ADMINISTRATIVE LAW MEETS THE REGULATORY AGENCIES: TOURNAMENT OF THE INCOMPATIBLE?

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Paper presented at ANU Public Law Weekend, Canberra, 6 November 2004.

Introduction

The objective of this paper is to present a regulator's perspective on the role of administrative and judicial appeals in relation to the regulation of utility services and the effect they have had on the practice of utility price regulation in Australia. The paper also makes some observations about the need for and direction of future reforms to the legal framework for such regulation and about the future role of appeal processes. I have had the opportunity to read Justin Gleeson's excellent paper on this topic prior to preparing these thoughts, and have sought to minimise the extent of duplication between the two papers, and also to expand upon some of his key themes from a regulator's point of view.

In the short time that the new legal framework governing utility price regulation has operated in Australia, there have been a number of appeals against regulators' decisions, both to the courts on traditional judicial review grounds, as well as to different types of administrative review bodies. In the energy sector alone, to date, there have been no fewer than three appeals to courts and five appeals to administrative tribunals in relation to utility pricing decisions,[1] as well as a number of appeals against pricing decisions in the rail and telecommunications sectors. While in many cases, the decisions of the relevant appeal bodies have wholly or largely upheld the decisions of the regulators, there have been a number of high-profile cases where large components of a regulator's decision have been overturned.

Although the threat of administrative review imposes pressures on regulators, I am firmly of the view that effective appeal mechanisms are an essential component of the new regulatory framework for utility pricing And this view is shared by the overwhelming majority of my fellow regulators.

This is not to say that improvements cannot be made to the current appeal mechanisms and also to the laws under which the regulatory decisions are made, in light of the experience to date. Australian Governments currently are reviewing through the Ministerial Council on Energy many aspects of the policy, law and subordinate regulatory instruments that govern economic regulation of the electricity and gas sectors. In addition to a number of policy and institutional matters, this review will address the appeal mechanisms that are to apply to regulators' decisions on pricing in future. Accordingly discussion on these matters is highly topical.

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The structure of the remainder of the paper is as follows.

An overview is provided first of the new framework for utility price regulation, how regulators undertake the task with which they are entrusted and the operational issues they face, as essential background to considering the appropriate role of appeals mechanisms. The paper then describes some of the effects that the appeal mechanisms and the decisions made to date have had on the work of regulators and their staff. Much of the impact has been positive, while some issues of concern have also been raised.

The paper then examines two broad themes or questions that flow from the appeals that we have seen to date. The first is to consider the appropriate role for the appeal mechanisms in utility pricing decisions, and whether the current appeal mechanisms are appropriate. The second question arises from Mr Gleeson's comments about the incommensurability of the objectives and criteria that some regulatory instruments oblige regulators to apply. An implication of this discussion is that the effectiveness of appeal mechanisms depends importantly on the clarity of the law that is being applied. That is, where judicial or merit review processes find laws and subordinate regulations to be unclear or internally inconsistent, it is preferable for the legislature to remedy the law, rather than leaving regulators and appeal bodies to make sense of poorly drafted regulatory frameworks.

Utility Price Regulation in Australia

Competition Policy Reforms and the Role of Appeals

The legal framework for the price regulation of utility services – that is, electricity, gas, water and like services – was introduced as part of the broader competition policy reforms adopted by federal and state governments in the early 1990s.

A key objective of the competition policy reforms was to put in place measures to permit competition in those parts of the utility service-chain where sustainable competition was feasible and socially desirable – such as in the generation and retail components of electricity supply. However, it was recognised from the start that the nature of the infrastructure technology involved meant that some parts of the utility service-chain would always be provided under monopoly conditions or at least conditions where the service provider would be in a position to exercise substantial market power. In these circumstances it was concluded that regulation of prices and the quality of supply in these sectors of the supply chain would be necessary.

This situation arises because the technology of electricity networks and gas grids is such that one provider is likely to supply the relevant market at a lower cost than two or more providers. In addition, as the assets required are sunk investments with little alternative use outside of the utility service, any potential new entrant faces a large risk of price discounting by the incumbent monopolist if it tries to enter the market. These two factors (economies of scale/scope and sunk investments) mean that competition in these parts of the supply chain is neither desirable nor likely.

The competition policy reforms described above were also accompanied by a fundamental change in the accepted view of the government's role in relation to the provision of utility services. In the preceding decades, most utility services were provided directly by governments by way of government owned business enterprises (GBEs). This involved government – through GBEs – trying to satisfy a number of competing objectives, including delivering appropriate industry policy outcomes, maximising the value of and their returns from the investments in the utility service, protecting customers with respect to price and service levels and regulating safety, environmental and like factors.

However, there was an increasing recognition that entities that are required to achieve multiple, conflicting objectives often met none of the objectives particularly well. The lack of clear objectives, performance measures and accountabilities often encouraged under performance and inefficiency, and the basis and implications of decisions on important trade-offs – such as between prices and service levels – were often made behind closed doors in environments that did not meet the community's expectations in relation to the transparency or the outcome of these decision-making processes.

As a result, a related reform involved changes to the governance arrangements of utility service provision by GBEs by separating out the functions of government and regulation and by clarifying the role, objectives and accountabilities of the government businesses that supply utility services. GBEs are now largely corporatised and are required to operate on a commercial basis with effective corporate governance. The different roles that can now be distinguished for governments, regulators and government-owned utilities are as follows:

1 *industry policy* – remains a core government function, but is now delivered in the same way that industry policy is implemented for the economy as a whole, treating privately and government owned firms on a neutral basis;

2 *investor* – which typically involves one or more Ministers being deemed the shareholding Minister for GBEs, with a unit in the Treasury monitoring the performance of the entity and oversighting corporate governance requirements;

3 *economic regulator* – involving a decision-making body that is independent of government whose role is to decide the appropriate price and service levels for regulated businesses, taking account of the interests of investors and customers.

