



ENERGY MARKET GOVERNANCE REVIEW

Response to Draft Report
24 August 2015

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EXECUTIVE SUMMARY

The Energy Networks Association (ENA) welcomes the opportunity to respond to the COAG Energy Council Review Panel's draft report *Review of Governance Arrangements for Australian Energy Markets*. This review is critical to the ongoing strength and resilience of energy markets over the next decade, and to safeguard the delivery of outcomes in the long-term interests of network customers.

The ENA is supportive of the draft report's broad conclusions and package of proposed reforms, and considers their implementation would materially enhance the effective governance of Australian energy markets.

The ENA welcomes the clear recognition by the Review Panel that the overarching division of responsibilities within the energy market, and the overall governance model, is fundamentally sound. The ENA also concurs with the Panel's focus on proposing discrete improvements to the existing arrangements.

In particular, the ENA welcomes the proposals to increase the number of AER and AEMC commissioners, to more clearly empower the AEMC to assist the COAG Energy Council in prioritising and executing energy market reform priorities, and recognising the importance of a rule-making body that is separate to the regulatory enforcement body.

In this submission, the ENA makes a number of recommendations which are directed at further enhancing the Review Panel's framework. Importantly, this includes a number of practical proposals designed to enhance the operational performance of the Australian Energy Regulator (AER) in the shorter term, ahead of any recommended institutional reviews that flow from the Panel's recommendations.

In its prior submission, the ENA proposed a significant set of reforms to the AER to enhance its operational capacity to carry out its economic regulatory functions effectively. These proposed measures seek to provide a constructive, pragmatic and actionable set of reforms to address some specific identified areas for performance improvement in the short term to medium term. Despite full and positive analysis of the ENA's and other stakeholders' concerns with some aspects of the AER's performance, the draft report does not contain a set of fully detailed follow-on recommendations in relation to observations by the Panel in this regard.

The ENA urges an active focus by the Review Panel on an expanded set of more pragmatic operational recommendations with potential impacts in the short-

medium term, in addition to the structural long-term options already in the draft report. This would ensure there is an appropriate balance in the level of recommendations made in respect of the AEMC and the AER, in particular. This approach would also ensure the final report had the potential to lead to practical 'early wins', given currently only two substantive recommendations have been made around the AER, and both of these are likely to be subject to further discussion and decision by Australian governments through other intergovernmental processes that may not produce immediate responses.

Another area of focus in the final report needs to be on developing a managed process for evaluating strategic, nationally significant issues in the scope of energy regulation.

This role could be undertaken by the AEMC or, a new body such as that recommended by the Harper Review of Competition Policy (i.e. the proposed Australian Council for Competition Policy). The ENA considers that it may be appropriate as part of this reform to consider amending the National Electricity Rules and Law to alter the role that the AER has historically played assessing the scope of regulation as part of its electricity regulatory processes. This is because significant market and regulatory design issues, such as the introduction of contestability in existing monopoly energy services, should be rigorously evaluated and resolved by an agency independent of the economic regulator.

Further, the Review Panel's draft report makes a number of further reform proposals which the ENA provides comments on. For example, in the ENA's view:

- » **There is a need to balance streamlined rule proposals with effective consultation** – for example, under the proposed two stage rule change process it is critical that effective consultation with stakeholders on the risks, costs and benefits of the proposed rule change occurs, rather than only consultation in relation to implementation of a recommended policy approach.
- » **The Panel should provide further guidance to ensure that the proposed mechanism for the AEMC to sign-off on final guidelines or procedures is applied to each new or revised guideline made under the National Electricity or Gas Rules.** In addition, the AEMC should be expected to informally consult with a range of stakeholders to help inform its view of the consistency of the guideline or procedure with the underlying rule obligation.

BACKGROUND

The Energy Networks Association (ENA) is the peak national body representing gas distribution and electricity transmission and distribution businesses throughout Australia.

Energy networks are the lower pressure gas pipes and low, medium and high voltage electricity lines that transmit and distribute gas and electricity from energy transmission systems directly to the doorsteps of energy customers. Twenty-five electricity and gas network companies are members of ENA, providing governments, policy-makers and the community with a single point of reference for major energy network issues in Australia.

INSTITUTIONAL COORDINATION

REFORM COORDINATION AND DELIVERY

The ENA welcomes the clear recognition by the Review Panel that the overarching division of responsibilities within the energy market, and the overall governance model is fundamentally sound. In this regard, the ENA agrees with the Review Panel that the focus of further work should be on enhancing the current arrangements, while locking in the strong benefits of the existing institutional framework.

