Submission to the Productivity Commission

Electricity Network Regulatory Frameworks – Draft Report

Introduction

Thank you for the opportunity to comment on the Productivity Commission (the Commission)'s *Electricity Network Regulatory Frameworks – Draft Report*.

The Department of Primary Industries (DPI) welcomes this review, which is a substantive addition to the study of the contemporary state of energy network regulation in Australia. Victoria has a long history of energy market reform leadership, and the Commission highlights many ways in which there is more work to be done to ensure that energy networks are priced and operated in the best interests of consumers.

This submission is structured in two parts: firstly, DPI makes comment on the broader context for benchmarking of network productivity. Secondly, the specific recommendations of the Commission are responded to.

Part 1 - Benchmarking in context

The Commission's analysis of benchmarking techniques, their benefits, disbenefits, prerequisites and likely results, is comprehensive.

However, the broader context of what productivity benchmarking might add to the regulation of networks appears missing in the Commission's analysis. The key question that needs to be asked is "what is the nature, and what *should* be the nature of the regulatory regime overall?".

A key frame for this question is whether the "economic efficiency" (which is referred to by the overarching National Electricity Objective (NEO) as the key instrument of meeting the long term interests of consumers) is to be approached in a static or dynamic way.

This in turn has implications for what the role of the regulator is, what incentives should be created by regulation, what the form of regulation should be and what benefits to consumers are measured and delivered.

The nature of network regulation in Australia

Australia's chosen method of regulating electricity network service providers will typically be referred to in commentary as one or the other of "the building blocks method" or "CPI-X incentive regulation".

These are both correct characterisations to some extent. While the former refers to a method of building up an estimate of the efficient costs of an Network Service Provider (NSP) from components, the other refers to the adjustment of prices throughout a regulatory period (which can be reset or rolled forward continuously thus increasing or lowering the incentive power) from an initial P_0 onwards.

Within the current Australian regulatory regime, the "building blocks" element takes some aspects of the business's actual condition as granted (the existing asset base, plus additions minus depreciation), while others are derived by regulatory estimation of forward looking efficient costs (capex, opex). Changes in prices over time are set by reference to inflation, adjusted by "X" (which we will return to later), for a fixed period. In this case X is not a productivity term even though a subjective assessment of future productivity potential maybe included in the forecast costs.

There are, of course, other possible combinations. The initial prices of P_0 of businesses can simply be the historical prices, taken as read, or they can be derived from an entirely abstract model of an efficient service provider. Changes in prices over time can be set *ex ante*, *ex post*, can be based on actual changes in costs within a business, or can be again derived from external indicators. These changes over time can be made for fixed periods, or ongoing methodologies of price adjustment can be set up.

In the 1990s, Australia settled on a regulatory estimation of the "efficient" cost of service that combined a regulated return on the asset base with fixed regulatory periods and a CPI-X price change formula. It was chosen as the most appropriate regulatory system that could be devised at a time when the electricity industry was undergoing significant change including vertical disaggregation and privatisation. At that time, a multitude of objectives had to be met simultaneously by the regulator, and the recent past could not be used to gauge the likely future.

In Victoria, the regulatory regime embodied in the Tariff Order from 1995 onward was responsive to the privatisation that had been undertaken. The nature of the regime and its effect on the prices paid at privatisation was a contested matter. Part of the eventual regulatory settlement included requiring the Office of the Regulator General through the Tariff Order to '*utilise price based regulation adopting a CPI-X approach and not rate of return regulation*'.[1] As incentive regulation broadly means that businesses are incentivised to create value by being able to retain some of the benefits of doing so, this commitment to incentive regulation affected the investment made by private investors in the Victorian electricity industry.

Incentive regulation or rate of return regulation?

However, in putting 'incentive regulation' into practice in Victoria, many concessions to reality had to be made. As the industry had operated as a vertically integrated monopoly with significant distortions and cross subsidies at play, good information on the efficient costs of providing services to Victorian consumers was not available. There was also a history of non-economic investments which the new owners had to take on. Finally, there was an impending step change in productivity as the newly privatised industry was radically restructured.

