PRODUCTIVITY COMMISSION

TOWARDS BEST PRACTICE REGULATION : THE NATIONAL 'STANDARD'

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Had I been giving an address to such a conference at the beginning of this decade, it would have had a quite different focus to that of my remarks today. No doubt, as Chairman of the Productivity Commission, I would have been trying to convince you of the urgent need for wide-ranging structural and pro-competitive reforms to an industry that is not only important in its own right, but is a key determinant of the fortunes of other industries — especially those that are intensive in their use of energy. Many such industries at that time were already facing increased competitive pressures and becoming quite vocal about the need for government utilities to get their own acts together.

In its inquiry into *Energy Generation and Distribution*, conducted in 1990-91, the Industry Commission found that the publicly-owned, vertically integrated monopolies which had traditionally dominated the electricity sector had left a legacy of excess capacity, gross over-manning and a cost structure which was not only excessive, but bore little relationship to prices.

Governments at that time had already recognised these problems, and had begun administrative reforms to commercialise or corporatise their utilities. The Commission saw a need to go further, with a set of sequential, integrated reforms that would enhance the competitive environment within and between State markets— forming a national market — by (among other things):

- expediting and consolidating the corporatisation process;
- separating ownership of generation, transmission and distribution functions;
- breaking up generation monopolies;
- requiring transmission and distribution bodies to provide open access, and
- progressively selling publicly owned generation and distribution assets.

Now, at the end of the 1990s, much of what the Commission advocated in its 1991 report has come to pass (though somewhat more slowly than it had envisaged):

- most jurisdictions have corporatised and separated their vertically integrated utilities into generation, transmission and distribution businesses;

- an interim national electricity market connecting NSW, Victoria, the ACT and SA got underway in May 1997 and was made fully operational in December 1998 (with an interconnector for Queensland scheduled to be completed by early 2001);
- competition is being further increased with the progressive lowering of the thresholds for customers to participate in the market.

While there have obviously been some adjustment costs in getting to this point, the reforms are already providing some real gains:

- average electricity prices fell by 24 per cent in real terms from 1991-92 to 1996-97, with most of the direct gains going to business customers, as a result of reductions in cross-subsidies;
- even so, residential electricity prices fell by 7 per cent;
- electricity prices in Australia are now ranked third lowest among a group of 16 OECD countries (marginally above Finland and Canada); and
- labour productivity has doubled, rising from 2 GWh per employee in 1991 to 4 GWh in 1997.

It is reasonable to expect further gains as the national market matures. Whether they will add up to the Industry Commission's earlier estimates of $2.4 billion annually, or 0.4 per cent of GDP, remains to be seen. But once we are talking billions of dollars, the degree of precision begins to look less important.

What clearly *is* important is that we should seek to fully realise the potential contribution of this industry in Australia. The competitive needs of Australian business and the imperative of raising Australians' living standards demands no less.

This raises issues to do with how well the structural reforms have been designed and implemented, and whether we could be doing things better. Policy implementation is inevitably a learning experience. Thus the Industry Commission's final recommendation in its 1991 report was that there be an independent review of the reforms after three years. That has yet to be done.

Whether such a review could still be timely or valuable may emerge from this conference, with its focus on best practice regulation and, by implication, industry concern that we don't yet have it.

It seems clear that the restructuring of this industry has brought with it a proliferation of regulations and indeed regulators. Some of this has been devised to manage the transition, but much of it — such as the regulatory framework underpinning the operations of the national market — has a longer term role. Is it all appropriate or optimally designed? I am not in a position to say. The development of the national market has been a long and complex exercise, in which the Commission has had little direct involvement. The Commission has done some related research in recent years for the NSW and SA Governments, but it has not had the opportunity for a broader review.