It is important that the COAG Energy Council effectively leads energy market reform and policy-making. The ENA supports the Review Panel's recommendation to devote additional resources to provide policy support through the Commonwealth Department of Industry and Science. This is to be complemented by an enhanced role of the AEMC in assisting the Energy Council in setting overall strategic priorities. The ENA is confident that the proposed measures will improve energy reform work program oversight and make the Energy Council's internal processes more effective.

Further, the proposed 'necessity criterion' has a significant merit as it will reinforce a national approach towards energy market reform. As noted in the draft report, there needs to be a continuous and strong focus in achieving consensus in national energy policy and regulation given the split responsibilities between Commonwealth, State and Territory governments.

This process will provide greater scrutiny and transparency around decisions by individual jurisdictions to exempt them from national policies, and has the potential to develop a consensus across all jurisdictions. To this end, the ENA continues to support a more frequent schedule of Energy Council meetings, to provide the opportunities for this consensus and revised approach to be trialled effectively.

Recommendations

1. Preparation of a Statement of Priorities in Energy Reform by COAG on advice of AEMC to provide an integrated, strategic reform focus.
2. An Annual Report on Energy Reform Progress on delivery against core priorities.
3. Increased frequency of Energy Council meetings and greater transparency surrounding core agenda items.

MEANING OF NATIONAL ENERGY OBJECTIVES

The ENA considers the national electricity and gas law objectives provide an essentially sound and clear foundation for policy, rule-making and regulatory decision-making under the relevant laws and rules. As such, they represent a key point of continuity and strength, while also reflecting the multiple lenses through which consumers' interests can be viewed (e.g. price, quality, and reliability).

The second reading speech of the National Electricity Law sets out that the objectives are intended to be primarily interpreted in economic efficiency terms, consistent with the Panel's view that other societal objectives that are the responsibility of parliaments are not implicitly subsidiary, but rather best effected when resources are not wasted in inefficient uses.

The ENA concurs that there has not always been a shared and uncontested understanding of the precise meaning of the expression 'the long-term interests of consumers'. In part, this is likely unavoidable given the different emphasis placed by stakeholders (including between individual consumers and classes of consumers) on what constitutes the optimum balancing of different aspects of price, quality and reliability.

There may be merit, however, in exploration by the Energy Council of steps to provide a supplementary guideline on the interpretation of the term 'long-term', in particular. A greater shared understanding of the time horizon this implies, and the impact this time scale has on assessing what are the relevant factors to be considered by decision-

makers could assist in promoting a more stable, transparent, and predictable governance, policy and regulatory framework.

The ENA considers that this supplementary guidance should address the fact that regulatory and pricing frameworks need to account for the fact that major network infrastructure investments are often long-lived and will be likely to be required to serve both current and future consumers, just as electricity and gas services that are available and potentially feasible today are underpinned by asset investments made 40-50 years ago. Similarly, policy, rule and regulatory decisions should appropriately and explicitly take into account the interests of both current and potential future consumers of electricity and gas services.

ENERGY MARKET AND REGULATORY DESIGN

The ENA considers that the Review Panel risks overlooking a valuable opportunity to address, through this review, some regulatory and governance implications of the transformation trends affecting energy networks and other service providers that arise due to rapidly evolving technologies and business models. These trends are challenging both policy and rule-making institutions like the AEMC and the COAG Energy Council, as well as the Australian Energy Regulator and Australian Energy Market Operator.

In light of these market developments, the primary challenge for the regulatory framework is to facilitate the incorporation of new technologies into the traditional network service.

Recent practice has seen some concerning tendencies as to how institutions grapple with the new issues. For example, fundamental market and regulatory design issues are too frequently being addressed in a disparate, rather than integrated manner, across the energy institutions. In addition, there has been a tendency for Federal, State and Territory governments to introduce policy interventions which may impact on competitive markets or network efficiency, without a full consideration of the costs and benefits of the intervention.

The Review Panel notes, correctly, that the market is moving rapidly and that delays or inaction will likely cause adverse consequences. That is why it is important to ensure clearly defined responsibilities for energy market and regulatory design, given their implications for the responsiveness of

policy framework to market developments. The ENA has identified a number of areas for improvement, which include:

