18 July 2012

Mr Philip Weickhardt
Presiding Commissioner
Review of Electricity Network Regulation
Productivity Commission
GPO Box 1428
Canberra City ACT 2600

Via email: electricity@pc.gov.au

Dear Mr Weickhardt

Supplementary Submission – Productivity Commission *Review of Electricity Network Regulation*

The Energy Networks Association (ENA) wishes to make a supplementary submission to the Productivity Commission *Issues Paper – Review of Electricity Network Regulation*.

ENA has provided a comprehensive submission on the place of benchmarking in an effective regulatory framework. This supplementary submission provides some related thoughts on the institutional framework for network regulation. The Commission's terms of reference raise the issue of how benchmarking can be applied to network regulation; the supplementary submission addresses this point by identifying ways to enhance the institutional framework.

Under any scheme of monopoly infrastructure regulation, regulators face complex challenges. Regulators must make difficult decisions about such uncertainties as future costs, demand and investment requirements with significant short and long-term consequences for energy consumers and regulated firms. These decisions will inevitably attract criticism, fair and unfair.

For just this reason, ENA emphasises that the establishment of the Australian Energy Regulator (AER) has been essential to more consistent, nationally-focused decision-making in the network sector. That said, after five years, ENA believes that opportunities to enhance the effectiveness of the AER have become apparent.

Constraints on AER capacity building

The AER was originally conceived in the 2002 *Independent Review of Energy Market Directions* as an independent, sector-specific body separate to the ACCC.[1] Ultimately, the Ministerial Council on Energy decided that the AER should be part of the ACCC, with a separate board of Commissioners.

[1] Independent Review of Energy Market Direction, *Towards a Truly National and Efficient Energy Market*, 2002, p.86

The rationale for this hybrid approach was to capture presumed economies of scale and scope with other regulatory activities undertaken by the ACCC.[2] In practice, the AER/ACCC's application of network regulation has been driven by the requirements of the relevant regulatory frameworks. This approach is entirely appropriate but it calls into question the original rationale for incorporating the AER in the ACCC.

The status of the AER as a constituent part of the ACCC has several disadvantages. One is that the ACCC's major roles have a reactive enforcement character, rather than a forward-looking medium-term focus. The AER faces internal competition for high quality staff from other parts of the ACCC. AER staff represent just 15% of total ACCC staff.[3] Opportunities to work on high profile competition issues elsewhere in the ACCC are likely to exert a significant 'pull' on key AER staff. The wider opportunities for transfer and rotation within the ACCC result in rapid staff turnover and the loss of specialist expertise acquired by the AER.

The consequence of this is ongoing reported concern by ENA members about a relative lack of stability and continuity within AER review teams even within the duration of a single review period of 12-24 months. Perhaps as a consequence of this, members have reported that relatively junior staff typically play a significant role in the initial stages of the AER's determination process, at times effectively 'pre-setting' some aspect of the AER's approach, and closing off alternative or more negotiated regulatory approaches. The AER does not appear to have an obvious central 'cadre' of specialists with detailed commercial industry background such as occurs in broadly equivalent regulatory bodies such as Ofgem in the UK. As an example, that body has an appointed Head of Profession – Engineering and Technical Advisor, providing a focal point for a body of expertise located within the regulatory body.

The lack of equivalent resources within the AER drives a significant reliance on externally sourced expertise, which by its nature does not add to the ongoing 'knowledge capital' of the AER. In part, this may be an unintended consequence of the AER being bound to employ staff on the same terms and conditions as ACCC staff (as the AER is a 'constituent part' of the ACCC), and the constraints of broader public sector resourcing decisions. In larger Commonwealth departments and agencies with equivalent remuneration and staff banding approaches, retention of high-performing staff after 5 to 7 years has been a significant challenge. ENA suggests that the Commission consider seeking further information from the AER on these internal resourcing questions, to provide a further basis for analysis.

By contrast, previous jurisdictional bodies had the benefit of being focused on network regulation as 'core business' with long-term experienced staff undertaking multiple sequential reviews. In a similar fashion, the Australian Energy Market Commission is a stand alone body which can invest in developing its in-house capacity with a much lower risk of high quality staff departing the organisation. As an independent body, the Commission has greater flexibility to attract expert staff.

