

15 May 2015

Dr Michael Vertigan AC
Chair
Energy Governance Review Expert Panel
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Dear Dr Vertigan

**Submission to Review of Governance Arrangements for Australian Energy Markets
Issues Paper**

The Australian Energy Regulator (AER) welcomes the opportunity to provide the attached submission to the Issues Paper for the Energy Markets Governance Review.

Our submission highlights that the governance arrangements are working well and have delivered outcomes in the long term interests of energy consumers. Whilst we consider that fundamental change to the current arrangements is not required, we have a number of suggestions which could make the current arrangements work more effectively.

Our submission also responds to the issues paper questions on the AER. This discussion highlights key features of how the AER operates, including our internal governance arrangements, reporting and accountability frameworks, and relationships with the other institutions.

Should you have any questions, please feel free to contact the AER's Chief Executive Officer, Michelle Groves, on (03) 9290 1423 or me on (03) 9290 1419.

Yours sincerely



Paula W. Conboy
Chair



Review of Governance Arrangements for Australian Energy Markets

AER Submission on Issues Paper

May 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 issues paper.

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, 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 and Tasmania (electricity only) and from 1 July 2015, Queensland, 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.

These functions are set out in detailed legislative arrangements. They broadly involve regulation of energy networks, enforcement, monitoring and reporting roles in wholesale and retail markets. These roles do not extend to addressing issues related to market design or constructing regulatory frameworks. More detail on our roles and responsibilities are provided in attachment A.

The Australian Competition and Consumer Commission (ACCC) retains responsibility for competition issues in energy markets under the *Competition and Consumer Act 2010*, including enforcement, mergers and authorisations.

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 addresses the key question of whether the governance arrangements are operating effectively. We consider that the governance arrangements - of an independent national regulator (AER), a rule maker and market development body (the Australian Energy Market Commission (AEMC)) and a market and system operator (the Australian Energy Market Operator (AEMO)) overseen by a ministerial council (now the Council of Australian Governments (COAG) Energy Council) - are working well and have delivered outcomes in the long term interests of energy consumers.

The roles of each body are generally well understood and the framework has supported the efficient operation of the market and necessary reforms in an integrated, comprehensive manner. Importantly, this experience provides confidence that the governance arrangements remain fit for purpose to deal with emerging challenges. Whilst we consider that fundamental change to the current arrangements is not required, we have a number of suggestions which could make the current arrangements work more effectively.

In the second part of the submission, we address a range of the specific questions in the issues paper. In particular, we provide comment on each of the questions that the Panel poses about the AER. This discussion highlights key features of how the AER operates, including our internal governance arrangements, reporting and accountability frameworks, and relationships with the other institutions.

2. Performance of the governance arrangements

As highlighted in the issues paper, a key element of the reforms of the last decade was to establish governance arrangements that would support the effective operation of Australian energy markets, including delivering necessary energy reforms.

The governance arrangements that resulted involve four key institutions.

- COAG Energy Council (formerly the Ministerial Council on Energy (MCE)) – the Energy Council provides national oversight and co-ordination of energy policy development
- 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
- Australian Energy Market Commission – the AEMC is the independent rule maker, with responsibility for national rule making and market development
- Australian Energy Market Operator – AEMO is the independent market operator, with responsibility for operating wholesale energy markets and delivering planning advice

While these are the four key institutions, there are a number of other bodies with responsibility, including the newly formed Energy Consumers Australia and jurisdictional regulators, who continue to have responsibility in some states.

2.1. How well have the governance arrangements worked?

To consider how well these governance arrangements have worked in practice, it is instructive to look at what governments were intending to achieve when they put these arrangements in place.

It was intended that the MCE be established as a single energy market governance body to provide national policy oversight and national leadership on key energy market policy issues. 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. This more national approach has helped the MCE and Energy Council drive a range of key energy market reforms over the past decade including the development

of the National Energy Customer Framework (NECF) and amendments to the merits review framework.

It was intended that by operating as a single national regulator, the AER would streamline and improve the quality of economic regulation, lower the cost and complexity of regulation facing investors and enhance regulatory certainty.¹ Before the formation of the AER there were 13 regulators with responsibility across all steps of the energy supply chain. Distribution and retail regulation, for example, were carried out on a jurisdiction by jurisdiction basis with different regulators in each state. The Parer Review² found that this multiplicity of regulators created a barrier to competitive interstate trade and added costs for the energy sector. 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.

It was intended that by operating as a national rule maker and market development body, the AEMC would provide a more streamlined approach to rule making in the energy sector. Before the formation of the AEMC, the ACCC and the National Electricity Code Administrator (NECA) had roles in developing and approving amendments to the National Electricity Code, while the National Gas Pipelines Advisory Committee and the National Gas Code Registrar had responsibilities in gas. The Parer Review found that the process for making changes to the Electricity Code effectively involved a dual assessment of proposed Code changes by NECA's Code Change Panel and the ACCC. A key driver behind creating the AEMC was to remove this regulatory overlap. The formation of the AEMC has delivered a more streamlined approach to rule changes. It has removed overlap in the rule change process and removed the potential for inconsistent rule change approaches in electricity and gas.

Finally, it was intended that AEMO would provide a more national focus to market operation and network planning. Previously, network planning had been undertaken on a state by state basis. Since its formation, AEMO has provided a national, independent focus to network planning and provided greater transparency around planning outcomes.

The vision behind the governance reforms, therefore, has largely been delivered.