The building blocks/CPI-X framework was the outcome of these dynamics, and of the regulatory precedents set in the United Kingdom, whose privatisation program was the major precedent for the Victorian program.

This regime provides for significant power for the regulator to set costs at the best estimate of "efficient" levels at P_0 (necessary in dealing with an industry in flux), but preserves an element of incentive regulation by then escalating prices at CPI-X over a fixed period, so that

NSPs are incentivised to find further efficiencies to reduce costs below this level. The re-occurrence of a "P_0" determination at the end of the fixed period again caters to the significant risk that actual efficient costs may be very different at the end of the period to what the regulator had estimated at its beginning.

It bears noting that the "incentive" CPI-X part of this framework is heavily circumscribed. Five years is not a long time given the long life assets involved and associated technological inertia, and the setting and re-setting of prices to a firm-specific estimate of "efficient" costs at the start and end means that efficiencies achieved by the firm may be confiscated by the regulator. This is reminiscent of cost-of-service/rate-of-return regulation. The regime is then made more complex by mechanisms such as the efficiency benefits sharing scheme to preserve or smooth some incentive power from period to period.

Static or dynamic efficiency in regulation

Elements of rate of return and incentive regulation co-exist within the National Electricity Rules. The setting of prices to a firm-specific "efficient" level at P_0 is characteristic of rate of return regulation, while the adjustment of prices by a fixed formula over time irrespective of changes in actual company costs is characteristic of incentive regulation.

The Commission accurately notes that regulatory determinations in the electricity industry have become incredibly complicated. In brief, this may well be because the setting of firm-specific "efficient" costs has come to dominate the regulatory enterprise. If this is the case, then the framework by definition is moving away from being an incentive regulatory regime. Certainly, in terms of the *Economic Regulation of Network Service Providers* rule change process, a great degree of emphasis is placed on the AER's role in regulating the asset base of NSPs. In a theoretically "pure" incentive regulatory regime, the asset base would be of relatively little concern to anyone but the business.

This does not in any way detract from the support of Victoria for the rule changes proposed, or the regulatory framework generally. Victoria is strongly committed to ensuring that the current regime works, and the AEMC's final determination will rectify several deficiencies with the existing Rules. Nevertheless, the question must be asked of what direction we are headed in.

This question can perhaps be made more concrete by examining how the framework characterises itself in practice.

The Victorian Tariff Order was unambiguous as to its intent to establish an incentive regulatory regime, while the NEL is more nuanced. Its Revenue and Pricing Principles are the main voice to speak of the nature of the regime, and these speak of the need to provide effective incentives to promote economic efficiency. However, this is heavily qualified, and set within other principles which clearly articulate concepts more familiar to rate of return based regimes, particularly having regard to existing asset bases and provision of a rate of return upon them.

Furthermore, the "incentive regulation" nature of the regime hinges on its price escalation methodology, which uses an "X-factor" to vary prices from the rate of inflation. In the UK where the methodology was first devised, X was initially intended to represent achievable

efficiency gains across the period. This is also the case in many North American applications of Inflation-X price formulae.[2] The AER, on the other hand, is quite explicit that it does *not* regard X as representing efficiency, but rather is a smoothing factor:

"The X smoothing factor is simply a price adjustment mechanism. It does not relate to actual productivity improvements in the operations of a TNSP. However, this does not mean that the AER ignores productivity improvements when assessing a TNSP's revenue proposal. Instead, the AER includes any expectation of productivity gains directly into the forecasts of costs."[3]

Here again, the role of the P_0 determination assumes pre-eminence against the incentivising role of prices that may diverge somewhat from efficient costs for a particular business. In particular, the role of firm-specific forecasts here removes any consideration that an efficiency-based X might be derived for the whole industry, rather than being firm specific.

Implications for the role of benchmarking

To return to the core matter of the Commission's inquiry, benchmarking may be used in two ways, in common with the dualistic nature of the regulatory framework. It may be used to estimate the present "efficient" costs of NSPs, to set prices to their efficient levels and eliminate monopoly rents in a static sense. Or, it may be used to set incentives which encourage the creation of value, and provide for sharing of the gains between NSPs and consumers.

