

By email: [energycouncil@industry.gov.au](mailto:energycouncil@industry.gov.au)

Dear Energy Council Secretariat

### **Spark Infrastructure's response to the review of limited merits review consultation paper**

Spark Infrastructure welcomes this opportunity to submit a response to the COAG Energy Council's (the Energy Council's) review of the limited merits review (LMR) regime consultation paper.

Spark Infrastructure is an Australian listed investment vehicle, with a market capitalisation of around \$4 billion. As an owner of regulated electricity transmission and distribution networks in New South Wales, South Australia and Victoria, Spark Infrastructure has a keen interest in the outcomes of this LMR review. Importantly, the outcomes must continue to promote the long term interests of consumers by not diminishing investor confidence in the stability of Australia's energy regulation regime and the decisions made within it.

Spark Infrastructure considers that LMR must be maintained, and where this review considers modifications, these must take in to account:

- The critical role of LMR in a stable regulatory regime
- The necessity of a stable regulatory regime for investor confidence
- That private investment is essential for ensuring the sustainable provision of services to consumers
- That issues attributed to the LMR regime will not be effectively resolved simply by changing the review framework alone because the primary decision process must also be addressed.

Importantly, a decision to seek merits review of an Australian Energy Regulator (AER) decision is not one taken lightly. Industry practice, and that of assets Spark Infrastructure invests in, is for boards to weigh up the relevant considerations of sustainable service provision, reputation, and future recovery of investments. Boards do so having due regard to market expectations, management advice and policy guidance. In this context, the fact that reviews have recently been sought confirms the quality of AER decisions warrants testing.

Spark Infrastructure does recognise there is room for improvement. Regulatory regime outcomes have shown deficiency in decision processes, AER performance and customer participation. This review can incrementally refine aspects of the LMR regime and the Energy Council can improve the AER's primary process to the benefit of all stakeholders.

Spark Infrastructure has prepared this submission to the Energy Council's consultation paper because it feels compelled to call out the important context and considerations that investors bring to this review. This submission explains:

- *Review context* – The uncertain energy policy and governance context facing energy infrastructure investors to which this review of LMR contributes
- *Role of LMR in investor confidence and costs* – The critical role of LMR in a stable regulatory regime that applies to infrastructure assets that have long service and investment lives
- *Recent LMR activity and status of prior reforms* – The importance of objectively assessing prior LMR activity and seeing through processes arising from recently implemented reforms prior to making further modifications that risk being poorly targeted or redundant
- *Implications of further reform options* – Key investor perspectives on the consultation paper options, including the reasons why Spark Infrastructure firmly believes that:

- i. LMR must be retained because judicial review alone cannot support a stable regulatory regime with the required degree of perceived regime legitimacy in the eyes of all stakeholders that is needed to promote consumers' long term interests
- ii. any further regime modifications must not only be based on evidence and sound analysis and be targeted, effective and infrequent but also be tested against the outcomes of the current review processes once completed

Spark Infrastructure would be happy to meet with the secretariat to discuss this submission further. Please contact Sally McMahon, Economic Regulatory Advisor on 0421057821 with any queries or to arrange a further discussion.



**Rick Francis**  
Managing Director & CEO  
Spark Infrastructure

## 1. Review context

Spark Infrastructure urges the Energy Council, its Senior Committee of Officials' (SCO) and its secretariat to:

- take an objective and holistic approach in making any further modifications to the LMR framework
- be mindful of the uncertain energy policy and governance context presently facing energy infrastructure investors, and within which they are conducting this LMR review.

Investors in the energy network sector are seeing numerous reviews, and yet little policy attention to implementing the outcomes of prior reviews before initiating further ones.

Spark Infrastructure appreciates that this LMR review arises from a commitment to a further review three years after the 2013 LMR review. However, those 2013 LMR reforms have not yet run their course, and current policy effort would be better directed to implementing existing recommendations of prior reviews.

### 1.1 Frequent review, and ongoing uncertainty about the outcomes of these reviews increases risk under the regulatory regime and erodes accountability over decisions and implementation

Given the long-term nature of its investments, Spark Infrastructure acknowledges that the energy sectors' policy, governance and regulatory framework will be reviewed. This has been true of recent experience, often with concurrent reviews looking at interrelated elements of the regime and making material change recommendations.

However, where reforms are put in place, these should be given opportunity to take full effect prior to considering further reforms. This LMR review does not enable this appropriate sequencing to occur. The merits review applications underway—which have occurred subsequent to the last round of LMR reforms—are yet to be completed.

Investor confidence is being reduced because, while the Energy Council has noted or accepted recommended regime modifications developed to address previously identified issues, many of these are yet to be implemented.

Relevant to this LMR review are several recent high profile reviews which have either not run their course, or their recommendations have not yet been actioned by the Energy Council. These include:

- *Energy markets governance* – This review considered the governance of the Australian Energy Markets<sup>1</sup> and its findings highlighted issues associated with the AER's performance:
  - i) The Energy Council acknowledged and agreed<sup>2</sup> that the panel had made a case for considering structural change to the AER to address identified performance deficiencies. In particular the deficiencies related to the panel finding that the AER has neither the control nor resources to achieve its tasks and be fully independent.<sup>3</sup> The Energy Council requested further work examining how a differently constituted AER would better deliver on energy customers' long term interests. Investors are perplexed that despite these findings, there is surprise at the number of AER decisions where LMR has been sought.
  - ii) The December 2015 Energy Council response also agreed with the expert panel's recommendation that the AER's performance be reviewed every three to five years by a panel of COAG-appointed experts. Investors consider that this review should have taken precedence over the current LMR review.

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<sup>1</sup> Dr Michael Vertigan AC, Professor George Yarrow, Mr Euan Morton, Review of Governance Arrangements for Australian Energy Markets, Final Report, October 2015.

<sup>2</sup> The COAG Energy Council response to the Review of Governance Arrangements for Australian Energy Markets, 4 December 2015, response to recommendations 4.1 and 4.4.

<sup>3</sup> Dr Michael Vertigan AC, Professor George Yarrow, Mr Euan Morton, Review of Governance Arrangements for Australian Energy Markets, Final Report, October 2015, p. 8.

