

1 September 2015

Dr Michael Vertigan AC  
Chair  
Energy Governance Review Panel  
GPO Box 9839  
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**By email: [energygovrev@industry.gov.au](mailto:energygovrev@industry.gov.au)**

Dear Dr Vertigan

**AER submission to Review of Governance Arrangements for Australian Energy Markets Draft Report**

The Australian Energy Regulator (AER) welcomes the opportunity to provide the attached submission on the Review of Governance Arrangements for Australian Energy Markets draft report.

Our submission firstly focuses on the overall performance of the governance arrangements. We consider that the governance arrangements work well and deliver outcomes in the long term interests of energy consumers. We agree with the Review Panel, however, that there is scope to improve strategic policy setting arrangements in the market. We generally support the recommendations in the draft report to address this issue.

Our submission then focuses on the draft report's findings and recommendations in relation to the AER. While we consider that we are an independent regulator with an organisational culture broadly appropriate to the exercise of our functions, we remain open to ideas to improve our performance. In this regard, we consider that a periodic 'peer review' of our performance could identify opportunities for improvement. We also highlight that these issues of how the AER operates and AER performance should be considered separately to the issue of the AER's institutional arrangements.

Should you have any questions, please feel free to contact the AER's a/g Chief Executive Officer, Sebastian Roberts, on (03) 9290 1895 or me on (03) 9290 1419.

Yours sincerely

A handwritten signature in blue ink, consisting of a stylized 'P' followed by 'W. Conboy'.

Paula W. Conboy  
Chair



# **Review of Governance Arrangements for Australian Energy Markets**

**AER Submission on Draft Report**

**August 2015**

# 1. Introduction

The Australian Energy Regulator (AER) welcomes the opportunity to provide a submission in response to the Review of Governance Arrangements for Australian Energy Markets draft report.

The AER is Australia's national energy market regulator and an independent decision making body. Our functions, which mostly relate to energy markets in eastern and southern Australia, are set out in detailed legislative arrangements and include:

- regulating electricity and gas network businesses, including through setting maximum allowed revenues for providing monopoly network services
- monitoring wholesale electricity and gas markets to ensure energy businesses comply with the legislation and rules, and taking enforcement action where necessary
- regulating retail energy businesses' compliance with the retail law and rules in New South Wales, South Australia, the ACT, Queensland and Tasmania (electricity only), and
- operating the Energy Made Easy comparator website and providing other information for energy consumers about how to participate in retail markets, and publishing information on energy markets, including the annual State of the Energy Market report, to assist participants and the wider community.

The AER therefore has diverse responsibilities across wholesale and retail energy markets, as well as energy networks. More detail on these roles and responsibilities is provided throughout the submission.

As a key agency in the energy market governance framework, we have a detailed understanding of the governance arrangements that are the subject of this review.

Our submission is structured into two parts.

The first part of the submission comments on key recommendations designed to improve the overall effectiveness of the governance arrangements. We consider that the governance arrangements are working well and have delivered outcomes in the long term interests of energy consumers. The roles of each market body are generally well defined, communication between the agencies is strong, and there is very little duplication of work. The framework has generally progressed necessary reforms in an integrated, comprehensive manner, thereby providing confidence that the governance arrangements remain fit for purpose to deal with emerging challenges. We agree with the Review Panel, however, that there is scope to improve strategic policy setting arrangements in the market. We generally support the recommendations in the report to address this issue.

In the second part of the submission, we focus on the draft report's findings and recommendations in relation to the AER. We highlight the AER's roles and responsibilities, and describe how we operate in detail. This discussion highlights that we are an

independent regulator with an organisational culture broadly appropriate to the exercise of our functions.

We remain open to ideas to improve our performance. In this regard, we consider that a periodic 'peer review' of our performance could identify opportunities for improvement. Finally, we highlight that these issues of how the AER operates and AER performance should be considered separately to the issue of the AER's institutional arrangements.

## 2. Performance of the governance arrangements

A key element of the reforms of the last decade has been to establish governance arrangements that would support the effective operation of Australian energy markets, including delivering necessary energy reforms.

Our submission on the issues paper highlighted what these governance arrangements were intended to achieve and what they have delivered over the past decade:

- Council of Australian Governments (COAG) Energy Council (formerly the Ministerial Council on Energy (MCE)) – the Energy Council provides national oversight and co-ordination of energy policy development. Over the past decade, the Energy Council and before that the MCE have delivered a more national and more co-ordinated approach to energy policy than the fragmented approach there was previously.
- Australian Energy Regulator – the AER is the independent national regulator, with responsibility for economic regulation of energy networks and ensuring that market participants comply with market rules and laws. Before the formation of the AER there were 13 regulators with responsibility across all steps of the energy supply chain. The formation of the AER and the subsequent increased responsibility for the AER has delivered more streamlined regulation across the wholesale, networks and retail sectors, and delivered a more nationally consistent approach to regulation.
- Australian Energy Market Commission (AEMC) – the AEMC is the independent rule maker, with responsibility for national rule making and market development. The formation of the AEMC has delivered a more streamlined approach to rule changes. It has removed overlap in the rule change process that formerly existed and removed the potential for inconsistent rule change approaches in electricity and gas.<sup>1</sup>
- Australian Energy Market Operator (AEMO) – AEMO is the independent market operator, with responsibility for operating wholesale energy markets and delivering planning advice. Since its formation, AEMO has provided a national, independent focus to network planning and provided greater transparency around planning outcomes.

We consider that the roles and responsibilities of the three market organisations are well understood and generally well defined, both in the Australian Energy Market Agreement (AEMA) and in energy market legislation. There is strong communication and well developed relationships between the market institutions.

While the Review Panel concludes that the governance architecture is sound, two strong themes are outlined in the draft report.