4 *non-economic regulation* –safety and environmental regulation is typically performed by specialist bodies, some of which are still housed in government departments, but some of which are independent bodies (such as the Victorian Office of the Chief Electrical Inspector);

5 *GBE business operation* – involving board oversight and governance, management of business operations, investment and service delivery on a corporatised, commercial basis.

A number of governments have gone a step further and sold some or all of the previously government-owned entities to private firms. That is, they have exited from the 'investor' function described above and passed the investment risk, service provision and corporate governance functions to private sector investors. In Victoria, almost all of the former State Electricity Commission of Victoria was sold between 1995 and 1997, and virtually all of the former Gas and Fuel Corporation of Victoria was sold in 1999.

Once the decision was made to separate-off the price and service regulation function from the government's other functions and to entrust it to an independent body, a set of rules and procedures was required governing the regulatory decision-making process. Had the GBEs supplying utility services remained in government hands, a less robust regulatory framework may have sufficed than was considered appropriate for the oversight of privately owned utility service providers. However, the requirements of national competition policy and the community's growing desire for more accountability and transparency in government-owned utility service provision and decision-making has resulted in similar regulatory requirements being imposed on utility service providers that remain under government ownership.

Importantly, however, the sale of the utility assets to private investors has imposed a high hurdle for both the transparency of the regulatory process, and for checks and balances in

the process. Utility services are vital to our economies and to the well-being of customers, and so continued provision of the services to the standards that customers seek – and the high levels of investment this requires – is paramount. The degree of confidence that private sector investors in particular have in the regulatory framework and decision-making processes under which their prices are determined will be a fundamental driver of their willingness to continue to invest in the infrastructure required for reliable and efficient service provision.

Accordingly, a necessary aspect of the new regulatory framework for providers of utility services, including gas and electricity services, involved the establishment of mechanisms to subject the decisions of the independent regulatory bodies to effective administrative review. The appeal mechanisms that have been established for this area of regulation represent an important means of holding regulators to account for the way they exercise the substantial powers they are given, in terms of both the merits of their decisions and their conformity to the powers and requirements of the laws they operate under. The checks and balances inherent in these appeal processes are also important means of providing investors in the delivery of services and the consumers of the services confidence in the regulatory process and the accountability arrangements that apply to it.

Setting Regulated Utility Prices

As noted above, the rationale for price regulation of the monopoly-parts of the utility service chain is to protect customers from excessive prices that the asset-owners may otherwise be able to (and have an incentive to) charge, while at the same time seeking to ensure that they receive efficient and reliable utility services. Generally, customers have an interest in lower prices for a given service level, whereas asset-owners have an interest in receiving higher prices and returns on their investments. The means of resolving the trade-off between the two sets of interests is to set prices with reference to the efficient cost of providing the service.

In this context, cost refers to economic cost, which includes a return on capital commensurate with the returns (adjusted for risk) that investors could earn from investing their capital in alternative investments. Prices are typically set for periods of five years, with adjustments for inflation (sometimes mitigated by an offset factor reflecting expected productivity improvement and possibly some well-defined events between reviews) with regulated prices otherwise remaining unchanged during the regulatory period.

While the idea of setting prices with reference to cost may appear straightforward, in practice it is far more complex.

First, when cost-based regulation is first introduced, a ‘cost’ or value must be assigned to the assets that are currently in existence.[2] However, economic principles do not provide an unambiguous answer to what this deemed asset value should be for purposes of determining prices for future services. It is generally accepted that consideration should be given to a range of factors (such as the expectations prior to the new regulatory regime, recent market valuations of comparable assets and the depreciated historical or replacement values of the assets). Even if a methodology were to be prescribed, the valuation of the existing assets of a utility service provider is something that generally cannot be observed (eg in a well informed and transparent market) and rather needs to be estimated.

Secondly, the regulated entities are generally large, complex businesses, and for their ongoing capital and operating costs, there is a large asymmetry in the information available to the regulated entity compared to the regulator about what needs to be spent to provide the relevant services, and even in some cases, what actually has been spent. The regulator is also not well placed to decide the optimal level of service for the regulated businesses

(such as reliability of electricity supply) or the design of their tariffs (such as the split between fixed and variable components). The usual regulatory response to this asymmetry of information about cost, service levels and tariff structures is to structure the regulatory regime and the decisions made under it so that the regulated entity has financial incentives (rewards and penalties) which encourage it to operate efficiently (that is, to incur only efficient cost, to provide the efficient level of service, and to set efficient prices). However, the structuring of regulatory decisions to provide such incentives has proved to be one source of disputation and administrative appeals.

Thirdly, the level decided for regulated prices is dependent upon forecasts of variables that are subject to a large degree of estimation imprecision, but which have a disproportionate impact on final prices approved for the regulated business. The estimate of the weighted average cost of capital for the entity is perhaps the most important of variable estimates that are involved and has been the subject of considerable disputation.

Finally, analysing and making decisions on all of the issues in a regulated price review is a long and complex task, which involves drawing on expertise from a number of disciplines (eg, engineering, economics/finance, law, etc) and assessing a substantial amount of material advanced during the review process. There are three specific aspects that need to be highlighted. First, the decision on prices will actually reflect a series of decisions on matters of principle or methodology, as well as findings of fact. The decisions of principle typically form a hierarchy, with positions on higher-level matters then determining the approach for considering issues at more detailed levels. Secondly, some of the decisions about methodology that are made in one price review are designed to assist with setting prices at the subsequent price review. Accordingly, part of the approach or methodology that is adopted at a particular price review may reflect decisions made five years previously. Thirdly, many of the issues are interrelated, requiring care and judgement in seeking to ensure consistency across all parts of the assessment.