We consider that the current governance arrangements have real strengths. The roles and responsibilities of each organisation are well understood and 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.³ Considerable expertise has been built up around the operation of energy markets and the challenges that these markets will face in future.

Since these governance arrangements were implemented, the agencies have worked together on a consistent market reform path characterised by ongoing stability around key market settings, combined with the implementation of necessary reforms to respond to changes in market conditions.

¹ See Ian Macfarlane, MP, Second Reading Speech for the Australian Energy Market Bill, 17 June 2004, p 30715.

² Council of Australian Governments Energy Market Review (2002), *Towards a Truly National and Efficient Energy Market*

³ More detail on these relationships is provided in the response to Question 18 later in this submission

The governance arrangements have supported a range of 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 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
- development of a range of initiatives to facilitate more efficient demand-side participation in the market, and
- development of gas market trading hubs.

The amendments to the rules for the economic regulation of network service providers and associated merits review processes provide a detailed case study of how these governance arrangements have delivered necessary reform in a timely, considered manner.

The electricity transmission rules were developed in 2006 and the electricity distribution rules were developed in 2007. After conducting a series of regulatory resets under these rules, the AER identified a series of concerns with the framework. These concerns related to framework for assessing capital and operating expenditure, efficiency incentives and the cost of capital framework.⁴

We subsequently lodged a rule change application with the AEMC in September 2011 to address the concerns that we identified. After a broad consultation process, with detailed analysis and multiple rounds of stakeholder submissions, the AEMC released final rules in November 2012. These revised rules addressed the concerns identified in the AER's rule change proposal.

Over the next year, the AER developed a series of guidelines under the Better Regulation program outlining its approach to regulation under the new rules.⁵ These included guidelines outlining the AER's approach to assessing expenditure forecasts, setting expenditure incentives and setting the rate of return, and a guideline which sets out a framework for better engagement by network businesses with consumers.

At the same time, the MCE reviewed the arrangements for reviewing the AER's regulatory decisions. This review concluded that the limited merits regime was not working as policy makers intended, with the scope of reviews being unduly narrow and insufficient attention paid to the long term interests of consumers in the review process (and indeed in network business and regulatory decision making prior to the appeal stage).

⁴ Detail on the AER's rule change application is available at <http://www.aer.gov.au/node/25041>

⁵ More information on these guidelines is available at <http://www.aer.gov.au/Better-regulation-reform-program>. This information includes the guideline documents, accompanying explanatory statement and guideline factsheets.

In response, the MCE agreed to amendments requiring:

- a network business to demonstrate that the AER erred and that addressing the grounds of appeal would lead to a materially preferable outcome in the long term interests of consumers
- the Tribunal to consider any matters interlinked with the grounds of the appeal, and to consult with relevant users and consumers.

The South Australian Parliament, as lead legislator, in November 2013 passed legislation to implement the reforms.

The arrangements therefore were able to identify problems with the revenue regulation rules and merits review arrangements, and policy bodies, the AEMC and AER put in place reforms to address the range of concerns that were identified. This was achieved in a little over two years. We consider this was a timely, considered response to what were complex, wide-ranging issues. These reforms were able to be in place for the next round of revenue resets. The first final decisions by the AER under this new framework were released by the AER on 30 April 2015.

This case study provides evidence to suggest how well the governance arrangements are able to progress required energy sector reforms.

2.2. Will the governance arrangements deliver in future?

A key issue posed by the terms of reference is whether the governance arrangements will continue to deliver going forward.

Energy markets worldwide are evolving. The evolution is being driven by consumers and fuelled by new technologies. Consumers are becoming more active participants in the markets; making more informed choices about their energy consumption and investments.

Rising cost pressures in Australia have provided the impetus for a growth in alternatives such as demand side response and small scale local generation. Roof top solar PV has been installed on over 1.4 million households nationally.

There may also be a significant increase in the take-up of electric vehicles in the future, which has the potential to change the way electricity is stored and consumed. Further, the IT and communication revolutions have opened up the scope for a host of new devices and appliances, allowing small-scale consumers for the first time to respond to local electricity market conditions.

These changes involve a significant shift in the way electricity is produced and consumed, and create a far more active role for consumers in the market; for example, by at times acting as net producers of electricity through their PV systems. A key question is whether the governance arrangements remain able to respond to this more dynamic market environment.

As highlighted earlier, the governance arrangements proved capable of addressing weaknesses in the network regulation framework. The governance arrangements have also proven to be flexible and adaptive – emerging market issues that were not fully anticipated at

the time the governance arrangements were put in place have been appropriately identified and dealt with.

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 facilitate efficient demand-side participation in the NEM. 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.

The development of gas market hubs is another market development that was not fully anticipated, but able to be dealt with under existing governance arrangements.

This experience provides confidence that the market governance arrangements will be able to identify emerging issues in future and put in place arrangements to promote ongoing efficient investment and innovation.

We consider that the features of governance arrangements that have worked well in the past – such as the well-defined roles and responsibilities, good lines of communication, and a strong knowledge of key issues – will also be able to deliver going forward.

2.3. Opportunities to improve governance arrangements

While we consider the arrangements have worked well, there are opportunities to make improvements to ensure that the framework continues to support the efficient operation of the market and deliver outcomes in the long term interest of energy consumers. Potential opportunities for improvement include suggestions to streamline the rule change process and initiatives to further enhance the Energy Council's energy market leadership role.

2.3.1. Changes to rule change process

While we identified a case study earlier to highlight how well the rule change process can work, we consider there is scope to refine this process for certain classes of rule changes to make the process work more efficiently.