First, the Review Panel argues that the pace of change in the energy sector is unprecedented and the current governance arrangements need to adapt to deal with the

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<sup>1</sup> Prior to the formation of the AEMC, separate agencies were responsible for considering changes to rules in electricity and gas.

changes. Second, the Panel argues that tendencies have emerged towards fragmentation, diminished clarity and focus in roles particularly at the policy level.<sup>2</sup>

## 2.1. Can the governance arrangements accommodate the changes occurring in energy markets

The draft report notes that the pace of change in the energy sector is arguably unprecedented, largely caused by new technologies and by policy responses to the assessed risks of harmful climate change. The draft report concludes that changes to governance arrangements will be required to deal with the increasingly dynamic nature of the market.<sup>3</sup>

The pace of technological change is greater now than previously. The governance arrangements are already identifying and starting to deal with the issues being raised as a result. As an example, the AEMC's 2012 Power of Choice review recognised the changes the Australian energy sector is facing and developed an integrated package of reforms to give consumers options in the way they use electricity. The overall objective of the Power of Choice reforms is to provide that consumers' demand for electricity is met by the lowest cost, most efficient combination of demand and supply side options. These reforms are designed to increase the responsiveness of the demand side to evolving market, technological developments and changing consumer interests over the next 15 to 20 years. These reforms are in the process of being implemented.

More generally, the governance arrangements have supported a range of other significant market operation and reform outcomes, including the:

- ongoing effective operation of a robust, stable wholesale electricity market
- the introduction of full retail competition in electricity and gas across all National Electricity Market (NEM) jurisdictions, with retail price deregulation increasingly being introduced
- development of the National Energy Customer Framework (NECF) and subsequent implementation in a majority of jurisdictions
- reforms to the rules for the economic regulation of network service providers and associated reforms to the arrangements for reviewing regulatory decisions, and
- development of gas market trading hubs.

This demonstrates that governance arrangements are resilient and will generally be able to accommodate market change.

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<sup>2</sup> *Review of Governance Arrangements for Australian Energy Markets Draft Report*, July 2015, p. 9.

<sup>3</sup> *Review of Governance Arrangements for Australian Energy Markets Draft Report*, July 2015, p. 9.

## 2.2. Recommendations to address the 'strategic policy deficit'

In the draft report, the Review Panel notes that a strong theme in written and verbal submissions is that:

*There has emerged a 'strategic policy deficit' which has led to tendencies towards fragmentation, diminished clarity and focus in roles, particularly in determining priorities, and a diminished sense of common purpose. These problems are most evident at the policy level, but they have also been identified across the market institutions as a whole.<sup>4</sup>*

As highlighted earlier, the Energy Council (and before it the MCE) have provided significant direction to energy market policy over the past decade and progressed a range of key reforms. The Council's role is critical to the effective operation of the market and the performance of the market institutions. It sets the overall policy and shapes the direction of market development and reform, through its own work and the work it requires of the three market institutions.

The draft report outlines a range of recommendations that would enhance the Energy Council's policy leadership role. In particular, we note the recommendation that the AEMC be tasked with advising the Energy Council on strategic direction and propose priorities for the Council's work program. This proposed role would involve the AEMC producing advice and a work plan setting out key strategic priorities and challenges for the energy market. The Review Panel notes that in undertaking these tasks, the AEMC should engage with the AER and AEMO, and include an 'open door' process for other stakeholders to get innovative thinking on to the agenda.

We consider this recommendation to be a key strength of the draft report. The recommendation proposes a broad based approach to policy development and recognises the wide variety of stakeholders that can positively contribute to make energy markets work better.

The recommendation also recognises the contribution that the AER and AEMO may provide to the AEMC as it undertakes this role. As we undertake our work, it is highly likely that we will come across areas where we believe market arrangements may operate more efficiently. The proposed process would allow the AER to put its ideas 'on the table' for further consideration. A further strength of the recommendation is that the strong communication and well developed relationships the AER has with the AEMC means that this engagement will proceed smoothly.

We believe that other recommendations in the draft report complement these policy reforms. In particular, we note the proposal for different rule change processes for reviews dealing with broad and complex issues; reviews dealing with specific or contained issues; and for reviews dealing with less complex issues. While some of the detail of this recommendation needs to be developed, this proposal involves a more tailored approach to the rule change

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<sup>4</sup> Review of Governance Arrangements for Australian Energy Markets Draft Report, July 2015, p. 9.



process than we see at present. This would facilitate a more streamlined and timely consideration of a range of rule changes.

Finally we support the recommendation that a 'necessity criterion' be established to apply to derogations from the national framework. A nationally framework minimises the regulatory burden for market participants and affords consumers across the market the same level of protection. While some derogations from the national framework may be appropriate, a necessity criterion ensures there is greater scrutiny and transparency around derogation decisions.

### 3. Response to draft report findings and recommendations on the AER

In this part of the submission, we comment on the key findings and recommendations that directly impact the AER. The draft report raises concerns with the AER's independence and organisational culture. We explain how we operate in practice to draw out the factors that underpin our independence and to highlight why our organisational culture is broadly appropriate for our functions.

As with any regulator, however, there is scope to build capacity and improve. We comment on the recommendations designed to improve our capacity, namely the recommendations for a periodic review of the AER and proposals to strengthen AER decision making processes. Finally, we comment on proposals to change the AER's current institutional arrangements. We consider that issues of how the AER operates and AER performance should be considered separately to the issue of the AER's institutional arrangements.

#### 3.1. AER independence

The Review Panel highlights the importance of a regulator's independence. The Panel notes:

*The independence of the regulator, in perception (because perceptions affect behaviour) as well as in fact, is a primary theme of international studies on good regulatory governance. As indicated, the operative notion of independence includes a lack of undue influence from differing agendas emanating from other government agencies, as well as from transient political priorities and from interest groups outside government.<sup>5</sup>*

We strongly agree that the independence of a regulator is a central element in fostering confidence in regulatory frameworks and effective participation in markets. We also agree with the Panel's observation that it is fundamental that the regulator be free from interference and undue influence from the Government of the day or political parties, and also from the sector being regulated or other vested interests.