By way of example, during the first review of the prices for the Victorian electricity distributors (that is, owners of the lower-voltage networks), the first consultation paper was released in June 1998, and the final determination made in September 2000 (and a redetermination after an appeal was made in November 2000). Between those two points in time, four further consultation papers were released on specific subjects, as well as a paper summarising the preliminary conclusions reached on certain higher-level matters of principle, a paper summarising the distributors' formal proposals for other interested parties, followed by a more detailed paper discussing the issues arising and a draft decision. Submissions were sought after the release of each of these papers, and volumes of material – both evidence and argument – were received and placed on the Commission's web site. Lastly, as well as a set of new controls over prices for the 2001-2005 regulatory period, another outcome of the review was a set of incentive arrangements designed to assist with the setting of prices for the following regulatory period – that is, the 2006-2010 period.[3]

The role of the regulatory decision-makers (and their staff) in resolving these matters can be a difficult one including in relation to achieving balance between the different interests involved under the legal rules that apply. The most effective advocates in the review are usually the owners of the regulated assets. While customers are the obvious beneficiaries of the regulatory process, the financial interests of utility customers are generally relatively small at the individual level and fragmented across many users compared to the substantial and concentrated interests of the regulated entities. It is inevitable, therefore, that while regulated entities can be relied upon to advocate their position professionally, it will often fall upon the regulator to identify and evaluate what may be the counter case, and to take it into account.

The Evolution of Regulatory Practice

As noted above, there have been a number of appeals against regulator's price review decisions. Some of these appeals have largely or wholly endorsed the regulator's decision,[4] others have found a number of legal defects in the decision that need remedying,[5] and yet others have made or required more substantial changes to the regulator's decision.[6] Moreover, the precedent now exists for a regulator's decision to be challenged at the draft stage.[7] There has been an evolution of the practice of utility price regulation in Australia since the new framework commenced operation in the mid 1990s, partly in response to the disciplines imposed by the experience obtained from the initial appeal decisions but also reflecting improvements that regulators have initiated themselves based on previous experience.

An important change to the practice of regulation over the period since the mid 1990s that has flowed directly from the appeals noted above has been the form of the written decisions. After the *Epic (WA)* decision in particular, most regulatory authorities have sought to document more carefully the reasons for decisions against the formal terms and requirements of their regulatory frameworks. This has included clear statements about their interpretation of the law governing the decision, clear statements of the decisions actually reached, and clear findings on any factual matters.

A second change that has occurred involves the internal operations of the regulatory authorities, in part in response to the influence of appeal decisions referred to above. Early in the life of a number of the regulatory authorities there was a blurring of the distinction between the decision-maker and the regulatory staff that managed the price review process, conducted the analysis and prepared recommendations for consideration. At that time the regulators tended to be more actively involved in the analysis of key issues that would influence the final decision.

In contrast, most regulators now seek to maintain a separation between the analysis and views formed by the staff and their own formal decision-making process, with internal processes being structured to maintain this distinction. This more formal separation between the staff and the statutory decision-makers has been an important influence in ensuring that decision-makers are able to make an independent assessment of each of the issues that have a bearing on the final regulated price decision and to make clear decisions on those matters. This has also been an important means of ensuring that the arguments advanced by all parties can be demonstrated to have been considered in reaching final decisions.

A complementary change has also been made to the structure of many of the statutory decision-making bodies. While many of the current state-based economic regulators were first established with a single person as the statutory decision-maker, almost all of the state economic regulators now have a commission comprising several members as the statutory decision-maker.[8] The creation of multi-person commissions rather than individuals as the decision-makers provides a further enhancement to the regulatory process by ensuring that all issues raised in the context of a price review are given balanced consideration by a panel of experienced decision-makers.

Many of these changes have improved the practice of economic regulation. Placing a greater emphasis on ensuring that the law is applied correctly and that clear decisions are reached and articulated should enhance the confidence of all parties in the regulatory regime and may also assist in reducing the need for disputation and appeal on its outcomes. As noted previously, improving the confidence of all parties in the regulatory regime is essential for ensuring that the necessary investment is forthcoming for the continued high standard of utility services demanded by utility customers and the community at large.

However, not all of the changes that have occurred in the area of utility regulation have been unambiguously beneficial. For example, one consequence of applying the law more carefully has been that decisions have become less accessible and comprehensible to the wider public. While in earlier decisions regulators made an effort to explain their decisions in more readily understandable terms, the advice that they now receive is that such general explanations may leave them open to claims of having misdirected themselves. There is also the potential for the threat of appeal to cause regulatory authorities to adopt a more conservative approach in conducting their processes and reaching and explaining their decisions. Accordingly, there is now the potential for the time taken to make decisions to be extended unnecessarily, for decisions to be excessively formal and legalistic or for decisions to be structured to minimise the risk of being overturned on appeal rather than to make them readable and comprehensible to a wide range of interested stakeholders.

In any system of regulation which is subject to effective checks and balances, trade-offs are inevitably involved. Notwithstanding these potentially negative effects of appeals against regulatory decisions, the benefits of maintaining the right of administrative review has clearly outweighed the detriments. However, further improvement can still be made. For example, there is scope to enhance further the benefits obtained from appeal processes while minimising the detriments, by ensuring that both the role assigned to the appeal bodies and the law being applied by them, are appropriate. These two matters are examined further below.

Appropriate Role of the Appeal Mechanisms

At the time that the new frameworks for utility price regulation in Australia were introduced, there was a degree of uncertainty about how regulators would approach the task, and the positions that would be taken on key issues, such as the level of return that investors should receive on their invested capital. Since that time, however, there have been more than 30 decisions on regulated prices for energy utilities alone. Regulators now place substantial weight on the approaches that other regulators have followed and on their actual decisions to the extent that they are relevant. This is creating a form of 'regulatory precedent' which has increased substantially the predicability and replicability of regulatory decisions and processes.

There was also a degree of uncertainty about how the appeal processes would operate and how appeal decisions would impact on the interests of investors and consumers. There have now been a number of appeal decisions in the energy and other utility service industries and there is a better understanding of these processes and their implications.

It is relevant to consider, however, where the decisions of appeal bodies fit into this evolving regulatory process and how they have contributed to the emerging body of regulatory precedent.

As Mr Gleeson has noted, two forms of appeal may be initiated against a regulator's decision. The first is the normal avenue of judicial review of administrative decisions by the courts, and the second is a form of merits review by a range of tribunals and appeal bodies.