Rule changes arising from a COAG Energy Council initiated review

For issues referred to the AEMC by the COAG Energy Council there can be a three stage process to develop rules. The process consists of the AEMC conducting a review and proposing draft rule amendments to the Energy Council; the Energy Council responding to the AEMC review and submitting proposed rule changes; and the AEMC conducting a rule change process. This can involve duplication as rule changes drafted in the first stage of the process, are considered and submitted in the second stage of the process, before being formally assessed in the third stage of the process.

There is scope to refine this process.

One option would be to provide the AEMC with the ability to conduct a one-step review and rule change process. Under this proposal, following receipt of terms of reference from the AEMC would conduct a review, develop rule change proposals and consult on these

proposed rules as part of a single process. Energy Council policy oversight throughout this process could be provided by requiring the AEMC to report to the Energy Council or Energy Council officials following review or prior to consultation on proposed rule changes. This option involves a significant change on current arrangements.

Another option would be to provide a two-step process where the AEMC's considerations would be separated into a review stage and an implementation stage. Under this proposal, the AEMC would assess the issue referred to it and develop options in the review stage. It would, however, not propose rule changes at this stage. If the Energy Council agreed with the AEMC's findings, the issue would be referred back to the AEMC for implementation, including the development of rule changes. This approach still involves significant change from current arrangements as the AEMC would be responsible for developing rule changes, but compared to the option highlighted in the previous paragraph involves more oversight for Energy Council as it would have a role in assessing the AEMC's review findings.

A more incremental change to the current arrangements would be to retain the three stage process, however with the AEMC reviewing an issue but not undertaking any proposed rule drafting at the initial review stage. This would remove some of the duplication of consideration of rule drafting that we see at present, but would still involve a detailed three stage process that will take time to complete.

Expedited rule change process

The rule change process allows the AEMC to consider rule changes under an expedited six week process where they are considered non-controversial or urgent. Otherwise, rule changes must be considered under a detailed consultation process set out under the National Electricity Law. There appears to be a range of rule changes that 'fall in the gap' – they are not so straightforward that they can be processed within the six week expedited process, yet the standard rule making process appears overly burdensome. For example, there may be cases where the issue is clear, but some consideration may need to be given to rule drafting.

This issue could be dealt with by giving the AEMC the ability to extend the six week period in expedited rule change process in circumstances where consultation is required and/or further consideration needs to be given to rule drafting. This would provide the AEMC with greater discretion to conduct a rule change process it thought was appropriate in the circumstances – but importantly would also promote a more streamlined rule change process that would reduce costs for the AEMC and interested parties.

2.3.2. Suggestions to enhance COAG Energy Council processes

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.

As highlighted earlier, the Energy Council (and before it the MCE) have provided significant direction to energy market reform over the past decade and progressed a range of key reforms. The Energy Council's recent initiatives around stakeholder inclusion and

engagement have also improved the operation of the six-monthly Energy Council meetings and allowed for broader perspectives to be considered in Energy Council decision making.

There is scope, however, to enhance the Energy Council's leadership role.

While the Energy Council's 2014 communique highlighted a range of broad priorities, it is not straightforward to understand what the Energy Council's key priorities currently are. Developing these strategic priorities would help guide the Energy Council's work program. It is clear from the issues paper that the Energy Council is progressing a wide range of reforms. However, it is not immediately obvious what the key workstreams are, how some work programs fit into a broader strategic vision, or how work programs are to be progressed. Publishing the Energy Council's strategic priorities on its website would provide stakeholders greater insight into key reform programs. Similarly, publication of the Council's work program, including project timelines and deliverables, would allow stakeholders to consider how current reforms might be related to issues they are interested in and gain confidence that matters were being progressed.

3. Response to issues paper questions

Question 9: How has (or how do you consider) the AER's performance tracked over time? What factors do you think are contributing to this?

Assessing the effectiveness of performance for bodies such as the AER is not straightforward. The AER has important roles and responsibilities within the national energy market and it is essential that we perform these effectively for the successful operation of the market. Our roles and responsibilities are undertaken within a broad policy framework, under specific legislation and regulations and in conjunction with other organisations. This can make it challenging in assessing what contribution the AER has made to overall market outcomes, as distinct from other drivers.

This has been recognised in the development of the Council's Statement of Expectations for the AER and in the AER's Statement of Intent, in response. Our measures of effectiveness include both qualitative and quantitative KPIs that focus on our role – including as a partner – in achieving the overall outcome of efficient and effective energy markets that deliver outcomes in the long term interests of consumers.

In this context we consider that the AER's performance has tracked well over time – and has improved as we have responded to concerns that have been raised. Over the past 10 years since establishment we have gained significant experience and expertise in all areas of our work. We have been involved in the development of important market reforms – providing us with a clear understanding of the objectives of these reforms and our role in delivering them. This has contributed to our effective performance.

We rely on a range of indicators when assessing performance, including –

- KPIs related to our delivery of our work program
- Budget and parliamentary accountability
- views expressed by stakeholders on aspects of our performance through surveys and other forms of engagement
- reviews, including by the Australian Competition Tribunal and Federal Court, of our decisions
- organisational health indicators, including retention rates, staff experience, learning and development and diversity

We note that in the past, some stakeholders have sought to focus on the AER's success under merits review and results of stakeholder surveys as indicators of the AER's performance. While we use these indicators to help assess our performance, they do need to be put in an appropriate context.