We consider that this is best achieved through a robust governance structure that encompasses culture, people and processes, and practices that embed the principles of good governance in everyday operations. This governance structure encompasses elements such as:

- appointment processes
- having a clear and proper purpose
- acting within authority
- having relevant expertise
- evidence and analysis based decision making

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<sup>5</sup> *Review of Governance Arrangements for Australian Energy Markets Draft Report*, July 2015, pp. 53 – 54.

- effective consultation and communications, and
- transparency and accountability

Considered against this framework, we are strongly of the view that the AER is an independent regulator.

The AER is established under the *Competition and Consumer Act 2010* (Cth) as an organisation charged with making decisions in relation to its functions under the National Electricity Law, National Gas Law and National Energy Retail Law. The purpose and objectives of the AER are clearly spelled out in the legislation, the AEMA and in COAG's Statement of Expectations for the AER. The independence of the AER is explicitly recognised in the COAG Energy Council's Statement of Expectations. The AER's Statement of Intent sets out how the AER will deliver on these expectations including how it aims to achieve principles of accountability and transparency, efficient regulation and effective engagement with stakeholders and other energy market bodies.

Appointment processes are clear, merits based and rigorous. Appointments to the Board are for a fixed period and Members can only be removed in exceptional circumstances. Recruitment of staff is overseen by the CEO of the AER in accordance with Australian Public Service requirements. The AER determines the type of staff it requires and the recruitment criteria for a job vacancy. The AER has control over its staffing and the staff report to the CEO of the AER who in turn reports to the Board.

The AER has made it a priority to ensure that its decisions are not only evidence based and supported by robust analysis, but are clearly reasoned and communicated. We have invested considerable resources in staff recruitment and in training to build up a body of knowledge, experience, expertise and diversity of skills. The most recent example of this is the establishment in 2013 of the Technical Advisors Group to provide us with greater industry expertise, particularly in power system engineering. In addition, AER decision making processes integrate specialist legal and economic advice to ensure that our processes and decisions are always within authority and directed at achieving the objectives of the regulatory framework and policy framework. Moreover, where appropriate we use external consultants to support our internal resources.

The decisions of the AER are informed by its own analysis which in turn is informed by a comprehensive consultation process that is open to all stakeholders. To address particular consultation needs, the AER has a number of consultative forums including the Consumer Challenge Panel and the Customer Consultative Group which includes representatives from a diverse range of users and consumer groups such as Energy Consumers Australia, St Vincent de Paul Society, Consumer Utilities Advocacy Centre, Public Interest Advocacy Centre, Consumer Action Law Centre and the National Retail Association.

We also undertake extensive consultation throughout our regulatory processes. This includes general approaches such as holding public forums to discuss proposals, issuing discussion papers and draft decisions, and inviting public submissions. We also have more targeted meetings, information inquiries and discussions with key stakeholders. This is all undertaken during the development of our draft decisions and prior to our making final

decisions. We have developed service charters and stakeholder engagement guidelines. These are published and help inform our stakeholders on what they should be able to expect from us.

The AER adheres to the principles of open government. Any stakeholder, including government and regulated businesses, may make submissions to any public inquiry conducted by the AER. There is a formal process for making submissions. Subject to confidentiality of information assessments, public versions of regulatory proposals from businesses, our reports and decisions, and submissions in response to these are published on our website. We are endeavouring to make our reports as fit for purpose as possible and that involves different layers and avenues of reporting of the decisions from easy to read fact sheets through to the more comprehensive, and by necessity detailed, decision and determination documents.

A critical aspect underpinning this independence is transparency and accountability. We are accountable for our decisions and, ultimately, our performance as a regulator. We must act impartially, with appropriate regard for proper process and within the limits of our authority.

A further element promoting independence of our decision making is the review mechanisms that apply to AER decisions. Our decisions cannot be overturned by government. Our decisions are subject to merits and judicial review and can only be overturned in those forums.

These features provide the AER with the independence that is essential for a regulator – that is the ability to make independent decisions based on the available evidence, including information provided by all stakeholders, while not being unduly or inappropriately influenced by them.

To address a theme from the draft report, this independence also includes a decision making framework that is completely independent, including from the ACCC. As highlighted in the Treasury's submission to this review:

*The Competition and Consumer Act 2010, under which the AER operates, is unequivocal in terms of the AER's independence and the AER's responsibility for decision making on its energy functions independent of the ACCC.<sup>6</sup>*

We consider the view that the ACCC influences how the AER Board discharges its responsibilities under energy market legislation is incorrect and not supported by evidence or analysis.

The Review Panel raises concerns around the AER's financing independence:

*A more fundamental concern to the Panel is that the AER is not in full control of the resources required to achieve its tasks – it lacks full independence in this area of decision making. In its submission, the ENA noted the recognition in the Review of the Limited Merits Review Regime process that, given the ACCC as a 'parent' body,*

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<sup>6</sup> Australian Government, The Treasury (2015), *Submission to the Review of Governance Arrangements for Australian Energy Markets*, May 2015, p. 2.

*the AER Chair and Members are somewhat constrained in their ability to direct the development and utilisation of the organisational expertise and capabilities required (to effectively carry out its role). The Panel also understands that the AER, while closely consulted on ACCC funding bids, does not have ultimate control over its finances.*<sup>7</sup>

The AER's budgetary arrangements are different than when the review of the Limited Merits Review Regime was conducted. From 2013-14, the AER became a separate program in the Portfolio Budget Statement (PBS).<sup>8</sup> This has provided us with our own budget allocation which we use to undertake our roles and responsibilities. As with other Government agencies, as part of this process, each year the AER is required to prepare and submit a PBS setting out any changes to the budget estimates approved in the previous budget round (e.g. new funds in response to an approved new policy proposal or decreased funds in response to a Whole of Government savings measure). The PBS is subject to ministerial and legislative approvals. Importantly, the AER is not constrained in its ability to direct resources under this budget allocation. Consideration of how to allocate the budget takes place as part of the annual review of priorities and work program conducted by the AER Board and the senior management group.

