



Government of Western Australia
Department of Finance
Public Utilities Office

Reforms to the Limited Merits Review Regime under the National Electricity Law and National Gas Law

Consultation Paper

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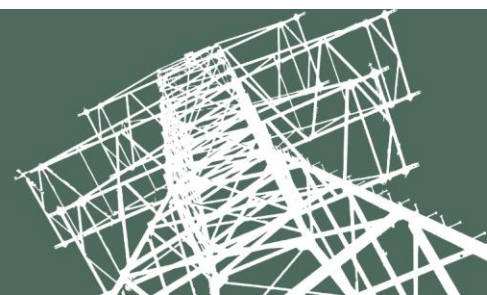


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1. Introduction

The Council of Australian Governments (COAG) Energy Council is currently considering reforms to the Limited Merits Review (LMR) regime that operates under the National Electricity Law (NEL) and the National Gas Law (NGL) regulatory schemes.

In Western Australia's context, the LMR regime applies to the regulation of gas pipelines in Western Australia that are subject to the NGL scheme via the *National Gas Access (WA) Act 2009 (WA)*. At present the NEL scheme does not apply in Western Australia.

Under the current LMR regime, parties can seek merits review from the Australian Competition Tribunal (Tribunal) of certain regulatory decisions of Australian Energy Regulator (AER) under the NEL and NGL, and the Economic Regulation Authority (ERA) decisions under the NGL.

Three gas pipelines are currently regulated in Western Australia by the ERA under the NGL. They are the Dampier to Bunbury Natural Gas Pipeline, the Goldfields Gas Pipeline, and the Mid West and South West Gas Distribution Networks. Gas access arrangement decisions of the ERA for these pipelines are subject to the LMR regime in the NGL.

In broad terms, the LMR regime allows gas pipelines and consumers to seek the correction of a material error of fact, incorrect exercise of discretion and or unreasonableness in the regulators' decision-making.

Following a review of the LMR regime in late 2016, the COAG Energy Council agreed at its meeting in December 2016 that the regime is not meeting its policy intent. Energy Ministers considered that the LMR regime remains an appropriate accountability mechanism for ensuring good regulatory decisions are made, but agreed in-principle to make reforms in the following areas.

- Tighten and clarify the grounds for review.
- Higher financial thresholds for leave which apply to individual grounds for review.
- Reviews to be conducted on the papers, rather than through expensive and adversarial oral hearings.
- Reviews to be conducted within a strict timeframe.
- A strengthened requirement for review appellants to demonstrate that overturning the regulator's decision would not be to the serious detriment of the long-term interests of consumers.
- More flexible arrangements for consumer participation in reviews.
- Introduction of a binding rate-of-return guideline, with relevant elements of the regulator's decision not subject to merits review.
- Remove opportunities for gaming by limiting the timeframes in which material can be submitted to the regulator.

- Costs of reviews, including those of the AER, to be borne by network businesses.¹

The COAG Energy Council is expected to consider policy positions to underpin legislative amendments to the NEL and NGL that will give effect to each of these areas of reform at its meeting in July 2017.

In forming a position on the specific legislative reforms to improve the LMR regime, the Western Australian Minister for Energy is seeking views of stakeholders, particularly Western Australian stakeholders, on the proposed areas of reform ahead of the COAG Energy Council meeting in July 2017.

This consultation paper has been prepared by the Public Utilities Office to assist stakeholders in providing their views for consideration by the Western Australian Minister for Energy. All interested stakeholders are encouraged to respond to the questions raised in this consultation paper as well as raising any other matters they consider relevant for making improvements to the LMR regime. Submission are invited by 30 June 2017.

¹ COAG Energy Council, *8th Meeting Communique*, 14 December 2016, available at www.coagenergycouncil.gov.au

2. Issues for consultation

The COAG Energy Council's Senior Committee of Officials (SCO) undertook a review of the LMR regime in late 2016. The review by SCO identified a number of regulatory failures in the LMR regime, including but not limited to:

- reviews remain routine;
- failure to deliver regulatory certainty and stability;
- barriers to effective consumer participation; and
- an absence of meaningful legislative guidance to ensure the delivery of outcomes which advance the long-term interests of consumers, as articulated in the national energy objectives – the National Electricity Objective (NEO) in the case of NEL and its analogous provision as the National Gas Objective (NGO) in the case of NGL.