- *2012 increases to AER discretion* – The 2012 changes to the national gas and electricity rules (the Rules) were initiated by the AER and expressly designed to afford it a greater degree of regulator discretion on the material network cost drivers of rate of return, and expenditure forecasts. The decisions under the new rules that have been subjected to review are yet to be completed. That is, the determinations by the Australian Competition Tribunal (Tribunal) upheld or remitted to the AER and now subject to review by the Federal Court, have yet to be completed. Therefore, it is premature to draw conclusions on the longer term performance of the LMR regime.
- *2013 LMR changes* – The 2013 changes to the national gas and electricity laws (the Laws) relating to LMR provided important guidance to the Tribunal on standing, objectives and remittance relevant to the issues considered in the current review. But these have not yet been completely implemented for any network, pending the outcome of the AER’s judicial review application, making it premature to judge their efficacy.
- *Current review of gas coverage criteria* – The ACCC’s recent East Coast Gas Inquiry (ACCC Inquiry), recommended strengthening the gas pipeline access regime, and subsequently Dr Michael Vertigan AC has been tasked by the COAG Energy Council to ‘*Examine the current regulatory test for the regulation of gas pipelines, in consultation with stakeholders, and provide recommendations on any future action to the Energy Council, including potentially replacing the test.*’ Implications of this are that gas infrastructure investors face:
  - i) review of how decisions on whether and how to regulate their assets will be made concurrent with this LMR review which could determine whether those decisions can be reviewed on their merits. The ACCC Inquiry was cognisant of the effect that regulation can have on investment and innovation but noted there are already sufficient safeguards in the National Gas Law and Rules, ‘*including the availability of merits review*<sup>4</sup>.
  - ii) the possibility that a strengthened gas pipeline access regime might be introduced while at the same time an important safeguard against regulatory error in decisions about applying this strengthened access regime might be removed.

## 1.2 Objective assessment must address what recent reviews have already found

When one acknowledges that a review of an AER decision under the LMR regime is taken at the end of a lengthy AER process required by the rules, it becomes apparent that the key contributor to LMR activity is the quality of AER’s process and decisions.

To only consider options to address the LMR regime and review body—particularly in the current absence of outcomes from this process—could unnecessarily constrain the effectiveness of any further modifications.

Faced with the review and regime change outcomes noted above from recent reviews, investors are at a loss to understand the singular focus on the LMR regime for the issues identified in the consultation paper, rather than acknowledging the contributions of:

- significant changes to the rules that expanded the discretion afforded to the AER when determining the largest contributors to the demand for investor funds, rate of return and expenditure
- widely recognised deficiencies in the performance of the AER which remain unaddressed.

Question 1 of the consultation paper asks:

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

Clearly the answer is *yes there are*. A prime driver of LMR review activity has been the primary decision making process of the AER and its refusal to accept Tribunal precedent established by previous reviews and follow its own guidelines.

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<sup>4</sup> ACCC, Inquiry into the east coast gas market, April 2016, p.21.

Although, there are likely to be modifications to the LMR regime that will assist with the expediency of the review processes, these should not be considered as being the only modifications required. Spark Infrastructure urges the Energy Council to follow through on its commitments to improve the AER's performance.

### 1.3 The role of private energy infrastructure investment in Australia is critical and growing

Private capital presently invested directly as equity or as debt financing for Australia's energy networks totals tens of billions of dollars. Private investment is critical to the continued provision of reliable and efficient network services and to ensure timely and efficient growth of energy infrastructure to meet increasing customer expectations.

The Harper National Competition Policy Review<sup>5</sup> observed that the outcomes achieved under private investment in Australia's energy infrastructure are more consistent with supporting the long term interests of consumers than outcomes being achieved by state-owned energy infrastructure.

Privatisation of remaining state owned assets will continue to increase the importance of private investment and investor confidence to the sector's performance. Capital for such private investment is sourced globally, and local infrastructure investments must compete for capital globally. Access to LMR is a significant contributor to both domestic and international investor confidence and a lower cost of capital, as explained in section 2.

### 1.4 Spark Infrastructure's investment in Australia's regulated energy infrastructure is material and long term

Spark Infrastructure makes long term investments in leading Australian energy networks. It has been an ASX listed investment vehicle since 2005, with a market capitalisation of around \$4 billion.

Spark Infrastructure's investment portfolio includes 49% interests in SA Power Networks, CitiPower and Powercor, and 15.01% interest in TransGrid. It is 80% owned by Australian institutional and retail investors; approximately 19,000 individual security holders. The regulated assets in which Spark Infrastructure holds an equity interest collectively need to refinance approximately \$8 billion<sup>6</sup> of debt over the next five years.



### 1.5 Proportionate process for a significant issue

The compressed timeline adopted by the Energy Council for this LMR review is itself a concerning contextual factor for investors. The timetable set out in the consultation paper is materially less than equivalent prior reviews. Removal of LMR, as contemplated in option 4, would have significant impacts. While Spark Infrastructure strongly advocates that Option 4 should be removed from consideration, if this option is to remain on the table, then the process for evaluating it should be far more rigorous than would be possible under the current review timeline.

Well targeted modifications may have a positive impact on investment, but poorly targeted modifications that ignore relevant information such as expert review recommendations and outcomes from the current round of reviews will give rise to increasing frequency of reviews and review fatigue.

Significant changes and activity since the last revisions to the limited merits review regime were introduced need to be taken in to account, and as a minimum, this LMR review should:

- Re-visit the recommendations from the governance review of Australia's energy markets and implementation of the full package of recommendations to achieve COAG's policy objectives
- Incorporate the experience and evidence from the conclusion of the current reviews, including the grounds, outcomes and reasons when assessing performance of the LMR regime

<sup>5</sup> The Australian Government Competition Policy Review, March 2015, section 11.1.

<sup>6</sup> Spark Infrastructure HY 2016 results presentation, August 2016, pp34-36

- In understanding the factors that have given rise to applications for LMR, properly isolate the effects of changes to the rules and other transitory issues from longer term systemic issues
- Consider both modifications to the primary decision process as well as complementary modifications to the LMR regime
- Undertake and incorporate the review of the performance and structure of the AER as previously agreed by the Energy Council.

