

17 April 2018

COAG Energy Council Secretariat

Via email: energycouncil@environment.gov.au

Dear COAG Energy Council Senior Committee of Officials,

Re: Response to consultation on binding rate of return (ROR) amendments

We represent major investors in Australian energy Network Service Providers (**NSPs**) and funds that are the custodians of the retirement and general savings for many millions of individual Australians.

Collectively, we have provided more than \$13 billion in capital to the following energy transmission and distribution network businesses; Ausgrid, Endeavour Energy and TransGrid in NSW; SAPN and ElectraNet in South Australia; CitiPower and Powercor in Victoria and ATCO Gas Australia in Western Australia.

As providers of capital to support the provision of energy network services to customers, we seek a regulatory regime that provides ongoing confidence to invest efficiently through stability and transparency of process and outcomes. This ensures that risk remains consistent with investor expectations and reduces the cost of new capital to NSPs and prices to customers.

The COAG Energy Council has released proposed amendments to the National Electricity Law (**NEL**) and National Gas Law (**NGL**) relating to the calculation of the ROR on capital and the value of imputation credits used in economic regulatory decisions. These changes are set out in the draft Statutes Amendment (**National Energy Laws**) (**Binding Rate of Return Instrument**) Bill 2018. The package of legislation (the **Legislative Package**) was put forward in response to the COAG Energy Council agreement to make the Rate of Return Guideline (**RORG**) binding on network operators and the Australian Energy Regulator (**AER**).

We accept the COAG Energy Council's previously stated policy to ensure greater certainty by requiring the AER, in consultation with stakeholders, to develop a binding RORG¹. Industry not only expected this change but was an active participant in the consultation process for reviewing the Limited Merits Review (**LMR**) framework in September 2016 where the adoption of a binding RORG was proposed.

However, the Legislative Package released for consultation goes significantly further than implementing this policy, as detailed further in the Attachment to this submission. Our key concern with the Legislative Package is that it impacts on the fundamentals of the regulatory system without clear policy justification or identified benefits to customers.

If implemented as proposed, the effect of the proposed Legislative Package will be to undermine what has traditionally been considered a stable regulatory environment, increase regulatory and sovereign risk and consequently increase the cost of both debt and equity investments in, and new financings of, regulated electricity assets. It would inevitably result in investors seeking higher risk premiums as compensation for this reduction in good governance, increasing prices to customers at the same time as reducing investment incentives.

Our position is that the Legislative Package should be limited to the changes required to make the RORG binding and not alter the powers of existing Australian energy institutions or the current ROR rules that were established through the Australian Energy Market Commission's (**AEMC's**) comprehensive and transparent process and have

¹ COAG Energy Council, Meeting Communique, 14 July 2017.

since been subject to considerable testing through LMR and the Federal Court. We consider that effective access to judicial review is critical to investors and customers to ensure that errors can be corrected, and strong incentives remain for the regulator to deliver quality decisions and regulatory accountability.

The impact on the risk to investors and increases in the cost of capital and prices to customers is driven by the following issues:

1. The Legislative Package effectively removes the only remaining check and balance mechanism remaining on ROR determinations. This is not in accordance with general principles of good governance and is unprecedented.
2. The Legislative Package creates considerable uncertainty in relation to the determination of key aspects of the ROR.
3. The process and the Legislative Package contravene the Australian Energy Market Agreement (**AEMA**).
4. The Legislative Package does not give effect to policy agreed or endorsed by the COAG Energy Council or any government participating in the national process.

Accordingly, we urge the COAG Energy Council Senior Committee of Officials (**SCO**) to modify the Legislative Package as follows:

- Limit amendments to only those required to make the RORG binding
- Do not make amendments that alter or remove the current ROR rules
- Do not make amendments that alter the powers of existing Australian institutions such as those that:
 - Increase the power of the AER by elevating the RORG into law
 - Remove the power of the AEMC to make rules in relation to the ROR
- Ensure that the changes to the RORG do not affect normal judicial review rights and opportunities in relation to ROR decisions consistent with other major administrative decisions.

In addition, to ensure that the issues raised by submitters on the Legislative Package are addressed we also recommend that:

- Information be provided on the process and timeline for making the binding RORG amendments
- A proposed policy statement is released for consultation on all elements of the amendments
- Further consultation occurs on the policy and supporting legislation if the policy is unanimously agreed by the COAG Energy Council.



The Attachment to this submission provides further information on the issues identified above.