For background to the 2016 Review of the LMR regime, stakeholders are referred to the consultation documents available from the COAG Energy Council's website.²

Consideration of these issues lead the COAG Energy Council to agree to pursue reforms to improve the operation of the LMR regime as outlined in the Energy Council's Meeting Communique of 14 December 2016.

The areas of the LMR regime the COAG Energy Council intends to implement reforms to can be grouped into three broad categories.

- The first category relates to changes that can be made to reduce the extent of reliance on the LMR in establishing regulatory decisions that are accepted by all stakeholders.
- The second category relates to changes that can be made to improve the need to have recourse to multiple reviews on rate of return issues settled by the Tribunal through the LMR process.
- The third category relates to administrative changes that can be made to improve the LMR process, including procedural changes to the Tribunal's processes and strengthening the ability of consumer groups to be a more effective participant in the LMR processes.

The issues for consultation are briefly discussed below in the context of these categories of reform being considered by the COAG Energy Council.

2.1 Reducing reliance on the LMR regime

There is strong evidence to suggest that the LMR regime has become a regular feature of the regulatory decision-making process, contrary to the policy intent of having an LMR regime to only correct for material deficiencies in the regulator's decision. In the case of decisions by the

² Available at: <http://www.coagenergycouncil.gov.au/publications/review-limited-merits-review-regime-consultation-paper>.

ERA in Western Australia under the NGL, gas pipelines have sought Tribunal reviews of almost every access arrangement decision to date.³

While there may be legitimate reasons for gas pipelines to seek a review of the regulator's decision, there is a recognised need for changes to the LMR regime to refocus on setting a very high bar for reviews to be initiated.

There are three areas of reform that the COAG Energy Council is considering that could help achieve the objective of setting a high bar for reviews. These are:

- tightening and clarifying the grounds for review;
- a strengthened requirement for review appellants to demonstrate that overturning the regulator's decision would not be to the serious detriment of the long-term interests of consumers; and
- higher financial thresholds for leave to initiate Tribunal reviews that would apply to individual grounds for review.

The grounds for review has been identified as one of the principal failings of the current LMR regime in allowing considerable scope for unnecessary challenges to made to the regulator's decisions.

Summarily, the grounds for review under the LMR regime in the NGL (with analogous provisions in the NEL) provide for a merits review of certain regulatory decisions to occur if it can be established that the regulator made an error of fact, incorrectly exercised discretion or made an unreasonable decision.⁴ These grounds for review apply at both the leave and review stages of the Tribunal's decision process.

The policy intent for providing these specific grounds for review was to ensure that the LMR regime provided a restricted nature of merits review that was different from a 'de novo' or 'full merits review'. The recent decision by the Full Federal Court on the AER's judicial review of the Tribunal's decision on the review of New South Wales and Australian Capital Territory network business revenue decisions provides some important judicial interpretation regarding how the current grounds for review operate, and would operate in the future without reform.⁵

One approach to meeting the COAG Energy Council's intention of tightening and clarifying the grounds for review could be to shift the focus of Tribunal reviews away from error correction to the decision as a whole and limiting assessment of the merits of the regulator's decision to factual grounds. However, such an approach may result in grounds for review being more closely aligned to a judicial review standard, where the reviewability of the regulator's decisions on matters related to the correct exercise of discretion and unreasonableness in decision-making are principally assessed on the basis of errors of law. Such an approach raises a question as to whether the LMR regime would remain a proper merits review process

³ Since the NGL began operation in Western Australia in 2009, two gas pipelines have sought reviews from the Tribunal on their two consecutive gas access arrangement decisions. One gas pipeline has recently commenced a judicial review action on the ERA's most recent access arrangement decision for that pipeline in the Supreme Court of Western Australia. The judicial review action was commenced without recourse to the Tribunal under the LMR regime.

⁴ Section 246 of the NGL.

⁵ *Australian Energy Regulator v Australian Competition Tribunal (No 2)* [2017] FCAFC 79.

in practice, as initially intended by the COAG Energy Council when the LMR regime was introduced.

Changes to the grounds for review must ultimately ensure that the ability to seek error correction, or challenge an incorrect exercise of regulatory discretion is not about mere differences of view between the appellant and regulator, but rather based on the weight of evidence considered by the regulator and the reasonableness of the regulator's reliance on that evidence in arriving at its decision.