## 2. Role of LMR in investor confidence and costs

### 2.1 Stable regulation requires checks and balances on decisions affecting property rights, especially where considerable discretion is exercised

LMR plays a vital role in maintaining a stable regulatory regime to support efficient investment in Australia's energy infrastructure assets. These assets have long service and investment (or lease) lives, which outlive any one five-yearly regulated revenue decision.

Investors in energy networks invest across jurisdictions in Europe, the Americas, Asia and Australia and allocate financial capital and service debt based on confidence in the transparency and stability of each regulatory system. These investors have confidence in the Australian regulatory system for four reasons:

- The separation of powers characterised by rule making by the Australian Energy Markets Commission (AEMC) and rule application by the AER
- The independence of the both the AER and AEMC from Government
- The existence of an effective review mechanism to guard against AER decisions that are in error, unreasonable in the exercise of discretion, or are otherwise unreasonable
- Reliance on precedent and consistency in decision making.

Merits review is an integral part of the economic regulation framework designed to facilitate efficient investment. It provides an opportunity to mitigate risk and reduce uncertainty. Where the risk is not mitigated, it leads to uncertainty about achievable returns and therefore a decision to invest less or not to invest at all.

Merits review provides recourse if things go wrong. It is not a guarantee of a particular outcome, but rather a guarantee of predictability that outcomes will not as a rule be subject to error, unreasonable use of discretion or lack independence from political interference.

Measuring the impact of investment uncertainty is difficult because it is unlikely to be identifiable in the short term, is unable to be compared to an alternative scenario and can be difficult to quantify and value.

It is also difficult to measure the costs to Australian energy users of limited access to services, lower safety standards and poorer reliability—all of which would result from inefficiently low levels of investment.

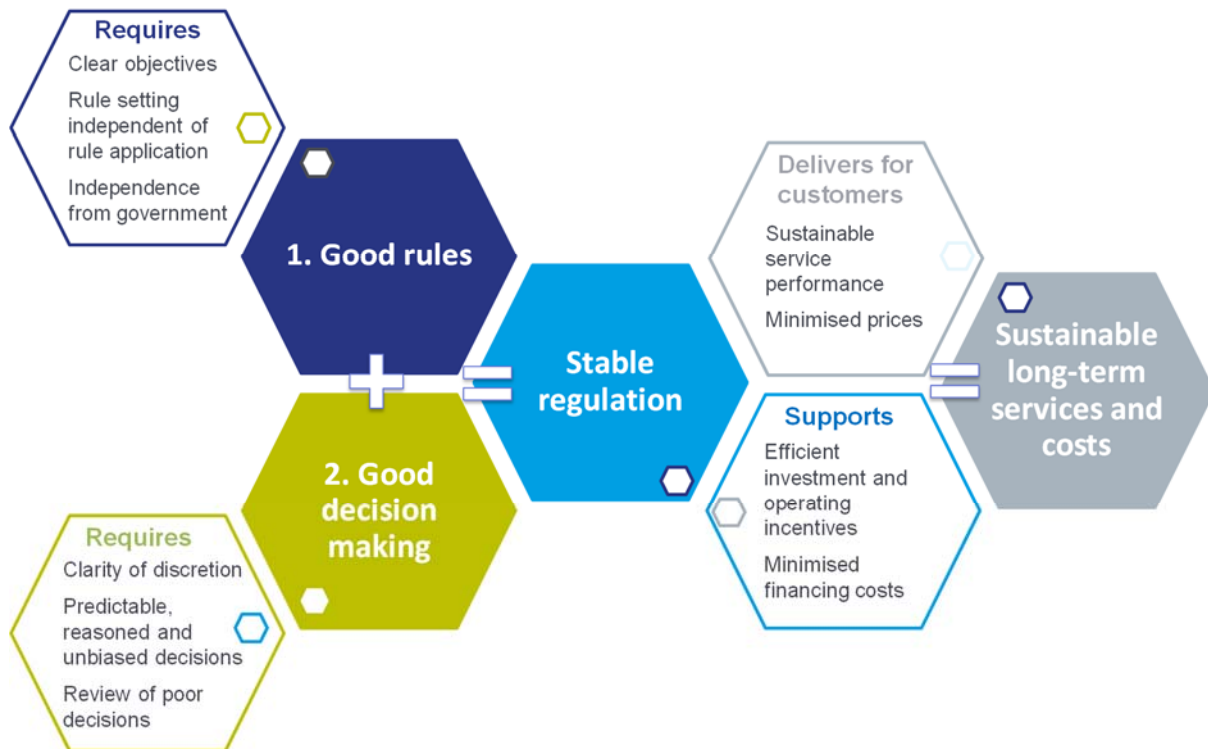
### 2.2 LMR supports the necessary preconditions for stable regulation

Spark Infrastructure cautions the Energy Council that investors must be assured of their ability to recover their investments over time. As Figure 1 illustrates, this requires *both*:

- 1) A good rules framework with clear scope of discretion, *and*
- 2) Good decision making within that framework through proper exercise of discretion.



Figure 1 | Preconditions for stable regulation



Australia's electricity and gas LMR regime plays a critical role in meeting these preconditions. It supports clarity of discretion afforded to the AER and good decision making through proper exercise of this discretion by:

- *Unbiased decisions* – Providing a check and balance over AER decisions, including reducing scope for volatility from the political and policy environments, or regulator capture by any given stakeholder (including the regulated firms)
- *Reasoned decisions* – Strengthening incentives on the AER to produce good quality decisions supported by transparent and robust reasons under the rules, because the credible threat of a decision being reviewed by a suitably qualified body for error or poor judgement should motivate the AER to resource and conduct itself so as to have the best decision possible in the first place, and thereby avoid further review and associated reputational damage
- *Quality decisions* – Serving as a necessary and appropriate partner to regulatory discretion, by instilling confidence in all stakeholders that error or improper exercise of AER discretion in decisions that materially affect billions of dollars of private property can be challenged based on the quality of those decision not just their legality
- *Clarity of discretion* – Improving decision quality over time though establishing confirmed precedent of what application of the rules best supports customers' long-term interests
- *Predictable decisions* – Applying confirmed precedent and administering robust consultation processes to support the primary decision, and thereby reducing the need for further LMR applications over time.