Please contact Sally McMahon, Economic Regulatory Advisor with Spark Infrastructure (phone: 0421 057 821, email: sally.mcmahon@sparkinfrastructure.com) for further discussion or questions.

Yours sincerely,

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Patrick Creaghan
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Attachment: Further information on concerns in relation to the COAG Energy Council's Senior Committee of Officials (SCO) consultation on the binding ROR amendments

1. The Legislative Package effectively removes the only remaining check and balance mechanism on ROR determinations. This is not in accordance with general principles of good governance and is unprecedented.

The existence of an independent review process assures accountability of the regulator and provides confidence in the regulatory system. A framework where regulatory errors are minimised or corrected is in the long-term interest of consumers.

1.1. The only remaining check and balance mechanism

Abolition of LMR removed an important check and balance mechanism and resulted in only judicial review remaining for stakeholders to seek redress of errors. However, it appears the Legislative Package will also remove any effective judicial review. This results in investors having no recourse where the AER's decisions are erroneous, considerably increasing regulatory and sovereign risk facing investors.

The Legislative Package appears to elevate the RORG into a form of subordinate or delegated legislation. Our understanding is that Australian courts have limited jurisdiction to decide on the validity of delegated legislation compared with the grounds available to a person seeking judicial review of an AER decision that is of an administrative character. On this basis, the grounds on which AER decisions could be challenged would appear to narrow significantly. Further, the wide discretion provided to the AER under the Legislative Package means those grounds are reduced further, leaving the judicial review process technically available but realistically inaccessible.

Neither the consultation to abolish the LMR nor the LMR Abolition Bill itself contemplated removing or limiting judicial review. In 2016, the COAG Energy Council asked the SCO to review the LMR regime. One of the options included abolishing LMR. However, this option did not contemplate a change to the availability of judicial review for AER decisions (including on ROR issues). For example (emphasis added):

Option 4: Remove access to LMR

This option would remove access to LMR. Affected stakeholders would retain access to judicial review.

Judicial review is not the re-hearing of the merits of a particular case. Rather, the court reviews a decision to make sure that the decision maker applied the relevant law correctly and reached a decision that was within jurisdiction, not unreasonable in the final result and arrived at by following the correct legal procedures.²

Importantly, none of the four options contemplated by SCO involved both removing LMR and narrowing the scope for judicial review of the AER's determinations on the ROR.

It is well known that the COAG Energy Council did not achieve consensus around the need to abolish LMR and instead agreed in principle to reform the LMR arrangements which, as the relevant COAG Energy Council Meeting Communique stated, included:

Introduction of a binding rate-of-return guideline, with relevant elements of the regulator's decision not subject to merits review.³

The Communique did not include any reference to reducing rights to judicial review of the RORG or instrument. The availability of some form of LMR or judicial review on AER's determinations, including on ROR, was contemplated in all the policy options considered. This suggests that, consistent with SCO's own consultation, it

² COAG Energy Council, *Review of Limited Merits Review Regime: Consultation Paper*, 6 September 2016, p.17.

³ COAG Energy Council, *Meeting Communique*, 14 December 2016, p.2.

was intended that judicial review would continue to be available as a realistic option for the binding RORG or instrument.

The Finkel Review also recommended that the reforms to LMR should be finalised and implemented without any reference to the idea that access to judicial review would be limited or altered on the binding RORG.⁴

Similarly, the introduction materials for the LMR Abolition Bill did not contemplate limitation or alteration of access to judicial review for the binding RORG or the ROR aspects of an AER determination.

Paragraph 1.18 of the Explanatory Memorandum for the LMR Abolition Bill states (emphasis added):

*New section 44A1A ensures that AER decisions made under the national energy laws are not subject to merits review by any State or Territory body. A person's right to seek judicial review of an AER decision is unaffected.*⁵

While the Minister for the Environment and Energy's second reading speech does not refer to judicial review, comments from several senators suggest that there was not a policy to affect rights to judicial review either generally or on ROR issues specifically. Several second reading speeches refer to the ongoing availability of judicial review (emphasis added):

"...with the passage of this bill there will still be a review option available: the judicial review. Evidence to the inquiry was quite clear that, while access to judicial review was possible, it was viewed as not being an adequate avenue for redress for industry, and there is concern that key stakeholders such as unions and consumer groups will not have standing within a judicial review and that, if they were to actually get that standing, they may face exorbitant cost orders" (Urquhart, Sen Anne, Monday 16 October 2017)

"Some – I note Senator Leyonhelm and Senator Bernardi – have mused about whether in fact too much power is left in the hands of the AER and whether in fact as a result of that there are insufficient safeguards put into the system. I would note in response to them that judicial review remains an option to the parties through this process. This does not remove all oversight in the processes; it simply ensures that a default referral to a competition tribunal will not be in the hands of every network operator in the future. Instead, they will have to undertake the more rigorous process of justifying a judicial review if they believe the AER has erred in its decision-making" (Birmingham, Sen Simon).