Turning first to the latter of these forms of appeal – the merits review – its essential feature is that the appeal body typically steps into the shoes of the original decision-maker (in this case, the regulator), and is able to question the judgements reached (and discretions exercised) by the regulator (either in general or in defined circumstances or on particular appeal grounds) and in some cases may issue its own decision[9] in place of the regulator's initial decision.

Mr Gleeson has also noted that there are substantial differences in the scope of such merit appeals in relation to utility price regulation decisions and that there is a plethora of different appeal bodies.

By way of example, in the energy sector, while the scope of the merits review for gas pricing decisions is common across jurisdictions,[10] the appeal bodies differ: the Australian Competition Tribunal (ACT) is the appeal body for decisions of the Australian Competition and Consumer Commission (ACCC) on transmission pricing issues, and each state and territory has its own appeal body for appeals against its regulator's decisions on distribution prices. In contrast, in the electricity industry there is no provision for merits appeal from the ACCC's decisions on electricity transmission prices, and the extent to which merits review is available in relation to state and territory regulators' electricity distribution pricing decisions varies from state to state.

By way of example, decisions of the Victorian Essential Services Commission can be appealed to a special appeal panel established under the Essential Services Commission Act 2001 but the scope of merits review for electricity distribution decisions available in Victoria differs from the scope of merit review for gas distribution decisions (the former adopting the general appeal mechanism that applies to all ESC decisions, whereas the latter adopts the specific provisions of the Gas Access Regime).[11]

The level of differentiation between these appeal mechanisms raises important public policy questions. There is no obvious reason why owners of electricity transmission and distribution assets should have inferior rights to appeal than owners of comparable gas network assets, and the presence of such differentiation raises concerns about whether the pattern of investment may be distorted between the industries, as well as raising basic question about fairness and natural justice. It is also undesirable for the same regulatory authority to face a materially different level of scrutiny across the industries that it regulates as there is a risk that this may (unintentionally) influence its own allocation of resources and approach to decision-making as between the industries.

Some of the differences in the appeal mechanisms between electricity and gas and across jurisdictions have arisen because reforms to the electricity and gas industries have to date been pursued independently. They have arisen also because the states and territories currently retain the role of regulating the distribution sector of the energy networks while the Commonwealth (via the ACCC) is responsible for regulating energy transmission.

The current Ministerial Council on Energy (MCE) process for the reform of energy sector policy and regulation is likely to result in a greater degree of commonality in the approach to regulation between the electricity and gas industries and also in the decision-making and appeal bodies. As part of that process, Australian governments have committed to establishing a national energy regulator (the Australian Energy Regulator) to take over responsibility for regulating all of the gas transmission and distribution networks, and the electricity transmission and distribution networks for the interconnected southern and eastern states.[12] It is also to be hoped that these reforms will establish a single approach for merit appeals from the AER's decisions (if such appeals are to be retained), and a single appeal body across electricity and gas. This also raises the question, however, of which merits appeal model should be selected (if any) among those currently in operation.

Prior to considering that question, however, it is worth identifying some implications of the existing arrangements for judicial review of energy price regulation decisions and the potential for inconsistency of treatment that can arise under that form of administrative review. The differential degrees of prescription that are involved in the existing regimes for electricity and gas network price regulations have particular implications for the judicial review process. In broad terms, the opportunity for aggrieved parties to seek judicial review

of regulators' decisions is directly related to the degree of prescription in the regulatory framework that governs the regulator's decision, with more prescription generally extending the scope for judicial review.

As was observed in the *Epic Energy (WA)* case,[13] the National Gas Code contains a range of objectives, criteria and rules including in relation to the methodologies to be applied by the relevant regulator when setting regulated prices. The regulator's interpretation and application of these detailed requirements can be challenged in the courts by means of judicial review. In the *Epic Energy (WA)* case, the court conducted a lengthy inquiry into the meaning of many provisions of the Code and presented a lengthy interpretation of the legal construction of the Code as part of its decision. The Court was therefore able to inquire into and make rulings on many aspects of the regulator's decision and to refer it back for re-determination in the light of those rulings.

At the other end of the prescriptiveness spectrum, the Victorian Essential Services Commission's decisions on electricity distribution prices are made under a much more general Victorian regulatory framework which provides high level objectives and guiding principles and includes only a small number of specific requirements. The Commission's decision on the electricity distribution prices for the 2001-2005 period was challenged in the Victorian Supreme Court on the grounds that it contravened one of these specific requirements.[14] In finding in favour of the Commission, the Court acknowledged the broad scope of its discretion.[15]

> The wording of cl.5.10, the purposes of the legislation and the objectives of the Office set out in the legislation, together with any relevant matters found in s.25(4) which were not inconsistent with the Tariff Order, establish that the task left to the Office involved the Office making its own decision with respect to the most appropriate methodology to achieve the incentive objectives of the price fixing exercise.
>
> This involved the Office making its own investigations of material that it could, and making its own judgment as to relevant factors, the methodology used and the weight that should be attached to the various relevant factors. The task was entrusted by Parliament to the Office.
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> It would only be a very clear case of a determination made without power which would justify this Court's intervention. TXU carries a very heavy burden in the light of the flexibility, discretion and judgment making given to the Office in going about its task of price regulation.
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> In the final analysis, it was a matter for the Office to investigate and obtain what information it could, relevant to its assessment, to select relevant matters to take into account and to determine the proper methodology. The choice of techniques for estimation and analysis, and the utility of certain matters that should be taken into account were all properly left, in my view to, the expert discretion of the Office. The Office employed and engaged consultants in the fields of price regulation and economics, and the Parliament and the framers of the Tariff Order intended that these matters should all be left to the good judgment of the Office.

Apart from identifying a further potential for inconsistency in the role played by judicial review, the discussion above suggests that scope for appeals from a regulator's decision will reflect at least two factors:

1 the degree of prescription in the regulatory framework – which will determine the scope for judicial review, with a more prescriptive framework permitting more matters to be challenged in a court; and

2 the design features of the merit review – that is, choices about such matters as the timelines for the review, hurdles that must be met for an appeal to be considered, etc, will determine the scope of any merit review.