The framework appropriately allows parties affected by our decisions to challenge them under merits review processes. However, it is important to note that outcomes under merits review can reflect a range of factors – uncertainty around interpretation of rules (particularly new rules), the operation of the merits review framework and the fact that there legitimately can be room for disagreement on a range of issues (such as rate of return issues) all affect

outcomes under merits review. It is important to acknowledge that rule makers and policy makers made changes to the regulatory rules and merits review arrangements to address deficiencies that were identified in these frameworks.⁶ These reforms strengthened the merits review regime by outlining that the long term interests of consumers are paramount.

The regulator can make errors, particularly given the wide range of ‘constituent decisions’ involved in making a regulatory determination. During 2009 and 2010 a number of businesses successfully challenged some aspects of our determinations. In the past four years, we have seen fewer businesses seek review of our decisions, the grounds of appeal are narrowing, and even on the grounds that are being reviewed we are being more successful. To the extent these are relevant measures of the AER’s performance they indicate fewer errors are being made in our decisions. We are happy to provide greater detail on the specifics of these recent cases to the Review Panel if this would be useful.

Regarding stakeholder surveys, the AER’s objective in these surveys is to track stakeholder views on our performance over time and to try and understand what affects those perceptions. The surveys, and the targeted interviews we conduct as part of the survey process, have assisted us to track our performance in certain areas, evaluate our performance, help maintain our performance and drive improvements in the way we operate.

They are not, however, an independent, expert ‘report card’ on the performance of the AER. Survey results are significantly influenced by their context. The results may reflect perceptions of performance at the time the survey is taken. It is widely accepted that the AER has a difficult role in the market and our decisions have significant direct impacts on stakeholders. This may influence perceptions that stakeholders have on our overall performance.

That said, the results of these surveys have portrayed an overall positive story about the AER’s performance across all areas of our work program (wholesale, retail and networks). The 2014 survey results and commentary indicate stakeholders have growing confidence in us and our ability to make good decisions.

In respect of our overall performance, we consider we have been adaptive and innovative – finding new ways of operating, new systems, tools and processes. We have sought to improve our engagement with all stakeholders and consider that we have been successful in this – which has in turn resulted in better outcomes. We have responded to concerns raised by our stakeholders about aspects of our operations.

Our Better Regulation Program is a very good example of this. Over the course of 12 months we developed new guidelines to give effect to the network regulation rule changes – using new forms of consultation and engagement to ensure greater stakeholder participation and ownership. We enhanced the use of regulatory techniques such as benchmarking, significantly developed our databases of network business information, established and engaged our Consumer Challenge Panel and increased our internal technical expertise through the establishment of our technical advisors group.

⁶ At this stage, there have been no regulatory decisions reviewed under these new arrangements.

Question 10: Does the concept of a national energy regulator, separate from the rule maker and jurisdictional governments, remain relevant in today's market? Should the Panel be considering alternative models?

We consider that the concept of a national energy regulator, separate from the rule maker and jurisdictional governments, remains important today.

A key feature of the current governance arrangements involves the separation of rule-making roles from rule enforcement and regulation roles. We consider that this separation has worked well in practice and remains relevant. A significant reason this separation was adopted was to remove a potential conflict of interest between the regulator's role as a rule maker and a rule enforcer. This separation reflects basic principles of good governance. Particularly in an enforcement context, there are significant potential issues in an agency writing rules that it is then responsible for enforcing. Separation between these functions avoids the risk of the regulator simply changing the rules to drive its enforcement success rate. Having a separate rule maker provides independent rule making, which promotes ongoing market transparency and in turn, trust and confidence in the regulatory framework.

Experience over the past decade has highlighted other benefits associated with having separation between the rule maker and regulator. The independent rule making process has in many cases brought in broader perspectives and stronger rules have been developed as a result. As an example, while consumer engagement initiatives were an important part of the AER's 2011 network regulation rule change, the rules the AEMC developed expanded the consumer engagement framework with new initiatives to promote consumer engagement in network decision making.

The question also asks whether the concept of a national regulator separate from jurisdictional governments remains relevant. As highlighted earlier in the submission, the Parer Review proposed the creation of a national energy regulator to be the independent regulator in all jurisdictions. This proposal was informed by a number of concerns, including that previously there were too many regulators, governing bodies had overlapping responsibilities, and there were perceptions of conflicts of interest where governments are owners, regulators and policy makers.

These are issues that the current structural arrangements effectively resolved. The separation between the national regulator, rule maker and jurisdictional governments removed the risk of any perceived or real conflicts of interest between the separate functions of policy setting, rule-making, and regulation. The arrangements for the national regulator and rule maker has also provided a more holistic approach to considering energy market issues, in that the national institutions have sight of the entire energy supply chain.

Question 11: Do you consider there are any issues in relation to the performance of the AER's functions? To what extent are your views on the performance of the AER due to its institutional arrangements, resourcing, the prescriptive rules environment, or other factors? To what extent does the AER's governance contribute to how it exercises its regulatory tasks, including its approach to enforcement?

The AER's roles and responsibilities are defined and also constrained by the legislative framework within which we operate. The nature of the framework affects the performance of the regime. For example, prescriptive rules provide greater certainty and consistency across time and decisions but may mean that the regime is less able to respond in a timely way to new issues as they arise. The trade-off between certainty and flexibility are matters that are taken into account in the context of particular reform proposals and rule changes. Whether the appropriate balance is achieved is a relevant consideration when assessing whether the regime is meeting the national energy objective.

The AER's performance needs to be considered in the context of how we undertake our roles within that regime. This assessment is concerned with matters such as our operations, management, systems and processes. As outlined above in our response to question 9 we consider that our performance has tracked well over time.