The most significant contribution that benchmarking could play is to assist in setting the change in network prices over time to better reflect the outcomes of a competitive market, which would incentivise innovation and competitiveness in productivity. In a competitive market, prices do not adjust themselves to the individual firm's preferences and histories, they are affected by the prices of the competition. A benchmarked and comparable business is the closest thing to a competitor that a monopolist is likely to encounter, and an aggregate industry benchmark is the best available proxy for a competitive market.

To make best use of benchmarking, however, a change in thinking is required about the nature of the regulatory regime. In particular, the role of changing prices over time to incentivise real dynamic efficiency gains must come to be pre-eminent over the re-setting of costs back to "efficient" levels. This becomes more feasible the longer the industry has operated under private control, as past productivity trends become more reasonable estimates of future ones. At the same time, the benefits of efficiency gains need to be shared with consumers as would be the case in a competitive market. In summary, the role of "X" must be a true efficiency factor. The role of benchmarking in regulation then flows from the decision about the nature of the regulatory regime.

The Commission has considered the role which Total Factor Productivity (TFP) – a broad aggregate benchmark of industry productivity – might play in the NER, including in setting an industry efficiency-derived X-factor. So too has the AEMC, in its *Review Into the Use of Total Factor Productivity for the Determination of Prices and Revenues*, which found that the utilisation of TFP could positively contribute to the National Electricity Objective[4]. The benefits of TFP were also recognised by the Expert Panel on Energy Access Pricing which in 2006 recommended its further development[5]. The Essential Services Commission of Victoria, recognising these benefits, began compiling TFP indices and data in 2001. Finally, the

Ministerial Council on Energy in recognition and preparation for further development of TFP included in Schedule 1, Section 26J to the NEL the provision for Rules to be made for this purpose.

It is regrettable, given all this consideration, that no rules have yet been made to give effect to the intent of Section 26J. In 2008 the State of Victoria submitted a proposed rule change to the AEMC to give this effect, but ultimately the AEMC declined to make Rules, instead submitting the results of its review to the MCE, which is yet to respond, but which will have regard to the Commission's findings in this review.

DPI considers it is time that at least the collection and compilation of an industry-wide TFP data set and index be begun in earnest, with an explicit intention to moving toward a more incentive based regulatory regime. The most certain and transparent way to achieve this is to make Rules as provided for by the NEL.

The issues raised by the Commission in regard to its actual utilisation (such as the potential for privatisations in some States to skew the trends) are real, but a careful reading of the Victorian 2008 rule change application will reveal that many of these issues were anticipated and accounted for in the proposal.

Certainly, the current path, as noted by the Commission, leads to greater and greater intrusion into the business of private companies, consequently fewer incentives to innovate, and in so doing may forego potential benefits for consumers. While it is important to address specific present issues with the current regime, and introduce more rigour through better use of benchmarking in applying the building blocks methodology, this should not be thought of as the end-point goal of regulatory development in Australia.

Part 2 - PC's recommendations

DPI's comments on the PC's recommendations follow. For brevity, we have omitted the text of the recommendations themselves.

Chapter 5 Regulatory incentives

DRAFT RECOMMENDATION 5.1

DPI notes that a perfectly balanced efficiency benefits sharing scheme may be difficult, if not impossible, to achieve in practice for the regulator. The necessity for such a scheme, however, arises from the fact of 5 year pricing resets. To the extent that it may be possible to eventually move away from these periodic resets, the need for such a scheme will reduce. In the present, we support further development of such schemes to improve the incentives set under the NER regime.

DRAFT RECOMMENDATION 5.2

It is probably unnecessary for the Rules to specify the various interdependencies of regulatory parameters. This may introduce unnecessary material into the NER. It should suffice for the purposes of review that the AER itself identify the interdependencies within its determinations. However, this does highlight the need for a review framework which can take

these interdependencies adequately into consideration, rather than focussing on the correction of specified "errors" in one parameter or another.

DRAFT RECOMMENDATION 5.3

DPI has no comment on the debt risk premium and risk free rate, but considers that the AER should take the Commission's advice into consideration in developing its new rate of return guidelines.

DRAFT RECOMMENDATION 5.4

The Commission's approach to prudency reviews of capital appears generally in keeping with the direction of the AEMC's consideration of the *Economic Regulation of Network Service Providers* rule change proposals. DPI has supported the AEMC's draft proposals.