Moreover, these two influences on the nature and scope of appeals are interdependent. In particular, if the rules and methodologies that a regulator is required to adopt when

assessing prices are prescribed in considerable detail, then judicial review alone may provide a sufficient check on the regulator's decision (ie, having clarified the interpretation of the law in areas under dispute, the matter can be referred back to the expert regulator to apply the law appropriately). On the other hand, however, a reduction in the degree of prescription in the Gas and Electricity Codes, would also reduce the scope for judicial review being reduced as a consequence. However, reducing the degree of prescription in the regulatory frameworks would expand the discretion of the regulator and so strengthen the case for retaining some form of merit review appeal.

It is argued in the next section of this paper that a problem with the current regulatory frameworks in the energy sector is that greater prescription brings with it a greater risk of ambiguity, inconsistency and inflexibility. The conclusion reached in that section is that a model that deserves consideration is for the governing law to contain well-defined objectives, high level guiding principles and key constraints on regulatory decision-making, but otherwise leave the regulator with discretion as to how it went about setting prices.

In relation to the jurisdiction of the merit review body, a sound case can be made that the most appropriate role for merit review is to focus on remedying clearly unreasonable decisions on important matters of principle, rather than on questioning each of the many judgements that a regulator is required to make when setting regulated prices.

It was noted above that price review decisions are complex tasks, with many interrelated elements and even with interrelationships between separate decisions over time. An implication is that it would be impracticable in any event for merit review bodies to be tasked with replicating entirely the pricing decisions made by regulatory bodies over much longer periods and with the support of expert analysts and staff. The resources required for this task would be excessive, a further element of uncertainty and variability would be introduced and the time taken to set new prices would increase substantially.

It was also noted earlier that a key reason for retaining both merit and judicial review is to provide a level of confidence in the overall system sufficient to ensure that investors remain willing to invest the capital required to provide the level of service demanded by the community over the long term. Satisfying this objective can be quite consistent with an approach of restricting the focus of administrative reviews to important matters of principle and interpretation while retaining a presumption in favour of the regulator's independent expertise and experience in relation to the more detailed aspects of the decision.

The role proposed above for the merit review bodies is very similar to the role that the courts in the United States decided to adopt in the landmark *Hope* case, albeit after nearly 50 years of judicial debate over complex regulatory pricing issues including the appropriate regulatory valuation to place on sunk assets:[16]

> Under the statutory standard of just and reasonable it is the result reached not the method employed which is controlling … It is not theory but the impact of the rate order which counts. If the total effect of the rate order cannot be said to be unjust and unreasonable, judicial enquiry under the Act is at an end. The fact that the method employed to reach that result may contain infirmities is not then important. Moreover, the Commission's order does not become suspect by reason of the fact that it is challenged. It is the product of expert judgement which carries a presumption of validity. And he who would upset the rate order under the Act carries the heavy burden of making a convincing showing that it is invalid because it is unjust and unreasonable in its consequences.

A desire to focus on the strategic issues would suggest that one of the models of 'intermediate merits review', as described by Mr Gleeson, that appear in a number of instruments may be the most appropriate. By way of example, the Gas Access Regime requires aggrieved parties seeking review of a pricing decision to demonstrate an error in the regulator's finding of fact, that the exercise of the regulator's discretion was unreasonable or

that the occasion for exercising the discretion did not arise. These limited grounds for appeal establish a hurdle to be met by including merit review and also provide the merit review body with considerable discretion over which matters it hears. Administered appropriately, this mechanism permits the appeal body to focus only on those matters that are considered to be of sufficient weight and importance having regard to the specified grounds of appeal. The Gas Access Regime also contains further desirable features including the preclusion against considering material that was not before the original regulator.

The effectiveness of the merit review mechanism will also depend on the capacity of, and approach taken by, the members of the body themselves. The tribunal chair and members need to be able to distinguish the matters that should be heard within the jurisdiction of the appeal process and to reject others that fall outside of it. They also need to be able to manage the appeal hearing and decision-making processes often to very demanding time lines. When faced with a battery of barristers and a large number of complex submissions for review, some appeal body members may be more easily persuaded to consider matters beyond their jurisdiction than would be the case for a judge presiding over a judicial review.

Indeed, of the merit reviews that have been heard to date, there have been a number of instances where appeal bodies have been drawn into matters that would appear not to have been of sufficient materiality. By way of example, the appeal body hearing the merit review of the Victorian Essential Services Commission's pricing decision on electricity distribution services was drawn into pronouncing on whether the Commission had appropriately included an allocation of overheads to streetlighting charges, notwithstanding that the amounts involved were immaterial in the context of the review.[17] Equally, one could question, on grounds of materiality, whether the Australian Competition Tribunal should have considered the issue of whether five or ten year bonds provide the better estimate of a risk free rate when deriving a rate of return.[18] There have also been instances where merits appeal bodies appear to have made rulings on matters of law which are appropriately the province of the courts under judicial review[19].

On the basis of this discussion, it is worth reflecting on how the decisions of merit review bodies could be considered to fit within the hierarchy of the emerging 'regulatory precedent' referred to above. Given the diversity of these merit review bodies and their roles and having regard to the experience to date, it is evident that their decisions on price review matters could not be expected to carry the same precedent weight as would superior court judicial review decisions. As most of the regulatory and analytical expertise necessary to assess the merit of price regulation decisions is necessarily possessed by the regulatory authorities, it would be unfair to expect the merit review bodies to be in a position to lead the development of regulatory methodology and practice. It is likely, however, that the decisions of merit review bodies will progressively be reflected in the evolving processes and methodologies of energy regulators and in that way will have influenced the emerging regulatory precedent.

Incommensurable Standards and the Clarity of the Current Law

As noted above, difficulties arise in interpreting and applying regulatory frameworks that prescribe in detail objectives, principles and criteria that are incapable of being objectively measured and compared and also prescribe in detail the methodologies that regulators are to follow when making their decisions. Such regulatory instruments involve a considerable potential for their instructions to be unclear or inconsistent, and to place regulators in the position of facing a high likelihood of appeal irrespective of the decision that they make. Indeed, one of the main outcomes of the appeals that have occurred to date has been a demonstration of the shortcomings and ambiguities of the current statutes and regulations that govern energy price regulation.