- » **Significant market and regulatory design issues, such as the introduction of contestability in existing monopoly energy services, should be rigorously evaluated and resolved by an agency independent of the economic regulator.** A managed process should apply for evaluating strategic, nationally significant issues in the scope of regulation. This role could be undertaken by the AEMC or, a new body such as that recommended by the Harper Review of Competition Policy (i.e. the proposed Australian Council for Competition Policy). As an example of the practical impact of this issue, it may be appropriate as part of this reform to consider amending the National Electricity Law and Rules to explicitly limit the extent to which the AER should assess the scope of regulation as part of its regulatory processes.
- » **COAG Energy Council should agree to provide a standardised role for the AEMC in assessing individual Federal, State and Territory policy interventions which may impact on energy markets or network efficiency.** While recognising the strategic policy leadership role of governments, the AEMC could provide advice on the consistency of individually proposed Federal, State and Territory carbon or energy policy measures with the national energy objectives. This would seek to ensure that individual jurisdictional carbon or energy policy measures interact with existing national energy policy settings in a coherent and coordinated way and that their implication on the broader National Electricity Market are fully assessed upfront. This measure, which integrates to some degree with the Panel's discussion of the proposed 'necessity criterion', would reinforce a national approach towards energy market reform. The ENA notes that a clear recommendation from the Panel on this issue could also further the COAG Energy Council's objective in its July communique, which indicated it had tasked officials with exploring how the national energy market bodies could provide input into the development and implementation of carbon mitigation policies in relation to their impact on the energy markets and the National Electricity and Gas Objectives.
- » **AEMC should have the unequivocal mandate, and accountability to lead energy market and regulatory design.** The AEMC should provide the leadership in the area of market and regulatory design,

and have the clear capacity to directly seek and receive regulatory and technical advice from the AER and AEMO. It is envisaged that the AEMC under this approach would more clearly represent the primary instrument or 'funnel' through which higher level Energy Council energy policy reform decisions would be planned, sequenced and executed. It should have the accountability for confronting fundamental market and regulatory design issues in proposed rule changes, sufficient to allow the evaluation of whether proposed changes are in the long-term interest of consumers.

The ENA considers that these initiatives are important to ensure that energy market and regulatory design processes deliver benefits to consumers.

Recommendations

4. Significant market and regulatory design issues, such as the introduction of contestability in existing monopoly energy services, should be rigorously evaluated by an agency independent of the economic regulator.
5. The COAG Energy Council should agree to provide a standardised role for the AEMC in assessing Federal, State and Territory policy interventions which may impact on energy markets or network efficiency.
6. The AEMC should be given the unequivocal mandate, and accountability to lead energy market and regulatory design.

PERIODIC REVIEWS OF ENERGY INSTITUTIONS

As positively recognised by the conduct of the current Panel's review, the operation of the energy market governance system should be subject to regular review to ensure it remains relevant and appropriate to the market and policy challenges as these evolve, recognising as well the need for overall stability and predictability in arrangements that underpin long-lived network and other investment.

The ENA supports the recommendation of the Review Panel for regular expert reviews of the performance of the AER. Taking into account the desirability for length of the regulatory period, and the need to provide an opportunity for performance improvements to be implemented prior to the next review, the ENA would recommend that a period between reviews of 7-10 years may be more appropriate than the lower end of the range proposed in the draft report (3 years).

Recommendation

7. Each energy market institution (AEMC, AER, AEMO and ECA) and the overall governance framework should be subject to an independent and public review by the Energy Council every 7-10 years.

AUSTRALIAN ENERGY MARKET COMMISSION

VALUE OF SEPARATE RULE-MAKING BODY

The ENA strongly concurs with the Review Panels' view that the principle of separation of the rule-making body from the economic regulator tasked with applying and enforcing the rules is a critical feature of the existing energy market arrangements.

The independence of the AEMC and the AER are in the long-term interests of energy consumers as it:

- » Provides transparency, predictability and stability in relation to the regulatory environment, thereby supporting efficient network investment over time;
- » Underpins networks' capacity to efficiently finance long-term capital, lowering consumer bills; and
- » Ensures appropriate checks and balances resistant to political pressures upon decision-making.

A number of parties have previously argued that the functions of the AEMC and the AER could be combined into a single body. The ENA is confident that any perceived deficiencies of the existing arrangements can be overcome by the improvements suggested in the draft report. Implementation of these proposed reforms should remove the concerns raised by some stakeholders.

While recognising the need to maintain the separation of rule-making and economic regulatory functions, the ENA considers that it is important that the AER has an appropriate level of expertise and resourcing to effectively perform its functions. Also, the ENA sees merit in the Review Panel's proposed mechanism to ensure that the policy that is implemented by the AER is consistent with the intent envisaged by the AEMC. The ENA comments on this proposal in the latter part of this submission.

MAXIMISING THE VALUE OF POLICY REVIEWS

The ENA notes lengthy delays that have arisen from the AEMC's and Energy Council's processes, which slow market reform, and, in some instances, duplicate analysis. In its draft report, the Review Panel considered how to better manage the review processes.

For market reviews, the Review Panel states that it is attracted to the AEMC's proposal for a two-staged review process. While we agree that there is a need to improve the timeliness of the consideration and completion of market reviews, the ENA has some concerns with the AEMC's two-stage review model.

