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Dear Mr Weickhardt

**Submission on Productivity Commission's Electricity Network Regulatory Frameworks Draft Report**

Please find attached the Australian Energy Regulator's (AER) submission on the Productivity Commission's (PC) Electricity Network Regulatory Frameworks Draft Report.

The AER's submission emphasises that in the areas covered by the Inquiry's terms of reference, namely benchmarking and interconnectors, the PC makes a considered contribution to the debate on these matters. The discussion on demand side issues is also a useful addition to that undertaken by the AEMC in its Power of Choice review. However, in some other areas, particularly in the discussion of governance issues, the AER believes that the PC has not fully considered the matters and that its observations are based on incomplete analysis and, in some cases, incorrect information.

The AER would be pleased to provide further information to assist the PC progress this review.

Yours sincerely

Andrew Reeves  
Chairman



## **AER Submission**

# **Productivity Commission's Electricity Network Regulatory Frameworks Draft Report**

November 2012

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# 1 Introduction

This submission provides the AER's response to the Productivity Commission's (PC) Electricity Network Regulatory Frameworks Draft Report (draft report).

The terms of reference for the review require the PC to examine:

- the use of benchmarking under the regulatory framework, and
- whether the regulatory regime is delivering economically efficient outcomes with respect to interconnector investment.

The PC has conducted a far broader review of electricity network issues, including issues surrounding network ownership and industry governance.

The PC has undertaken strong and useful analysis in the areas related to its terms of reference and on demand side participation issues. More generally, the PC's draft report has provided a comprehensive overview of a range of issues currently being considered by policy makers and by the rule making body, the Australian Energy Market Commission (AEMC). As highlighted in the submission, in these areas the PC has reached a range of conclusions many of which are supported by the AER.

In other areas, however, the AER believes that the PC's analysis would benefit from further consideration of the issues and additional information. In particular, the discussion of the economic regulatory framework does not accurately reflect the inherent issues with the National Electricity Rules (rules) and the discussion of governance arrangements does not consider the principles for institutional design of the regulatory framework.<sup>1</sup> Further the PC makes statements about the AER which are not well-founded and which the AER considers are incorrect.

The AER's submission is structured as follows:

- Sections 2 and 3 address the PC's analysis of the issues covered under the terms of reference, namely benchmarking and interconnector investment issues.
- Section 4 addresses issues relating to the operation of the current rules. In essence, the AER believes that the deficiencies in the rules for setting network revenues are more significant than suggested by the PC's analysis.
- Section 5 addresses the PC's discussion of demand side participation.
- Section 6 addresses the PC's discussion of the governance arrangements in the NEM. The AER believes that if the PC is to offer views on governance, it should consider the institutional arrangements from first principles, drawing on the analysis of other authorities such as the Hilmer and Parer reviews. This submission notes their findings and highlights the theoretical and practical benefits of the current institutional framework in the National Electricity Market (NEM). This submission further notes that the PC's consideration of the performance of the AER is not factually based.

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<sup>1</sup> New rules which significantly improve the regulatory framework were finalised by the AEMC in October 2012. The discussion of issues with the rules in this submission refers to the AER's experience with the rules that existed previously.

## 2 Benchmarking

The PC's report provides a balanced, first principles view of benchmarking as a general concept and examines the typical types of data and methodologies routinely used to undertake benchmarking. It presents a useful analysis of the desirable aspects of a benchmarking framework and its potential pitfalls by referring to previous benchmarking studies. The PC's conclusion that any benchmarking approach will be imperfect is consistent with the AER's approach to using benchmark techniques as set out in our initial submission to the inquiry. The AER agrees that the regulator should take into account a range of data when setting expenditure allowances, rather than being tied mechanistically to particular quantitative measures.

The use of benchmarking information adds an important element in considering the efficiency of network business proposals and also introduces information which can be used to assess expenditures more holistically rather than a partial, line-by-line assessment. Increasing the range of information available to the regulator when making its decisions requires more judgement in assessing the relative merits of several (and potentially conflicting) data sources. The AER supports such an assessment approach and agrees that it must be supported by transparency in decision making and a robust appeal mechanism which, like the regulator, should consider proposals from a holistic, rather than piecemeal, perspective. The AER and its consultants have used benchmarking in the past. However, we expect benchmarking to play a more prominent role in expenditure assessments following recent amendments to the electricity rules that clarify the role of benchmarking.

The following section outlines the AER's response to the PC draft report's recommendations in Chapters 5 and 8 with respect to benchmarking.

### 2.1 Benchmarking work program at the AER

The PC recommends the AER undertake aggregated factor productivity benchmarking as well as detailed benchmarking in consultation with various stakeholders and experts. As set out in our initial submission to the PC's inquiry, over the past year, the AER has undertaken its own review of benchmarking techniques and has been developing its benchmarking capabilities. As part of this work, we will be initiating substantive consultation on a full suite of expenditure assessment methods, including various types of benchmarking approaches, in the coming months.

The AER already reports annually on network performance and is intending to expand this to cover the reporting of expenditures for the purposes of comparison. Amendments to the rules by the AEMC will also require the AER to publish annual benchmarking reports in 'reasonably plain language'.

The AER is alert to the reputational risks and incentives on individual network businesses through monitoring of actual performance against targets and also with respect to that of their peers. For these types of comparisons to be fully effective it will be necessary to carefully consider a variety of factors such as those discussed in chapter 6 of the PC's draft report, including differences in service delivery outcomes that occur between network businesses and over time. This is a substantial exercise and it may not be cost effective to undertake comprehensively for all network businesses on an annual basis.

The PC's specific recommendations regarding geographic or regional based reporting may have merit, however, this will require further exploration with the sector amongst the many factors affecting network businesses' costs and the ways to account for them robustly in benchmarking analysis. The AER expects to canvass these issues in its consultation processes in the coming months.

## 2.2 Use of benchmarking in decision making

### 2.2.1 Using benchmarking to negotiate settlements and simplify determinations

The AER has some concerns with recommendation 8.4, namely that benchmarking should be used as a trigger for a negotiated and shorter price control settlement process involving an appropriately resourced customer representative.

The AER endorses the notion that an appropriately resourced and independent body representing consumer interests should be present in the determination process, and is also interested in exploring options to minimise costly and detailed assessments. However the AER's primary concern is ensuring robust and transparent decisions. This particular recommendation appears at odds with the PC's core finding that benchmarking should not be relied upon mechanistically and is typically a gateway to further analysis rather than an end. The PC has also overestimated the potential role of expenditure benchmarking in terms of being able to 'fast track' an entire regulatory proposal, which includes a considerable amount of material non-expenditure items. In our assessment, a more reasonable perspective is that such approaches will be more suitable to some parts of the sector and some areas of a regulatory proposal rather than as a broad approach which can be applied equally across the whole sector.