There is greater transparency around AER resources. The Portfolio Budget Statements 2015-16 include the appropriation allocated by the Australian Government to the AER (\$33,578,000 for 2015-16). The Treasury's submission to this review outlines forward estimates of AER budgets up until 2018-19.<sup>9</sup>

The AER's Annual Report breaks down how we spend the budget we have been allocated. Total expenditure is broken down by category including employee costs, external consultancy and legal expenditure, and corporate overhead and administration. Corporate overhead is in turn broken down into further categories (such as legal services, human resources and IT services and depreciation). This Annual Report is available on our website.

The Panel also notes that the current arrangements, including restricted salary levels, 'appear to establish unnecessary obstacles' to the AER developing the expertise it requires<sup>10</sup>.

The AER has significant flexibility to attract and retain expertise. These arrangements include individual flexibility arrangements, which allow employees to negotiate remuneration, allowances and leave entitlements, and special salary levels. We can also pay a special rate of salary to high performing employees and employees with special knowledge, skills and qualifications.

As a result, the AER has built up a broad based team of specialists—specialists in regulatory frameworks, the operation of wholesale and retail energy markets, in energy network

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<sup>7</sup> *Review of Governance Arrangements for Australian Energy Markets Draft Report*, July 2015, p. 55.

<sup>8</sup> AER funding is specified separately as Program 1.2 in the Treasury Portfolio Budget Statement for the ACCC.

<sup>9</sup> Australian Government, The Treasury (2015), *Submission to the Review of Governance Arrangements for Australian Energy Markets*, May 2015, p. 4.

<sup>10</sup> *Review of Governance Arrangements for Australian Energy Markets Draft Report*, July 2015, p. 55.

regulation, and in energy market compliance and enforcement. Reflecting the various demands of our work program, our team includes economists, engineers, lawyers and accounting/finance specialists.

It has been difficult for the AER to fully utilise these mechanisms to develop and retain expertise. However, these constraints result from the amount of resources allocated through the Commonwealth budget to the AER, not from the AER's relationship with the ACCC. Issues surrounding the AER's resourcing are discussed in section 3.6 of the submission.

### 3.2. The AER's scope of operations and organisational culture

The Panel notes that there are questions on the AER's performance that relate to a perceived influence of the ACCC's culture on the AER. We would suggest that the discussion in the report does not appear to reflect the independence of the AER from the ACCC or the diversity of our roles and therefore may not have had the opportunity to reflect on the fact that different roles and responsibilities by their nature are necessarily supported by different cultural factors, frameworks and skills.

#### *AER functions*

The draft report notes that:

*"The AER's primary task can be summarised as regulating network access (prices and standards) to promote efficiencies that serve the long-term interests of consumers." <sup>11</sup>*

While clearly network regulation is a core AER role, our key responsibilities are broad and encompass all steps of the supply chain.

#### *Wholesale*

The AER has a range of responsibilities in relation to the NEM and gas spot markets.<sup>12</sup> We:

- monitor and enforce the obligations in the legislation and rules. In the electricity wholesale market, there are obligations on a variety of entities including; generators, network service providers, market customers (retailers), metering service providers and AEMO.<sup>13</sup> In gas, there are obligations on players such as shippers, bulletin board operators, distributors, market participants (retailers), pipeline operators and facility operators
- report on the performance of the markets, such as through weekly electricity and gas market reports and reports into high priced events, and
- report on compliance issues in these markets, such as through Quarterly Compliance Reports.

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<sup>11</sup> *Review of Governance Arrangements for Australian Energy Markets Draft Report*, July 2015, p. 47

<sup>12</sup> Spot market hubs in Adelaide, Sydney, Brisbane, Victoria and Wallumbilla

<sup>13</sup> Indeed around 40% of the obligations in the wholesale market are on AEMO.

## *Retail*

The AER is responsible under the National Energy Retail Law for regulating retail energy markets in New South Wales, South Australia, the ACT, Queensland and Tasmania (electricity only). We:

- oversee retail market entry and exit by assessing applications from businesses looking to become energy retailers, granting exemptions from the requirement to hold a retailer authorisation and administering a national retailer of last resort scheme to protect consumers and the market if a retailer fails
- monitor and enforce compliance (by retailers and distributors) with obligations in the Retail Law, Rules and Regulations
- report on the performance of the market and energy businesses (including information on energy affordability)
- approve customer hardship policies that energy retailers must implement for customers facing financial hardship and looking for help to manage their bills
- maintain an energy price comparator website ([www.energymadeeasy.gov.au](http://www.energymadeeasy.gov.au)).

## *Energy networks*

The AER has two broad roles in relation to energy networks, both related to its role as economic regulator.

First, the AER regulates the amount of revenue that network businesses can recover from their customers in the form of network charges. Network businesses must periodically (typically every five years) submit regulatory proposals (electricity) and proposed access arrangements (gas) to us for approval. We assess the proposals and justify our pricing decisions against the relevant legislative criteria.