The current institutional arrangements are effective in that they allow the AER to make its decisions independently and fulfil its functions and responsibilities to promote the objectives of the energy market legislation. Our relationship with the ACCC and the similarity in some of our regulatory tasks has assisted both agencies to draw on our respective expertise and develop best practice approaches to regulation. Our institutional arrangements, including our relationship with the ACCC, are discussed further in response to question 13 below.

With respect to the AER's approach to enforcement in particular, we have not been an overly litigious enforcement agency. Over the past decade the bulk of our work in this area 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.

We also take effective, targeted and timely enforcement action when necessary. Enforcement action can include issuing infringement notices or instituting proceedings in the Federal Court. While these types of actions are very important enforcement tools and not ones that we shy away from, they have not been a significant focus of our activity. Over the past decade the AER has instituted proceedings in three separate matters and issued twenty infringement notices.

The AER's institutional arrangements have not played a role in determining our approach to our compliance and enforcement activities. As with all areas of our work program, the AER Board makes independent decisions on what enforcement and compliance activities it will pursue (the independence of the Board and the processes for setting its priorities is set out in response to question 13 below). While we are able to draw on the specific enforcement expertise of the ACCC at times, this does not determine our overall approach to compliance and enforcement activities – it assists us in more effectively implementing our determined approach.

Question 12: To what extent does the AER's current three member structure, and the split between Commonwealth and state membership, affect its capabilities? Are there alternative oversight models the Panel should consider, for example a board structure or additional members?

The current Board structure and appointment process has served the market and the AER well. The arrangements have allowed the AER to operate independently within a national, but jurisdiction sensitive framework.

The AER has an independent Board comprised of two State members and a Commonwealth member. The Commonwealth member is a full time member of both the AER and the ACCC. The AEMA, entered into between the States and the Commonwealth, outlines the process for Board appointments. The two State members are recommended for appointment by agreement of at least five States and Territories. The Commonwealth member is recommended for appointment by the Chair of the ACCC. The appointment of all ACCC Commissioners, including the Commonwealth member of the AER Board, must be supported by a majority of the States and Territories. Appointments to the AER Board are made by the Governor-General-in-Council. Recommendations for the appointment of all Board members have been based on skills based criteria.

The AER Board is an independent decision making body. It sets its own strategic priorities and work program within its functions and powers as set out in the national energy legislation and rules. The AER Board approves the internal budget allocation according to its strategic priorities, anticipated work program and workforce requirements.

The split between Commonwealth and State membership is not an issue in terms of the operation of the AER and its decision making. All Board members make decisions in accordance with the relevant legislative requirements irrespective of their State or Commonwealth appointment status.

With respect to alternative oversight models, we note that the Board arrangements were enhanced in 2013 with the movement to appointing a full-time (rather than part-time) state member. This change has enhanced the capacity and capability of the Board.

We note that the suggestion in the question to reform the AER Board structure to increase the number of AER Board members or move to a Board structure. Increasing the number of Board members has been raised in other forum, including most recently by the Senate Environment and Communications References Committee.⁷ We consider that while there may be benefits in increasing the number of Board members, the objectives for such a move should be clearly articulated. With additional board members, current rules for quorum and voting would also need to be considered.

Question 13: The Panel notes a number of stakeholders have expressed a view that the AER should be separate from the ACCC. Is this a sovereignty issue or is there a systemic problem in performance of the AER? If the latter, what evidence is there of a problem that such changes would address, or alternatively what are the pros and

⁷ For example, The Senate Environment and Communications References Committee, *Performance and management of electricity network companies—Interim report*, April 2015, Recommendation 14.

cons to be weighed up in considering the merits of such a change? Do these assessments change with different models for a separate regulator, for example a standalone but otherwise unchanged AER, or combined with other monopoly network regulators as proposed in the Harper Review?

We consider that the AER's current institutional arrangements are effective. The AER makes its decisions independently and has not had its resources constrained because of its relationship with the ACCC. The similarity in some of the roles of the ACCC and AER, particularly with respect to economic regulation and enforcement, has assisted both agencies in developing best practice approaches.

AER acts independently

The AER is an independent decision-making body whose functions and powers are set out in the national energy legislation and rules. The independence of the AER's activities is underpinned by:

- clearly defined roles and functions
- a well-established governance and reporting framework
- the application of a rigorous process of timely, considered, evidence-based and transparent decision making.

As noted above, the AER has an independent Board comprised of two State members and a Commonwealth member. The Board is assisted in discharging its responsibilities and in the management of the AER by a CEO, who is accountable to the Board, and a dedicated body of staff. AER staff are accountable to the AER CEO.

The staff and facilities of the AER are funded through the ACCC's agency appropriation. AER Board members are also members of the ACCC/AER Corporate Governance Board, which oversees the agency's corporate and financial performance and considers agency-wide operational issues (such as risk management). We note that shared services models are not unusual in public administration. Such arrangements can avoid duplication in corporate functions, reduce costs and generate efficiencies.

In addition each year, as part of the Commonwealth Budget, the Portfolio Budget Statement: Treasury Portfolio budget papers sets out separate program deliverables and performance indicators for the AER.

The AER Board, in consultation with the CEO and senior staff, sets the strategic priorities of the AER and the strategic direction for the work of the AER staff. The AER Board approves the internal budget allocation according to its strategic priorities, anticipated work program and workforce requirements.