Essentially, the AEMC proposes to separate the policy from implementation issues, by recommending a policy position to the COAG Energy Council without industry input and consultation. The AEMC identifies it as a benefit that stakeholder consultation during a specific implementation phase would be more effective where the Energy Council has approved the policy position.

The ENA considers that there may be merit to the approach of separating policy from implementation issues. However, it is essential that the policy development stage undergoes consultation prior to the consideration of any implementation issues. In the absence of thorough stakeholder consultation, there is a risk of policy pursuing irrelevant directions – the draft report itself highlights this concern.

IMPROVING THE RULE MAKING PROCESS

One of the key issues identified by stakeholders relates to the timeliness of the AEMC's rule-making process. As the Review Panel observes, timeliness in decision-making needs to be balanced against the risk of error. This issue has been considered carefully in the design of the rule change arrangements, including prescribed timelines, and the establishment and resourcing of the AEMC.

The draft report proposes some positive initiatives, which have the potential to improve the timeliness, efficiency, responsiveness and quality of the rule change process. These include a mechanism for terminating rules change processes (and reviews) where they are no longer relevant or appropriate, as well as amendments to the expedited rule-making process. In addition, a staged review process contemplated in the report has the potential to improve the

timeliness of market reviews, as well as rule change processes flowing from these reviews.

The ENA notes the Review Panel's concern that allowing the AEMC to initiate its own rule changes may be problematic as it would entail the AEMC directing policy in the energy market. This is not the outcome that has been envisaged by the ENA. To clarify our prior proposal, the AEMC should be able to initiate rule changes consistent with the specific recommendations of an Energy Council commissioned AEMC review. Recent practice has seen delays arising from the AEMC being unable to initiate a rule change, even where it has been asked to identify rule changes to address specific issues by the COAG Energy Council. Allowing the AEMC to initiate a rule change in such circumstances is reasonable as it will allow for the timely consideration of implementation issues, ultimately accelerating the pace of energy market reform. Consistent with the current practice, the AEMC would be required to consider whether the proposed rule change is likely to promote the National Electricity or Gas Objective and could make a more preferable rule, if alternative superior approaches are identified through stakeholder consultation.

In addition to the measures proposed by the Review Panel, the ENA suggests a small number of relatively modest targeted amendments to the existing rule change process in the National Electricity and Gas Law, which would further improve the rule-making process.

Recommendations

8. Maximum periods should be defined in legislation covering the lodgment of a rule change and the formal commencement of an associated rule change assessment; and
9. The AEMC should have the power to initiate a rule proposal consistent with the specific recommendations of an Energy Council commissioned AEMC review even in the absence of a draft proposed rule change.

PROPOSED NEW MECHANISMS

The ENA wishes to provide its view in relation to the new mechanisms proposed by the Review Panel. In particular,

1. The draft report contemplates the development of a 'gateway test' process to enhance the AEMC's ability to effectively contribute to strategic market reform.
2. The draft report proposes the process for the AEMC to confirm that the final guidelines or procedures arising from an AEMC process meet the original intent.

Both of these are welcome proposals which will require further consideration to ensure that they achieve the desired objective.

'Gateway test' process

The ENA is in favour of some initial testing process, which would provide the opportunity to identify and prioritise rule changes for commencement. The ENA understands that under the 'gateway test', the proposed rules will be considered against the strategic priorities, thereby allowing energy institutions to respond to the most important issues first.

There is currently insufficient guidance as to how this mechanism may work in practice. It is important that the proposal for the Energy Council is developed in consultation with stakeholders. The ENA looks forward to engaging with the AEMC in relation to this matter.

Delegated rule-making

The Panel has proposed the putting in place of a formal mechanism for the AEMC to sign-off on final guidelines or procedures if they have arisen from an AEMC process.

The ENA supports the policy goal of ensuring that the execution of quasi-rule making functions by other bodies should occur with an accountability check to ensure that subsidiary guidelines and procedures are clearly consistent with the original policy intent of the AEMC. There have been some examples of guidelines developed by the AER in which the approaches adopted by the AER under the guideline have been queried both by the AER's Consumer Challenge Panel and network business.¹

The ENA considers there are five potential benefits of this mechanism:

1. A process to allow for the correction of guidelines that are inconsistent with the declared policy intent will avoid poorly specified guidelines or procedures being put into effect, potentially nullifying or frustrating the intended function of the original rule;
2. Reducing the risk that effort and resources are wasted developing guidelines and procedures that are contrary

to the underlying policy intent of the relevant AEMC-made rule;

3. An enhancement of regulatory certainty arising from guidelines and procedures being transparently assessed upfront as giving proper effect to the original rule;
4. Reduction in the potential for costly and lengthy disputes around the consistency of the guideline or procedure with the underlying rules; and
5. Incentivising the fullest possible consultation and consideration of the interplay of rule design, implementation and enforcement between AEMC and AER/AEMO in the rule-making phase, to avoid unduly broad delegation of what can amount substantively to rule-making obligations.

