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Key questions for RIIO-T2 and GD2

LESSONS FROM THE APPEALS REGIME IN AUSTRALIA

This is part of a series of discussion notes that are relevant for the next RIIO price controls.

The appeals regime for electricity and gas was changed in 2011 to allow the Competition and Markets Authority (CMA) to review specific parts of Ofgem's price control decisions, rather than the decision as a whole. Fears that the UK would be following in the steps of the (unsuccessful) appeals regime that operates in Australia's energy markets have not (yet) materialised. But the Australian experience can still provide insight into the approach stakeholders in the UK should adopt to price controls.

AUSTRALIA: A NEVER-ENDING CYCLE OF REVIEWS AND APPEALS

The Australian energy market is governed by a multitude of agencies at both federal and state levels. The Australian Energy Regulator (AER) has a largely implementational role, with very little room to develop policy. The AER has to comply with detailed requirements for how it sets allowed revenues for energy networks, which are set out in the National Electricity Rules. Even after a significant revision to the Rules in 2012, the AER still has far less regulatory discretion than Ofgem. Guiding the AER's decisions is the National Electricity Objective:

> *"[To] promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity with respect to—*
> *(a) price, quality, safety, reliability and security of supply of electricity; and*
> *(b) the reliability, safety and security of the national electricity system."*

The appeals ('limited merits review') regime allows network companies to cherry-pick specific parts of the AER's decisions. It is no surprise, then, that it has not always acted in consumers' interest. Network companies are less interested in engaging with the regulator, knowing that they can always seek a better deal from the Tribunal.

With the failings of the regime clear, the Federal government introduced a requirement in 2013 that the Tribunal consider whether a different decision to the one made by the AER is "materially preferable with regard to the National Electricity Objective". The results of this change, however, have been mixed.

The first appeal following the introduction of the new requirement was by the network companies in the state of New South Wales (NSW) and in the Australian Capital Territory (ACT). The Tribunal for this appeal only paid lip service to the notion of a materially preferable decision as it decided against the AER on nearly every major point appealed. The AER appealed the Tribunal's decision to judicial review at the Federal Court but lost on key grounds of that appeal. Before the matter could be escalated further the Federal Government stepped in and unilaterally abolished the limited merit reviews regime – making it harder for stakeholders to appeal future decisions by the AER.

Bizarrely, the AER had an unexpected win between losing the NSW/ACT case at the Tribunal and it taking the matter to the Federal Court. In an appeal by the electricity distribution business in the state of South Australia – made on the same grounds that were successful in the NSW/ACT appeal – a Tribunal consisting of different members ruled in favour of the AER on all grounds. The Tribunal's decision was based on a view that the AER had to exercise judgement in considering different sets of imperfect information.

THE PRECEDENT SET BY THE CMA IN RIIO-ED1

To date, the experience in the UK has been vastly different from Australia's. Concerns that allowing network companies (and other parties) to appeal specific parts of Ofgem's price control decisions would lead to the same kind of cherry-picking witnessed in Australia have not materialised. In ruling on the appeals by Northern Powergrid (NPg) and British Gas, the CMA was careful not to act as a second regulator. Instead, the key question for the CMA was whether Ofgem made a decision that was wrong on one of the statutory grounds according to which Ofgem must act.

This line of thinking was reflected in the CMA's decision to only uphold one of the grounds for appeal by NPg (the treatment of smart metering benefits), and only partially uphold one of the grounds for appeal by British Gas (calibration of the Information Quality Incentive). In both cases, the issue as far as the CMA was concerned was that Ofgem's final decisions were not in line with its own strategy decision documents. The fact that Ofgem writes and implements its own regulatory policy gives it a stronger position in the case of an appeal than the AER, which has to interpret rules written by another body.

Even so, NPg may consider its appeal a relative success – the additional revenue provided by the CMA's decision on the treatment of smart metering benefits outweighed the cost to NPg of making the appeal. The CMA allowed NPg to recover additional costs of £31.5 million, of which £11 million are reflected in higher allowed revenue during the eight years of RIIO-ED1, with the rest recovered in future price controls.