The utility of benchmarking also relies to a large extent on the quality of the data and the AER considers that much more analysis is required on how best to achieve the "holy grail" of incentivising network businesses to reveal their efficient costs (which appears to be an area of interest to the PC).

In this area, Ofgem is slowly gaining experience with its Information Quality Incentive (IQI) and its "fast tracking" process (which is a related but separate element of the RIIO framework). This approach was first applied this year to two transmission network businesses, both of which were given a second chance to submit proposals given this element of the regulatory framework was still new.<sup>2</sup>

Under the AEMC's final network regulation rules the AER has the power to trial "small scale" incentive schemes which may include those of the type implemented by Ofgem. As per the AEMC's view, the experience from such a scheme may evolve into a rule change at a later date. The PC's recommendation is therefore premature in this context.

### 2.2.2 Longer term applications of benchmarking

The AER recognises that robust benchmarking methods will take time to establish. The PC's recommendation 8.5 accords with our view that the degree of reliance placed on benchmarking (even as a filtering method for further analysis) should be proportionate to its robustness. For those areas of expenditure where benchmarking is not feasible or is still in its infancy, it may be appropriate to use bottom up assessments.

We agree with the PC's considerations on setting benchmark allowances away from the measured efficiency frontier, in terms of incentive effects and also in the context of data uncertainty and error.

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<sup>2</sup> Ofgem, *RIIO-T1: Decision on fast-tracking for SP Transmission Ltd and Scottish Hydro Electric Transmission Ltd*, January 2012, p. 2.

## 2.3 Treatment of uncontrollable costs

The PC's draft report refers to various potential factors that may detract from making like-for-like comparisons of costs across network businesses, in many cases highlighting problems with various benchmarking studies that did not adequately account for uncontrollable factors.

The AER has some concerns that, in our own attempts to conduct benchmarking, network businesses may present general arguments around these differences in order to justify a lack of engagement and to resist moves to collect data for the purposes of benchmarking. To allay network businesses' concerns, it is important to establish some principles around the treatment of uncontrollable cost differences to facilitate proper discussion with affected network businesses and other stakeholders around the collection of input data and as part of the regulator's judgment in interpreting results. The AER suggests an effective benchmarking framework is one which recognises such cost differences only if they are:

- supported by evidence, with the onus on network businesses to demonstrate these differences exist, including how they might impact on discrete parts of their networks
- capable of robust measurement over time and are ideally quantifiable from an independent source
- demonstrably uncontrollable
- material.

The AER recognises that there are a range of environmental factors that affect costs differently across network businesses. For example, network businesses operating in remote areas may argue the need to pay higher wages in order to attract skilled labour away from major population centres, while those in urban areas may do the same to meet demands around the higher costs of living. Another example is customer density whereby a predominantly rural network business would justifiably argue for higher extra travel costs in responding to faults however network businesses operating in dense urban environments would need to then acknowledge their relative advantage in lower travel costs. Network businesses should also be expected to explore any degree of influence they have or offsetting factors at play, for example the ability to counter labour cost increases through negotiations or productivity targets.

Accounting for uncontrollable cost influences will need to have regard to materiality and any data limitations. Ambiguities in identifying and measuring these influences also create potential gaming opportunities. In implementing a cost effective expenditure assessment framework the AER and other parties should be cautious of engaging in a "race to the bottom" with potentially all (and only) cost disadvantages being identified and systematically taken into account without regard to their overall materiality, the robustness of supporting data and the need to maintain a transparent and simple assessment approach.

While the AER will need to look at this aspect in terms of Australian characteristics, it is instructive that Ofgem's approach in electricity revenue determinations has been to use a limited number of uncontrollable cost factors, with a particular focus on the significantly disparate operating conditions between only two network businesses, one which operates in and around London and with the other in the north of Scotland. Ofgem has recently indicated it is not minded to continue to use regional and network business specific adjustments in the forthcoming regulatory period unless these are

demonstrated on the basis of robust evidence, and where network businesses can demonstrate they had taken steps to manage the impact of such cost disadvantages.<sup>3</sup>

There may also be value in the PC also examining the approach adopted by the Commonwealth Grants Commission (CGC) in assessing GST revenue allocations to state governments as it attempts to quantify a whole range of cost 'disabilities' faced by state governments in public service delivery.<sup>4</sup> The various disabilities it examines include:

- demography (e.g. age, income) affecting service utilisation
- administrative scale (the presence of fixed costs being spread over a smaller revenue base)
- service delivery scale (including diseconomies of small scale)
- input costs in different geographic locations
- transport/ travel costs
- factors specific to particular regions, such as native title and services in capital cities.

In developing its own benchmarking approaches the AER would be looking at how such factors, as typified by Ofgem and the CGC, could be addressed. Given the expected importance of uncontrollable environmental costs in the Australian context, the AER sees merit in the PC systematically cataloguing and examining all available evidence on uncontrollable cost differences for network businesses in the NEM. This review could also include the approaches adopted by Ofgem, the CGC and other organisations in accordance with the criteria set out in chapter 4 of the draft report, particularly around the use of independent data sources and the use of judgment to compensate for data limitations.

## 2.4 Data publication and developing benchmarking expertise

The AER supports recommendations 8.6 and 8.7 to retain in-house expertise and benchmarking databases and the publication of input data. As noted by the PC, any publication of data will be subject to accepted confidentiality claims but may also be released on the condition that known qualifications/ limitations must be acknowledged if it is to be re-released. It is the AER's standard practice to make available all information underlying network business proposals and its decisions, which would include information pertaining to the robustness of any benchmarking techniques used and the resulting outcomes. Given the large amount of data, this is not usually published but is available on request to any interested stakeholder. Further, the AER also notes that, under the current electricity law provisions, it may only obtain certain information from NSPs on the basis that it is used for an explicit purpose. That is, the AER may not be able to use or publish information received via other means for the purposes of satisfying this recommendation.

The AER agrees that data published by independent sources is useful in reviewing the underlying assumptions used by network businesses. The AER already uses AEMO's forecasts of maximum demand and energy consumption, however, there are limitations on performing reconciliations as noted by the PC due to measurement issues (e.g. diversity factors) as well as having to also examine the validity of the independent forecast. The PC may wish to clarify what it means by 'average demand' and its use in considering draft recommendation 8.8.