Second, we have a networks oversight role which complements our revenue regulation role. This role includes:

- **tariff assessment**—We review network tariffs for electricity distribution businesses, and for gas transmission and distribution businesses, annually to ensure they are consistent with the revenue controls that have been set in our pricing decisions and meet other pricing principles related to efficiency and other considerations. This role is expanding with new obligations on network businesses to prepare and submit tariff structure statements to the AER setting out how tariffs will become more cost reflective
- **cost pass throughs**—A network business can apply to pass through to customer costs arising from events outside its control and not anticipated when its price determination was made. We assess these pass through requests
- **guideline development**—Our approach to economic regulation is outlined in a range of regulatory guidelines, covering issues such as our approach to setting the rate of return, how we assess expenditure proposals, and how we create incentives to encourage efficient network business decision making and to meet reliability targets. We develop and amend these guidelines as required



- regulatory investment test for electricity—We monitor and enforce compliance of the network businesses applying the regulatory investment test for transmission (RIT-T) and distribution (RIT-D)
- access (connection) disputes—We resolve customers’ disputes with distribution businesses on the cost and the terms and conditions of connection offers
- compliance with regulatory obligations—We have a role of assessing network businesses’ compliance with requirements under the Electricity and Gas Rules. If we find a breach of the business’s regulatory obligations, we may take enforcement action
- incentives for improved performance—We develop incentive schemes for network businesses to improve their performance, administer the schemes and ensure compliance
- regulatory decision reviews—Network businesses can seek a merits review of our decisions by the Australian Competition Tribunal. If the Tribunal reviews a network pricing decision, we are a party to the review
- performance reporting—We publish information on network businesses’ revenues, prices, expenditures, operations and service delivery. We also report on network reliability and customer service, and businesses’ performance against targets. From 2014, we also began publishing benchmarking reports for network businesses, and
- rule changes and policy development—Where we highlight concerns with the operation of the rules, we may lodge applications to amend the rules to the rule making body, the Australian Energy Market Commission. Notably, in 2011, we lodged an application to amend the network regulation rules. We also lodge submissions on rule changes proposed by other parties. We also actively participate in energy reform initiatives and make submissions to the COAG Energy Council as well as specific Commonwealth or State government processes.

It is clear that these networks roles encompass both revenue setting functions and compliance and enforcement functions. The arrangements are an integral part of the design and facilitate effective competition in both the wholesale and retail energy markets.

*Implications for the AER from the diversity of our functions*

We have diverse responsibilities across energy networks, wholesale markets and retail markets. The diversity of tasks the AER conducts has implications for the skill set we require to undertake these responsibilities.

*“There is general agreement on the importance of the skills, expertise and experience of regulatory staff, and also of organisational culture, for the effective conduct of regulation. Network regulation in particular requires a distinctive blend of skills and a particular culture, since in this activity the regulator is substituting its own decisions in relation to matters that would normally be settled by a market. This is very different from, say, the legislative task of establishing rules or the enforcement*



*task of preventing violations of those rules: acting as a substitute for and serving as a complement to market exchange and initiative are different types of role.”<sup>14</sup>*

We agree that network regulation and enforcement tasks require different skills. This is recognised through our internal structure. We have five branches within the AER – three of them related to network regulation and two related to the competitive parts of the energy markets, wholesale and retail. The skills and expertise of staff in the networks areas can be quite distinct from those in the wholesale or retail areas. This is appropriate considering the distinct tasks and processes undertaken across the AER.

As highlighted above, the AER’s roles include both regulation and enforcement roles. These are complementary roles designed to achieve the overall objective of meeting the long term interests of energy consumers.

It is important to note that in today’s rapidly changing energy market the boundaries between monopoly and competition are shifting as are the boundaries between service provider and service consumer. As an example, our work in retail market entrance – authorisation and exemptions – has provided us with early insight into the consequence of new technologies and services and impacts on customers. This is not just in the retail area, but has also informed our consideration of the sort of regulation that may be required in networks in the future. The understanding of consumer preferences and changing consumer protection requirements that we gain through our work in retail compliance is essential when considering the changing nature of traditional network services such as metering (to name just one). The nature of required intervention in the market is shifting and in this context it is desirable to have a regulator with the ability to decide which type of response is required, informed by a deep, practical understanding of all aspects of the changing markets.

We would further suggest that energy policy and implementation are highly complex and require an integrated, not fragmented approach. The Panel’s own observations in relation to the “Strategic Policy Deficit” acknowledge that fragmentation is not desirable. The AER’s responsibilities are diverse and inter-related reflecting the nature of the energy markets.

We would further argue that such diversity of roles, skills and the consequent experience gained from those roles promotes more effective regulatory approaches. As an example, the AER’s input into various policy considerations can be better informed by reflecting on practical considerations and drawing on actual experience such as the enforceability of particular proposals as well as the efficacy at a practical level. As has been the case, we are able to draw on our enforcement experience to suggest improvements to rule change proposals to better achieve the objectives.

Far from adopting an “adversarial enforcement mindset” that appears to be emphasised by submissions to the Panel, the AER has invested considerable time and resources on developing a broadly based and fit for purpose culture. We are aware, and have accounted for, the different ways of operating when undertaking enforcement work, compliance work, or the type of continuous learning and engagement that is necessary in network regulation and

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<sup>14</sup> *Review of Governance Arrangements for Australian Energy Markets Draft Report*, July 2015, p. 50.

building consumer confidence. As set out above, our organisational structure and diverse skills and expertise, demonstrate our awareness of the potential issues.

Our structure is then supported by clear, transparent policies that set out how we engage with stakeholders when undertaking different programs of work. These published policies clearly demonstrate the different nature of our engagement and reflect how we have a culture that embraces the diverse mindsets required.

The bulk of our work over the past decade in enforcement and compliance has focused on education and monitoring to promote a strong compliance culture among industry participants. This has included promoting best practice through a range of compliance publications and audits and undertaking more targeted compliance work on a small number of strategic compliance projects each year. The AER also works to develop a collaborative approach to compliance where appropriate. An excellent example of this is in relation to the work we have undertaken on retailers' hardship programs.<sup>15</sup>

We take effective, targeted and timely enforcement action when necessary. Enforcement action can include issuing infringement notices or instituting proceedings in the Federal Court. These processes, and the culture required to perform them, may be perceived as adversarial given the necessarily formal nature of engagement between the AER and respective businesses. While these types of actions are very important enforcement tools and not ones that we shy away from, they are not a significant focus of our activity. Over the past decade the AER has instituted proceedings in three separate matters and issued twenty infringement notices.