Spark Infrastructure notes that the Energy Council's options assessment must consider the extent to which each option is capable of achieving all five of these preconditions for good decision making.

### 2.3 A stable regulatory regime is a key consideration when choosing when, where, how much to invest

The debt and equity capital that funds Australia’s energy infrastructure is globally sourced to efficiently minimise costs. Investors allocate capital across regulatory jurisdictions from across the world, and the effects of their perceptions of Australian regulatory stability will cascade through networks’ access to and cost of capital because:

- Australian utilities source debt from global markets, including Australia
- Listed owners (including Spark Infrastructure, DUET, AusNet and APA) source debt and equity capital from domestic and offshore investors
- Foreign owners (Singapore Power, State Grid Corporation of China, CKI, ATCO) and domestic offshore direct investors (super/pension and sovereign funds) allocate capital across their global portfolios.

In preparing this submission Spark Infrastructure surveyed a number of investors in the sector, the results of which are set out in Box 1. These show a common view about the important role LMR plays in Australia’s stable regulatory framework.

Regulatory uncertainty is a major barrier to investment in infrastructure, particularly for overseas investors.<sup>7</sup>

A stable regulatory regime will attract investment, whereas an unstable one will discourage it and make it costlier. It is well documented that unstable regimes that have none or less robust versions of the checks and balances noted in the above preconditions attract significant country risk premiums on their capital inflows and insurances.<sup>8</sup>

The scope for access to LMR to affect financing costs is evidenced in recent commentary from Moody’s.<sup>9</sup>

*“Appeal process balances the Australian Energy Regulator’s (AER) discretionary powers. The ability of the networks to contest the regulator’s revenue/tariff decisions evidences limits on the increase since 2013 in the AER’s level of discretionary power, and reinforces the transparency and predictability of the regulatory framework, a fundamental credit support for the networks.”*

In Spark Infrastructure’s own experiences dealing with foreign capital, access to robust merits review contributes significantly to investor confidence to provide capital, often in a binary capacity.

#### Box 1 | Investor survey

*“Limited Merits Review has provided best practice protections for Australian energy networks, especially as they pass through regulatory determinations. It is important that mistakes in the application of economic regulation get resolved via a timely and efficient process. The low risk and high quality of Australian regulated networks in a global context is partly attributable to the effective appeals process, which has been in place for many years.”*

David Maywald | Senior Investment Analyst and Portfolio Manager - Yield Strategy | RARE Infrastructure Limited

*“Magellan Asset Management strongly encourages the Council of Australian Governments Energy Council to recommend the preservation of the existing limited merits review (“LMR”) regime under the National Electricity Law and the National Gas Law. As a long-standing investor in this sector, we consider that LMR plays a crucial role in establishing a transparent and equitable regulatory framework that promotes efficient investment. Moreover, we consider this regime a vital safeguard against the risk of erroneous regulatory determinations destroying the capital that our investors have entrusted to us”.*

Gerald Stack | Head of Investments | Magellan Asset Management Limited

*“Investors Mutual strongly supports the retention of a Limited Merits Review (LMR) regime. As outlined in the objectives for administrative review and objectives for merits review, a key outcome of the review process is ensuring transparency and enabling a mechanism for the correction of errors. If left solely to a judicial review framework, the rights of recourse for network operators*

<sup>7</sup> An example of the role of regulatory certainty in classifying investments is outlined in QIC, Submission to Productivity Commission Inquiry into the Economic Regulation of Airport Services, 8 April 2011, p. 4.

<sup>8</sup> For example Delcredere | Ducreire, the Belgian public credit insurer, publishes country risk rankings that among other things include detailed assessment of expropriation and government action risk.

<sup>9</sup> Australian Regulated Electricity and Gas Networks – 2017 Outlook, Moody’s, 14 June 2016.



In the case of the TransGrid acquisition, the existence of LMR was an important consideration on the due diligence process, in particular for Spark Infrastructure's offshore partners (CDPO, ADIA and Wren House) and it forms a central part of the assessment of the regulatory regime which in turn has a material impact on the asset valuation.

It cannot be overlooked that reduced confidence by investors in debt and equity will increase the cost of capital that, when properly recognised as contributing to the efficient cost of services will increase prices to consumers, and if not properly recognised, will reduce investment in the provision of services.

*on matters of administrative error could be significantly diminished given the judicial review process is predominantly focused on procedural correctness. This could potentially alter the risk profile of network companies and their ability to attract scarce capital resources when assessing new or existing investment options compared to an environment where an LMR regime exists."*

Anton Tagliaferro | Investment Director | Investors Mutual Limited

### 3. Recent LMR activity and status of prior reforms

Spark Infrastructure considers that it is premature to modify the current LMR regime before outcomes of the current reforms and associated reviews are known. Until then, the Energy Council will be:

- Unable to appropriately assess option 1
- Unable to take action that is properly informed and sufficiently targeted to *actual* rather than perceived deficiencies in the recent 2013 LMR changes.

#### 3.1 The context of the 2013 LMR changes makes current LMR activity unsurprising to investors

The current LMR activity is more likely to reflect issues arising outside of the LMR regime than the 2013 LMR changes which are yet to run their course. The 2013 changes were introduced concurrently with the 2012 rule changes instigated by the AER which increased AER discretion on material issues of the allowed rate of return and assessing expenditure forecasts.<sup>10</sup>

The extent of the increase in regulatory discretion was accompanied by a requirement for the AER to publish guidelines on how it would exercise this greater discretion. This was a necessary complement to the shift in the regulatory regime to support ongoing confidence in its stability.

However, these guidelines did not achieve their purpose of providing clarity and predictability about decision making under these newly made rules:

- *The rate of return guideline didn't adhere to the new rules for return on equity* – The rate of return guideline shocked investors and regulated firms by ignoring the guidance of the AEMC in the 2012 return on equity rule changes. Instead, the AER established a return on equity approach that substantively locked in its former practice of relying on Sharpe Lintner capital asset pricing model and not placing any weight on other available models for estimating return on equity. This was despite the rules having been explicitly amended to allow the AER to use these.
- *The assessment guideline wasn't followed in actual AER decision making* – The expenditure assessment guideline foreshadowed using new economic benchmarking techniques as part of what the AER described as a 'first pass test' for looking at expenditure efficiency which would then influence the form and level of scrutiny the AER would use in assessing opex. However, in its actual decision for the NSW and ACT electricity distributors, the AER applied this 'first pass test' to set the allowed opex for these businesses in a deterministic manner.

