially in addition to further changes elsewhere.

I am loathe to ever recommend the wholesale copying of any given set of arrangements from one place to another, since legal and institutional principles and arrangements differ between jurisdictions. But based on my own experience, the UK regime (albeit that elements of it have

changed since I led the appeal body) may provide an indication of how this process could be improved.

- It is framed by legislation that provides greater clarity of purpose, with further clarity generated by careful application of these principles on cases.
- It utilises a body that has access to all the resources it requires to make good decisions.
- Within the clearly prescribed legal procedures and under the guidance of legal experts, it accommodates fairly informal hearings, with technical matters and expert opinion assessed by technical staff with directly relevant and extensive expertise.
- The review process is completely open and transparent, with the review body publishing in advance the milestones for the various stages of the review.
- It allows sufficient time to complete reviews, 6 months, which does not have any of the dramatic downside risks that are implied in the consultation paper.
- It provides very full reports, setting out all the probative evidence considered by the review body, with clear justification for decisions made. The reasoning set out in these decisions acting as clear guides to sector regulators as to how they should conduct their decision-making and the limits on their discretion.
- For all of the above reasons, it provides confidence and clarity to policy makers, investors and the public.

As a result of these properties, while the UK system may look to be more expensive and time-consuming, it has, I believe, actually worked very well because it has generated relatively far fewer appeals (both in terms of merits reviews and judicial reviews), although of course, it may well be that a great proportion of the credit should be awarded to Ofgem, who is generally considered to have taken sound decisions. Nevertheless, elements of the UK approach may provide an indication of where incremental improvements could be made in Australia.

I also need to address directly the issue of the duration of appeals. The consultation paper, while at several points recognising that the issues can be technically very complex and difficult, appears to proceed on the belief that the merits review process can be made quick, cheap, easily accessed and easily understood. While speed and efficiency are certainly desirable, there are very severe trade-offs, not only between these elements but between such a process and sound decision-making.

It is unrealistic and misguided to think that the objectives of a sound merits review system—namely, the promotion of accountability of the regulator, correction of material errors, and promotion of confidence in the regulatory arrangements—can be achieved through an abbreviated and cursory review process. This needs to be recognised by policymakers.

Institutions need to be properly constituted and funded in order for them to be able to take good decisions on complex matters. In my experience, in the long-run short cuts will not lead to fewer appeals, but more. The UK experience supports strongly this view.

In conclusion, whichever of these solutions, or some combination thereof, is adopted, considerably more work will be necessary in order to ensure any changes are fit for purpose. This work should include exploring whether other aspects of the regulatory regime are fit for purpose. It would be unfortunate if a further review was necessary in short order because fundamental weaknesses were left undiagnosed and therefore unaddressed.

Final remarks

I have material concerns over the consultation process that is being run to decide how to proceed on an issue of fundamental importance to Australia's national interest. The evidence base presented to inform this consultation is in my view incomplete and there is a material risk that a flawed conclusion may be reached as a result. This is exacerbated by allowing just a few weeks to gather evidence. A better process is required to identify correctly the underlying problem and to propose well thought through remedies.

Very few developed nations have no merits review process, and in the main those nations that do have such arrangements do not seem to have the problems identified by the consultation paper in Australia. Given the critical importance of an effective merits review regime to business and consumer confidence, and economic growth, the proposal to switch off merits reviews entirely is, in my mind, simply untenable from the standpoint of good public policymaking. There are many successful models that could be adopted from around the world, of which the UK is one, none of which impose overly burdensome costs on society.

Finally, I am currently working on something similar in China, where the Authorities are trying to make an appeals process more effective. At present, few if any enterprises appeal, because of the severe risk that this will put them in the Authorities' bad books in relation to future initiatives, licences, funding and so on. It would be ironic and distinctly troubling if a communist dictatorship was pushing for more accountability while a fully-fledged democracy committed to appropriate protections for private property rights was seeking to abolish it.

Yours sincerely,

Sir Derek Morris