With respect to our network regulation roles, we put considerable effort into understanding each business's proposals and maintaining ongoing relationships with the businesses. Aspects of the process can appear adversarial, but this is largely a function of the regulatory framework and the energy laws and rules that we operate under. For example, the traditional 'propose-respond' network regulatory framework where the AER was required to 'disprove' various aspects of the business's proposal before forming its own judgment lends itself to adversarial relationships between the regulator and regulated businesses. Similarly, a framework where affected parties can seek review of aspects of the regulator's decision through a legal process before the Competition Tribunal similarly can support that perception.

In summary, the AER has regulatory, compliance and enforcement and performance monitoring functions across the entire energy supply chain and has put in place a skill set and expertise that are appropriate to the tasks at hand.

### 3.3. Recommendation to establish the AER as a stand-alone energy regulator

The key recommendation in the draft report in relation to the AER is the recommendation for the AER to be established as a stand-alone energy regulator, separate from the ACCC. We

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<sup>15</sup> Details of this can be found at <http://www.aer.gov.au/retail-markets/energy-retailers-customer-hardship-policies>

consider that issues around the appropriate structural model for the AER should be considered separately to questions around the AER's performance.

The issues that drive this recommendation appear to be concerns over the AER's independence and organisational culture. As highlighted earlier, we consider we have the independence and organisational culture required. We have control over how we spend our budget and have the ability to develop a management style, culture and skill set capable of adapting to changes in energy markets. Later in the submission, we comment on recommendations which we believe would enhance the AER's capacity as a regulator. These reforms can be progressed, irrespective of decisions on the administrative structure for the AER and ACCC.

We note, however, that there are some issues with the Review Panel's preferred option.

We consider the costs of establishing a stand-alone AER have been underestimated and do not reflect the government's broad policy agendas of reducing the regulatory burden on business as a means of improving national productivity.

*It has been put to the Panel that the overall quantum of resources required to support a stand-alone entity would be significantly larger than that currently required for the AER leveraging off ACCC resources. Again, however, this argument appears to rest on static 'business as usual' presumptions and ignores the point repeatedly made by submitters that the sector is undergoing profound changes. Those changes require a management style, culture and skill set that are capable of adapting according to a set of transparent, easily understood principles that are capable of sustaining regulatory certainty even as things change. The Panel is aware of no evidence that substantiates a view that this is more likely to be effectively and efficiently achieved by embedding the relevant functions in a much larger organisation that has a broader range of objectives and preoccupations. ... The Panel is therefore not of the view that its recommendations necessarily imply a significant increase in funding requirements.<sup>16</sup>*

This does not reflect all the costs of establishing a stand-alone AER. The AER is a small agency of approximately 125 staff. Consistent with the Australian Government's shared services model, the AER obtains its corporate services and in-house legal and economic support from the ACCC. A stand-alone AER would need to establish separate offices in each state in which it has a presence, a separate IT system, separate corporate functions, and separate legal and economic staff.

Decisions to establish a stand-alone energy regulator would presumably need to consider these types of separation costs in detail. It is also worth mentioning that the Productivity Commission's recent review into this issue, in recommending that the current AER institutional arrangements should be maintained, concluded that forming a stand-alone AER would be 'costly and disruptive.'<sup>17</sup>

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<sup>16</sup> *Review of Governance Arrangements for Australian Energy Markets Draft Report*, July 2015, p. 59.

<sup>17</sup> Productivity Commission (2013), *Electricity Network Regulatory Frameworks*, Report No. 62, p. 784.

We also consider that the Review Panel downplays the benefits of the AER's relationship with the ACCC. The Review Panel notes that:

*the current organisational set-up has some potentially beneficial 'static' synergies. They include the ability of the AER to access the ACCC's legal and other corporate resources at lower cost than if the AER were independent of the ACCC, and the ability of the AER to have a physical presence in each jurisdiction that it regulates.*<sup>18</sup>

The benefits of the current shared services model are not static, but rather deliver ongoing efficiencies. This shared services model is increasingly being rolled out across the public service.

Moreover, the benefits of the current institutional arrangements are more significant than cost savings. Economic regulation of energy networks is a core responsibility of the AER. Network regulation is also a key ACCC role, with regulatory responsibility in communications, rail, ports, water and postal services. The AER also has enforcement, consumer protection and education responsibilities under energy legislation that have similarities, but are also distinct, to the responsibilities of the ACCC under the Australian Consumer Law.

While these functions are undertaken separately by the AER and ACCC as distinct, independent entities, the institutional arrangements have facilitated improved understanding of general approaches to economic regulation and general principles applying to enforcement policies.

The institutional arrangements that exist between the AER and the ACCC have also assisted both organisations in taking a coordinated approach to issues of common interest under the *Competition and Consumer Act* and national energy legislation. The issue of door knocking by energy company marketers is an example where responsibilities of the AER and ACCC potentially overlapped, and where the AER was able to assist the ACCC.

We finally note the comment that the proposal to establish a stand-alone AER would 'likely also see some narrowing of AER activities (more specifically consumer and competition functions would remain with the ACCC along with price monitoring and surveillance of those markets that are open to competition).'<sup>19</sup> While we note the Review Panel's comment that the issue of which existing AER functions will remain with the AER and which will be transferred to the ACCC will not be able to be resolved in the final report, we wish to highlight that there are significant concerns with any proposal to split the AER's functions between multiple agencies.<sup>20</sup>

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<sup>18</sup> *Review of Governance Arrangements for Australian Energy Markets Draft Report*, July 2015, p. 54.

<sup>19</sup> *Review of Governance Arrangements for Australian Energy Markets Draft Report*, July 2015, p. 56.