DRAFT RECOMMENDATION 5.6

The Commission proposes that the AER publish its preferred estimate for a revenue determination along with the final determination if it feels constrained by the Rules.

The AER may be placed in a difficult position regarding merits review were it to do this. Furthermore, a merits review body would be highly unlikely to wish to pursue matters regarding a hypothetical decision where the AER's actual decision is clearly in accordance with the Rules. This applies whether the review body is legalistic or administrative in nature.

Chapter 7 Ownership

DRAFT RECOMMENDATION 7.1

Victoria is of course unaffected by the Commission's support for privatisation, being the first mover in this regard. DPI notes the relatively positive experience of Victorian network regulation outcomes with privately owned networks compared to other States, and considers that the national framework as a whole would be enhanced if its assumptions regarding profit motivation held true in each jurisdiction.

DRAFT RECOMMENDATION 7.2

DPI supports the intent of the Commission's proposals for ownership and governance reforms of State-owned enterprises. Indeed, further measures could be contemplated in respect of governance reform of state-owned businesses. For example, the shareholding responsibility could be transferred to a State-owned holding company with an independent Board to ensure its separation from influence by central Government, and vice versa.

Chapter 8 Using benchmarking

DRAFT RECOMMENDATION 8.1

DPI strongly supports the AER undertaking aggregate benchmarking. The absence of such aggregate benchmarking to date has impeded the regulator's ability to adequately assess expenditure proposals from businesses.

DRAFT RECOMMENDATION 8.2

DPI supports the recommendation that the AER undertake further detailed benchmarking analysis. It is particularly important to keep track of international developments, and develop benchmarks with an eye to compatibility with comparable international businesses.

DRAFT RECOMMENDATION 8.3

DPI supports the AER undertaking comparative assessment of NSPs. Where such comparisons are limited to particular reasons, there should be a clear rationale for such limitations. To the extent possible, like for like comparisons should be made as widely as possible.

DRAFT RECOMMENDATION 8.4

The Commission recommends that a form of 'negotiated settlement' between consumers and NSPs be brought into the regulatory framework.

The implications of this construct need to be carefully thought through. The parallels with practice in many North American jurisdictions are noted. However, the role of the 'counterparty' in these negotiations is a heavy one to bear for the appointed party, as they would in effect be negotiating on behalf of millions of consumers, with hundreds of millions of dollars at stake.

The Commission needs to ask itself "on what basis would the agreement of the consumer group to the settlement gain general legitimacy with consumers?".

The proposal, and the Commission's discussion elsewhere of the various views of the role of the regulator, are useful contributions. However, in Victoria the role of the regulator has generally been characterised as being engaged in developing a bargain with the businesses on behalf of consumers. Philosophically, the regulator is *not* a neutral arbitrator, but an entity actively engaged in optimising pricing outcomes in the long-term best interests of consumers. In this view, there is no inconsistency of regulatory investigation and consumer representation, *so long as the regulator remains adequately informed of consumers' preferences*.

With respect to this last statement, DPI supports further initiatives to improve the voice of consumers, so that regulatory outcomes are optimised. However, we remain unconvinced of the need for consumer representatives to take over one of the substantive roles of the regulator, in determining acceptable prices.

DRAFT RECOMMENDATION 8.5

DPI has maintained in submissions to the AEMC's TFP review that there may be scope to utilise benchmarking in order to set regulatory parameters, at least in Victoria where the industry has been privatised and regulated for a considerable length of time.[6] Nevertheless,

Victoria's proposed rules for utilisation of TFP as a regulatory methodology were in the nature of a pilot scheme, and allowed businesses to voluntarily go under a TFP based price path. This is the most sensible way to pursue such a reform, in order to build confidence in a more incentive based regulatory regime.

Ultimately, the case for using benchmarking needs to be assessed by the regulator, having in mind the need to meet the pricing principles and national energy objectives, and the potential for the regulator's decisions to be appealed under the limited merits review framework. If the regulator is confident of the robustness of its benchmarking exercise, we see no reason why it should not rely on it as a determinative factor in its decisions.