<sup>10</sup> Those changes also introduced new untested terms. Much of the subsequent reviews have been about understanding these terms (e.g. 'efficient financing costs' and 'benchmark efficient entity').

So it was unsurprising to Spark Infrastructure that the first businesses affected by the new rules and guidelines sought review of the AER's decisions on these material issues. It was also unsurprising when subsequent reviews occurred on similar issues given the lack of resolution of contested matters or the adoption of precedent on these issues. Table 1 seeks to put simply, how these issues were understood by the investment community.

**Table 1 | Investors' understanding of recent LMR activity**

Ground	AER's exercise of discretion	Question for investors
Return on equity	The AER did not appear to expand its consideration of cost of equity models despite being explicitly encouraged to do so under the amended rules. Further, the methods it used to estimate the parameters of the adopted single model did not appear to be capable of delivering a commercially reasonable return.	Was this a proper exercise of discretion?
Return on debt	The manner in which the AER effected the transition to a trailing average did not have due regard to the financing practices of efficient businesses.	Was this an error?
Tax costs	The AER ignored prior Tribunal precedent about what method of valuing imputation credits best supported the national gas and electricity objectives, and instead determined these on their utilisation rather than their value as required by the rules.	Was this a proper exercise of discretion?
Expenditure forecasts	The AER used new untested benchmarking tools to determinatively cut operating expenditure allowances by as much as a third.	Was this a proper exercise of discretion?

All four of the grounds outlined above related to rules that were new or significantly amended in the 2012 rule changes. Seeking review of these decisions given the significance of the changes in the rules and practices of the AER was appropriate for two reasons:

- The material financial implications of these decisions on the ability for the businesses to recover the efficient costs of providing services, including the cost of debt and equity, putting at risk
  - i) the ability for investors to earn a return on investment and attract funds
  - ii) materially compromising the services being provided to consumers over time with regard to cost, reliability, quality, safety and security of supply.
- To establish important precedent in the wake of significant discrepancies in the interpretation of the new rules and guidelines. The establishment of precedent facilitates stability and would be expected to result in a reduced demand for future reviews where that precedent is duly followed.

### 3.2 Full implementation of the 2013 LMR changes has been halted by the AER's actions

The 2013 LMR changes deliberately instructed the Tribunal to remit what are necessarily complex decisions back to AER to remake, having regard to:

- The Tribunal's finding on error and the proper exercise of discretions afforded to the AER under the rules, as well as
- The decision interdependencies that need to be weighed up in developing a substitute materially preferable decision.

While this bias created some concern for Spark Infrastructure about the timeliness of remade decisions, it was understood within the policy makers' stated desire to achieve holistic materially preferable decision making. With the benefit of hindsight, it now seems remiss to have not put appropriate constraints on the timing and manner in which the AER should remake such decisions.

The AER's reaction to substantively decline to remake the decisions and instead seek judicial review of the Tribunal's decisions means we have not yet had the opportunity to properly assess how the full 2013 LMR changes will work in practice.

The AER has chosen not to use the new precedents established by the Tribunal in its subsequent decisions. As a result, many of grounds set out in networks' LMR applications for subsequent AER decisions are directly consequent on the AER not following Tribunal-established precedent. It is therefore not appropriate to consider these reviews as a failing of the LMR framework but rather a result of the AER effectively delegating responsibility for these decisions to the Tribunal.

It is this assessment of the *substance* of recent LMR activity, rather than the superficial assessment of the *volume* of such activity that informs investor confidence, and must also be what informs any policy response arising from this LMR review. In this context, the only questions that the volume of activity raise for Spark Infrastructure relate to the AER's performance in exercising its discretions.

### 3.3 Evidence gleaned from this context cannot sustain a decision to remove LMR

A proper consideration of the context shows that current outcomes reflect a functioning LMR framework with the potential to give effect to the policy objectives of the 2013 LMR changes. Policy response in this LMR review cannot cite these circumstances as evidence to discard this important check and balance altogether.

In this context, Table 2 sets out Spark Infrastructure's views on the consultation paper's identified areas for performance consideration from the current (post 2013) LMR regime.

Table 2 | Performance considerations in the current context

Consideration	Situation	Status for the purpose of considering LMR amendment
Threshold for review	The matters which were granted leave for review had a material financial bearing on the ability of the affected networks to sustainably provide the cost, reliability, quality, safety and security of supply outcomes that their customers value. This is especially true when the precedent value of these decisions is taken into account.	Capable of consideration
Basis of the Tribunal's decisions	The question of describing in a decision document how a given decision accounts for customers' long term interests, as opposed to asserting that it has, is one equally levelled at the AER.  Addressing the quality of the AER's primary decision and the 'how' element of its NEO and NGO considerations therein will make it easier for future Tribunal decisions to address this point in a more targeted fashion.	Requires consideration of the quality of the primary decisions
Material considered by the Tribunal	The scale of information before the Tribunal is a direct function of the scale of information required by the AER in its primary process. Much of this results from the price reset regulatory information notices that the AER serves on networks to specify the information it considers necessary to apply the rules.	Requires consideration of the quality of the primary decisions and the extent of information the AER demands for these
Approach adopted in reviews and	Customer participation has increased, and there remains scope for the efficacy of this to be increased.	Capable of consideration

Consideration	Situation	Status for the purpose of considering LMR amendment
consumer consultation		
Delivery of regulatory certainty	<p>The past LMR reforms have not been given full effect through completion of any remade AER decisions, which are the outcome that is needed for assessing certainty.</p> <p>The AER has not consistently followed Tribunal precedent where this is available to it, which erodes certainty.</p>	Too early to judge this aspect of current performance

Further, LMR also affects coverage decisions of the National Competition Council and Ministers. Having a robust process for determining whether to regulate and if so, to what extent, is a key consideration for investor confidence. While the outcomes of this LMR review would affect this important aspect of Australia’s energy regulation regime, the Consultation Paper provides no comfort that it is being properly accounted for.