[2] See for example, 'ACCC and Energy Market Reform, Speech by Mr Ed Willet, ACCC Commissioner 11 November 2004

[3] ACCC and Australian Energy Regulator *Annual Report 2010-11*, p.217.

AER performance

There is clear independent evidence that the AER is having difficulties with applying network regulation.

The Australian Competition Tribunal has found material errors in many AER network pricing determinations. The Tribunal has identified recurring fundamental errors in network determinations, including cases where the AER:

- applied a statistic averaging approach to inputs to determining the appropriate corporate income tax allowance which had "no logic to it", confusing basic statistical concepts of point estimates and theoretical upper bounds[4];

- adopted maintenance cost forecasts which assumed a zero defect rate for new growth assets installed, whilst also failing to adequately account for the established relationship between asset age and defect or failure rates[5]; and

- excluded consideration of a published 'fair value' bond yield estimate on the basis of an inadequate sample of five data points, and incorrectly applied a statistical test to identify outlier data points[6].

The AER itself has conceded errors on its part in more than one-third of all matters raised by parties.[7]

The material errors relate to fundamental issues, such as the use of relevant evidence, correct interpretation and application of accepted statistical techniques, and the application of logically consistent principles to derive conclusions from empirical evidence. These errors are not due to uncertain evidence or a justifiable difference of opinion on a discretionary issue. Rather, they represent failures in decision-making and analysis.

Another troubling indicator is the results of the most recent AER stakeholder survey.[8] Responses from a broad range of stakeholders suggest that, on many self-selected measures of performance, the AER is experiencing difficulties.

The AER stakeholder surveys rated AER performance across metrics such as 'professionalism' and 'quality of outputs' in 2008 and 2011. Across all 12 measures of performance, stakeholders rated the AER's performance *more* favourably in 2008 than in 2011. Critically, the three metrics returning the least favourable ratings in 2011 were 'understanding', 'quality of outputs' and 'technical competence'. The survey shows substantial declines on other key measures of performance. The percentage of respondents rating the AER's outputs as 'good' or 'excellent' fell from 62 per cent to 43 per cent. Ratings for 'analytical/intellectual capacity', and 'professionalism' declined sharply

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[4] Application by Energex Ltd (No.2) [2010] ACompT 7

[5] Application by EnergyAustralia and Others [2009] ACompT 8

[6] Application by ActewAGL Distribution [2010] ACompT 4 (17 September 2010)

[7] 23 of 63 matters, based on an assessment of Australian Competition Tribunal cases to date.

[8] See Buchan *Australian Energy Regulator 2011 Stakeholder Survey Report*, September 2011, p.6 and p.15 <http://www.aer.gov.au/node/6023>

between 2008 and 2011. Ratings for reputational measures such as 'credibility', 'reliability' and 'effectiveness' also declined.

The trends in these survey results are concerning. It would have been reasonable to expect the AER survey in 2011 to return more positive results than in 2008; as a new agency in 2008, the AER could have been expected to encounter teething problems with these issues resolved three years later. According to the 2011 survey, the opposite seems to have occurred.

Possible changes for policy consideration

ENA considers there are two possible steps which might be deliberated on by Australian governments to address the constraints identified above. These steps are:

1. ***An external review of AER structure and resourcing*** – to recognise the growing responsibilities of the AER since its establishment and the costs involved in obtaining the specialist skills needed for network regulation. This review could also consider the following step:

2. ***Potential separation of the AER from the ACCC*** – to enable the continuous development of specialist sector-specific capabilities, to promote the status of the AER as a key economic regulator oversighting energy networks valued at over $60 billion and to allow for maximum agency-level flexibility in staffing appointments.

ENA does not view these comments as criticism of the performance of AER staff. ENA's concern is that the regulatory structure is preventing the AER from building a stable skills base for its complex regulatory work. The success of stand alone regulators and rule making bodies in Australia and overseas shows that a long-term commitment to capacity building is essential to improving regulatory performance. This commitment is most easily achieved without in-house competition for resources.

If you have any questions, or ENA can be of further assistance in developing the Commission's views on these important issues, please contact Garth Crawford, Principal Advisor, Economic Regulation Thank you for your consideration.

Yours sincerely

Malcolm Roberts
Chief Executive Officer