The detailed management of the workforce plan is the responsibility of the AER CEO. At present, the AER has around 130 staff who are engaged exclusively on energy matters. The AER also has access to specialist legal and economic staff, which it shares with the ACCC. The sharing arrangement reflect economies of service provision, and the specialist nature of the knowledge and skills involved in the application of regulatory economic and legal

frameworks. When the shared legal and economic staff are engaged on AER matters, they work within the AER framework to the Board.

The AER Board is required to make a wide range of statutory decisions, and decisions on compliance and enforcement matters. The Board also approves major policy submissions and provides direction and guidance to staff on these matters.

The AER's decision making is directed by the national energy objectives, that is, to promote efficient investment in, and efficient operation and use of, energy services for the long term interests of consumers of energy with respect to:

- price, quality, safety, reliability and security of supply of energy
- the reliability, safety and security of the national energy systems.

These decisions are made by the AER Board supported by the CEO and senior staff. This process is informed through detailed analysis of information, and constructive engagement and consultation with a range of stakeholders—including the regulated businesses, consumer groups, other energy market bodies, state governments and jurisdictional regulators, and the investment community. Decisions are made on their merits, transparently reported and are made in accordance with the regulatory framework.

The Commonwealth, State and Territory Governments provide appropriate levels of oversight through the COAG Energy Council processes, including the Statement of Expectations process (discussed further at question 19 below).

Commonality with ACCC functions

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.

These functions are undertaken pursuant to different legislative frameworks and are undertaken separately by the AER and ACCC as distinct, independent entities. The extent to which the AER's practices, procedures or policies are similar to those of the ACCC is a reflection of commonly practiced good principles of government administration and public policy. Examples include similar approaches to internal budgeting and risk management frameworks, general approaches to regulatory pricing considerations, and general principles applying to enforcement policies.

The institutional arrangements that exist between the AER and the ACCC have 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.

Alternative governance models

The draft Harper Review report involved transferring the AER's network regulation and wholesale market functions to a new access and pricing regulator, with the retail market functions being undertaken by the ACCC.

The AER did not support these proposals, raising a number of concerns including that:

- the proposal to create separate regulators does not reflect the integrated and changing nature of energy markets, and
- the proposal that the ACCC assume the AER's retail functions mischaracterises the Retail Law and the AER's obligations under it, in particular that these obligations were largely related to consumer protection and competition functions.⁸

It is our view that 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. With the roles of generators, networks, retailers and customers rapidly evolving and an increasingly integrated market structure, the need for this holistic view is now more important than ever.

With respect to our retail roles set out in the Retail Law (detailed in attachment A), while there are strong elements of consumer protection in a number of these provisions, many of the functions are essentially regulatory roles. For example authorising retailers and granting exemptions is a regulatory role requiring detailed energy sector knowledge.

We also raised a number of detailed practical implementation issues with the proposal including:

- establishing whether the new regulator would be a Commonwealth or national regulator, noting the proposed functions of a combined access and pricing regulator would fall under both Commonwealth jurisdictions (in the case of telecommunications) and state law (in the case of energy)
- similarly, whether the Board appointment process would preserve the existing 'national but jurisdiction – sensitive' approach
- establishing legislative requirements to implement the proposal.

Another implication is that virtually all market participants would be regulated by both the new regulator and the ACCC under effectively the same legislation.

Given the integrated nature of issues in the energy sectors both the new regulator and the ACCC will need to establish and maintain strong technical knowledge across network,

⁸ The AER's submission on the draft Harper Review report is available at http://www.aer.gov.au/sites/default/files/AER%20submission%20to%20Competition%20Policy%20Review%20-%201%20August%202014_0.pdf

generation, retail and market operation. This will involve duplication of technical skills and increase regulatory costs.

The final Harper Review report supported an integrated AER, but recommended that it be part of a new proposed Access and Pricing regulator. While this recommendation addressed a major concern that the AER had with the Harper Review draft report - that is the proposal to split the AER's functions between multiple regulators - the implementation costs related to governance, funding and resourcing of moving to such a regime remain. In our view it is still not clear that the benefits of moving to the proposed Access and Pricing regulator model will outweigh these implementation costs.

Question 14: Noting the importance of maintaining independence, what are the opportunities to improve the oversight of the AER by the Energy Council, or individual jurisdictions? How should the Panel consider the potential conflicts which arise from individual jurisdictions (and thereby an element of the Energy Council) holding assets regulated by the AER?

The current level of oversight of the AER by the Energy Council and individual jurisdictions is appropriate. In 2014 the COAG Energy Council put in place new accountability and performance frameworks for the AER. The Council developed a Statement of Expectations which sets out what it expects from the AER with respect to its roles and responsibilities, relationship with government, and issues of transparency and accountability.

The AER supports these improvements to the accountability and performance frameworks. In response, the AER published its inaugural Statement of Intent in June 2014, setting out how we will meet those expectations during 2014–15, including through our strategic priorities and wider ongoing work program. The statement also sets out deliverables and performance indicators to measure our progress in meeting expectations. Further detail on our accountability and performance reporting frameworks are set out in response to question 19 below.

On the question of the potential for conflicts of interest arising from individual jurisdictions holding assets regulated by the AER, we do not consider that this is a major concern. The AER is a national regulator funded by the Commonwealth. As noted above the AER is an independent decision-making body whose functions and powers are set out in the national energy legislation and rules. The independence of the AER's activities is underpinned by the existing legislative and governance arrangements. The underlying ownership structures of the various participants we regulate do not affect our approach to regulation or enforcement.