#### 4. Implications of further reform options

Spark Infrastructure has set out in this section its key investor perspectives on the consultation paper options. Chief among these are the reasons why Spark Infrastructure firmly believes that judicial review alone (Option 4) cannot support a stable regulatory regime that promotes the long term interests of consumers,

Spark Infrastructure considers that there may be modifications to the LMR regime that could improve investor confidence and alignment with policy objectives (option 2). Nevertheless, further modifications should only be implemented when the current reviews are complete and proposals for change assessed against those outcomes. This will ensure they remain relevant and target the right problems.

If there are to be any changes to the LMR regime arising from consideration of these options, they must be further consulted on, and must ensure:

- Errors and use of discretion can be reviewed and addressed
- The solutions address the right problems, being causes not symptoms
- Continued independence of economic regulation decisions from government
- A clear distinction between the regulator giving effect to the law and rules, and consumer advocacy.

##### 4.1 Option 1 – Retain the Tribunal as the review body without legislative amendments (status quo)

Spark Infrastructure recognises that there may be modifications to the LMR regime that could improve investor confidence and alignment with policy objectives. However, premature identification and implementation of modifications risks overlooking relevant information, incorrectly diagnosing problems, poor targeting and further reviews. If this were the case, regulatory stability and investor confidence would deteriorate.

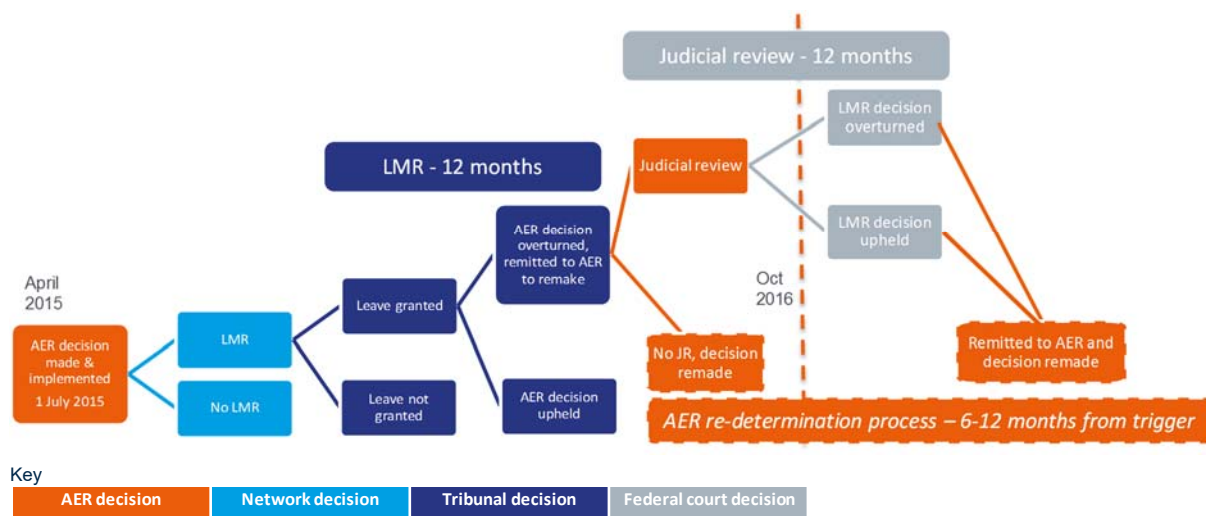
As observed above, any assessment of the status quo must:

- Acknowledge that reviews under the recently amended LMR framework have not run their course through to completion in remade AER decisions
- Appreciate that the number of recent LMR reviews is to a significant extent a function of implementing the 2012 rule changes and the AER’s unresponsiveness to Tribunal precedent, rather than the conduct of LMR by the Tribunal

- Recognise that, consistent with the intent of the 2013 LMR changes, we have so far seen more customer representation in Tribunal processes, and decisions being remitted back to the AER to remake in a fashion that addresses perceived risk of 'cherry picking'
- Recognise that the effectiveness of customer participation in Tribunal processes is likely to improve with increased experience, and in particular establishment of Energy Consumers Australia.

Spark Infrastructure understands that the Federal Court's decision on the AER's judicial review application is unlikely before first quarter 2017, and any remade decision after that could be between 6 to 12 months later based on prior examples of AER redeterminations and AER feedback on the debt ground. These outcomes will be relevant to assessing the status quo, and Figure 2 illustrates the timeline that has and is unfolding for the NSW/ACT reviews and thus the first full implementation of the 2013 LMR reforms.

Figure 2 | Status of reviews and time to resolution of current LMR reform outcomes



In this context material LMR change risks an investor perception that where governments don't like the outcome of an independent process, they step in to undo it. This is a costly prospect when that process affects billions of dollars of private capital and essential infrastructure that fuels Australia's economy and households.

#### 4.2 Option 2 - Retain the Tribunal as the review body with legislative amendments

Spark Infrastructure supports this option where it comprises targeted and effective modifications to the LMR regime that improve alignment with policy objectives and support regulatory stability. However, these modifications should not be implemented prematurely or in the absence of complementary modifications and review of the AER's primary decision process and structure.

Should high quality analysis of evidence obtained through the LMR review find any aspect of the current regime deficient in delivering its policy objectives, Spark Infrastructure observes that option 2 is the one most consistent with achieving the necessary regulatory stability.

As outlined in section 2, retaining LMR is consistent with achieving policy objectives and providing the necessary regime stability, and investor and stakeholder confidence. The experience to date, outlined in section 3, is not consistent with a conclusion that the LMR regime under the Tribunal has failed.

Nevertheless, experience from those parts of the process that have completed in the recent LMR reviews, together with the drivers of those LMR reviews still pending, suggests that addressing some specific identified issues with targeted changes could improve the operation of LMR to better align with policy objectives.

Spark Infrastructure considers any such further regime modifications must be based on evidence and sound analysis and be targeted, effective and infrequent and should focus on:

- *AER performance* – reducing the potential for error in the AER's decisions by implementing measures to address identified issues with the AER's performance

- *Process improvements for addressing common errors* – reducing the number of reviews when error occurs by considering measures that confirm Tribunal precedents and avoid successive LMR applications simply to secure the correct and preferable decisions as previously made by the Tribunal
- *Customer participation* – Improving access, effectiveness and transparency for consumers participating in the LMR process.