Questions for stakeholders

1. To what extent should the grounds for review under the NGL be amended to clarify and confine their scope such that Tribunal reviews are not routine and only sought where there is a genuine case to seek a review of the regulator's decision?
2. Has the recent Full Federal Court decision provided sufficient clarity about how the existing grounds for review should operate and are they consistent with the policy intent of providing a restricted nature of merits review that only correct for material deficiencies in the regulator's decision?
3. Will limiting the scope of review grounds to errors of fact likely lead to a reduction in the quality of regulatory decision making? If so, how?

Another change that the COAG Energy Council is considering relates to the current 'materially preferable' NGO test in the NGL, which requires that the Tribunal only proceed with a review and, subsequently only set aside the original decision, where correcting an error would *materially* contribute to the achievement of the NGO.

The materially preferable NGO test was introduced into the LMR regime in 2013 in response to concerns that Tribunal reviews were unduly focusing on error correction at the expense of consideration of whether the decision as a whole was preferable. The addition of this test was intended to reorient the LMR regime outcomes explicitly towards the delivery of the NGL's statutory objective of achieving regulatory outcomes that are in the long term interest of consumers.

It has been suggested that the materially preferable test is open to significant differences in interpretation, is challenging to implement at the Tribunal's review stage, and not practical to apply at the leave stage. The recent Federal Court decision on the AER's judicial review has provided some judicial commentary on the materially preferable test which may be helpful in determining the extent of changes necessary to achieve Tribunal decisions under the LMR regime that are in the long-term interest of consumers.⁶

⁶ Ibid.

Questions for stakeholders

4. How can the current materially preferable NGO test be amended to better achieve its policy intent of allowing the Tribunal to only set aside the original decision where a new decision would materially contribute to the achievement of the long term interest of consumers?
5. How can a more practical requirement be established at the leave stage for determining whether issues are sufficiently serious to proceed to a review by the Tribunal?
6. Should the materially preferable NGO test be amended to provide greater transparency regarding the trade-off between price changes and benefits to quality, safety, reliability and security of supply in the case made by appellants and/or the Tribunal to overturn the regulator's decision?

The third potential area of change to the LMR regime involves raising the financial thresholds to individual issues at the leave stage of the Tribunal's review, rather than allowing the collective impact of multiple small issues to meet the leave threshold. Under the NGL currently, the Tribunal is required to refuse leave for review of a gas access arrangement decision unless the amount that is specified in, or derived from, the decision to be reviewed exceeds the lesser of \$5,000,000 or two per cent of the average annual regulated revenue of the gas pipeline.⁷

There are concerns that current legislative provisions are having the unintended consequence of allowing a number of small, non-material issues to be contested at the Tribunal as they can be packaged with larger issues to meet relevant financial threshold requirements for being granted leave. To address these concerns, one option could be to substantially increase the value of financial thresholds. Some industry stakeholders suggested during the SCO's 2016 Review of the LMR regime that doubling the current leave financial threshold may provide a better balance between minimum review costs, and the revenue amounts being disputed.

Another option to address the leave financial threshold issue is to align the minimum financial threshold value to the constituent revenue components within each regulatory decision – i.e. the revenue building block components of a gas access arrangement decision.

Questions for consultation

7. To what extent should the financial threshold be increased to apply to the leave stage of Tribunal reviews to be an effective filter of excluding disputes about non-material issues?
8. Are there any specific implications for gas pipelines from increasing the current leave financial threshold?

2.2 Improving the determination on the rate of return

The rate of return (determined by the weighted average cost of capital or "WACC") and associated tax components are the largest elements of a gas pipeline's regulated revenue.

⁷ Section 249 of the NGL.

The smallest difference in regulator's determination on the rate of return allowance can have revenue impacts that are the order of millions of dollars. Hence, it is the most contested issue in the regulatory process.

The National Gas Rules (NGR) were substantially amended by the Australian Energy Market Commission (AEMC) in 2012 to introduce a requirement for the regulator to establish a rate of return guideline that, while non-binding in an access arrangement decision in a legal sense, would provide sufficient certainty for how complex financial parameters would be determined by the regulator at the time of making a particular gas pipeline's access arrangement decision.⁸

The AEMC set a three-year timeframe for the regulator to refresh its rate of return guideline through an industry review process. The intention of a periodic three-year review was to allow for flexibility to deal with financial market uncertainties and the evolution of new financial methods that could have an important bearing on how efficient financing costs of regulated gas pipelines should be estimated. It was also intended to allow the industry to provide collective input on how various financial parameters would be determined, thereby largely negating the need for repeated consideration of highly complex rate of return issues in each access arrangement decision.