<sup>3</sup> Ofgem, *Strategy consultation for the RIIO-ED1 electricity distribution price control - Tools for cost assessment*, September 2012, pp 80-1.

<sup>4</sup> Commonwealth Grants Commission, *Report on GST Revenue Sharing Relativities — 2010 Review Volume 2 — Assessments of State Fiscal Capacities*, 2010. See chapter 29 and page 569.

The AER also supports the recommendation to subject its analysis to independent expert review.

Overall the usefulness of the exercise envisaged in the second part of draft recommendation 8.8 is not clear from the PC's analysis. The AER considers that benchmarking results over time would improve as data and methods are debated, however the notion of being able to compare results ex post to a 'true' estimate is overly simplistic. The time and cost involved in recasting earlier determinations on the basis of new assessment techniques (or "primitive benchmarking") would be prohibitive and not without debate or controversy.

The AER has also engaged in staff secondments with regulators in several Australian jurisdictions as well as Ofgem to facilitate learning on various regulatory approaches including expenditure assessment. More recently, the AER has also begun liaising more closely with the New Zealand Commerce Commission. The AER will be considering the ability to align approaches and data templates with the view of adopting best practice techniques.

## **2.5 Cost-benefit assessments and information burden**

The AER agrees with recommendation 8.12 to conduct periodic cost-benefit assessments of benchmarking methodologies. The review of the effectiveness of, and benefits delivered by, regulatory instruments in comparison to the burden they place on network businesses and other stakeholders is standard regulatory practice. The AER is also required to issue impact statements with information notices and orders issued under national energy legislation.

Overall the AER considers that any move away from the current practice of detailed, forensic assessments towards one where benchmarking has more prominence will deliver net benefits for the sector.

Benchmarking plays an important role in providing the regulator various tools with which to assess the efficiency of expenditure proposals. Such tools need to be developed and refined with network businesses and other stakeholders over time, recognising that new approaches require some burden in data collection and in compliance monitoring to ensure high quality information is provided to the regulator. It may be the case that some approaches are tried, with the consent of network businesses, yet are ultimately abandoned as they may not be capable of producing robust results. The AER considers that the notional efficient network business would already be collecting some information that would be relevant to the approaches identified by the PC, such as disaggregated activity based benchmarking, in providing assurances to their own Board and shareholders in expenditure monitoring/ budgetary processes. The cost/ amount of information the AER currently collects from network businesses in the NEM for price reviews and annual reporting for the purposes of comparative analysis is barely comparable to that in other regimes where benchmarking is systematically used.

The information reporting templates used by the AER to date have largely reflected the desire to maintain a consistent time series of data as reported to previous jurisdictional regulators, noting that this information was not for the purposes of supporting most of the benchmarking methods canvassed by the PC (i.e. beyond tentative comparisons of aggregated expenditure or partial indicators). In examining this data in the current rules framework which features a reversed onus of proof (i.e. where it is the regulator that must demonstrate inefficiencies and the network businesses' proposal is the default) the AER has been drawn into detailed examination and expert engineering reviews of all elements of the expenditure proposal, at considerable expense for all parties, with limited benefits in being able to properly scrutinise proposals from an holistic perspective. Under the new rules

framework, it is expected that both the approach to the assessment of proposals and the use of benchmarking will be significantly enhanced.

## 3 Interconnectors

Chapters 17, 18 and 19 of the PC's draft report considered the role and use of interconnectors in the NEM and the adequacy of the existing regulatory regime to deliver efficient interconnection in the future. The PC's analysis undertaken draws out many of the key issues to take into account when examining such questions.

The AER is largely supportive of the PC's main draft findings, namely:

- measures should be implemented to address disorderly bidding, potentially via the AEMC's proposed Optional Firm Access (OFA) model, and
- the current physical capacity of interconnectors is reasonably appropriate.

### 3.1 Promoting the efficient use of interconnectors

The draft report highlights the issues arising as a result of disorderly bidding and expresses support for the AEMC's OFA as a potential solution.

The AER agrees that there are compelling grounds to ensure that any future framework for transmission planning and pricing addresses disorderly bidding. Soon the AER will release a detailed Congestion Report which examines the prevalence of disorderly bidding in the NEM and also the impact of this behaviour on interconnectors. Disorderly bidding has reduced the value of the settlement residues, which undermines the effectiveness of inter-regional hedging for market participants. The AER notes that the auctioning of rights to settlement residues was designed to promote competition between regions through enhanced inter-regional trade.

Consistent with the PC's position, the AER welcomes the AEMC's work to develop the OFA model. It aims to address a range of important issues, including increasing the firmness of interconnector availability, in order to improve energy contract liquidity and competition. While the AEMC has made significant progress, there are many important areas of detail that are yet to be developed. The success of the model will, in part, lie in the detail.

As the AEMC is tackling a range of very complex issues, it is likely that any reforms will take some time to implement. Therefore, the AER strongly believes that, given the significant and pressing issues associated with disorderly bidding and counter-price interconnector flows, a simplified congestion management mechanism should be implemented in the short term. This mechanism could be introduced via relatively straightforward changes to AEMO's settlement systems and could in effect be a stepping stone towards the full OFA model. A congestion management mechanism in itself would deliver significant gains. In particular, it could address much of the disorderly bidding problem, which would have flow on effects in terms of improving interconnector flows and the firmness of inter-regional hedges.

Draft recommendation 18.1 suggests that the AER should monitor and report on any changes in observed patterns of generator bidding behaviour that arise following the implementation of the OFA model. The AER agrees that this role would be appropriate. Indeed it would fall within the AER's existing market monitoring role. The AER already monitors and reports on generator bidding

behaviour. Where appropriate, the AER also proposes rule changes to resolve unintended market outcomes.<sup>5</sup>

## 3.2 Identifying future transmission investment

Chapter 19 of the draft report explored whether the current regulatory regime would promote efficient transmission planning and investment in the future. The AER agrees with the PC that efficient interconnector investment must be supported by an appropriate planning and investment regulatory regime. As the AER is responsible for the publication, maintenance and enforcement of the RIT-T, it has a particular interest in the review of the adequacy of the RIT-T to support efficient transmission investment in the NEM. Thus, the AER has focused its comments in this section on the RIT-T issues raised by the PC.

### 3.2.1 Expanded role of the RIT-T

In the draft report, the PC sought participant opinions as to whether:

- the RIT-T should be applied to the replacement of existing assets and
- the AER could have an expanded role in the assessment of the RIT-T

#### Replacement network assets

The PC considered that as network replacement assets did not have to undergo a RIT-T consultation and assessment would mean that network replacement assets would not be subject to public scrutiny and may create a perverse incentive for a transmission network businesses to favour the simple replacement.