Question 15: Do you consider the AER is adequately resourced? Should the AER be funded by market participants or cost recovery, rather than being funded through the Commonwealth budget?

The AER original budget was based on the understanding of its roles, responsibilities and expectations that existed in 2006. Our resources have been supplemented on several occasions either when new functions have been transferred to the AER or when particular needs were identified, for example in 2013 additional resources to increase consumer engagement in regulatory processes and expand engineering technical expertise.

The AER is currently facing a high work load, largely due to the timing of regulatory reviews of energy networks. In 2014–15 we are reviewing, or commencing reviews of, the revenues of 20 energy networks. This unprecedented peak workload has required us to focus our available resources on this core legislative role in setting energy network revenues.

We have put in place a range of measures to deliver this network program. We have focused attention throughout the AER on what efficiencies we can put in place to cut our costs. We have cut some of our costs, including travel and consultancies. This focus on network reviews has also meant diverting resources away from a range of other work in wholesale and retail, particularly more discretionary work such as the level of our engagement in policy matters. Our engagement on policy matters and rule changes is important for ensuring that implementation issues are adequately addressed. Diverting resources away from these activities make it difficult for us to engage on these issues adequately and increase the risks associated with rule implementation.

There are new functions proposed for the AER including assuming new regulatory responsibilities from some of the states and territories (discussed further below) and in other areas such as new tariff responsibilities, which have commenced. At this stage, the AER has not received funding for these roles. There are growing expectations on the AER with respect to engagement with consumers and consumer protection initiatives. While we support these developments, it is critical that additional resourcing is provided to the AER to undertake these new roles and meet reasonable expectations.

Also significantly, the scope, scale and complexity of much of the work we undertake have increased in line with the broader experience of energy markets. The understanding developed in 2006 of the base line resources required to properly perform all the roles required of the AER is being challenged by this more complex environment and the expectations of stakeholders.

We support further consideration of whether partial or full industry funding is an appropriate model for an agency such as the AER. Industry funding may ease the tension between the AER's funding and its growing workload. If we were to move to such a model there would need to be transparent structures in place to ensure that there is operational independence and any expenses recovered are reasonable and proportionate to the AER's roles and responsibilities.

Consideration of what resources the AER requires should also form part of the rule change process and also part of the Energy Council's consideration of whether to provide the AER with new functions. This is important because at present there is a potential disconnect between how the AER acquires responsibilities and how we are funded.

Question 16: Should the AER's role be expanded or reduced in any areas, particularly in relation to its market monitoring functions?

Over the past decade, the AER has progressively assumed greater regulatory responsibility. When the AER commenced operation in 2005, it was responsible for electricity transmission and wholesale market oversight. Since that time the AER has assumed responsibility for electricity and gas transmission and distribution regulation and oversight of gas wholesale

markets. The AER has also progressively assumed responsibility for retail market regulation in the ACT, Tasmania, South Australia and New South Wales.

The role of the AER is likely to continue to expand. In future, our retail regulatory role is expected to include Queensland and Victoria. The Northern Territory Government has committed to transferring network regulation functions to the AER and is also planning to transfer the regulation of the Territory's wholesale and retail markets to the AER. Separately the Western Australian Government has announced its intention to transfer of regulation of electricity and gas networks from the Economic Regulation Authority to the AER.

The COAG Energy Council has also tasked officials with undertaking further work on proposals to confer on the AER powers to monitor the competitiveness of wholesale electricity markets and a retail price reporting function.

The AER's functions have been expanded following decisions by the Energy Council or following AEMC rule changes. These processes for considering whether our functions should be expanded are appropriate.

The AER considers that its existing roles and functions and the proposed new areas of regulation and market monitoring and reporting functions are consistent with the original vision for the national regulator. They are within scope of our existing expertise, and are of the nature expected of a national energy regulator and will provide us with oversight of the industry at a truly national level.

Question 17: How could the relationship between the AER and the other two market institutions (AEMC and AEMO) be improved? Should the AER be given increased capacity to help develop expedited rule changes, or an increased role in reviews or policy advice?

The AER has very good, productive relationships with both the AEMC and AEMO. The roles and responsibilities between the three organisations are clear and well understood and exchange of information is strong. Our work requires regular and ongoing interaction between the three institutions and we work cooperatively to achieve results which are in the long term interests of consumers.

There is ongoing Board and staff level contact between the three agencies.

- The AEMC and the AER board meet regularly, as do senior executives. We also communicate regularly with the AEMC on policy reviews and rule change proposals, and make frequent submissions to the AEMC. We sometimes propose rule changes to the AEMC for consideration.
- The AEMO board and the AER board meet on occasion, and senior executives meet every second month. We also have frequent operational meetings with AEMO on wholesale energy market issues, retailer of last resort, network pricing decisions and planning decisions. We rely on AEMO for much of our market data, and use its information and forecasts in our network pricing determinations.

These interactions are supported by memorandums of understanding between the agencies. The MoUs set out the agreed arrangements for promoting effective cooperation,

communication and co-ordination between the agencies in the performance of their different, but complementary, roles. The MoUs are public documents which are available to all stakeholders.

There have also been a number of staff movements between the three agencies through exchanges, secondments and permanent placements. This has acted to further strengthen the effective working relationships between the three agencies as well as promote the sharing of expertise and skills at an officer level.