In practice, the AEMC's rule change has done little to abate the level of contention between the regulator and gas pipelines in establishing settled approaches to many of the financial parameters that are pertinent to determining the rate of return allowance. The rate of return has remained the most contested issue in the regulatory process and subsequent Tribunal reviews. This is not just unique to gas pipelines, but the level of dispute is equally prevalent in revenue determinations of electricity network businesses.

The determination of the rate of return has been identified as a key area of reform to improve the LMR regime because of the need for gas pipelines to initiate multiple reviews to contest rate of return methodologies and financial parameters that are sufficiently common across all access arrangement decisions. At present, there are repeated considerations of the same rate of return issues in each gas pipeline access arrangement determination process, with further disputation of those same issues multiple times through the LMR process initiated by each gas pipeline.

The problem of multiple consideration of rate of return issues occurs for two reasons. First, the regulator's rate of return guideline is not binding, meaning that gas pipelines (and other stakeholders) are able to argue during each access arrangement decision for the regulator to consider departing from any specific methodology or financial parameter estimation established in the rate of return guideline.

The second reason is where methodologies or financial parameters are appealed by the gas pipeline for review by the Tribunal, and that appeal remains unresolved at the point at which the regulator's determination for the next gas access arrangement in the regulatory cycle is due. This issue is particularly problematic in the context for the substantial number of gas pipelines and electricity network businesses regulated by the AER, but is equally an issue for the ERA in Western Australia in regulating the three gas pipelines in sequential regulatory cycles. There is currently no ability for gas pipelines to seek an industry wide Tribunal review

⁸ The AEMC also introduced similar arrangements for the determination of rate of return for electricity network businesses in the National Electricity Rules at the same time.

of the regulator’s approach to rate of return determination outside of an individual access arrangement regulatory decision (or individual revenue determination in the case of electricity network businesses).

One way to address the need to initiate multiple Tribunal reviews on rate of return determination is to make the existing rate of return guideline ‘binding’. This would mean that once the rate of return guideline was periodically established by the regulator through appropriate industry review and consultation, there would be no scope for stakeholders to raise any case for departure during any individual access arrangement decision within the guidelines’ application period. The application period for the rate of return guideline would apply for three years as is currently the case, or could be extended for a longer period.

For this approach to work, rate of return related matters would no longer be subject to LMR in each access arrangement decision as is currently the case. This is necessary because for the rate of return guideline to be binding, it cannot be open to reconsideration during an access arrangement regulatory decision, and be made subject to any subsequent review by the Tribunal on an individual basis.

A question remains about whether the binding rate of return guideline should be subject to a separate merits review process. Allowing industry, particularly gas pipelines, to collectively seek merits review of a binding rate of return guideline would ensure that the regulatory framework maintains accountability and transparency in regulatory decision-making, especially in an area where regulatory decisions have the potential to have substantial impact on investor confidence and the ability of gas pipelines to attract future investment capital. It would also ensure that rate of return issues would be periodically contested through the merits review process once, rather than multiple times.

Questions for stakeholders

9. To what extent would a binding rate of return guideline resolve issues of multiple Tribunal reviews on rate of return matters?
10. How should a binding rate of return guideline be implemented and what level of prescription should the guideline contain?
11. Should a binding rate of return guideline be subject to a separate merits review process? If so, what should be the scope of this review and how could it operate effectively to reduce the level of contention on rate of return matters?

2.3 Administrative changes

Administrative reforms to the LMR regime being considered by the COAG Energy Council include:

- Tribunal reviews to be conducted ‘on the papers’ and within a strict timeframe;
- costs incurred by the regulator in Tribunal reviews being borne by gas pipelines;
- setting strict time limits for gas pipelines to submit material to the regulator during an access arrangement process; and
- facilitating more flexible arrangements for consumer participation in Tribunal reviews.