That said, it hasn't been difficult, in preparing today's presentation, for even this poorly informed spectator to identify some concerns being aired which might warrant policy attention. These include:

- alleged *over-regulation* of the sector — with the ESAA raising questions about the costs of having 20 or so separate regulatory bodies operating in the sector, and whether their roles and responsibilities are adequately delineated;
- alleged *inconsistencies* in regulations among jurisdictions impeding interstate competitors and the potential for economies within the national market;
- alleged *heavy-handedness* of regulation, with an increasing trend towards prescription — the 'how' over the 'what',
  - and particular concerns about the nature of CSO and greenhouse requirements, among other regulations;
- and claims that *uncertainties* associated with the regulatory regime are adversely impacting on investment decisions.

The purpose of my talk today is not to assess the validity of these concerns, but rather, drawing on the experience of the Office of Regulation Review within the Commission, to set out some observations about what constitutes best practice in regulation generally and — more importantly — how to achieve it. I shall then leave it to the more knowledgeable industry and regulatory representatives here today to compare what they observe with some of the principles that I believe are fundamental to good regulatory outcomes.

Before looking at these, I should briefly explain what the Office of Regulation Review (the ORR, as it is generally known) does. The ORR is essentially an independent watchdog on good regulatory practice within the Commonwealth. Its core function is to advise departments and agencies about whether regulation impact statements are required for any regulatory initiative, and to monitor and, through the Productivity Commission, report on compliance. In addition to this role in helping to discipline the *flow* of new Commonwealth regulation, the ORR also has a role in approving individual programs of review for the *stock* of Commonwealth regulation, under the NCP agreement with the States and Territories. Its role has been heightened under the present Government and this experience may have some relevance to regulatory issues within the electricity sector.

Best practice regulation

At the most general level, there are two pre-conditions for good regulation:

1. It must be fully justified — directed at solving a problem that cannot be addressed by the market or by individuals acting without government involvement; and
2. It must provide the greatest net benefit, given its rationale, by being well targeted and minimising any 'collateral damage' or adverse side-effects.

Turning to the first condition, it must be established that without regulation the community would be worse off. In many areas of economic and social life that is hard to prove. Nevertheless, it is generally accepted that electricity provision has a number of features that indicate a role for government intervention. These include:

Natural monopoly features

- While generation is not a natural monopoly, the network is characterised by both economies of scale and scope of such magnitude that an incumbent would face little threat of direct competition. As the Industry Commission observed: *In this situation, some regulation is warranted to curb the potential for the abuse of market power.*

The characteristics of electricity

- Electricity cannot be economically stored in large quantities, it is a 'fungible' commodity and there must be a balance of supply and demand at all times. As a consequence, some features of the market arrangements need to be different from those which apply in other commodity markets. In particular, procedures need to be in place to ensure the overall integrity of the system.

Consumption and network externalities

- Apart from broader environmental impacts, there are externalities which relate to certain features of the technology itself. Consumption externalities arise from congestion whenever there are many users. Also, the operation of one generating unit can impact on other generators and users of the network and the security of the system can be affected.

Community service obligations

- Finally, electricity is seen as an essential service and governments have views about its availability and price, typically with the aim of ensuring supplies to regional locations at 'reasonable' prices. And some governments understandably want utilities to make special provision for those who cannot afford electricity under normal arrangements. Where electricity suppliers have such a community service obligation, this will generally require government funding and/or regulation to achieve.

Maximising net benefits

Overall, the benefits provided by a particular regulation should not just exceed the costs it imposes — the best regulation provides the greatest net benefit to the community out of all the options available.

The best regulation will generally achieve its objectives effectively and directly with minimum adverse side-effects and compliance costs.

Compliance costs count

The costs of complying with (and administering) regulation increase in line with:

- the detail of the requirements;
- the extent to which they change behaviour;
- whether or not they are mandatory or optional;
- whether or not they are enforced by government or by industry;
- the extent to which they are consistent across jurisdictions and types of business, and (a particular sensitivity!)
- the paperwork involved in demonstrating compliance.

All of these are summed up by the term 'red-tape'. The detail, the technical costs of complying, the extent to which they side-track commercial practice all add to a firm's costs.