As noted by Mr Gleeson in his paper, it is evident that the law and regulatory instruments that apply for the regulation of gas and electricity industry prices are overly complex structures embodying a range of 'incommensurable' objectives, principles, criteria and regulatory rules that provide the potential for confusion, disputation and appeal on a broad range of issues. The National Gas Code has been the subject of most of the appeals to date and, as Mr Gleeson has commented at some length, the various appeal decisions have produced a body of precedent which provide some assistance to regulators in assigning priority to the hierarchy of criteria and principles that are required to be considered or applied in reaching a decision under the Code. Nevertheless, to date, those decisions have not produced a clear roadmap that a regulator can apply and have reasonable confidence that its decision will not be subject to appeal.

As Mr Gleeson has also noted, two of the more substantial appeal decisions in the area – the West Australian Supreme Court in the *Epic Energy (WA)* matter and the Australian Competition Tribunal in the *East Australian Pipeline* matter – provide quite different (and arguably, irreconcilable) views as to the application of the hierarchy of the criteria and principles in the Gas Code. From the point of view of regulators, one of the more important differences is the role that each review body considered that economic principles should play in guiding the regulator's interpretation of the Code and exercise of discretion.

In the *Epic Energy (WA)* matter, the impression that one has from the reasoning in the decision is that the Court tended to downplay the weight that should be placed on economic principles, and rather, in a number of places, emphasised the need to focus on a broader set of guiding principles. By way of example, when considering the relevance of the actual purchase price of a pipeline (which may have contained capitalised monopoly rents) in the determination of the pipeline's value for regulatory purposes the Court noted that:[20]

> A sale at market value may well involve the capitalisation of some monopoly returns. These will have been paid to the original owner by the new purchaser. While economic theory would turn its face against such a market value, a sale in these circumstances introduces, as an additional factor, the legitimate investment and businesses interests of the new purchaser … Economic theory aside, this investment has social, political and public interest dimensions and it is not a surprising circumstance that the Act and the Code should seek to accommodate them.

The Court also considered the italicised 'overview' comments at the front of the chapter of the Code dealing with pricing principles which state that 'efficient cost' is an overarching element of the principles governing the setting of regulated prices, and concluded that:[21]

> it follows that the submissions … insofar as they advanced the view that section 8.1(a) [efficient costs] had an overarching effect, must be rejected.

In contrast, however, in the *East Australian Pipeline* matter, the overall impression that one gains is that the Australian Competition Tribunal took the view that economic principles are a primary consideration in giving appropriate meaning to the provision of the Gas Code, for example, in the following:[22]

> the primary quest is for a proper contemporaneous value from which to deduce a tariff that will replicate a hypothetical competitive market.

Moreover, somewhat in contrast to the views of the West Australian Supreme Court, it noted that:[23]

> DORC is the methodology most in keeping with the recovery of efficient costs … which the Overview describes (in our opinion correctly) as the 'overarching' requirement of the Tariff principles.

As economic principles provide an internally consistent framework for analysing economic regulation problems (with economic efficiency being a principal element), the view of the

Australian Competition Tribunal is the more attractive one from the view point of economic regulators. However, the different view taken by the Western Australian Supreme Court simply emphasises the ambiguity that remains in interpreting and applying the Gas Code in its current form and the potential that remains for disputation and appeal in relation to its application by regulators.

Against that background, while the efforts of the appeal bodies at attempting to clarify the current law are to be applauded, there is a limit to the extent to which regulators, the courts and appeal bodies can clarify law that is ambiguous and even contradictory in terms of its objective and interpretation. This appears to be the case in relation to the Gas Code in the light of various rulings on appeals against decisions made under it. While there have not been any appeals against regulators' decisions under the pricing elements of the National Electricity Code (Chapter 6) (largely due to the absence of merit appeals under that instrument), these provisions are arguably as unclear as the equivalent provisions of the Gas Code.

The first priority for policy and the legislatures, therefore, should be to subject these instruments to review and reform in the light of the experience to date. One important objective of such a review should be to establish clearly a single overarching objective of the Codes, to simplify their guiding principles and criteria and to provide less prescription and greater discretion for regulators in their application of the Codes. As discussed in the previous section, a substantial reduction in the prescription of the regulatory framework that applies under the Gas and Electricity Codes would also be highly desirable in reducing the scope and need for administrative review, and in focusing future reviews on those elements that are of most importance.

One issue raised by Mr Gleeson that deserves further comment was the finding of the Australian Competition Tribunal in a recent *GasNet* matter, which can be described as establishing a 'point within a range' rule. In that case, the Tribunal concluded that where an estimate or value proposed by a regulated entity is deemed to fall within the range reasonably consistent with the requirements of the Gas Code, then it is beyond power for the regulator to reject the proposal merely because it prefers an alternative estimate or valuation.[24] Specifically in relation to the rate of return, the Tribunal held that:[25]

> Contrary to the submission of the ACCC, it is not the task of the Relevant Regulator under s 8.30 and s 8.31 of the Code to determine a '*return which is commensurate with prevailing conditions in the market for funds and the risk involved in delivering the Reference Service*'. The task of the ACCC is to determine whether the proposed AA in its treatment of Rate of Return is consistent with the provisions of s 8.30 and s 8.31 and that the rate determined falls within the range of rates commensurate with the prevailing market conditions and the relevant risk.

There is a danger that the Tribunal's view on this matter, if accepted, would substantially change the nature of the regulatory regime, as well as increase the complexity of its administration. The plausible 'range of rates' that can be established through defensible empirical and statistical analyses is sufficiently wide as to imply that regulatory intervention under this rule would be a rare event indeed. Moreover establishing the plausible range is likely to be at least as complex a matter as establishing an appropriate estimated value.