The AER notes that the replacement of network assets by transmission network businesses is not entirely free from public scrutiny as they are required to report on them as part of their Annual Planning Reporting obligations. Under clause 5.6.2A(6) of the Electricity Rules, transmission network businesses must set out for all proposed replacement transmission network assets the description of the replacement assets, the date from which they will become operational, a list of any reasonable network or non-network alternatives considered being considered by the business and the estimated total capitalised expenditure of the replacement asset. While this reporting obligation does not provide the same level of cost-benefit analysis as the RIT-T, it does subject the transmission network businesses' proposed replacement asset decisions to some scrutiny. However, the AER agrees that the replacement of network assets would be subject to greater scrutiny if transmission network businesses were required to conduct a RIT-T when replacing assets.

#### AER role in RIT-T assessment

The AER is the body responsible for monitoring and enforcing compliance with the rules, including the RIT-T. The AER's oversight of RIT-T assessment extends beyond just matters of process, and includes broad scrutiny of a transmission network business's analysis to ensure it is compliant with the requirements of the RIT-T. For example, the AER may review a RIT-T assessment to ensure that the transmission network business has not improperly excluded an alternative option on the basis it is

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<sup>5</sup> See, for instance, AER, Rule change proposal "Ramp Rates, Market Ancillary Service Offers, and Dispatch Inflexibility" January 2009.

not a credible option<sup>6</sup> or has in its reasonable scenarios used a reasonable forecast of electricity demand.<sup>7</sup>

However, the AER has limited powers to take action for a breach of the RIT-T by the transmission network business. As the RIT-T and the associated Electricity Rules are not civil penalty provisions, the only formal remedy available to the AER to address a breach of the RIT-T is court action seeking an order for the business to redo the RIT-T. This is both resource and time intensive.

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<sup>6</sup> National Electricity Rule 5.6.5D.

<sup>7</sup> Paragraph 15(a), RIT-T.

## 4 Electricity rules

Chapter 5 of the PC's report discusses the operation of the current regime for regulating networks in the NEM. It sets out the PC's views on a number of matters, including:

- the effectiveness of incentives applying to capital expenditure
- the method of calculation of the weighted average cost of capital
- the use of ex post reviews of capital expenditure
- the AER's ability to determine forecasts of efficient expenditure.

Section 4.1 provides background and context regarding incentive regulation as applied in the NEM, and the remainder of the chapter provides more detailed comments in response to some of the issues raised by the PC.

### 4.1 Incentive regulation in Australia

The PC's draft report includes a discussion of incentive regulation. The AER believes that it is important to highlight the unique characteristics of the incentive regulation framework that has applied in the NEM.

The incentive regulation framework that governs the current set of revenue determinations was developed in the mid 2000's.<sup>8</sup> It was designed to address concerns that investment in critical infrastructure may be insufficient to support economic growth.<sup>9</sup> These concerns were stated strongly at the time by the PC, particularly in Review of the National Access Regime, which found that the access regulation arrangements for essential infrastructure services could have a "potential 'chilling' effect on investment".<sup>10</sup>

The approach to addressing these perceived risks was to prescribe key elements of the approach governing the regulation of transmission networks in the rules. Chapter 6A, and Chapter 6 which followed, codified not only the procedural rules that govern the process by which regulatory decisions are made, such as decision making timeframes, but also core elements of the substantive rules. This included specifying in the rules the methodologies and decision making criteria that govern the application of regulation to individual businesses. This was a significantly different approach to other state based regulatory regimes or those in existence in other countries.

At the time, the AER expressed concern with the framework that was being developed. The AER argued that the framework would not deliver effective incentives for efficient investment, would tilt the regulatory balance in favour of the network business and would limit the AER's capacity to respond to the individual circumstances of each network business.<sup>11</sup>

Subsequent experience reinforced the AER's view that the regulatory regime did not appropriately balance the interests of network businesses and electricity consumers. These concerns led the AER to submit a rule change proposal in September 2011 to address the weaknesses in the regime.

<sup>8</sup> AEMC, *Rule Determination, National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006 No 18*, 16 November 2006.

<sup>9</sup> AEMC, *Rule Determination, National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006 No 18*, 16 November 2006, pg 31.

<sup>10</sup> Productivity Commission, *Review of the National Access Regime Inquiry Report*, Report No 17, 28 September 2001, pg XIX.

<sup>11</sup> See for example AER, *Submission to Australian Energy Market Commission, Draft National Electricity Amendment (Economic Regulation of Transmission Service) Rule 2006*, March 2006.

The AEMC's final rules responding to the AER's rule change proposal were released on 29 November 2012. The new rules address the AER's major concerns by amending or removing provisions which restricted our ability to assess the overall reasonableness of a network businesses' regulatory proposal. There are other areas where the AEMC has made considerable improvements, particularly in respect of its proposed initiatives to improve consumer engagement. While these amendments are significant, the new rules still recognise the importance of investment certainty and the requirement that a network business be given the opportunity to recover at least its efficient costs incurred in the provision of network services.

Accordingly, a number of the issues discussed in Chapter 5 the PC's draft report have already been considered and addressed as part of the AEMC's rule change.

## 4.2 Capital expenditure incentives

The PC's draft report provides a wide-ranging commentary on capital expenditure incentives. This submission provides comments in relation to efficiency benefit sharing schemes, the methodology used to calculate the weighted average cost of capital, and the use of ex post reviews.

### 4.2.1 Requirement on AER to adopt an Efficiency Benefit Sharing Scheme

The PC recommends that the AER should develop an Efficiency Benefit Sharing Scheme (EBSS) to apply to capital expenditure that provides consistent incentives to reduce capital incentives, both over time and when compared with operating expenditure. We note that this approach was also advocated by some electricity networks in their submissions to the PC's issues paper.<sup>12</sup>

The AER agrees that it is desirable to adopt incentive mechanisms that provide consistent incentives over time. However, such a mechanism must be designed having careful regard to its interaction with other elements of the regulatory framework, otherwise there is scope for unwanted consequences.

The AER did not adopt a capex EBSS under the 2006-08 NER framework due to concerns that it could create incentives for distribution businesses to inefficiently defer capex.<sup>13</sup> The mechanism available to the AER under the current rules created a risk that distribution businesses could be rewarded for spending too little, with consequent risks for service standards.