These comments support the position that there was no intention to alter or limit rights to judicial review of the AER's decisions generally or of its RORG more specifically. Instead, it was contemplated that judicial review would remain available. Investors seek a statement on the policy in relation to judicial review and the reasons for any change.

In addition to the removal of the LMR, it is noted that the Economic Regulation Authority's (ERA's) requirement to have the draft guideline reviewed by an independent panel is also expected to be removed in the WA transitional arrangements, ensuring that there is no independent oversight of the ERA's decision for the first binding guideline.

1.2. Governance issues

Limiting access to effective judicial review of ROR issues and removing the right to seek any review at all if the AER does not follow the legislated process, is a departure from the current rights to judicial review of Australian regulatory decisions.

No other Federal regulatory regime in Australia has effectively removed judicial review of ROR issues. For example, judicial review is available on broad grounds for final determinations made by the Australian Competition and Consumer Commission (ACCC) for access to telecommunications services under Part XIC of the Competition and Consumer Act 2010 (Cth).

⁴ Dr Alan Finkel AO, *Independent Review into the Future Security of the National Electricity Market – Blueprint for the Future*, June 2017, recommendation 5.4.

⁵ Schedule 1, item 3, subsection 44ZZM(1) of the CCA.

In addition, state-based regimes have retained full access to judicial review of ROR issues and, in some cases a form of LMR, for decisions made by state regulators, such as for decisions by the Queensland Competition Authority in relation to its decision to accept or reject an access undertaking from Aurizon Network (including in relation to ROR issues) under the Queensland Competition Authority Act 1997 (Qld) and Judicial Review Act 1991 (Qld).

Further, this Legislative Package puts Australia completely out of step with review rights in other common law countries. We are not aware of any country or region with a similar regulatory background to Australia (for example, New Zealand, England, Ontario and Alberta) that has limited the scope of potential review in the manner contemplated by the Legislative Package for regulatory decisions generally or on the ROR specifically.

The AER⁶ and the ACCC⁷ have stated that judicial review is the appropriate accountability measure for the reasonableness and lawfulness of regulatory decisions. No policy justification has been provided as to why the Legislative Package proposes to exclude ROR decisions from full accountability under judicial review that even the AER itself believes it should be properly subject to.

Investors highly value the checks and balances on the regulatory regime and the AER. These checks and balances provide confidence to network businesses and consumers that the AER will make quality decisions free from error and bias and in the long-term interests of consumers. A framework where regulatory errors can be reversed is in the long-term interest of consumers.

The importance of this is underscored by the fact that the Australian Competition Tribunal (**ACT**) has previously found that the AER had made material errors that, if left uncorrected, would not be in the long-term interests of consumers. Several of these errors were subsequently confirmed by the Federal Court⁸. In response, the Commonwealth abolished LMR. It appears now that it is proposed to also materially narrow the courts' jurisdiction, rather than to address the underlying cause of the errors themselves.

A reasonable response to removing LMR should have been to undertake a thorough review of the National Energy Law and National Energy Rules to reduce the discretion provided to the AER - as is contemplated by making the RORG binding. However, the effect of elevating the RORG in to law, removing the ROR rules, and removing the role of the AEMC in making the ROR rules, is to increase the discretion of the AER and reduce its accountability. The AER becomes the policy maker, rule maker and rule enforcer with effectively no bounds to its discretion, nor rights of review. This direction is in complete contrast to expected or prior stated policy and counter to all accepted standards of good governance. As outlined by The Hon. Justice Deirdre O'Connor⁹:

The availability of administrative review has led to increased awareness among decision makers about the exercise of decision making power within the terms of authorising legislation, promoted the consistent application of the law by decision makers and led to improvements in the quality of primary decision making.

Administrative review is now an integral part of the framework of government accountability together with the other elements of the administrative law system - the Ombudsman, judicial review in the courts and the Freedom of Information Act 1982. In the report Accountability in the Commonwealth Public Sector, accountability is described in the following terms:

⁶ AER, *Submission to the Review of Limited Merits Review Regime: Consultation Paper*, 4 October 2016.