DRAFT RECOMMENDATION 8.6

It is self evident that the AER should develop and maintain appropriate benchmarking databases and in-house expertise as suggested by the Commission.

DRAFT RECOMMENDATION 8.7

DPI supports the publication of information regarding industry performance wherever possible. This builds confidence in the regulatory regime and allows appropriate scrutiny of both the industry and the decisions of the regulator.

DRAFT RECOMMENDATION 8.8

Care must be taken when retrospectively comparing past forecasts, and making comparisons between the forecasts of a single entity against the combined forecasts of a group. It is of greatest importance that the broad incentives of the regulatory framework act to ensure that it is in businesses' best interests to get the forecasts right. In this respect, forward looking 'self correcting' mechanisms are greatly preferable to those that rely on point-in-time forecasts.

DRAFT RECOMMENDATION 8.9

The Commission's recommendations around collaboration between the AER and other agencies seem sensible.

DRAFT RECOMMENDATION 8.10

The regulator should take responsibility for its development of benchmarking methodologies, and should apply them in the context of reviewable decisions under the limited merits review framework. DPI considers that the regulator should establish processes for internal review and procure external assistance where necessary, but establishment of a separate external peer review mechanism in addition to internal and limited merits review may be unnecessarily costly.

DRAFT RECOMMENDATION 8.11

DPI supports the AER publishing its analysis and results from benchmarking exercises.

DRAFT RECOMMENDATION 8.12

The benefits of having wide ranging and consistent benchmarking data from across the industry may be difficult to quantify at first, but the absence of such a data set is an impediment to effective regulation and *prima facie* ought to be pursued. The AER will have regard to the NEO in determining what data needs to be collected, but its approach should be forward looking and aim to collect time series data that may be required at a later date.

Chapter 10 Demand management technologies

DRAFT RECOMMENDATION 10.1

Victoria's roll-out of advanced metering infrastructure is well advanced, and the Government is moving to ensure that the potential consumer benefits of this roll-out are realised.

More Victorians will have the option of moving to flexible pricing plans for electricity from the middle of 2013, giving consumers another tool to help control their power bills. Flexible pricing gives customers the choice of plans based on off-peak, shoulder and peak times of the day.

Wider availability of flexible pricing plans is designed to provide energy customers with more options to reduce individual and overall energy costs by reducing the need for network upgrades and new generation.

The issue of mandating time of use tariffs is one which Victoria has given considerable thought to. A mandatory approach may force some customers off tariff structures which best suit their needs. This is not a decision to be taken lightly. In Victoria, therefore, the introduction of flexible network tariffs will be undertaken on a voluntary basis for residential customers, to ensure that customers choose flexible tariffs when they perceive there to be a benefit from doing so. The regulatory framework should maintain the interests of customers as its first priority.

Energy customers will stay on a flat rate unless they choose to change. The Government will support consumers during the introduction of flexible pricing plans with independent price comparison tools and advice.

Furthermore, there will be "safe try" period up until March 2015 during which households will be able to move to a new flexible price offer with their current retailer with the confidence that they can switch back to their previous tariff without penalty if they are uncomfortable with the change.

To facilitate this transition, the current moratorium on flexible network tariffs will be lifted in the middle of 2013, as appropriate consumer protections are introduced.

The Government has developed the new arrangements in close consultation with industry and key consumer and welfare groups through the Advanced Metering Infrastructure Ministerial Advisory Council that was established in early 2012.

The independent cost-benefit analysis on the smart meter roll-out, commissioned by the Coalition Government in 2011, found that a key benefit of smart meters was the ability to

introduce widespread flexible pricing options, which could deliver economic benefits of up to $229 million.

Victoria sees the benefits in other jurisdictions following suit in a way that best optimises the costs and benefits for those jurisdictions. However, regard needs to be had to the implications for national market systems and frameworks. The benefits of further smart meter roll-outs will be increased if there are cost effective national systems and frameworks to 'plug in' to.

Chapter 11 Time-based pricing

DRAFT RECOMMENDATION 11.1

Victoria has considered this matter as part of its planned introduction of flexible pricing.

DPI believes that all residential customers should be provided with choice regarding whether or not they should be on a TOU network tariff.

