HERBERT SMITH FREEHILLS

INFRASTRUCTURE TRENDS - #8: INCREASED POLITICAL AND REGULATORY UNCERTAINTY

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Legal Briefings – By **Robert Nicholson, Liza Carver and Matthew Fitzgerald**

In this series of short articles we look at the current trends affecting infrastructure investment in Australia. This article considers trend #8 – Increased political and regulatory uncertainty

RISE IN SOVEREIGN RISK – 12 CLEAR EXAMPLES

Sovereign risk can arise through change in law, interfering with contractual rights and market intervention which impacts sunk investment. Our perception is that sovereign risk is rising in the Australian energy and infrastructure sectors (recognising that this is possibly a global trend). Here are twelve examples:

1. CHANGING THE WAY REGULATED TARIFFS ARE DETERMINED

Australia has long had well-established review mechanisms for administrative decisions - to protect citizens from wayward determinations by regulators and other decision makers by providing for reviews of regulator decisions, usually by tribunals. The Australian Energy Regulator's electricity network revenue determinations have been reviewable by the Australian Competition Tribunal, a well-respected body whose members include Federal judges and highly credentialed economists, through the "Limited Merits Review". Here, decisions of the AER can be overturned where the ACT finds error or unreasonableness, and a different decision is considered likely to promote efficient investment in and operation of electricity services for the long term interests of consumers. In the past, the ACT has found serious flaws in some of the AER determinations.

Any change to these appeal mechanisms is supposed to be supported by a unanimous decision of the COAG Energy Council, comprising representatives of Federal, State and Territory Energy ministers. However, unable to gain support for the abolition of these important rights at COAG, the Commonwealth has decided to "go it alone" and take away the ACT's jurisdiction. This leaves electricity network operators with only the right to challenge a more limited range of legal flaws in AER decisions through the courts.

2. IMPOSITION OF PRICE REGULATION FOR GAS TRANSMISSION

Most gas transmission assets are currently subject to a "negotiate – arbitrate" model. If a party considers they are not getting adequate access to a pipeline, they can apply for a pipeline to be covered which, if the criteria are met, then means they have the right to negotiate terms of access. Failing agreement, they can arbitrate specific elements of access before the Australian Competition Tribunal. The Vertigan Review was commissioned to evaluate the effectiveness of this mechanism. Its recommendations appear likely to be carried further than was intended, such that there is the potential for pipelines to be required to sell access on terms which had never been contemplated when the pipeline was constructed, or potentially even to be forced to make investments to deliver new capacity which no rational investor would contemplate.

3. CHANGES TO THE NATIONAL ELECTRICITY MARKET RULE MAKING PROCESS

The Australian Energy Market Commission was established to consider and manage changes to the National Electricity Rules in a considered and orderly fashion. COAG has recently supported a process designed to bypass that mechanism and allow the South Australian Minister to make rules in connection with energy security or long-term planning (after a recommendation from the newly formed Energy Security Board and approval by the COAG Energy Council). This is a possible source of sovereign risk if broader agendas are pursued through this mechanism. The urgency argument for this power is flawed as AEMC can already make rules on an urgent basis.

4. TEARING UP CONTRACTS

The best example of this is the current Victorian Government's insistence that it would "tear up" binding agreements entered into by the previous Government underpinning the East – West Link in Melbourne (albeit 2 weeks before the calling of an election). Governments cannot simply tear up agreements, which are enforceable in the courts. However, they can legislate to give themselves the power to do so, which the Government threatened to do. Ultimately, investors in the project reached agreement to terminate the contracts at a cost of approximately $1B to the State of Victoria. The investment community was concerned by the Victorian Government's approach, notwithstanding that "tearing up" the East – West contracts was an election promise.

5. USING FIRB TO EFFECT A CHANGE IN TAX LAW WITHOUT LEGISLATION

The Westminster system of government and the rule of law founded on the Magna Carta requires laws to be passed by an elected parliament, administered faithfully by government agencies and enforced by an independent judiciary. Governments frustrated with the legislative process can be tempted to use administrative processes to change the way a law operates. An example is the rising role of the Australian Taxation Office in Foreign Investment Review Board deliberations. The ATO's role in the FIRB process appears to be being used as a tool to persuade investors to adopt investment structures favoured by the ATO, at times even under the threat of withholding FIRB approval if they do not. While the impact of a transaction on government revenues has always been relevant to the national interest test, this has typically only been where wholesale tax avoidance is involved – not where investors seek to adopt established investment models, especially where those structures have previously been the subject of favourable tax rulings or follow international treaties.