The evident intention of governments when legislating to establish the Gas and Electricity Codes was to ensure that there were bodies in place – the regulators – with the independence and expertise to stand above the commercial interests of both asset owners and customers, to act independently of the short-term political pressures on governments and to make decisions that are in the public interest under the requirements of the law. This latest decision risks cutting across this public policy objective and would seem to provide a further imperative for review of the codes and the basis for appeals under them.

Conclusions

The title of this session, 'the tournament of the incompatible' may be taken to imply that there is tension and conflict between regulation, regulators and the administrative appeal processes to which they are subject. However, regulators, in general, support the need for robust checks and balances in their regulatory frameworks and processes including the accountability of an effective administrative review process. Indeed, many of the reactions of regulators to the reality of appeal have been positive. Appeals have provided pressure to improve the quality of analysis, and have also provided an additional source of pressure for organisational reforms to improve the quality of decisions – such as introducing a clearer separation between the decision-makers and staff, and replacing individual decision-makers with multi-person commissions.

With the corporatisation and, in some cases, privatisation of many of our utility services, it is imperative that private investors have confidence to continue to invest as necessary to meet the levels of service that customers will seek over the long term, and that governments have confidence that customers' interests are protected. Appeal mechanisms have also played an important part in providing this confidence as well as in holding independent regulatory decision-makers to account and ensuring that fairness and natural justice requirements are satisfied.

At the same time, both this paper and Mr Gleeson's have identified shortcomings as well as benefits arising from the experience to date with processes of administrative reviews applied to energy price regulation decisions. Both papers have also identified opportunities for strengthening the outcomes that can be achieved from future appeal processes while minimising the negatives.

One of the shortcomings with the appeal mechanisms is the degree of inconsistency currently in the scope of appeals from price review decisions between industries and jurisdictions. There is wide variation in the design features of the merit review mechanisms – such as grounds of appeal, evidence that can be considered and timelines – as well as in the extent to which merit review is available at all. In addition, the extent of prescription differs across the various regulatory frameworks, which necessarily implies varying scope for judicial review. These inconsistencies raise public policy concerns, and are one of the matters that are expected to be reviewed by the current reforms to energy sector regulation being pursued through the Ministerial Council on Energy. This review also provides an opportunity to inquire into the most appropriate role for appeal mechanisms in the energy sector.

The characteristics of price reviews provide essential background to the design of the appeal mechanisms from regulators' decisions. Unlike many matters that come before the various appeal bodies for which either a 'yes' or 'no' answer is required, pricing decisions are based on the exercise of judgement on numerous interrelated and complex matters, ranging from general principles to findings on specific facts. The process is based on detailed analysis requiring substantial expertise and generally takes more than a year of consultation, fact-finding and analysis. The reality is that appeal bodies would not be able to perform effectively the role of replicating all of the analyses and findings that form the basis of a price review decision. Both the time and resources required for these roles would be prohibitive.

Against this background, this paper has suggested that the most appropriate role for merit review bodies would be to focus on the application of high-level principles the application of which has a material effect on the balance and impact of the decision, and to intervene only where decisions are manifestly unreasonable. Such an approach would be consistent with achieving the objective of creating confidence in the system, while also reducing the likelihood that the threat of appeals would lead to delays in regulators issuing decisions, the

introduction of formality and inflexibility into their decisions and reasons and increased risk and uncertainty as to the likelihood and outcome of appeals on the decisions. Some of the current 'intermediate merit review' mechanisms identified in this paper and Mr Gleeson's may provide a useful model for such a mechanism, noting however, the role performed by appeal bodies inevitably is determined largely by the decisions of the appeal body members themselves.

A second shortcoming with the current appeal mechanisms relates not to the structure of the appeal mechanisms themselves, but to the structure of the regulatory frameworks that are in place. One of the main outcomes of the appeals that have occurred to date has been to demonstrate the ambiguity that exists in the current regulatory frameworks, including the adoption in some cases of what are often 'incommensurable' objectives, principles, criteria and regulatory rules to be applied at different levels of the decision-making process. While there are a number of precedents now providing guidance on how to navigate through these regulatory instruments, to date, those decisions have not produced a clear roadmap that a regulator can apply and have reasonable confidence that its decision will not be subject to appeal.

Indeed, two of the major cases in the area – the West Australian Supreme Court decision on the *Epic (WA)* matter and the Australian Competition Tribunal's decision in the *East Australian Pipeline* matter – stand at odds on an issue that is of fundamental interest to economic regulators. That is, the role of economic principles in guiding decisions under the National Gas Code. In addition, more recent decisions that have suggested that a regulator's task is only to disallow a pricing proposal if it is outside of a 'reasonable range' have the potential to substantially change the application of the existing regulatory regimes, and in a manner that was unlikely to have been intended by governments.

While the efforts of the various appeal bodies in seeking to clarify the legal structure and interpretation of these regulatory instruments is to be encouraged, the more appropriate remedy for uncertain law is for it to be remedied by the legislature. Accordingly, a priority for policy makers and the legislature should be to review the instruments in light of the experience to date, with a view to establishing clearly the overarching objective of the relevant instruments, preferably simplifying the guiding principles and criteria and providing less prescription and greater discretion for regulators. The current review of energy sector regulation being undertaken by the Ministerial Council on Energy provides a platform for such desirable reform.

It would be inappropriate, however, to conclude a discussion about energy sector regulation and the role of appeals therein, without emphasising the substantial positives that have flowed from the experience to date.

The Australian economy as a whole is better off as a result of the complementary reforms of competition policy and GBE corporatisation. Moreover, the injection of private participation into this previously government owned and operated domain of utility service provision has been an additional spur to efficiency and improved consumer service. These developments have and will continue to benefit all Australians for years to come. While experience has shown that improvements are possible to overcome shortcomings that exist in the regulatory frameworks and appeal mechanisms that currently exist, these shortcomings have not undermined the success of the wider reforms or the delivery of substantial benefits from the judicial and merit review decisions that have been made to date.