DRAFT RECOMMENDATION 11.2

The absence of a national distributor authorisation was an explicit decision of policy makers in developing the National Energy Customer Framework, but it is one that was always expected to be revisited. DPI supports this work in principle.

DRAFT RECOMMENDATION 11.3

The Commission's proposals to amend the rules governing tariff proposals are best considered at a later time when the longer term framework for distribution tariffs is clear.

DRAFT RECOMMENDATION 11.4

See response to recommendation 11.3.

DRAFT RECOMMENDATION 11.5

See response to recommendation 11.3.

DRAFT RECOMMENDATION 11.6

DPI notes that State Governments are responsible for determining energy concessions.

The Victorian Government currently provides an uncapped, proportional concession for low-income and vulnerable Victorians (the Annual Electricity Concession provides 17.5 per cent off electricity bills for the whole year, with an adjustment from 1 July 2012 for the Commonwealth carbon price compensation), which is responsive to changes in tariff structure and fluctuating electricity prices in a deregulated electricity market. A proportional concession is equitable as it provides the same level of discount to each customer, regardless of household size or type, e.g. by providing electricity concessions as a percentage of the total bill, greater support is provided to households who require more electricity such as larger families.

Given that flexible pricing will be introduced in Victoria on a voluntary basis together with the responsive nature of Victoria's Annual Electricity Concession, changes to current welfare and concessions arrangements in response to the introduction of flexible tariffs may not be required.

DRAFT RECOMMENDATION 11.7

The Commission's recommendations that businesses consult with consumers in preparing regulatory proposals is supported. DPI notes that similar provisions are being considered by the AEMC in its rule change process.

Chapter 12 Complementary reforms to support demand management

DRAFT RECOMMENDATION 12.1

Victoria already utilises weighted average price caps and has no comment to make on this recommendation.

DRAFT RECOMMENDATION 12.2

DPI supports the recommendation that the AER review its demand management incentive scheme, which is consistent with the AEMC's proposals in its Power of Choice Review.

DRAFT RECOMMENDATION 12.3

Victoria has consistently advocated for removal of retail price regulation where possible. The continued existence of price regulation exerts a distortionary effect on the incentives of energy market participants and should be removed wherever there is effective competition.

Chapter 13 Distributed generation

DRAFT RECOMMENDATION 13.1

Victoria has commenced implementation of the recommendations of Victorian Competition and Efficiency Commission (VCEC) Inquiry into Feed-in Tariff Arrangements and Barriers to Distributed Generation. The Government has moved to limit the over-generous subsidies provided by previous schemes such as the Premium Feed-in Tariff and is expanding the eligibility for the future feed-in tariffs (FiT) schemes to include other renewable energy sources beyond solar. The Government will put in place a minimum feed in tariff rate based on the adjusted wholesale price of power from 1 January 2013. This adjusted wholesale price, initially set at 8 cents per kilowatt-hour broadly reflects the price at which electricity retailers purchase power from generators through the National Electricity Market.

Chapter 14 Reliability frameworks

DRAFT RECOMMENDATION 14.1

Victoria has strongly supported the development of networks and network regulation based on the best available information on the preferences of consumers. The increasingly

prominent role that AEMO is playing in overseeing national transmission arrangements lends itself well to the role of being the holder of data regarding the value of customer reliability.

Chapters 15, 18 and 19 Transmission investment issues

Instead of addressing the specific recommendations of the Commission in these chapters, we note the significant developments occurring under the auspices of the AEMC's Transmission Frameworks Review, which will soon be concluded and submitted to the SCER for consideration.

The Victorian transmission planning regime has delivered cost effective outcomes for consumers over the past decade, and Victoria is concerned not to lose the benefits of a regime which ensures that transmission planning and operation is not affected by the exercise of market power by a transmission company.

On the other hand, there are new challenges facing the electricity supply industry, and the transmission framework must be capable of responding to these flexibly and with the maximum input of commercial signals for investment.

DPI has made several submissions to the AEMC's Transmission Frameworks Review promoting a forward looking approach to transmission planning and investment, recognising the challenges posed by a changing energy system. DPI's submission to the AEMC's Second Interim Report is **attached** for reference and further detail on these points.