According to the ESAA, electricity supply businesses were surveyed in late 1998 on costs of regulation arising from requirements for provision of information, reporting and compliance. It was estimated that the overall cost to electricity supply businesses and governments across Australia of regulation was at least $100 million.

Better light than heavy-handed

Consideration of compliance and administrative costs brings into relief the relative merits of 'light-handed' regulation. As its name suggests, this refers to regulatory approaches which give greater weight to outcomes than the particular methods of achieving them.

At one level is the choice between explicit 'black letter' regulation, directly imposed and administered by government, and self-regulation, or what has come to be called 'quasi-regulation'.

The ORR's 'Guide to Regulation' for Commonwealth agencies goes into some of the criteria relevant to such a choice.

Self-regulation may be most appropriate where*:*

- the problem is a low risk event, of low impact or significance; and
- it can be fixed by the market itself. For example, there may be an incentive for individuals and groups to develop and comply with self-regulatory arrangements because industry survival depends on it.

Quasi-regulation refers to the range of rules, instruments and standards whereby government influences business to comply, but which do not form a part of explicit government regulation. Examples include government endorsed industry codes of practice or standards, government agency guidance notes, industry-government agreements and national accreditation schemes.

Quasi regulation should be considered where:

- there are cost advantages from flexible, tailor made solutions and less formal mechanisms such as access to a speedy, low cost complaints handling and redress mechanisms; and

- there are advantages in government engaging in a collaborative approach with industry, with industry having substantial ownership of the scheme.

For either approach to be successful, there needs to be:

- a cohesive industry with like-minded participants, motivated to achieve the goals;
- a viable industry association with the resources necessary to develop and/or enforce the scheme, and
- effective sanctions or incentives to achieve the required level of compliance.

If explicit government regulation is required, it is still preferable to set up structures which maximise the potential for market forces to operate — and this has essentially been the underlying principle behind the regulatory framework for the electricity sector. Competition should apply where possible, with freedom for producers to pursue their commercial interests within reasonable bounds.

Where standards are needed, the understandable temptation for a regulator is to lay down prescriptive, process-based rules to provide certainty. However the informational demands facing the regulator wishing to choose rules about inputs, processes or prices that are optimal — or, more importantly, that will *remain* optimal in ever-changing markets — are extreme. Seen the other way, 'command and control' approaches can stultify the incentive for firms to search for lowest cost means of achieving regulators' goals. Worse, they can create incentives to find ways of by-passing the rules to the detriment of those goals.

Performance-based rules are generally preferable in those circumstances in which the desired outcome is easily quantifiable. In specifying the desired outcome, they leave it to individuals and firms to seek out the least-cost way of achieving it.

The interesting issues arise where failure to achieve the agreed outcome can have extreme economic (or social) consequences. To come back to the electricity industry, the risk of blackouts is obviously one central concern. But such risks can in principle be addressed in a variety of ways, on the supply and demand sides, and with varying degrees of regulatory prescription.

Good process is the key

It is all very well to talk about what good regulation looks like; the more difficult task is actually achieving it. The ORR's experience has been that good regulation rarely just 'happens'. Like any other production activity, what comes out at the end

depends on the quality of what goes in. Good regulation is generally an outcome of good process.

The elements of good process are in themselves pretty unexceptionable. The essential ingredients involve:

(a) determining that a problem exists for which regulatory action is justified;

(b) looking at the impacts and 'administerability' of the alternative means of achieving the objective; and

(c) finally deciding among the alternatives, on the basis of transparent criteria.

These steps, with some elaboration, have been incorporated into the *Regulation Impact Statements* (RISs) that all Commonwealth agencies are now obliged to prepare in devising any regulation with potentially adverse impacts on business (including small business) or competition. (*See slide.*)

The second of the three broadest elements — identifying and evaluating alternative approaches — is at the heart of the process. Doing it well is generally not a simple exercise. It can require information that is not readily available — or is obtainable only from those likely to be affected by the regulation. For this reason, and to achieve wider acceptance of the eventual outcome, public consultation is an important part of the RIS process. I know from personal experience, in a variety of public inquiries, that policy prescriptions that initially look pretty good can soon lose their allure after the reality check of public consultation.