On the contrary, since the introduction of the reforms we have seen the development of a substantial body of regulatory thinking and practice that has substantially improved the predicability and replicability of regulatory decisions and processes. The threat – and occurrence – of appeals has been an important a part of the development of this regulatory

precedent, and will continue to provide a positive pressure for improved regulatory decision-making into the future.

Endnotes

1 The court appeals that have been concluded are *TXU Electricity Limited v Office of the Regulator-General & Ors* [2001] VSC 153 (17 May 2001) and *Re Michael; Ex parte Epic Energy (WA) Nominees Pty Limited* [2002] WASCA 231. The appeals to merit review bodies that have been concluded are *In the matter of the Office of the Regulator-General Act 1994 and in the matter of an appeal pursuant to s.37 of the Act brought by AGL Electricity Limited, United Energy Limited, TXU Electricity Limited and Powercor Australia Limited* (16 October 2000), *Re Application for Review of the Decision by the Australian Competition and Consumer Commission Published on 17 January 2003 in connection with Revisions to the Access Arrangement for the Gas Transmission System owned by GasNet Australia (Operations) Pty Ltd* (23 December 2003), *Application by Epic Energy South Australia Pty Ltd* [2002] ACompT 4 (27 November 2002) and *Application by East Australian Pipeline Limited* [2004] ACompT 8 (8 July 2004). In addition, the ACCC has sought leave to appeal the Australian Competition Tribunal's decision in the *East Australian Pipeline* matter to the Federal Court, and a merit review of the West Australian Economic Regulatory Authority's decision on the Epic Energy (WA) access arrangement is currently in process.

2 In economic regulation, the deeming of a 'cost' for an asset and assigning a 'value' for that asset refer to the same process. This is because the goal of cost-based regulation is to provide a revenue stream that is equal to the costs incurred, and so a deemed cost to the entity causes the same amount of revenue, and so is also a value.

3 By way of example, the incentive arrangements reward the distributors for reducing their cost below that forecast by the Commission. Because of the existence of these incentives, at the following review, the Commission will be able to draw an inference that the distributors' actual expenditure has been efficient, and obviate the need independently to assess the efficiency of their operation.

4 For example, *TXU Electricity Limited v Office of the Regulator-General & Ors* [2001] VSC 153 (17 May 2001).

5 For example, *Re Michael; Ex parte Epic Energy (WA) Nominees Pty Limited* [2002] WASCA 231.

6 For example, *Re Michael; Ex parte Epic Energy (WA) Nominees Pty Limited* [2002] WASCA 231.

7 For example, *Application by East Australian Pipeline Limited* [2004] ACompT 8 (8 July 2004).

8 The economic regulators in Victoria, South Australia, Western Australia, the ACT, Tasmania and the Northern Territory were all established with an individual as the statutory decision-maker. Now, multi-person commissions exist in all jurisdictions except for Tasmania and the Northern Territory.

9 All of the administrative appeal bodies for appeals from energy-sector pricing decisions are also able to remit matters to the regulator to redetermine subject to its findings if they so choose, and this choice has been exercised (for example, by the Australian Competition Tribunal in *Application by East Australian Pipeline Limited* [2004] ACompT 8 (8 July 2004)). However, the Tribunal has also chosen to issue its own replacement decision, including recalculated prices, for example, in *Re Application for Review of the Decision by the Australian Competition and Consumer Commission Published on 17 January 2003 in connection with Revisions to the Access Arrangement for the Gas Transmission System owned by GasNet Australia (Operations) Pty Ltd,* 23 December 2003.

10 This is because the Gas Access Regime governs all appeals. The Gas Access Regime comprises the Gas Access Pipelines Law, the National Third party Access Code for Natural Gas Pipeline Systems and the Inter-Government Natural Gas Pipelines Access Agreement (7 November 1997).

11 The principal differences relate to the restrictions that apply to appeals, and the evidence that may be considered.

12 South Australia, Tasmania, Victoria, the ACT, New South Wales and Queensland.

13 *Re Michael; Ex parte Epic Energy (WA) Nominees Pty Limited* [2002] WASCA 231.

14 The Commission was then the Office of the Regulator-General.

15 *TXU Electricity Limited v Office of the Regulator-General & Ors* [2001] VSC 153 (17 May 2001), paras 314-317.

16 *Federal Power Commission v Hope Natural Gas* 320 US 591 (1945). The debate in the courts about the valuation of assets for regulatory purposes dated back at least to *Smyth v Ames* 169 US 466 (1898).

17 *In the matter of the Office of the Regulator-General Act 1994 and in the matter of an appeal pursuant to s.37 of the Act brought by AGL Electricity Limited* (16 October 2000).

18 *Application for Review of the Decision by the Australian Competition and Consumer Commission Published on 17 January 2003 in connection with Revisions to the Access Arrangement for the Gas Transmission System owned by GasNet Australia (Operations) Pty Ltd*), 23 December 2003.

19 The Australian Competition Tribunal's decision on the 'rate of return' issue in the GasNet matter is a possible example (*Application for Review of the Decision by the Australian Competition and Consumer Commission Published on 17 January 2003 in connection with Revisions to the Access Arrangement for the Gas Transmission System owned by GasNet Australia (Operations) Pty Ltd*), 23 December 2003). In that case, the Tribunal's decision, for the most part, reflected its view that the ACCC had interpreted the law incorrectly, rather than having reached an inappropriate judgement.

Comments to this effect were also made in the court decision on *TXU Electricity Limited v Office of the Regulator-General & Ors* [2001] VSC 153 (17 May 2001)

20 *Re Michael; Ex parte Epic Energy (WA) Nominees Pty Limited* [2002] WASCA 231, para 178.

21 Ibid, para 160.

22 *Application by East Australian Pipeline Limited* [2004] ACompT 8 (8 July 2004), para 34.

23 Ibid, para 38.

24 *Application for Review of the Decision by the Australian Competition and Consumer Commission Published on 17 January 2003 in connection with Revisions to the Access Arrangement for the Gas Transmission System owned by GasNet Australia (Operations) Pty Ltd*, 23 December 2003, para 29.

25 Ibid, para 42.