The AER was informed by the Essential Services Commission of Victoria's (ESCV's) experience of applying a similar mechanism in Victoria. The ESCV was obliged to discontinue its capex incentive scheme in the context of significant underspending by Victorian distribution businesses during the 2001-05 regulatory period, followed by an increase in capex forecasts submitted by those distribution businesses for the 2006-10 regulatory period.

It is important therefore that the rule framework enables the development of a capex incentive mechanism which creates appropriate incentives in relation to both overspending and underspending.

Following the AEMC's consideration of the AER's rule network regulation change proposal, it has determined to apply a new regime for capex incentives, and under this new regime the AER will be developing a capex incentive scheme.

<sup>12</sup> See, for instance, ETSA Utilities, Citipower and Powercor (pg 20).

<sup>13</sup> AER, *Electricity distribution network service providers – Efficiency benefits sharing scheme*, June 2008, pp 10-11. The problem of a capex EBSS "over-counting" the benefit from project deferrals (unless appropriate adjustments to the scheme can be made) has been recognised in the joint consultant report commissioned by the ENA. PwC, Gilbert+Tobin, NERA, *Design of capital expenditure incentive arrangements – A joint report for the ENA*, 8 December 2011, pg 29.

This new framework gives the AER flexibility to develop a capex incentive mechanism subject to certain guiding principles. The AER is required to have regard to the benefits of providing a continuous incentive, but is not forced to adopt a continuous incentive if such an approach is likely to be detrimental to the long term interests of consumers. This approach will enable the AER to design more suitable capex incentives having regard to a range of factors, including the incentives associated with other elements of the regulatory package and the NSP's past expenditure relative to allowances.

#### **4.2.2 Methodology used to determine the weighted average cost of capital**

The AER agrees that the rules should specify the interdependent nature of parameters used to estimate the WACC, and specify that any merits review also consider the relevant rule in that light.<sup>14</sup> However, we have concerns with the PC's draft recommendation that estimates of the debt risk premium and risk free rate used in the calculation of the WACC should be calculated using long term averages.<sup>15</sup>

A highly prescriptive approach to calculating the WACC, such as that outlined in draft recommendation 5.3, would not enable the rate of return to appropriately reflect either current approaches or new thinking on calculating rate of return parameters.

This issue has been consulted on extensively as part of the AEMC's consideration of the network regulation rule change. The method(s) for setting various elements of the WACC for electricity and gas network businesses will be appropriately dealt with in consultations on the AER's rate of return guideline and in subsequent determinations.

#### **4.2.3 Implementation of ex post reviews**

The AER notes the PC's recommendation that network businesses should be able to apply for pre-approval of expenditure that exceeds approved levels. The AER has concerns that this approach could undermine the incentive properties of the periodic review framework. Rather than seeking to control their costs, network businesses would be incentivised to increase their allowed revenues by applying for advanced permission to overspend.

### **4.3 The AER's ability to determine expenditure forecasts**

The AER notes the PC's comments in relation to the AER's ability to determine expenditure forecasts under the electricity rules, in particular that "there is limited evidence that the AER has in practice been significantly restricted by the existing arrangements".<sup>16</sup>

The AER agrees that it has had the ability to undertake a 'normal regulatory review', including expert technical review and a consultation process. However it is simplistic to draw conclusions from this observation. What is in question is whether the AER has been inappropriately constrained in its ability to make decisions that promote the long term interests of consumers.

While the AER has been empowered to reject proposals which do not reasonably reflect efficient costs, difficulties have arisen when the AER seeks to determine a substitute forecast. The rules have constrained the AER's discretion to determine the efficient level of expenditure required. This is because in effect, whether under Chapter 6 or Chapter 6A, the rules have constrained the AER to amending the network businesses' proposal only to the extent necessary rather than to one that

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<sup>14</sup> Draft recommendation 5.2.

<sup>15</sup> Draft recommendation 5.3.

<sup>16</sup> PC Draft Report, pg 177.

reasonably reflects efficient costs and the longer term interests of consumers. As these constraints have also reduced the effective adverse consequence for the network business in the event that the AER rejects a proposal, it also has contributed to incentives for NSPs to submit highly conservative forecasts.

Overall, the AER considers that the rules have restricted our ability to undertake a holistic independent assessment of the NSP's required expenditure. Restrictions in certain areas of the rules have drawn the AER into a line by line assessment of a network business' "bottom up" calculations of required expenditure. A more balanced approach would have allowed the AER to weigh up all available information, evidence and data and make use of a range of techniques including benchmarking when assessing forecasts.

For these reasons, the AER does not support the PC's improved propose-respond model as outlined in the draft report.<sup>17</sup> In particular, an approach whereby the AER would "start from the business proposal and reduce it just enough to meet a reasonableness criterion" will be biased in favour of network businesses and inconsistent with the National Electricity Objective.

The AER notes that there was considerable debate around the interpretation of 'reasonableness' during both the initial chapter 6A and the Expert Panel on Energy Access Pricing reviews.<sup>18</sup> This experience suggests that the task of reducing a network business's proposal enough to meet a reasonableness criterion is fraught. There is potentially a wide range of proposals that could be termed reasonable. A rule that requires a regulator to accept proposals within a reasonable range, as suggested in Figure 5.5, encourages a network business to test the boundaries of this range and will lead to an upward bias in revenues for regulated businesses.

The AER's revenue regulation rule change proposal was designed in part to deal with this concern. These rules have now been reviewed and amended by the AEMC. The new rules allow the AER to undertake a holistic assessment of a network business's proposal. Key changes include:

- amendments that increase the scope for the AER to form allowances for capex, opex and the rate of return for a network business that are not constrained by the proposals of the network businesses
- amendments that clarify the AER's ability to use benchmarking to assess the efficiency of a network business and determine capital and operating expenditure allowances.

The AER supports the revised rules as determined by the AEMC. We do not support arrangements which require the AER to amend the businesses' proposal just enough to meet a reasonableness criterion.

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<sup>17</sup> PC Draft Report, pages 215-16.

<sup>18</sup> Expert Panel on Energy Access Pricing (2006), *Report to the Ministerial Council on Energy*, April 2006.

## 5 Demand Side Participation

The PC recommended a number of regulatory reforms in an effort to facilitate efficient levels of demand-side participation (DSP) in the NEM. The AER notes that these reforms seek to achieve a number of goals that are similar to those that were recently advocated by the AEMC in its draft report on the Power of Choice review of DSP, including:

- the introduction of network tariffs that are reflective of peak demand costs on the network, to provide impetus for efficient consumer behaviour
- rolling out meters capable for interval data measurement to facilitate the provision of efficient network price signals to consumers
- reforming the distribution pricing principles in the rules to provide greater certainty that distribution networks will set tariffs in a manner that reflects the underlying impact of peak demand on network costs
- reforming the incentive arrangements in the rules to encourage distribution networks to engage more in DSP.