The ENA considers the proposal should be applied to each new or revised guideline made under the National Electricity or Gas Rules. In particular, it is critical that this mechanism should apply to the scheduled review of the set of guidelines that constitute the AER's Better Regulation package. The ENA further recommends that in the implementation of the proposed reform, the AEMC should be expected to informally consult with a range of stakeholders to help inform its view of the consistency of the guideline or procedure with the underlying rule obligation.

In terms of further evolving the design of the measure, the Panel may wish to consider providing for:

- » The AEMC to have the capacity to express an initial assessment in the draft guideline phase, to allow the AER to efficiently adjust its approach to take account of any potential concerns;
- » An approach that provided the AEMC with the discretion to examine and report on only major AER guidelines, and not be under an obligation to examine and report on more numerous technical AEMO procedures or market rule changes;
- » The operation of the mechanism such that a guideline was presumed to be assessed as consistent unless an explicit finding of inconsistency was made by the AEMC.

¹ For example, the approach of the AER Rate of Return Guideline in relation to consideration of asset pricing models and other market evidence have been questioned by both current appellants of the AER's NSW and ACT electricity determination, but also the AER's Consumer Challenge Panel, see *Smelling the roses and escaping the rabbit holes: the value of looking at actual outcomes in deciding WACC*, Consumer Challenge Panel, July 2014, p.3 and p.14.

Recommendations

10. The AEMC should be required to sign-off on new or revised AER/AEMO guidelines or procedures, taking into account the input of stakeholders.

AUSTRALIAN ENERGY REGULATOR

The establishment of the AER in 2005 was an essential step towards more consistent, nationally-focused decision-making in the network sector. The ENA continues to support the role of the AER in the economic regulation of electricity and gas transmission and distribution networks and enforcing of the Rules for the National Electricity Market (NEM).

Notwithstanding this strong support, on a number of occasions since its establishment, ENA has expressed concerns over aspects of the governance, performance and capabilities of the AER. In its prior submission, the ENA proposed potential reforms to the AER to enhance its capacity to carry out its economic regulatory functions. These reforms represent a genuine and effective response to underlying governance issues. Despite positive analysis of ENA's and other stakeholders' concerns with the AER, the draft report does not contain a set of fully detailed follow-on recommendations in relation to observations by the Panel in this regard. In this submission, the ENA seeks to reinforce its recommendations and provide further evidence to the Review Panel.

RECOMMENDATIONS FOR IMPROVEMENT

Governance and accountability

The Review Panel considered that three board members are insufficient to make complex revenue determinations and provide adequate attention and oversight. This is consistent with the view of Australia's energy networks and ENA's recommendations. An increase in the number of Commissioners would provide recognition of the growing scope and role of the AER since its establishment in 2005, and recognise the growing responsibilities it is likely to assume over the next few years (with potential assumption of network regulatory functions across WA and Northern Territory being examples). Further, additional members will

increase the number and mix of expertise available to the AER.

As noted, as part of a recent package of COAG Energy Council reforms, the Energy Council now develops a *Statement of Expectations* for the AER on an annual basis, and this statement is effectively responded to by a matching AER *Statement of Intent*, which outlines the expected work program and priorities of the body.

The clear specification of expectations and plans increases transparency and accountability. In this regard, however, there is more that can be done. In particular, the setting of expectations for a significant regulatory body such as the AER should routinely include an opportunity for stakeholder comment and input.

The ENA also wishes to draw the Review Panel's attention to the Australian Government's *Regulator Performance Framework*, which establishes a common set of performance measures that would allow for the comprehensive assessment of a regulator's performance and its engagement with stakeholders.

The Framework applies to Commonwealth regulators that administer, monitor or enforce regulation. It does not formally apply to the AER, however, the *AER's Statement of Intent* for 2015/16 recognises the Framework.

Information Box - Key performance indicators²

KPI 1 - Regulators do not unnecessarily impede the efficient operation of regulated entities;

KPI 2 - Communication with regulated entities is clear, targeted and effective;

KPI 3 - Actions undertaken by regulators are proportionate to the regulatory risk being managed;

KPI 4 - Compliance and monitoring approaches are streamlined and co-ordinated;

KPI 5 - Regulators are open and transparent in their dealings with regulated entities; and

KPI 6 - Regulators actively contribute to the continuous improvement of regulatory frameworks.