Changes to how the Tribunal conducts its reviews and the timeframes in which those reviews are conducted has been necessitated by concerns that, despite significant changes in 2013, the LMR process remains inherently legalistic, adversarial, lengthy, costly and creates significant barriers to consumer participation. Some of the changes that can be made to enhance the Tribunal's process and timeframe could include:

- requiring the Tribunal to undertake its review primarily through submission of written material by parties with only limited exceptions for holding oral hearings;
- introducing procedural discipline to the review process through page limits and prescriptive requirements on the form of submissions to be made to the Tribunal; and
- establishing firm deadlines within which the Tribunal must complete its reviews.

Questions for stakeholders

12. What changes can be made to provide a more efficient and timely review process that better enables the Tribunal to identify and focus its limited resources on the substantive issues in contention?

The case for requiring gas pipelines to cover the regulator's cost of Tribunal reviews is designed to partially address the current imbalance in the strongly perceived incentive of gas pipelines to seek higher revenues through the LMR process at substantial financial and resource expenses that the regulator has to incur in defending its primary decision.

Requiring gas pipelines to cover the regulator's cost can be based on the legal principle of costs following the event – that is, to not require gas pipelines to fund the correction of errors in the regulator's decision, but equally ensure the regulator is not awarded costs against the gas pipelines in all circumstances.

Questions for stakeholders

13. Should gas pipelines pay the costs of the regulator's participation in Tribunal reviews?
14. Would it be reasonable to not require gas pipelines to pay for the regulator's costs of participation where the Tribunal identifies errors and varies or sets aside the regulator's decision?

The rationale for setting strict time limits for submission of material to the regulator is driven by concerns that current regulatory requirements encourage strategic behaviours by gas pipelines whereby lengthy, complex and legalistic material can be submitted to the regulator very late in the access arrangement decision process. Specifically, the NGR currently does not preclude gas pipelines from submitting material to the regulator very late in the process, leaving the regulator little time to consider matters raised before meeting required timeframes for making its final access arrangement decision. Once submitted, the material falls within the scope of 'review related matter' which can be considered as part of the Tribunal's review process.

Questions for stakeholders

15. Should the Tribunal be prevented from considering material which the regulator could not reasonably have had time to consider as part of its initial access arrangement decision?
16. Should there a fixed cut-off time for material that the regulator can consider as part of its access arrangement decision process?

It is widely recognised that consumer groups face significant resourcing challenges in participating in both the regulator's primary decision process and subsequent Tribunal reviews through the LMR processes. In Western Australia, the level of consumer engagement in gas access arrangement decisions, and subsequent Tribunal reviews, has been particularly lacking. There is a clear need to ensure consumer groups have adequate funding to provide a counterpoint for claims by gas pipelines for increases in their regulated revenue allowances.

Questions for stakeholders

17. How can consumer participation in Tribunal reviews be improved?
18. What options could be explored to allow greater industry funding for participation by consumer groups in the primary decision process and subsequent Tribunal reviews?

3. Making a submission

Written submissions are invited on this consultation paper. Submissions should be received by the Public Utilities Office by **30 June 2017**.

Electronic copies of submissions are preferred and should be emailed to PUOsubmissions@finance.wa.gov.au. Alternatively, submissions can be sent to:

Reforms to Limited Merits Review Regime
Attn: Zaeen Khan
Public Utilities Office, Department of Finance
Locked Bag 11
Cloisters Square WA 6850

In the interests of transparency and to promote informed discussion, submissions will be made publicly available. If a person making a submission does not want that submission to be public, that person must make a claim for confidentiality in respect of the document (or a clearly designated part of the document). Claims for confidentiality should be clearly noted on the front page of the submission and the relevant sections of the submission should be marked as confidential, so that the remainder of the document can be made publicly available. In that circumstance it would also be appreciated if two copies of the submissions could be provided: one complete version and a version in which the confidential information is excised. Persons making any claim for confidentiality should familiarise themselves with the provisions of the *Freedom of Information Act 1992 (WA)*, which imposes a range of obligations on the Department of Finance in relation to the production of documents.

Submissions will be available for public review at www.finance.wa.gov.au/publicutilitiesoffice. Contact information, other than your name and organisation (where applicable) will not be published.

Any enquiries on this consultation paper should be directed to Zaeen Khan on (08) 6551 4661 or via email at zaeen.khan@finance.wa.gov.au.

4. Disclaimer

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