### AER performance

A high performing regulator is in everyone's interests. While no regulator will be free from error, there may be opportunities for reducing the likelihood of errors as recent reviews (cited in section 1) have found. Spark Infrastructure urges the Energy Council to:

- Increase funding for the AER, including consideration of industry funding, and ensure sufficient reporting by the AER to reveal how it is targeting the resources made available it. To this end, Spark Infrastructure awaits with interest the outcome of Treasury's review of AER resourcing, given the funding announced in the 2016-17 budget for this purpose
- Implement the Energy Council's prior commitment to consider the composition of the AER's Board to include industry, operational and financial experience, as recommended by the Vertigan Review of Governance Arrangements for Australia's Energy Markets
- Implement that governance review's recommendation to undertake a periodic performance review of the AER, which it made on the finding that the AER has neither the control nor resources to achieve its tasks and be fully independent.

### Process improvements

The desirability of process improvements is illustrated by the status of the four key review items outlined in section 3. Table 3 shows this status and its implications for the number of reviews raised.

**Table 3 | LMR and AER process performance**

Issue	Tribunal finding	Subsequent decisions	AER	Subsequent applications	LMR
Return equity	on ✓ Yes, proper exercise of discretion	✓ Maintained approach verified by Tribunal and explicitly reference this precedent	✓	✓ No challenges	
Return debt	on ✗ Erroneous	✗ Maintained approach rejected by Tribunal	✗	✗ Challenged by: SA Power Networks, Jemena Vic, AusNet Services, ActewAGL gas	
Tax costs	✗ No, incorrect application of the rules	✗ Maintained approach rejected by Tribunal	✗	✗ Challenged by: SA Power Networks, all five Vic networks, ActewAGL gas	
Expenditure forecasts	✗ No, improper exercise of discretion	✓ AER has not applied benchmarking deterministically	✓	✓ No challenges	



Process improvements are warranted to:

- Streamline the process for having tribunal decisions on specific grounds common to multiple networks' reviews being applied in those decisions. From Table 2, a key element is likely to be allowed rate of return decisions. Frequency of review may be reduced through:
  - i) Requiring the AER to implement Tribunal precedents and having mechanism for linking overlapping AER decisions to Tribunal outcomes
  - ii) Requiring each subsequent new LMR ground to be materially different to those already given leave or determined—subject to establishing the linking in item i)
  - iii) Making the rate of return guideline binding, and subjecting it to either:
    - AEMC approval as recommended by the Vertigan governance review, or
    - allowing the guideline to be subject to LMR similar to New Zealand's merits review of its input methodologies.
- Increase engagement between the regulator and regulated businesses in the primary decision process including utilising independent experts to facilitate shared understanding of facts and issues amongst consumers, businesses and the AER.
- In some circumstances enable reduced costs and less legalistic processes by improving the availability of other fit-for-purpose dispute and error correction forums and mechanisms, where mutually agreed to by the AER and affected parties, e.g:
  - i) Use of 'slip provisions' when an unintended error is identified and agreed such that issuing an amended determination can fix this administratively
  - ii) Use of the alternative dispute resolution mechanisms currently overseen by the AER.

#### *Customer participation*

Customer participation has increased and the effectiveness of consumer participation will likely improve with further experience. Spark Infrastructure however appreciates that there is scope for improving access to, effectiveness of and transparency of influence from consumer participation in LMR processes. This could be facilitated by:

- Providing automatic standing for consumers in review processes, as presently applies for Ministers
- Bolstering the explicit requirement to address consumer submissions and the outcomes of networks' customer engagement in the primary and review process
- Reviewing the funding for customer engagement in both the primary and review processes.

#### **4.3 Option 3: Replace the role of the Tribunal with a new investigatory body**

Spark Infrastructure does not support replacing the Tribunal with a new investigatory body because the Tribunal has adhered to the framework implemented in the 2013 LMR review. Spark Infrastructure has found no link between the issues raised in the consultation paper and the nature of the review body. Changing the review body without first addressing issues arising from the primary AER process and LMR framework is unlikely to have any effect on the issues identified. On the contrary, such a change will likely maintain review activity at current levels as parties test the new review body and would introduce additional uncertainty in the process and outcomes.

A new investigatory body risks greater uncertainty by:

- *Triggering further proving* – Potentially losing the precedent value of prior AER and tribunal decisions as participants seek to confirm if the new 'better qualified' body would reach a different conclusion on what a proper exercise of discretion means for material elements of the Rules

- *Treating symptoms rather than causes* – Failing to recognise that issues with the volume and length of LMR processes are more rightly attributed to AER performance and these root causes must be addressed prior to changing the institutional structure for LMR.

In any event, insufficient detail has been developed either in the consultation paper or the prior 2012 expert panel work to allow proper consideration of this option at this stage of this review.

Given the non-trivial cost and uncertainty associated with establishing a new review body, Spark Infrastructure favours retaining the Tribunal and considering other alternative dispute resolution mechanisms that may be fit-for-purpose and complementary to the current or amended LMR regime.

Finally, as noted above, the compressed timeline determined by the Energy Council for this LMR review does not allow proper consideration of this option.

#### 4.4 Option 4: Remove access to LMR

Spark Infrastructure strongly opposes removing access to LMR and considers that this option will have the greatest negative impact on investor confidence, regulatory stability, and the long term interests of consumers. This option results in a realisation of sovereign risk (policy makers changing the law if they don't like the outcome of the independent body), increases costs, timelines and uncertainty, reduces participation of consumers and increases the risk to investors and therefore the cost of capital. An increase in the cost of capital will result in increased prices to customers if it is recognised, as it should be under the Rules, or a deterioration of services as investment is constrained or withheld due to the inability to attract capital.

*Judicial review cannot deliver the levels of regulatory stability that LMR provides*

Judicial review (JR) alone cannot achieve the objective of a stable regulatory regime with the required degree of perceived regime legitimacy in the eyes of all stakeholders. It cannot provide the checks and balances investors expect when their property rights are affected by discretionary decisions. The test of a decision's legality can often have no bearing on the actual quality of that decision.