To provide a systemic approach, the Panel should consider making explicit findings on the need for the AER to consult on the performance metrics above and then monitor and report against these metrics. One option is for these metrics to be included in the *Statement of Expectations* for the AER.

²Regulator Performance Framework
<https://cuttingredtape.gov.au/resources/rpf>

This represents an opportunity to ensure that:

- » Engaging across reviews (ring-fencing, Regulatory Information Notices etc.), happens in a consistent and coordinated way; and
- » Appropriate performance metrics are identified for inclusion in the AER's future *Statement of Intent*.

In addition, ENA considers that the Panel's final report provides an opportunity to draw on not just principles of good regulatory practices, but specific examples drawn from international regulatory bodies. The Information Box below highlights a number of these which have no direct analogue in AER's current practice.

Information Box – Example of innovation and best-practice regulatory approaches

- » Appointment by UK water regulator (Ofwat) of a specific 'investor relations manager' to facilitate structured formal feedback avenues to the regulator on investor perspectives on regulatory determination and capital markets.
- » Forward-looking and generic 'Problem Identification' consultations by New Zealand Commerce Commission examining with industry and consumer input the materiality of potential issues arising from energy market and technology changes for traditional energy network regulation (including the potential need to review traditional regulatory depreciation approaches).
- » Regular and structured 'lessons learnt' post-decision consultations for major determination processes such as recently commenced by Ofwat.
- » Limited but positive financial incentive programs for demonstrated strong stakeholder engagement, administered by the UK energy regulator Ofgem.

The ENA considers that these initiatives demonstrate a robust and active agenda for continuous performance improvement on the part of international regulators. A fruitful avenue for the Panel's exploration in the final report would be the mechanisms through which these types of innovative approaches could be further fostered, noting that in most cases they would appear to not require either complex rules or indeed any major structural changes at all.

Recommendation

11. Public consultation should occur both on COAG Energy Council's statement of expectations and AER's corresponding Statement of Intent, rather than this being a closed process between the COAG Energy Council and AER.
12. Performance metrics under the Australian Government's *Regulator Performance Framework* should be included in the Statement of Expectations for the AER.

Regulatory decision-making

A significant concern of the ENA members has been that individual determinations made by AER do not consistently apply rigour and sound evidence to reach a reasonable decision. This assessment is based on evidence from past merits-based appeals, AER stakeholder surveys and examples from the most recent round of determination and guideline processes.

The ENA does not agree with the conclusions of the Review Panel that the Australian Competition Tribunal (Tribunal) processes in which the AER has participated are not a useful indicator for assessing its performance. This is because in a majority of cases errors of fact have been established by the Tribunal. Therefore, it would be an error to characterise these as merely reflecting uncertainty about the application of the rules or disagreements on the issues. Rather, factual errors indicate the level of the regulator's capacity to assess and use data reasonably, and conduct rigorous, replicable analysis that is consistent with a well-defined and logical analytic and theoretical framework.

While no regulator can entirely avoid error in conducting complex multifaceted access pricing determinations, the record of findings by the Tribunal relating to AER decisions makes clear that the AER's decisions have at times been affected by material and avoidable regulatory errors with potentially significant consequences for the long-term interests of consumers, and network infrastructure investors.

This is an area in which there may be substantial scope for performance improvements. For example, the outcome of the 2014 stakeholder survey also indicates declining performance on metrics such as 'Decisions based on evidence and robust analysis' when compared to the 2011 results.³

³ See AER *Annual Report 2013-14*, September 2014, Part 4, p.57-71

Improving mechanisms to address potential regulatory error

In its previous submission, the ENA proposed some pragmatic and positive suggestions to address potential regulatory errors. There is an ongoing need for arrangements that provide efficient, proportionate opportunities to correct regulatory errors outside of costly merits review proceedings. The draft report recommendations do not go far enough in this respect. The benefit of arrangements that can increase the AER's and stakeholders' confidence in regulatory outcomes and credibility of the decisions bears further emphasis in the final report.

The capacity to address clear errors in a regulatory proceeding using an informal internal review mechanism may be of significant assistance in avoiding the risks and costs of regulatory error, improving final decisions, and avoiding costly legal appeals. Such a mechanism has precedent across a range of different international regulatory regimes, as noted in the recent AER-ACCC working paper International Insights for the Better Economic Regulation of Infrastructure.⁴

The industry is concerned that the AER's current approach to the development of the benchmarking analysis and its application is inconsistent with the rigor and transparency required for good regulatory practice and may actually undermine the future credibility benchmarking techniques. The industry reiterates that it would welcome the opportunity to further work with the AER and other stakeholders to improve the AER's benchmarking approach.