6. CHALLENGING FIRB DECISIONS

Decisions of the Treasurer to reject foreign investment applications are extremely rare. However, some recent decisions have often been made very late in sales processes (even after as much as a year of analysis), or based on security considerations which are difficult for the market to understand. Some decisions appear inconsistent with previous approvals. The potential for a negative decision to be made (or "guidance" that approval may not be given) after a party has been publicly involved in a sales process for several months has caused anxiety among some investors. The recent establishment of the Critical Infrastructure Centre and register (draft legislation for which has just been released) will hopefully help create a smoother and more predictable process for FIRB approval requests in the sensitive electricity, ports, water and now gas sectors.

7. LEGISLATING MORATORIA ON GAS PRODUCTION

NSW, Victoria and the Northern Territory have all passed legislation which prevents the development of unconventional gas projects. This legislation has marooned significant investments made in good faith by gas explorers or producers (and also affected pipeline operators). These policies have contributed to the gas supply issues now affecting the security and pricing of electricity in the National Electricity Market.

8. LEGISLATING GAS EXPORT CONTROLS

The recent Australian Domestic Gas Security Mechanism is a spectacular example of intervention by a government to impose controls on major investments after investment decisions have been taken. Here, LNG exporters are threatened with the inability to export LNG at Gladstone to meet their contractual obligations, in circumstances where there might be a shortfall in domestic gas supplies. Recently, a shortfall was found to be likely and the three Gladstone LNG operators agreed a voluntary mechanism to avoid the security mechanism being invoked. The Government acknowledges the desperate nature of this measure but defends it based on the crisis it claims was caused by the State Government moratoria (example 7), the use of gas previously destined for domestic markets to meet export commitments contrary to expectations when the projects were approved and the need for more gas to meet electricity supply shortfalls arising from the rise in intermittent renewable generation.

9. SUBSIDISING INVESTMENTS IN COMPETITION WITH INVESTMENTS ALREADY MADE

Climate change would ordinarily be a Federal responsibility, given Australia's commitment to the Paris Agreement. However, most State and Territory Governments have taken it upon themselves to directly stimulate investment in renewable energy in addition to the existing Federal Renewable Energy Target, either through direct procurement of energy or capacity support or through price guarantee mechanisms such as the Victorian Renewable Energy Target mechanism or Queensland's long term revenue guarantees, issued under its Solar 150 programme. The State and Territory Governments argue that these mechanisms are required due to a lack of coherent (or consistent) Federal Government policy regarding renewables and climate change. The recent Finkel review highlighted the "trilemma" between electricity security, electricity affordability and climate change, and attempts to balance these renewables mechanisms with considerations regarding system security and affordability. Very little investment is now occurring in electricity generation without a Government subsidy or support of one kind or another.

10. MAKING DIRECT INVESTMENTS IN THE ENERGY SECTOR

The Federal Government announced in March plans to expand the capacity of the Snowy Hydro scheme by 2,000MW to include an expanded pumped storage component. Only weeks earlier, Snowy's submission to the Finkel Review had made no mention of this potential project. Investment in the project remains unclear. This week the Queensland government has proposed "re-entering" the electricity retail market, having sold its retail businesses some years ago. Similarly, the South Australian Government responded to its electricity crisis by directly procuring gas-peaker and battery capacity. These actions reverse the decades-long trend of Governments reducing their involvement in the energy sector. The presence of Government-owned participants in the energy sector risks non-commercial behaviour and may be seen as a deterrent to private sector investment.

11. IMPOSING RETAIL PRICE CONTROLS

The Victorian Government is considering electricity price controls. These have the potential to strand retailers with fixed price long term commitments and make it difficult for retailers without access to low cost electricity contracts to compete with large retailers who do have such access. Again, these actions reverse a trend of de-regulating the Australian energy sector.

12. FORCED RELIABILITY AND EMISSIONS GUARANTEES

The proposed National Energy Guarantee will require electricity retailers to prove they are sourcing supplies which meet minimum reliability and emissions standards. Whilst controls of this general nature have been flagged for some time, they have the potential to impact existing investments in both renewable plant (in regions where there is thought to be too much) and thermal plant (if the settings are such that retailers cannot afford to contract with certain high emission plant). Retailers themselves could be impacted where their procurement mix does not fit with these standards, once promulgated. Having said that, the business community has been pleading for stability in this policy area, seeking a long term predictable framework to create a stable investment climate, and this model has received some support.

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

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