The AER can make a valuable contribution to energy policy matters, particularly where we have gained specific expertise through our day to day work. While we provide the assistance we can, our participation in energy policy matters can be constrained by resources particularly during periods of peak workloads. In the past we have had a significant role in a range of energy policy reviews. We have proposed our own rule changes, actively participated in AEMC and COAG Energy Council steering groups, made submissions to energy policy reviews and provided information to the bodies conducting those reviews. We also publish information about the Australian energy industry, including our flagship publication—the annual State of the energy market report. This information can be used to inform policy debates.

Question 18: Should the AER have an expanded role in regulating state specific functions outside national frameworks? What are the opportunities to improve interaction with state technical, safety or economic regulators within the national market, and with Northern Territory and Western Australian counterparts?

The AER was established as a national regulator to apply a nationally consistent framework. The NEM and Australia's gas markets operate across state boundaries. The markets are integrated with many participants active across a number of states and markets. In this context the markets and consumers are best served by a nationally consistent regime. A nationally consistent regime minimises the regulatory burden for market participants and affords consumers the same level of protection.

We consider that it is desirable that any of the rules we have to administer are subject to the robust, transparent, inclusive processes under the national framework – particularly the AEMC review and rule change processes. This process enables a broad and considered examination of new rules within the broader context – ensuring they can operate holistically.

The AER's expertise and value largely lies in applying this national regime.

It is not apparent why the AER would be better placed to regulate state specific functions than state regulators. Having said that there is merit in the AER regulating specific functions during the transition to the adoption of the national frameworks provided these functions are within the scope of our existing functions.

More generally, we maintain strong relationships with state regulators. In recent years this has particularly focused on ensuring an efficient handover of functions when jurisdictions adopt the Retail Law, but also recognising that some state and territory energy regulators retain some functions. In Victoria and Queensland, which are yet to adopt the National Energy Retail Law, state regulators still monitor and enforce retailer obligations. In New

South Wales, Queensland, Tasmania and the ACT, local agencies regulate the retail price of electricity (and in New South Wales, gas).

With the ACCC, we also organise the Utility Regulators Forum—a twice yearly meeting of decision makers and senior staff from all Australian and New Zealand infrastructure regulators. The Forum acts as a focal point for regulators in different jurisdictions and aims to facilitate:

- the exchange of information
- understanding of the issues faced by regulators
- consistency in the application of regulatory functions and
- the review of new ideas about regulatory practices.

We also undertake targeted consultation with jurisdictional regulators on an as needs basis, particularly on substantial policy reform issues. For example, we engaged specifically with the Economic Regulatory Authority in Western Australia at both a Board and staff level during the development of our Rate of Return Guideline. This interaction was particularly important as both agencies were considering similar issues, under the same regime and within the same timeframe.

Question 19: Are there opportunities to improve confidence in regulatory outcomes, for example through improved communication or performance and accountability measures?

We adopt accountable and transparent processes across our work program and have responded effectively to the developments to the accountability and performance frameworks over recent years.

As noted above the COAG Energy Council has implemented new accountability and performance frameworks. Under these frameworks it has published a Statement of Expectations which sets out what it expects from the AER. In response, the AER published its inaugural Statement of Intent in June 2014, setting out how we will meet those expectations during 2014–15. Prior to the establishment of the Statement of Expectations the AER regularly published its strategic priorities and work program.

In addition each year, as part of the Commonwealth Budget, the Portfolio Budget Statement: Treasury Portfolio budget papers sets out program deliverables and performance indicators for the AER.

We report against our performance in a number of fora:

- We commenced publishing our own separate annual reports (with the first covering the 2012–13 financial year). Our annual reports explain our work and performance over the previous year and include performance indicators, as well as information on our staff and expenditure.
- We also provide supplementary half yearly reports to the COAG Energy Council to update ministers on our work activities.
- We publish a summary of the results of our stakeholder surveys.

- We have reported every year since 2005 on how our funds have been spent through the joint ACCC–AER Annual Report

To promote predictability, transparency and confidence in our processes we also:

- publish guidelines which set out our approach to regulatory functions, and framework and approach processes and draft decisions on regulatory reviews,
- consult widely on our regulatory tasks including on our guidelines, framework and approach processes and draft decisions on regulatory reviews in consultation with stakeholders
- publish fact sheets which provide short simple summaries on network review decisions
- publish compliance bulletins and guidelines on our approach to enforcement, and reporting on outcomes of our enforcement activity.

We have also implemented a number of initiatives to improve our engagement with stakeholders and technical expertise. The feedback we are receiving is that we are heading in the right direction with these sorts of initiatives. That said, we will continue looking for opportunities to improve confidence in regulatory outcomes through enhanced communications.

Attachment A: AER roles and functions

The AER now has broad responsibilities covering energy networks, wholesale energy markets and retail energy markets.

Wholesale

The AER has a range of responsibilities in relation to the NEM and gas spot markets.⁹ 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 the Australian Energy Market Operator (AEMO).¹⁰ 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.

Retail

The AER is responsible under the National Energy Retail Law for regulating retail energy markets in New South Wales, South Australia, the ACT and Tasmania (electricity only). It is expected these responsibilities will expand to Queensland in 2015. 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).

Energy networks

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

⁹ Spot market hubs in Adelaide, Sydney, Brisbane, Victoria and Wallumbilla

¹⁰ Indeed around 40% of the obligations in the wholesale market are on AEMO.

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, the AER has a networks oversight role which complements its 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 customers 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 will also publish 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.

The AER has put in place distinct teams comprised of staff with specialist expertise to manage this broad ranging work program. In addition to the three networks branches there are separate wholesale and retail markets branches. We have additional mechanisms to coordinate any interrelated issues across the work streams to ensure the benefits of an integrated regulator are realised.