Clearly there are several preferred models in play at this time, and while DPI sees advantages in the AEMC's proposed Optional Firm Access proposal for economic transmission rights for generators, we are conscious of the need to preserve the strengths of the current Victorian planning regime, which are highlighted by the Commission.

DPI considers that a firm transmission rights framework will deliver improved coordination of transmission and generation investment, provide a better basis for directing future transmission investment, and provide generators with an ability to better manage market and investment risks.

However, before being able to support the specifics of the Optional Firm Access model preferred by the AEMC, DPI is seeking additional information and analysis as follows:

1. Overseas experience with transmission rights regimes.
2. Additional analysis of the effects and impacts of the Optional Firm Access (OFA) model, including on market behaviour to ensure that there is not distortion of generation bidding behaviour or gaming.
3. Further analysis is needed to ensure that there is confidence that the arrangements will sufficiently incentivise TNSPs to enter into access agreements and to operate and invest efficiently for all customer needs.

A decision on the introduction of financial transmission rights gives rise in turn to a further series of questions regarding the appropriate roles of AEMO and the TNSPs in areas such as local and national transmission planning, connections work and demand side augmentations. These will have to be carefully analysed by the SCER in determining its response.

Chapter 21 Governance

DRAFT RECOMMENDATION 21.1

DPI welcomes the PC's consideration of the broader structural issues around the governance of the regulatory institutions under the national energy rules. One of the most pressing issues is to ensure that the regulators are properly resourced to undertake all the functions which are assigned to them, and that there are no structural impediments to the proper execution of their duties.

In this regard, DPI considers that there are strong merits to establishing the AER as an independent agency separate to the ACCC. At present, the AER board is entirely dependent on the ACCC for staffing, support, material and financial resources. This puts the AER itself in a position of subordination to the priorities of a larger organisation.

There are also problems of transparency and accountability associated with the present structure. A regulator that is not fully in control of its staff, resources and internal policies cannot be held fully accountable for its decisions. The AER also publishes no substantive information on its performance, and referred to in to a small descriptive part of the ACCC's annual report. The budgetary arrangements are opaque as a result, making it difficult to ascertain whether any identified issues with the AER's output is a factor of under-resourcing, or reflective of the board's own discretion.

This is problematic in its own right, and also compares poorly to examples of best practice regulatory governance overseas, which are outlined below.

Comparison with international regulators

In the United Kingdom, the Office of Gas and Electricity Markets (Ofgem) is governed by an independent regulatory authority with its own board structure (comprising a total of 12 execs and non-execs) and is wholly separate from the Office of Fair Trading (OFT) which, like the ACCC, is responsible for competition and consumer issues. Ofgem has existed in the United Kingdom since 1999. Ofgem shares concurrent powers with the UK Office of Fair Trading on competition enforcement issues.

The role of Ofgem as independent regulator for energy in the United Kingdom was recently endorsed by the UK Government in May 2011.

Ofgem is accountable to the UK Parliament and reports annually, with reports covering its budget and KPIs, as well as summarising the key themes of its work.

Ofgem employs 545 staff and in 2011/12 its operating costs were 62M GBP (which, when compared to the OFT budget which is also 62m GBP, gives a good idea of the importance the UK Government places on Ofgem). It should, however, be noted that Ofgem's scope of functions is much broader than the AER. Ofgem administers rule changes (equivalent to the AEMC) and also administers schemes including the Renewables Obligation, Feed in Tariff schemes as well as the offshore electricity transmission frameworks.

Also worth noting is the Federal Energy Regulatory Commission (FERC) in the USA, which is responsible for regulation of electricity and gas transmission companies, mergers assessments in the energy sector, and market monitoring and surveillance. FERC is accountable to Congress. It submits five yearly strategic plans every three years. This forms the basis of its goals and objectives. FERC publishes an annual performance report which relates objectives and strategy to outputs against an annual performance target. FERC has up to 5 commissioners, plus a chair. It has a budget of $298m US and a staff of over 1400.

By contrast the AER has 3 board members, it does not publish an annual set of accounts/report. Instead it publishes a joint document with the ACCC, which provides comparatively little information about the AER. The AER employs 140 staff; we do not know its budget.