The other distribution network operators, who did not appeal their 'slow-track' decision, effectively lost out on a significant amount of money. In future, making strategic appeals may be seen as attractive to network companies, given the potential upside demonstrated by the NPg case.

WHAT AUSTRALIA TEACHES US ABOUT REGULATORY STRATEGY AND BEST PRACTICE REGULATION

The differences between the UK and Australian regimes are clear. We understand that the litigious nature of the Australian regime has meant that informal information-sharing workshops and meetings between the network companies and the AER are no longer a common occurrence. Both sides are understandably cautious of any discussions being recorded and used against them at a tribunal/court. This contrasts with the more open process that Ofgem operates. Ofgem staff and network representatives (as well as other affected stakeholders such as retailers) are able to discuss issues relatively informally, followed-up by formal questions and responses.

Nevertheless, there are still valuable things that regulators, network companies and other stakeholders in the UK can take from the Australian experience and, particularly, from the Tribunal's decision on the NSW/ACT appeal:

- The Tribunal stressed that the AER's role is to balance consumers' interest to pay less for electricity at any point in time with the need for network companies to recover their efficient costs. The Tribunal saw the latter as being in consumers' long-term interest, as it allows for appropriate levels of investment in

the network. This is consistent with Ofgem's stated approach.

- The regulator must adhere to transparent and consultative processes. The Tribunal criticised the AER for not giving the network companies an opportunity to scrutinise the cost assessment benchmarking models before the regulator made its draft determination. At the same time, the Tribunal considered that the AER used its discretion in a way that was not consistent with its own regulatory guidelines (this is a similar argument to the one made by the CMA where it ruled against Ofgem).
- Also on the topic of cost assessment and benchmarking, the Tribunal criticised the AER's reliance on a single model. In forming this view, the Tribunal cited CEPA's expert advice to the network companies. Our advice drew on our UK experience of developing multiple models to 'triangulate' an estimate of efficient operating and capital expenditure, rather than relying on a single model.
- The Tribunal struggled with the requirement in the National Electricity Rules that the rate of return be commensurate with the cost of capital of a 'benchmark efficient entity'. One of the key grounds for the AER's decision to go to judicial review is the view that the Tribunal erred when it determined that the cost of capital of a regulated network company should be based on competitive benchmarks. This issue highlights the highly technical nature of debate on the cost of capital, and the difficulty of addressing this debate in a (legalistic) appeal setting.
- Lastly, the experience of the South Australia Tribunal making the opposite decision to the NSW/ACT tribunal despite looking at very similar arguments should be a source of caution for UK stakeholders. The CMA set a constructive precedent in the RIIO-ED1 appeals, but there is no guarantee that, at a future appeal, a CMA panel consisting of different members will take the same approach.

EFFECT ON DIFFERENT INDUSTRY PLAYERS

Network companies
• Will have to engage earlier and be clearer about the outcomes they want from Ofgem's strategy decision, rather than treating it as a prelude to the battle over the final decision
Suppliers
• Will have to establish expertise in the technical matters of price controls if they are to be effective counterweights to the networks

Ofgem
• Will have to provide sufficient detail and specificity in its strategy decision to inform network companies' business plans. But will need to balance that against leaving enough flexibility to take on different approaches, if the need arises
Consumers
• Unclear whether suppliers (fully) represent consumers' interests in an appeal

KEY QUESTIONS

1. What does the precedent set by the CMA on RIIO-ED1 mean for Ofgem and companies' strategy for RIIO-T2 and GD2?
2. Were there issues with Ofgem's decisions for previous RIIO price controls that were not challenged, and should stakeholders seek to challenge similar decisions this time around?
3. How should Ofgem, network companies, and other stakeholders should position themselves to mitigate the risk of appeals, in light of Australian experience?

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