⁷ ACCC, *Retail Electricity Pricing Inquiry, Preliminary Report*, 22 September 2017.

⁸ In February 2016, the Australian Competition Tribunal (**ACT**) set aside the AER's decision in relation to the return on debt, the value of imputation credits (gamma) and operating expenditure for electricity and gas distribution networks in New South Wales and the electricity distribution network in the Australian Capital Territory and remitted the decisions back to the AER. The AER sought review of the ACT's decision to the Federal Court and in May 2017 the Federal Court upheld the decision of the ACT on the return on debt and operating expenditure.

⁹ The Hon. Justice Deirdre O'Connor, *Lessons from the Past/Challenges for the Future: Merits Review in the New Millennium*, Paper presented at the 2000 National Administrative Law Forum – Sunrise or Sunset? Administrative Law in the New Millennium, June 2000, p. 1

Accountability is fundamental to good governance in modern, open societies. Australians rightly see a high level of accountability of public officials as one of the essential guarantees and underpinnings, not just of the kinds of civic freedoms they enjoy, but of efficient, impartial and ethical public administration. Indeed, public acceptance of government and the roles of officials depends upon trust and confidence founded upon the administration being held accountable for its actions.¹⁰

The administrative law system, when working properly, supplements and enhances the traditional processes of ministerial and parliamentary accountability in our system of government. As the Administrative Review Council (ARC) has stated, the administrative law remedies ensure that the administration is accountable to an individual in respect of its decisions that affect that person. Moreover, administrative law remedies improve the whole system of government decision making by increasing its openness and transparency and providing feedback on its performance.¹¹ Confident executive government should welcome this kind of audit.

The substantial increase in discretion and effective limitation on rights to judicial review reduces the AER's accountability and undermines what has traditionally been considered a stable and predictable regulatory environment. This will result in investors and debt providers demanding higher risk premiums to compensate for this increased uncertainty. Further, a reduction in good governance will increase regulatory and sovereign risk. As a result, costs will rise to reflect increases in both debt and equity in financing regulated electricity assets with no offsetting benefit to customers. The risk is likely to be severe and irreversible and could be particularly detrimental should that higher cost of capital coincide with an increased need for capital to support investment in the Integrated System Plan currently being developed by Australian Energy Markets Operator (AEMO).

The Legislative Package will also affect the relative stability and predictability of the Australian energy regulatory system compared with other international jurisdictions. Australia would be alone in having a regulator that sets rules on fundamental issues and which has no real accountability for how it exercises its powers, materially increasing the relative regulatory and sovereign risk compared to investing elsewhere.

2. The Legislative Package creates considerable uncertainty in relation to the determination of key aspects of the ROR

The Legislative Package removes the current rules that provide guidance in relation to the determination of the ROR and the AEMC's power to make any future rules on ROR matters. This creates considerable uncertainty that increases risk to investors, the cost of capital and prices to customers because:

- Guiding principles underpinning the regulatory framework, such as the concept of the benchmark efficient entity and the right to earn a return commensurate with risk are removed; and
- The ability of stakeholders to propose changes in relation to the ROR and have the proposal assessed by an independent rule-maker is removed.

In 2012, the AEMC undertook a comprehensive and transparent review process to develop the ROR rules. The AEMC carefully considered the benefits of providing guidance in the NER and NGR balancing flexibility and certainty for stakeholders. These rules contain fundamental principles of the benchmark efficient entity and the right to earn a return commensurate with risk critical to an effective incentive-based regulatory framework and attracting low cost capital. These principles work together to ensure that customers are provided with the desired level of service at lowest long-term cost.

These rules have been tested extensively by the Australian Competition Tribunal and the Federal Court. Important and valuable precedent has been established. Accordingly, the current rules provide certainty for investors about

¹⁰ Management Advisory Board and Management Improvement Advisory Committee, *Accountability in the Commonwealth Public Sector*, Report No. 11, AGPS, Canberra, 1993, p. 3.

¹¹ Administrative Review Council, *The Contracting Out of Government Services*, Report No. 42, Canberra, 1998, p. 15.

the return to be earned on investment and how the allowed regulated return may change over time and in line with prevailing market conditions.

In addition, the established and independent process to consider and give effect to changes in the rules provides certainty. Under the Legislative Package, stakeholders will no longer be able to shape the regulatory framework by proposing changes to the rules and changes in policy will require a change in law.