<sup>20</sup> The AER's submission to the Competition Policy Review draft report explored a similar proposal at length. The Competition Policy Review draft report proposed transferring the AER's network and wholesale functions to a new access and pricing regulator with the AER's retail functions to be undertaken by the ACCC. The submission is available at: <http://www.aer.gov.au/sites/default/files/AER%20submission%20on%20Competition%20Policy%20Review%20Draft%20Report.pdf>

First, the proposal to create multiple regulators does not reflect the integrated and changing nature of energy markets. While the AER has wholesale market, networks and retail market roles, it is not possible to consider one element of the supply chain in isolation. Outcomes in the network sector critically influence decisions in upstream and downstream markets. As an example, network constraints critically affect the efficiency of generation dispatch and outcomes in wholesale markets.

Another implication to dealing with elements of the sector in isolation is that energy markets are dynamic and the roles of generators, networks, retailers and customers are rapidly evolving. With the significant uptake of household and recent developments in energy storage, customers are becoming much more than passive players at the end of the energy supply chain. These developments mean that customers will potentially be consumers one day and generators the next. Customers could increasingly provide services to distribution businesses (to manage network issues) and to retailers (to manage wholesale market issues). These changes are profound and have impacts across the whole sector. It is unclear whether a framework that tries to split regulatory roles will be able to approach regulation with a holistic view on these developments.

Second, the proposal that the ACCC assume the AER's wholesale and retail functions mischaracterises the energy legislation and the AER's responsibilities. The AER's retail responsibilities, for example, are not limited to consumer protection and competition functions.

The Retail Law governs the relationship between energy retailers, distributors and retail customers – it affects a range of market participants including retailers, distributors, metering providers, ancillary service providers and the market operator. These players have interrelated obligations in other legislation, such as the National Electricity Law and Gas Law.

While there are strong elements of consumer protection in a number of these Retail Law provisions, a range of these functions are essentially regulatory roles. The role of authorising retailers and granting exemptions is a regulatory role requiring detailed energy sector knowledge. Retail authorisation models are evolving to include generation (embedded and renewables), energy storage capability and service provision.

Third, a proposal to split regulatory roles will require some market participants to report to multiple regulators. As an example, not only would distribution businesses be subject to network revenue regulation by the AER but, as highlighted above, would be regulated by the ACCC for obligations under the Retail Law. This increases the cost and complexity of regulation for these market participants.

### 3.4. Recommendation for periodic review of the AER

The Review Panel recommends that the AER be reviewed every three to five years by a COAG Energy Council Panel of Experts. We agree there is a need for the evaluation of the performance of regulatory agencies such as the AER.

Some elements of a performance reporting framework are already in place.

In December 2013, the COAG Energy Council released a Statement of Expectations for the AER. The Statement of Expectations outlines the AER's roles and responsibilities, its relationship with the COAG Energy Council, and guidance on transparency and accountability requirements, including performance measures. The Statement of Expectations highlights that the COAG Energy Council can provide feedback on any performance indicator developed by the AER.

The AER responded to the expectations of the COAG Energy Council by releasing a Statement of Intent that sets out the AER's objectives, supported by details on its strategic priorities and broader work program. We have also developed and published detailed performance indicators and deliverables, which we report against in our annual report. Further, we provide half yearly reports to the COAG Energy Council.

While these processes help form a strong accountability framework for the AER, a review of the type suggested in the recommendation could complement these existing processes. We consider that this review should provide advice on potential areas for improvement. We think that this would be best achieved through a 'peer review' by a Panel of Experts with a detailed understanding of regulatory issues. Ideally, the Panel of Experts would consist of regulators and other experts.

Any review should involve the AER 'throwing open its doors' to the Panel of Experts, and getting them to review documentation, sit in on Board meetings, and interview Board members and staff. This process should provide the Panel of Experts with an understanding of how the AER operates and identify any potential areas for improvement. Recommendations of the Panel of Experts should be made public, with the AER required to report on how it proposed to address the areas for improvement that have been identified.

While we consider this review process could be beneficial, the timing of any review would need to be cognisant of our workload. We would also caution against reviews being conducted too frequently. After any review, it takes time to implement changes and assess the effectiveness of these changes in practice. As such, a review every three years appears too frequent, and even with a five year review cycle it may be difficult to assess the effectiveness of changes from the previous review.

### 3.5. Recommendations in relation to AER Board

The Panel makes a number of recommendations in relation to the size and appointment process for the AER Board.



The key recommendation is that ‘... the membership of AER be expanded from three to up to five members, with the Chairman full-time and the remaining members a mix of full-time and part-time.’<sup>21</sup>

The Panel considers this would broaden the diversity of experience of Board members and improve decision making. Diversity can be an important component of strong decision making and it is something the AER Board has always valued – through its engagement with external stakeholders and through its internal processes. The AER Board has sought to support its decision making through having access to diverse views as part of its processes – including through Board meetings. There is strong participation of staff at Board meetings, including staff with significant experience in consumer issues. All staff are encouraged by the Board to actively debate issues as part of Board decision processes – this brings in a broad range of voices and tests the Board’s thinking in ways that strengthen the final decisions. Specialist staff can bring the value of their particular perspective, for example consumer behaviour and preference, and advise and challenge as part of Board discussions.

Irrespective of the decision about the number of Board members, we consider that a mix of full-time and part-time Board members as recommended by the Review Panel is problematic. This recommendation should be considered in light of the recent decision by COAG to make the previous part-time position on the AER Board a full-time position. This change was appropriate not only in recognition of the workload but the practical difficulties of having part-time members who may not, because of the part-time nature of their appointment, be able to be fully across the complexities and inter-related nature of issues. Another important difficulty with part-time Board members is that such members are more likely to have other interests and employment outside of the AER which could give rise to conflicts.

### 3.6. Recommendations in relation to AER funding

The Review Panel recommends that the AER should be funded by all jurisdictions who are members of the COAG Energy Council in a manner determined by the Energy Council.

As highlighted in our submission on the issues paper, the issue that is critical for the AER is that the level of our funding is sufficient for us to fulfil our responsibilities under legislation efficiently and in a timely manner. We agree with the Review Panel that there needs to be a level of ‘stable and reliable funding’ for operations.