The AER is broadly supportive of these goals where they can assist to create more interaction possibilities for both ends of the electricity supply chain in an effort to create a more efficient demand and supply balance in the NEM. The key issues for the AER relate to the appropriate models or approaches for their implementation. The AER's positions on these goals have effectively been set out in the submission to the AEMC's draft report<sup>19</sup> and the PC is referred to that submission, given the similarity of issues considered by the AEMC and the PC. It is noted, however, that there are some differences between the PC and the AEMC in relation these matters. Among these are the appropriate model for rolling out meters, with the PC advocating for a monopoly (distribution network business) led region-by-region roll out, rather than a contestable model as proposed by the AEMC and the approach to introduce cost reflective tariffs flowing from the meter roll out model.

### ***Roll out of interval meters***

As set out in the AER's submission to the AEMC, the AER generally supports a contestable model for rolling out interval meters, where this model can be delivered at lower cost and improve meter service offerings. The AER favours such an approach which would see the following:

- Competition for the provision of meters and meter services providing impetus for innovation and economic efficiencies over time.
- Consumer preferences determining who provides interval meters and how they should be provided – that is, having choice on the range of DSP related services that might be bundled with the provision of a meter, or attached to the meter.
- Arrangements developed to prevent consumer 'locking-in' concerns in relation to energy contracts and meter type (and to prevent inefficient meter churning).
- Some consumers having the option of whether to face a cost reflective tariff or remain on a flat tariff – at least in the short term.

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<sup>19</sup> <http://www.aemc.gov.au/Media/docs/Australian-Energy-Regulator---received-12-October-2012-55b2e371-734a-44d1-aae0-ceabeac062f7-0.pdf>

In supporting a consumer driven and competitive model to roll out interval meters, the AER believes that consideration might need to be given to any lost economies of scale and meter technology compatibility issues that could arise where multiple parties are individually rolling out meters in the same areas and competing for such services. These issues were highlighted by the PC as some of the reasons favouring its monopoly led roll out model. The AER has noted that there might be a need to consider further technology specification issues under the AEMC's model, which itself already seeks to standardise a number of capabilities. Further and in specific regard to any significant economies of scale issues, the AER has noted that a possible alternative to the fully contestable model would be to undertake a competitive tender for the exclusive provision of meters on a region by region basis. However, such an approach would need to effectively balance the need to address the benefits of any scale economies, with any issues resulting from lost consumer choice.

In addition to any competition related concerns posed by a monopoly led model, the AER notes that such a model (in contrast to a contestable model), delivered on a region by region basis would present a much more fundamental role for the analysis of any costs and benefits to be derived from interval meters. The outcome of such an assessment would determine for example, the regions that distribution network businesses would propose to warrant interval meters, and the extent of any regulatory allowances that would be required for distribution network businesses.

The AER notes that region by region cost benefit assessments would attempt to ensure that the benefits of meters are linked to localised network constraints. However, this is likely to present a number of quantitative difficulties, given that the benefits in this approach may need to be modelled against the effectiveness of providing consumers with network tariffs specific to the region in question – that is, locational pricing. The AER considers that locational based distribution pricing is at least in the short term likely to be impractical, given both the need to significantly increase the level of consumer engagement and information on time varying and cost reflective tariffs, and the difficulty that distribution network businesses might have in designing tariffs with the level of granularity required to present peak demand costs on localised distribution areas.

### ***Efficient network pricing***

The PC has recommended a number of policies in relation to network pricing by distribution network businesses. The AER notes that the underlying goal of these policies is to move towards time varying/ cost reflective prices. That is, prices which reflect the cost that peak demand imposes on the network. The AER supports this objective, and agrees that the achievement of this objective requires consideration of both the design of the distribution pricing principles in the rules and the control mechanisms that are applied to distribution network businesses. In regard to these two issues, the PC proposes the following:

- Strengthening the pricing principles in the rules to reduce the level of discretion currently afforded to distribution network businesses, by requiring that network tariffs be set according to long run marginal cost (LRMC).
- Adopting weighted average price caps (WAPC) for all distribution network businesses within the NEM.

The AER has stated its views on the merits of both LRMC pricing and the use of the WAPC in its recent review of control mechanisms for the NSW/ACT distribution network businesses. The AER considers that the combination of these two approaches, and their impact on pricing, requires greater consideration. In particular, the AER notes that the two approaches provide conflicting incentives for distribution network businesses when setting prices. That is, the WAPC (notwithstanding practical

problems) provides distribution network businesses with an incentive to set tariffs for price sensitive services at short run marginal cost, while the pricing principles would specify LRMC as the relevant parameter to set prices.<sup>20</sup> The AER considers that this inconsistency needs to be addressed.

The AER has so far favoured the application of a revenue cap in its upcoming NSW/ACT review. Further, as set out in the submission to the AEMC's Power of Choice review, the AER favours a broad review and tightening of the pricing principles in the NER to ensure that distribution network businesses are required to establish network tariffs that reflect the cost of peak demand on the network. This approach would provide (via the pricing principles) the requirement for distribution network businesses to set efficient prices, while reducing conflicting incentives from the form of control mechanism (via a revenue cap).

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<sup>20</sup> The economic literature is well established on the theoretical incentives provided by the WAPC. That is, the WAPC provides an incentive for the firm to reduce the price on price sensitive services towards short run marginal cost and increase prices on other services. As revenue increases when the volume of sales increases under a WAPC, firms have an incentive to reduce the price on these services to short run marginal cost. The firm is then able to increase prices for services that are not price sensitive to maximise profit and still satisfy the WAPC constraint.

## 6 Governance

Chapter 21 of the PC's draft report discusses a range of governance issues.

There are some issues discussed in this chapter where the AER supports the recommendations of the PC. The PC argues for the establishment of a well resourced body to represent the interest of consumers in regulatory processes. This is a position that the AER has been advocating for some time.

There are other recommendations in this chapter that the AER does not support. The suggestion that the South Australian Minister be given a broader power to make rules with the agreement of the SCER bypasses the robust assessment of rule change proposals evident in the existing rule making processes in the NEM.

Further, the AER has concerns with the PC's discussion on the governance of the AER. The PC's report responds to two matters of concern regarding the AER raised by certain stakeholders – one relates to the performance of the AER, while the other relates to its degree of 'independence' given the institutional links between the AER and the ACCC.