Necessary reforms

DPI considers that a number of reforms need to be made to improve the governance of regulatory institutions in the energy sector, some of which have been touched upon by the Commission.

In our view the accountability framework in Australia is poor and the incorporation of the AER within the ACCC is inconsistent with regulatory practice elsewhere (including the US and UK). It makes it hard to assess the cost effectiveness of the institution or the adequacy of the resourcing, and may also affect the ability to develop a strong regulatory culture. This is particularly the case where the energy sector is dominated by network monopolies which require highly technical regulations.

Furthermore, having the AER as a section of the ACCC means that energy market regulation loses priority and focus within the broader organisation. The ACCC's broader remit covers competition, mergers and anti-trust laws, as well as the AER's regulatory responsibilities. Within such a wide span of responsibilities, a dedicated focus on energy regulation is difficult. This contrasts to independent energy regulators in other jurisdictions, such as Ofgem and the FERC.

Separation of the two entities is the logical solution to these problems. The arguments in favour of retaining the AER as part of the ACCC appear to relate to the benefits of retained "synergies" and efficiencies.

The AER, as a division of the ACCC, is already a substantial organisation. We would expect the AER to grow further in future. There should be no issue of efficient scale for a stand-alone AER. Furthermore, many synergies between agencies can be realised through service agreements, memoranda of understanding, or general secondment and transfer arrangements within the public sector.

Reforms are also required to the board structure of the AER. The AER board appears rather small by international standards. It is possible that a larger board would provide a better platform for internal review and public scrutiny of AER decisions, as well as bringing a more diverse skill set to bear on the AER's growing realm of responsibility.

It also seems likely that steps to ensure a more autonomous and empowered institution would assist in attracting and retaining high calibre board appointees.

Finally, DPI agrees with the Commission that the regulator does need additional resources, noting the qualification regarding the transparency of existing resourcing. Energy sector expertise is highly sought after, not least by the businesses who must submit regulatory proposals to the AER. The price of the AER not being able to obtain necessary expertise can be millions of dollars for energy consumers. Building up the capacity of the AER to properly scrutinise regulatory proposals through additional resources should be looked at as an investment on behalf of consumers.

DRAFT RECOMMENDATION 21.2

DPI agrees that the points listed by the Commission would enhance the role of the regulator. Each of these would accompany or be better assisted by the AER being a fully separate organisation responsible to its own Board, and we query why the Commission has not gone this extra step in its recommendations.

DRAFT RECOMMENDATION 21.3

DPI agrees that enhancements could be made to consumer representation in the regulatory regime. For the regulator to optimise regulatory outcomes in the long term interests of consumers, it must be well informed of the preferences of consumers, at a detailed level, at each stage in the regulatory process. The current advocacy arrangements provide only for individual grants, which may impair the continuity of consumer input into the regulatory process.

DRAFT RECOMMENDATION 21.4

DPI has no comment on the means by which reforms are implemented, which are secondary to determination of what those reforms will be. This is properly the role of the SCER.

Footnotes:

[1] Governor of Victoria. *Victorian electricity supply industry tariff order*. On The Web, June 1995.

[2] NERA Economic Consulting. *The general efficiency assumption: setting X in RPI-X* . On The Web, October 2002.

[3] Australian Energy Regulator. *Final decision: Amendment – Electricity transmission network service providers Post-tax revenue model handbook*. On the web. December 2010.

[4] Australian Energy Market Commission. *Review into the use of total factor productivity for the determination of prices and revenues: final report*. On The Web, June 2011.

[5] Roger Beale, Greg Houston, Paul Kenny, Euan Morton and John Tamblyn. *Expert panel on energy access pricing report to the Ministerial Council on Energy*. On The Web, April 2006.

[6] See: http://www.aemc.gov.au/Media/docs/Department%20of%20Primary%20Industries-743fc371-14a2-4beb-b9c6-2f586cd41afa-0.pdf
and http://www.aemc.gov.au/Media/docs/Victorian%20Department%20of%20Primary%20In

dustries%20-%20received%201%20March%202010-2d719e34-e12c-4187-9672-fa85322f4f13-0.PDF