As far as investors are aware, there has been no policy change, or change in circumstances considered by the AEMC to warrant a change in the rules. In any event, if changes to the rules are warranted, they should be properly considered through the AEMC's process.

The Legislative Package transfers the power to make the rules relating to the ROR to the AER with very limited guidance about how the ROR should be determined. Further, although the proposed Legislative Package includes additional process requirements compared to those that currently exist, the RORG remains a valid instrument even if those process requirements are not followed.

We are also concerned that the requirement to convene a customer reference group (**CRG**) may lead to more weight placed on input from one group rather than input from other stakeholders. The interests of the CRG needs to be fairly and evenly balanced against those having to source and provide capital to these businesses, ie. Investors. Investors have valuable and relevant information regarding issues that affect investment decisions and capital allocation and should also be recognised in the AER's processes. Therefore, we recommend that additional stakeholder Reference Groups be considered and further guidance on the composition of the groups be provided. Where the AER relies on advice or information provided by Reference Groups, that advice and information should be made available for review subject to any valid claims of confidentiality.

3. The process and Legislative Package contravene the Australian Energy Market Agreement (AEMA).

The AEMA was a ground-breaking agreement that underpinned energy market reform to support the long-term interests of consumers. Key objectives of this agreement relate directly to supporting investment in energy infrastructure by:

- strengthening the quality, timeliness and national character of governance of the energy markets to improve the climate for investment;
- streamlining and improving the quality of economic regulation across energy markets to lower the cost and complexity of regulation facing investors, thereby enhancing regulatory certainty and lowering barriers to competition; and
- creating a stable framework for efficient investment in new generation and transmission capacity.¹²

The AEMA underpinned the success of these reforms. In addition to key objectives to create the right environment for investment, this agreement also enshrined the prioritisation of policy over politics. This was achieved through separating the policy makers from the rule makers and the rule makers from the rule enforcer. It also set out that there should be no changes to the law, or even any action taken at odds with the law, without the unanimous support of the Australian governments party to the agreement. These boundaries established transparency and independence to support investment certainty and prevent the longer-term interests of all consumers from being put at risk by short term politics.

The arrangements captured in the AEMA enabled the establishment of a stable and innovative regulatory framework where the rules of play were clear, and businesses had strong incentives to deliver low cost and sustainable services. Under the current arrangements, investors only do well when customers do well. The success of this regime is based on principles that enable an investor to earn a reasonable return on efficient investment and share in financial rewards when it reduces costs without compromising service. Underpinning this is important checks and balances, so that if something goes wrong, it could be corrected, safeguarding the long-term interests of customers.

¹² Commonwealth and state governments of Australia, *Amendments to the Australian Energy Market Agreement*, 9 December 2013, p.9.

4. The Legislative Package does not give effect to agreed or endorsed policy by the COAG Energy Council or any government participating in the national process

The COAG Energy Council Bulletin accompanying the release of the Legislative Package stated:

The draft Bill does not represent government policy and has not been endorsed by the Energy Council or any government participating in the national process at this stage.¹³

In the absence of a transparent and agreed policy, it is inappropriate to develop detailed draft legislation, and impossible to assess the amendments proposed in the Legislative Package against policy intent.

Further, the amendments make changes that appear to depart significantly from prior stated policy. In the October 2017 COAG Energy Council SCO Bulletin it noted the Energy Council's decision to implement a binding guideline for the ROR components of the AER's determinations for electricity and gas and stated that:

This move to a binding rate of return guideline, developed through an industry-wide process, will improve the transparency and certainty of the regulators' decisions, reduce the regulatory burden for all stakeholders, and provide a more robust process for the development of the rate of return.¹⁴

The Legislative Package not only makes the RORG binding on NSPs and the AER, it also:

- removes the current guidance in the rules established by the AEMC in 2012;
- removes the AEMC's power to make rules that govern the return on investments in energy network sector;
- significantly increases the AER's discretion and removes accountability to the Federal Court; and
- fundamentally increases the power of the AER from administrative body to legislator, by giving the ROR Guideline the force of law.

These additional and far-reaching changes warrant explanation. We seek a clear statement of policy on these matters before the Legislative Package goes any further.

¹³ COAG Energy Council Senior Committee of Officials, Bulletin, *Consultation on binding rate of return amendments*, March 2018.

¹⁴ COAG Energy Council Senior Committee of Officials, Bulletin, *Binding Rate of Return Guideline*, October 2017.