The AER considers that, if the PC does put forward its views on governance, those views should be informed by consideration of the principles for the institutional framework of economic regulation and should take account of the recommendations from previous relevant reviews, including the Hilmer Competition Policy Review<sup>21</sup> and the Parer Energy Markets Framework Review.<sup>22</sup>

The discussion below responds to the issues raised by the PC. The AER believes that the PC has based its comments about the performance of the AER on information that is incorrect or misleading.

Concerning the 'independence' of the AER, the PC does not reflect the nature of the independence that is essential for an economic regulator – that is the need to make independent decisions based on the available evidence, including information provided by stakeholders, but not unduly or inappropriately influenced by them. This independence is set up through the legal framework that establishes the AER under Part IIIAA of the *Competition and Consumer Act 2010*. This independence is clearly not undermined by the current institutional links between the AER and the ACCC.

### 6.1 The performance of the AER

The AER has assessed the PC's analysis of the AER's performance outlined in the draft report. The AER acknowledges the validity of some of the concerns that have been raised by stakeholders. As a developing organisation, the AER has taken account of its own experience and of expressions of stakeholder concerns. As a result the AER has implemented measures such as:

- developing its stakeholder engagement strategy
- increasing its in-house technical capability to reduce reliance on external consultants
- developing regulatory approaches through the experience of a greater number of determinations and

<sup>21</sup> Hilmer, F.G., M. Rayner and G.Taperell (1993), *National Competition Policy*

<sup>22</sup> Parer, W., P. Breslin, R. Sims and D. Agostini (2002), *Towards a Truly National and Efficient Energy Market*

- making AER decision documents clearer and more understandable to a broader range of stakeholders.

As highlighted below, we believe that the PC has overstated the extent of the concerns or is reflecting views that were formed in earlier times and are now less relevant to the organisation. The concerns reflect to some extent the AER grew rapidly when its role was significantly expanded to include the economic regulation of distribution networks. That said, in each of the four areas of concern raised in the draft report, the PC has made statements that are not substantiated and in some instances are incorrect.

## Stakeholder confidence and trust

The PC report notes that ‘many stakeholders currently have poor perceptions of the AER.’ To support this position, the PC has relied significantly on the results of the AER’s stakeholder survey conducted by Buchan Consulting in early 2011.

It is important to put the stakeholder surveys into their context.

The surveys are not intended to be used as a ‘report card’ on the performance of the AER. Instead, they provide a snapshot of the perceptions of around 110 stakeholders at the time the survey is conducted. The last survey was conducted in May 2011 and reflects experience of dealings with the AER in the years prior to this, including the period of the first distribution determinations made by the AER under the National Electricity Rules and the National Gas Rules. The AER has taken on board comments received in the 2011 survey, drawn on its experience and implemented a number of significant changes. It has acted on concerns about in-house technical expertise and employed more in-house technical experts. It has also put significant effort into improving engagement with network businesses. These efforts are bearing fruit with better engagement between the AER and network businesses.<sup>23</sup>

The PC appears to base most of its arguments on the AER’s performance on the decline in survey results from 2008 to 2011. The PC claims that it ‘might be reasonable to expect that the longer the AER operated, the more experienced it would have become in managing its functions and, thus, the more positive would have been the views of stakeholders.’ However, this view fails to take into account the very different operating environment that the AER faced in 2011 compared to 2008.

In 2008, the AER was still in a ‘honeymoon period’ and had not assumed its full range of responsibilities. In particular, it had not completed any distribution resets and had not assumed responsibility for retail regulation. Merits review of AER regulatory decisions was just commencing. By 2011, the AER was in the midst of its first round of distribution resets, involving much more contentious and difficult decision making for the AER. By 2011, merits review of AER regulatory decisions was common place, creating a far more adversarial relationship between the AER and businesses. The external operating environment was also fundamentally different, with continued discussion within the community about rising electricity prices.

Notwithstanding that survey results are influenced by their context, the AER will continue to undertake stakeholder surveys in future. While the AER’s primary objective in undertaking a survey is to identify any issues that may need to be addressed, publishing survey outcomes also serves as a valuable

<sup>23</sup> As an example, there has been positive engagement between the AER and businesses in the development of transitional arrangements for the new network regulation rules. See the submissions of the NSW distribution businesses and Transgrid to this review: <http://www.aemc.gov.au/Media/docs/Rule-Change-Submission-ERC0134---NSW-DNSP-121026-official-versionpdf-004086f2-8796-491d-8141-80640329db7d-0.pdf>  
<http://www.aemc.gov.au/Media/docs/TransGrid-PDF-b8655efb-3754-4cd1-866a-1a99ae8a4f4b-0.PDF>

transparency tool. Most regulators undertake stakeholder surveys, with some regulators publishing the results and others keeping the results confidential. Over time, the survey results should also provide a useful benchmarking tool for the AER.

The AER also notes that while the PC has reported that many stakeholders have poor perceptions of the AER, other reviews, such as the Senate Select Committee, provide a more balanced perspective on the current performance of the AER. While some submissions argued that the AER lacked certain skills and expertise, other witnesses provided evidence that the AER has highly capable and professional staff.<sup>24</sup> The Senate Select Committee also heard evidence that the AER was significantly hamstrung by regulatory gaming by network businesses and by limitations in the rules.<sup>25</sup> The PC does not appear to have considered these effects.

Similarly, the PC notes that “some have claimed that it (the AER) is overly legalistic, adversarial, insufficiently consultative and that it does not have enough in-house expertise.” The Senate Select Committee provides a more balanced assessment of these issues. Some evidence provided to the Senate highlighted that a legalistic and adversarial process was an inevitable result of the regulatory framework set up under chapters 6 and 6A of the rules and the merits review arrangements.

Submissions to the Senate also highlighted different views on the independence and rigour of the AER, and the extent of consultation, to those outlined in the PC’s report. Indeed, the Energy Networks Association’s submission to the Senate Select Committee noted that:

*Australia is fortunate to have a strong, independent institutional framework for energy market regulation in the National Electricity Market (NEM). ... The AER determination process is open and consultative. Over what is usually 12 months, the original network proposal is subjected to rigorous expert analysis.<sup>26</sup>*

## Resourcing and capacity

The PC’s draft report expresses concern about the resourcing and capacity of the AER. The PC’s findings appear to be largely based on the claims made in the ENA’s submission to the PC. In particular, the PC reiterates, without testing, the ENA’s claims that being part of the ACCC has an adverse impact on the capacity of the AER to attract high quality staff and leads to an over reliance on consultants.