There are now requirements to follow a RIS process not only for Commonwealth agencies, but also within most states and inter-governmental Ministerial Councils and Standard Setting bodies under COAG guidelines. As the Productivity Commission recently documented in *Regulation and its Review 1997-98*, compliance at the Commonwealth and intergovernmental levels has generally been patchy so far. The impression gained from some other Commission inquiries is that the same applies within most State and Territories.

My understanding is that formal RISs have not been used for most electricity regulation. This is partly because some of the major decisions on restructuring the sector occurred before COAG first implemented RIS requirements in 1995. After this time, it is not clear why the National Grid Management Council and then, the National Electricity Code Administrator (NECA) did not prepare a RIS for any of the major decisions it proposed to jurisdictional ministers.

More recently, however, I believe that RIS-like reviews were conducted by the ACCC before it authorised the National Electricity Code and accepted the National Electricity Market Access Code.

The ORR's experience within the Commonwealth domain is that RIS-type processes have traditionally not been part of the 'culture' within most regulatory agencies (to put it mildly). Despite formal RIS requirements of long standing, until recently most

agencies paid them little more than lip service. When done, they were typically not done well and often too late to adequately inform regulatory decisions. The critical public consultation dimension was often the biggest casualty.

It was against this background, and with a renewed concern to reduce the red tape burden on small business in particular, that the present Government undertook a number of institutional reforms which, collectively, have considerably increased the disciplines on Commonwealth departments and regulatory agencies.

The new provisions make RISs mandatory for *all* regulations that impact on business or restrict competition. They give the ORR a central role in assisting and monitoring this process, with the Productivity Commission required to document compliance in its annual report. And, for the first time, a Minister (the Assistant Treasurer) has been given responsibility to ensure good regulatory practice.

These provisions recognise the reality that bureaucratic and political imperatives (including time and resource constraints) will often militate against best practice in policy formulation. The designation of an independent agency to monitor and report publicly on RIS compliance, together with the designation of a Minister with responsibility to encourage compliance from the top, is an attempt to change the balance of incentives and thus behaviour. It won't happen overnight. But hopefully, to borrow from the TV commercial, it *will* happen. Indeed signs of progress, in what was still a transitional year for the new arrangements in 1997-98, are already there.

Again, whether such institutional disciplines could or should apply to development of regulation within the electricity sector is something which this group might care to consider.

A particular challenge in achieving best practice regulation in electricity is the mix of jurisdictional involvement. As noted, electricity supply is dominated by many rule makers and regulators. The multiplicity of interfaces entails some costs, which are likely to be compounded for those operating in more than one State.

At issue is the ongoing need to ensure that the decisions of individual regulators are nationally coherent — meaning that they are mutually consistent and avoid overlap or duplication. Industry clearly perceives some need for improvement here.

In many cases, good process at the level of each individual jurisdiction should add up to good national outcomes. I also suspect that competition throughout the national market will ultimately provide its own discipline on regulatory performance within any particular jurisdiction. Hopefully, this is a case where inter-state rivalry will ensure that good regulation drives out bad, rather than the other way round.

It follows that the national market may also provide some incentive for cooperative regulatory effort. In this respect, I note the recent establishment of the Utility Regulators' Forum, which could be expected to bring a useful breadth of perspective on the evolving regulatory systems and an opportunity for inter-jurisdictional learning about what approaches work best.

In concluding, I should emphasise that best regulatory practice is ultimately about delivering maximum benefits to the Australian community and economy. This requires a balance to be achieved between minimising resultant costs to the industry and effectively addressing the sources of market failure (or power) that justify intervention in the first place. Such a balance can only be discovered through good processes. I have briefly indicated, drawing on the 'national' experience through our Office of Regulation Review, what that involves. I'll now leave it to you to consider any implications for the electricity sector.