While supporting the ability of the AER to make appropriate use of economic benchmarking as a regulatory tool, there are clearly substantial issues with the AER's benchmarking analysis, which highlight the need for an independent peer review. Network firms have requested the AER and the Australian Government, to seek their own review of the AER's benchmarking approach and model outputs by a recognised independent body with substantial expertise in benchmarking issues. This is consistent with the Productivity Commission's recommendation that the AER should submit its major benchmarking analyses of electricity networks for independent expert peer review.

⁴ AER-ACCC Working Paper International Insights for the Better Economic Regulation of Infrastructure, March 2015, p.106.

Facilitating better regulatory outcomes

While not directly related to the performance of the AER, the ENA wishes to emphasise here that the final report needs to explore a managed process for evaluating strategic, nationally significant issues in the scope of regulation. This role could be undertaken by the AEMC or, a new body such as that recommended by the Harper Review of Competition Policy (i.e. the proposed Australian Council for Competition Policy). It may be appropriate as part of this reform to consider amending the National Electricity Rules and Law to explicitly limit the extent to which the AER should assess the scope of regulation as part of its regulatory processes.

The proposal above is consistent with recent comments by the Harper review and the Monash Business Policy Forum on the separation of competition functions from market functions, defining the scope of core regulated services, and defining the boundaries of unregulated and contestable markets. Under current electricity arrangements the same body (the AER) both carries out the primary regulatory functions, and defines the scope of this function.

In regulatory design terms, this dual function has the potential to lead to perverse organisational incentives, in particular, to retain intrusive regulatory controls even where strong contestability is emerging and feasible. It is noted that in respect of gas, this functional separation exists, with the National Competition Council undertaking the role of assessing 'what should be regulated?'

To facilitate better regulatory outcomes, the ENA also considers that the AER should hold public forums prior to releasing issues papers, especially on issues of how it can relevantly apply its discretion and the rules against evolving market circumstances, outside of individual price reviews. The example where this approach could be applied in the immediate future is the upcoming review of the ring-fencing guidelines.

In accordance with distribution/transmission consultation procedures under the National Electricity Rules, there is no requirement on the AER to release an issues paper or hold a public forum prior to publishing its proposed guideline, methodology, model, scheme, test or amendment. The AER has discretionary control over including additional consultation steps, and on a number of occasions, has chosen to do so. The ENA would like to encourage the AER to hold public forums prior to its commencing formal consultation, so that the AER can benefit from hearing a variety of network businesses', their customers' and other relevant stakeholders' perspectives prior to forming its initial position on the matter under consideration.

A further issue is that on a number of occasions the AER has failed to afford sufficient time for consultation on major new expert reports and critical evidence that it used to inform its regulatory decisions. In its prior submission, the ENA provided examples of process failures on the AER's part, where the AER did not conduct the required consultation and scrutiny envisaged under the National Electricity and Gas Rules.

Recommendations

13. Introduction of informal 'no-fault' error correction opportunities in major network determination processes.
14. AER should, as standard practice, obtain and publish independent expert peer review of the benchmarking methodology, models and data choices.
15. There should be an obligation to disclose and consult on any new expert reports or external sourced evidence the AER proposes to rely on at any stage of the determination process, including prior to the final determination.

Skills and experience

A potential reason for the AER experiencing difficulties in relation to external stakeholders' assessments of its technical capability may relate to the availability of specialist staff to the AER and the impact of such on the quality of its decision-making.

There is an ongoing concern amongst regulated network firms about a relative lack of stability and continuity within the AER 'regulatory reset' teams even within the duration of a single regulatory determination process, which typically takes approximately 18 months.

As the AER noted, as stakeholder survey evidence develops over time, comparisons between the various surveys represent a useful benchmarking tool for the AER.⁵

The AER's 2014 stakeholder survey shows the metric of 'Industry experience' was rated as poor, which is concerning for an industry-specific regulatory body. It is also surprising given that it would be expected a regulator would be observed by stakeholders to have become more experienced and skilled over time, having performed its functions for ten years. This is the trend observed in comparable stakeholder surveys taken over extended time

⁵ AER, Submission on Productivity Commission's Electricity Network Regulatory Frameworks Draft Report, 30 November 2012, p.20.

periods, such as that released by the NSW Independent Pricing and Regulatory Tribunal.⁶

The fact that the AER continues to rely significantly on external consultants also suggests that it may not yet have sufficient in-house expertise. The ENA, however, recognises the AER's recent efforts to increase the use of in-house technical expertise (including engineering capabilities) with a small team in order to strengthen technically focused engagement with regulated businesses.