The AER’s roles and responsibilities are determined by the COAG Energy Council through the national energy legislation and by the AEMC through the National Energy Rules. As highlighted in the draft report, there is a lack of alignment between those who determine the AER’s workload and those responsible for the AER’s resourcing.

Previously, AER resources have increased broadly in line with a range of new responsibilities and functions – for example, in 2011, when the National Energy Customer Framework was enacted and in 2013, to strengthen consumer engagement and enhance regulatory tools such as benchmarking.

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<sup>21</sup> *Review of Governance Arrangements for Australian Energy Markets Draft Report*, July 2015, p. 79.

However, it has not always been the case that resources have increased in line with new responsibilities or functions. Since our last budget increase there have been a large number of rule and law changes that have impacted on the AER's work program – either by adding new functions or by requiring changes in the way existing roles are undertaken. The network regulation rule changes introduced in November 2012 made fundamental changes to how network regulation is undertaken. Since then, a further 90 new clauses have been added to the National Gas Rules, National Electricity Rules (NER) and National Energy Retail Rules and a further 136 clauses have been amended.

A number of these amendments have been very significant in their own right, for example – taking on responsibility for Northern Territory network regulation; the new framework for network regulation in chapters 6 and 6A of the NER; and introduction of a new cost reflective network tariff framework. Others, while only having a small incremental effect individually, have now added up to a material change collectively.

The scope, scale and complexity of much of our work have increased as energy markets have become more complex and dynamic. The understanding developed in 2006 of baseline resources required to properly perform our roles is being challenged by this more complex environment and the expectations of stakeholders.

The AER faces growing expectations in respect of consumer engagement, education and consumer protection. We consider that increasing engagement with consumers and our other stakeholders is essential to maintain the trust and respect required of an effective regulator.

We believe that a significant increase in our resourcing is required. A sufficient and stable level of funding is required to undertake our functions and meet the challenges of changing energy markets. We are less concerned with where this funding comes from, provided that our independence is in no way compromised by funding arrangements.

### 3.7. Recommendation that the AEMC sign off on AER regulatory guidelines

Under the section of the draft report titled 'Delegated Rule Making', the Review Panel recommends that:

*The AEMC should put in place a formal mechanism for the AEMC to sign off on the final guidelines or procedures if they have arisen from an AEMC process, to ensure that they meet the original intent.<sup>22</sup>*

This recommendation would mean that the AEMC would need to sign off on AER regulatory guidelines if they have arisen from an AEMC rule change process. We believe that this recommendation is unnecessary and would involve significant cost and delay.

The Review Panel should be aware that since the revenue regulation rules were first developed in 2006-07, they have required the AER to develop regulatory guidelines on issues that have been provided for at a more general level in the NER. Since this time, some

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<sup>22</sup> *Review of Governance Arrangements for Australian Energy Markets Draft Report*, July 2015, p. 45



parties have argued that the role of the AER in developing guidelines involved the conferral of rule making power onto the regulator and/or that there were no safeguards to ensure that guidelines met the AEMC's policy intent.

Both of these issues were explicitly dealt with by the AEMC when the revenue regulation rules were first developed.

The AEMC noted that the development of guidelines by the AER was not a rule making power, but rather 'where guidelines are required by the Revenue Rule, these relate to the detailed application or implementation of matters that have been provided for at a more general level in the relevant Rule.'<sup>23</sup> The development of guidelines by the AER, therefore, is not delegated rule making, but rather is a standard part of the regulator's toolkit to explain the regulatory approach to the application of certain rules.

Guidelines are developed by the AER to clearly set out how we will approach the exercise of our discretion under the Rules. They are generally not binding on other parties, but do provide for a level of constraint on us. The AER would need to have good reason to depart from a stated approach that had been developed following inclusive consultation with affected stakeholders. These guidelines are not by their nature a 'delegation' by the AEMC of its rule making powers.

The AEMC also noted that there were safeguards in place under the NER to ensure that guidelines met the rule making intent:

*The Revenue Rules ensure that the guidelines are developed in line with the intention of the Rules by placing specific conditions upon the AER's guideline development and review processes.*<sup>24</sup>

In particular, the AEMC highlighted the guideline consultation procedures as an important factor in ensuring that guidelines are developed in line with the intent of the Rules.

We further note there are other processes in place to raise concerns that AER guidelines were not meeting the AEMC's rule making intent or involved delegated rule making. In particular, interested parties have the ability to propose a rule change to the AEMC.

We consider these existing processes provide appropriate discipline on the AER's guideline development.

We also are not clear how the recommendation would operate in practice. As highlighted above, guidelines regularly involve detailed application or implementation of matters provided for at a high level in the rules. Some of the material in AER guidelines is therefore quite detailed and technical in nature. It is not clear whether the AEMC would have the scope to 'sign off' on detailed issues such as aspects of the AER rate of return guidelines.

This proposed process would also appear to potentially involve duplication of work between the AER and AEMC; involve significant additional cost for the AER, AEMC and interested parties; and introduce delay in the finalisation of guidelines, with consequent uncertainty. It

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<sup>23</sup> AEMC, *Economic Regulation of Transmission Services, Rule Determination*, November 2006, p. 64.

<sup>24</sup> AEMC, *Economic Regulation of Transmission Services, Rule Determination*, November 2006, pp. 64-5.

may be difficult for the AEMC to prevent stakeholders from re-prosecuting arguments already made to the AER through a guideline review process. This creates the possibility of forum shopping.

## 4. Conclusion

As outlined above, the AER considers that the energy market governance arrangements work well and deliver outcomes in the long term interests of energy consumers. We are, however, supportive of the Review Panel's recommendations to improve strategic policy setting arrangements in the market and streamline rule change processes. We have also discussed the AER's roles and responsibilities, and described how we operate in detail. While this highlights that we are an independent regulator with an appropriate organisational culture, the Review Panel's recommendations, particularly the recommendation for a 'peer review', could identify opportunities for further improvement.