AER decisions involve complex issues and expert judgement, materially affect property rights, and apply to essential infrastructure services relied upon by all Australian households and businesses every day.

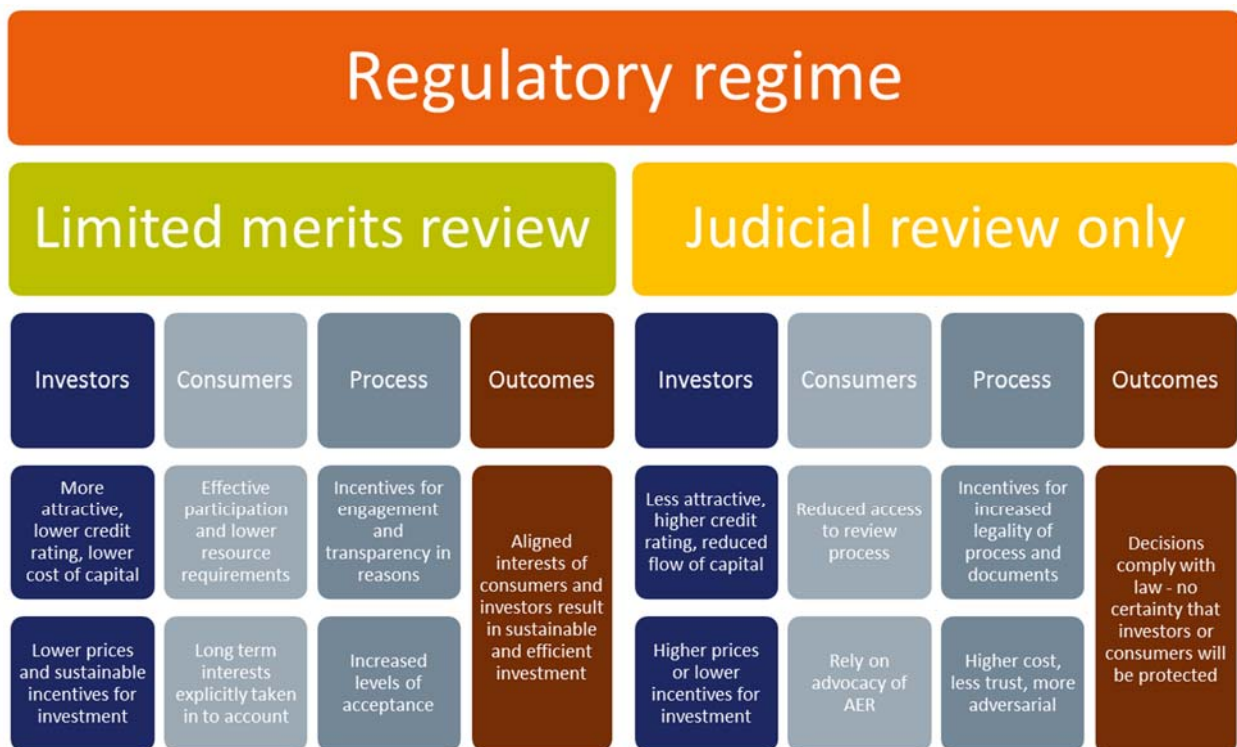
By design JR is not fit for reviewing such decisions and thereby supporting the Energy Council's policy objectives because of the:

- *Nature of errors that can be tested* – JR only deals with errors of law, not errors of fact or unreasonable use of discretion that can significantly affect the economic interests of investors. The AER must be accountable for properly exercising its discretion and there must be mechanisms for correcting errors, particularly when property rights affecting billions of dollars of investment are at stake. JR cannot assess the quality of such decisions, and the likely consequence of only testing errors of law, is that participants will seek more rule changes to address AER performance through ever-greater levels of rule prescription.
- *The nature of errors that will affect customers' interests* – No regulator is free from errors, and for such large decisions, the likelihood that these will only ever be errors of law is low. There is an inherent asymmetry in the risk of under resourcing energy service provision in our economy and society, which JR cannot account for. LMR ensures factual errors or misuse of discretion does not put at risk the networks' ability to provide essential services through being unable to fund required activities.
- *Fact that JR does not account for customer's interests* – LMR requires the Tribunal to have regard to and uphold the long term interest of energy consumers (via the NEO and NGO). This requirement would not be accounted for in JR. Thus JR cannot safeguard the ability of networks to recover the efficient costs of providing services so efficient investment and service levels are not at risk.
- *Fact that JR is neither time bound nor accessible* – The current LMR is bound by time constraints and has automatic provision for Ministers to be heard and customers to participate. These features do not exist in JR, and all parties need to legally seek the right to be heard on a case by case basis.

The differences between LMR and JR have been widely documented, and prior reviews of the energy sector—including by the Productivity Commission, Energy Council Energy Governance Review and 2012 LMR expert panel—have consistently reinforced the appropriateness of having merits review of economic regulatory decisions.

Given the many aspects of LMR and JR that must be compared, Figure 3 summarises key elements relevant to participants, processes and outcomes of both forms of review, to illustrate a scorecard of why these prior reviews have reached this common conclusion about the need for LMR in the energy regulatory framework.

Figure 3 | Comparison of LMR and JR



Recognising these points of difference, leads to the realisation that having JR only is likely to exacerbate many of the issues that the consultation paper identified under the current LMR regime or that have been identified with the performance of the AER in its primary decisions. Importantly:

- There is no reason to consider that JR will reduce the number of reviews of AER decisions
- JR will increase costs for review participants because it is inherently legalistic
- JR will likely face reduced consumer participation relative to the levels recently achieved in LMR
- The uncertainty of outcomes cannot be improved because there are no explicit time limits on the decision, JR decisions are not bound to have regard to customers' long term interests, and they will not address the quality of AER decisions, only their legality
- By only holding to account the legality of AER decisions, JR can have the perverse effect of providing incentives for the AER's decision process to focus on a legally correct decision rather than an economically responsible decision that properly exercises its discretion in a manner consistent with best supporting customers' long term interests.

For these reasons Spark Infrastructure strongly opposes removing access to LMR.