ENA considers that further scope exists to improve the technical expertise available to the AER, beyond initiatives which the AER has taken itself to date. One form that may be worth exploration is the opportunity for periodic secondments from industry.

Recommendation

16. The AER should explore obtaining increased access to specialist industry expertise through secondment arrangements with the industry.

Independence from ACCC

The Review Panel has tentatively concluded that of the variety of potential models, a stand-alone regulatory body has the best opportunity to develop the particular autonomy, specialised skills and appropriate regulatory culture required.

The ENA has argued in the past that the status of the AER as a constituent part of the ACCC has a number of disadvantages. One is that the ACCC's major roles have a reactive enforcement character and are focused on consumer protection goals. These objectives are distinct from the forward-looking medium term focus decision-making that is applied by the AER.

The ENA is supportive of the Review Panel's conclusions that a stand alone AER would be in a position to more effectively perform its operations. As noted in our prior submission, however, this matter is a low priority to the other identified recommendations in this submission, which have the significant potential to impact on the AER's operational performance in the more immediate term, regardless of future government decisions on the AER's structure.

⁶ [IPART Stakeholder Survey 2013](#)

Recommendation

17. In principle ENA supports the separation of the AER from the ACCC, however, this is a lower priority than other identified reform measures.

AUSTRALIAN ENERGY MARKET OPERATOR

The ENA supports the changes to AEMO's constitution as recommended by the Review Panel. In particular, the draft report recommends that:

- » AEMO's role as the market and system operator needs to be better aligned with the Australian Energy Market Agreement; and
- » A reference to 'promoting the development' of the operation and administration of the wholesale exchange and gas markets is removed from AEMO's statutory functions.

Another positive in the report is that the Review Panel encourages the COAG Energy Council to avoid assigning policy-related tasks to the AEMO. As noted in our previous submission, the ENA considers that the market operator should not generally be a primary provider of advice on energy policy and the economic regulatory framework as it has a separate, distinct role.

While supporting in principle industry ownership or majority ownership of AEMO, the ENA agrees with the Review Panel that the ownership structure is a second order issue.

There are, however, further steps that can be made to enhance AEMO's governance arrangements, which are independent of the ownership structure. The specific recommendations include:

- » Streamlining the process for appointment of Directors so that it is consistent with corporate practice; and
- » Aligning independence requirements with the ASX framework.

Recommendation

18. Corporate governance improvements should achieve improved accountability for the strategic and operational activities of the organisation and approval of its annual budget. AEMO governance arrangements can be enhanced by:

- » Normalising the appointment of Directors in accordance with corporate practice; and
- » Aligning independence requirements with the ASX framework.

POSSIBLE INDUSTRY FUNDING OF INSTITUTIONS

The ENA supports the Panel's consideration of the future funding options for energy market institutions. Joint funding by State, Territory and Commonwealth governments of the AEMC and AER is appropriate given their shared national mandate.

The development of stable and preferably multiple sources of funding would better provide for funding predictability, stability and efficiency over time, optimising the use of resources. In addition, substantive minimum funding by all jurisdictions is appropriate due to the economy-wide benefits and impacts of effective energy market governance and institutions.

The Panel correctly identifies the need to carefully consider the appropriateness of industry contributions, and avoid the provision of delegated power to raise or levy industry contributions. This would reduce the incentives for cost-efficient regulation and raise accountability issues. To the extent that the Panel has received feedback from other stakeholders concerning the perceived independence of energy market institutions, it may be problematic to move to an approach that has the potential to exacerbate these concerns. For this reason, the ENA considers that while appropriate resourcing for the energy market institutions is a critical issue, industry contributions should be:

- » Recognised as just one of a portfolio of potential funding sources; and
- » Recovered from end consumers on a transparent basis consistent with other regulatory obligations (e.g. *National Electricity Law* under 7A(2)(b)).

Regardless of final recommendations on the issue of industry funding, the ENA considers two critical steps to optimising the cost effectiveness of AER resourcing:

- » A focus on initial cost-benefit analysis of proposed new regulatory obligations or information provision processes; and
- » Consideration of annual opportunities to remove redundant regulatory obligations.

Recommendations

19. Given likely continued resource constraints over the medium term, the AER should be required to undertake clearer cost-benefit assessments prior to introducing major new initiatives.
20. The AER should consider implementation of a regulatory 'Simplification Initiative' to identify opportunities to remove or reduce the cost of regulatory obligations on regulated firms and their customers.
21. A review of the adequacy of AER funding should take into account its expanded functions.
22. To the extent that the Panel finds that accountability, capability and performance issues will be addressed by additional funding, more resources should be given to the AER.