The PC repeats ENA claims that the AER faces ‘internal competition’ for high quality staff from other parts of the organisation, which has led to rapid staff turnover. This statement is incorrect. The AER is seen as an attractive area to work, with internal and externally advertised vacancies attracting strong and competitive fields. While there is some movement from the AER into other areas of the ACCC, this turn-over is at a low level.

The PC also notes that the AER relies significantly on externally sourced specialist expertise. Engaging external consultants adds significant rigour to the AER’s assessment of a network business’s proposal. This point was acknowledged in evidence provided to the Senate Select Committee.<sup>27</sup> However, the AER appreciates the need for this to be complemented by in-house

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<sup>24</sup> Senate Select Committee on Electricity Prices (2012) *Reducing energy bills and improving efficiency*, November 2012, p. 76.

<sup>25</sup> Senate Select Committee on Electricity Prices (2012) *Reducing energy bills and improving efficiency*, November 2012, pp. 75-76.

<sup>26</sup> Energy Networks Association (2012) Submission to the Senate Select Committee on Electricity Prices, p.16.

<sup>27</sup> Mr Peter Price, Executive General Manager, Network Performance, Energex, Proof Committee Hansard, 3 October 2012, p. 39.

expertise. While it is still building up capability in this area, the AER already has technical expertise in-house. It has a range of staff with an engineering background with decades of experience in the electricity sector. The AER also has staff who have joined from network businesses and other regulators, both within Australia and overseas. The AER will be increasing its in-house strategic technical resources to assist in developing and implementing the new regulatory approaches allowed under the changed rules framework.

## Errors

The PC makes a number of statements about the performance of the AER based on the outcomes of cases under the limited merits review regime.

The AER believes that the material relied upon by the PC as evidence of errors is misleading. For example, the PC refers to the ENA's statement that the AER has 'conceded error' in more than a third of all matters. Of the 23 'concessions', 16 involved WACC issues. WACC issues are generally common to all businesses. These 16 WACC concessions cover three issues – gamma, the debt risk premium (DRP) and DRP annualisation. Thirteen of the errors claimed by the ENA effectively involve 'double counting'.

There are two reasons for this 'double counting.' First, the AER's schedule of resets (including Tribunal processes) overlaps. This means that when a business seeks review on a WACC issue, the AER may not know what the Tribunal's position is on that issue before the AER has to consider the same issue in subsequent decisions. To attribute fault on the part of the AER based on information (a Tribunal decision for a previous business) that was not available to the AER at the time it made its final decision for a subsequent business is not reasonable. For example, what the ENA counts as nine separate errors in relation to gamma was in fact only one unique error. The AER did not know the Tribunal's position on this issue when it made seven subsequent decisions. Consequently, when these seven subsequent decisions on gamma were appealed and the Tribunal's position on the initial appeals was known, the AER conceded error.

Second, the AER typically makes decisions for different businesses in the same state at the same time. Accordingly, if the Tribunal finds that the AER made any error involving a common issue in the decision for one business it will affect the other decisions made at the same time. For example, in the Victorian electricity distribution review the Tribunal found error in the way the DRP was annualised. This error affected five businesses because the decisions were made simultaneously. The ENA counts this as five separate errors in its analysis.

Similarly, Table 21.1 outlining Tribunal cases involving non-WACC issues needs to be considered in the broader context of merits review and regulatory decision making.

Review by the Tribunal has added some \$3.2 billion to the revenues of the network businesses. Of this amount, decisions on the averaging period for the risk free rate increased revenues by \$2 billion and decisions on the value of gamma increased revenues by \$780 million. Tribunal decisions on these two issues therefore account for 85 percent of the total increase in revenues for businesses from merits review. The non-WACC elements of the decisions referred to in Table 21.1 by contrast accounted for under one percent of the additional revenues resulting from merits review decisions.

Finally, the AER notes that the last three decisions of the AER have not been appealed.

## Scope of reviews

The PC also notes that another area of concern with the performance of the AER concerns its failure to use powers under section 71O(1) of the National Electricity Law (NEL) to broaden the scope of reviews before the Australian Competition Tribunal. As highlighted in the draft report, the Expert Panel sought legal advice from the Australian Government Solicitor as to why section 71O(1) of the NEL has not been used more actively by the AER.

This legal advice confirms that:

*Since the grounds for review are those specified by an applicant or intervener, there is no scope for the addition of other grounds for review ... The scope of a review before the Tribunal cannot, therefore, be broadened by the AER or the Tribunal.<sup>28</sup>*

As such, the PC's description of the failure to broaden the scope of reviews as an 'area of concern' with the performance of the AER is unreasonable. The issue raised by the PC reflects a weakness in the limited merits review regime, rather than any concern with the performance of the AER.

## 6.2 The 'independence' of the AER

The PC's report also raises concerns with the 'independence' of the AER, given its institutional links with the ACCC.

The PC's discussion of the AER's independence overlooks the fundamental point that the AER is established as an independent regulatory authority.<sup>29</sup> It has an independent Board with a Chair appointed in accordance with the Australian Energy Market Agreement and an independent State appointed part time member. The ACCC provides the AER with dedicated staff, resources and facilities.

The AER rejects any suggestion that it is not an independent regulator. The Buchan Consulting Report, referred to by the PC in its draft report, clearly highlights that stakeholders see the AER's independence as a key strength. In the 2011 results, of the 12 performance indicators measured, 'independence' was the measure where respondents ranked the AER most highly with over 70 per cent of respondents ranking the AER's independence as 'excellent' or 'good.'

The PC's discussion is not about this 'regulatory independence' but is more accurately characterised as a discussion of NEM governance and institutional arrangements.

The AER notes that there have been a number of reviews of institutional arrangements over the years, most notably the Hilmer review and the Parer review. The AER believes that the PC's discussion of institutional arrangements would benefit from further consideration of the issues raised in these reviews.

The Hilmer review considered the question of whether regulation should be undertaken by an industry-specific or a multi-sector regulator. The Review Committee concluded that:

*"there are sufficient common features between access issues in the key network industries to administer them through a common body. As well as the administrative savings involved, there are undoubted advantages in ensuring regulators take an economy-wide perspective*

<sup>28</sup> Australian Government Solicitor (2012) In the Matter of the Limited Merits Review Regimes in the National Electricity Law and the National Gas Law, Opinion, SG no. 22 of 2012, p. 2.

<sup>29</sup> Competition and Consumer Act 2010 (Cth), Part IIIA.

*and have sufficient distance from particular industries to form objective views on often difficult issues.*<sup>30</sup>

PC's discussion of the Parer review highlighted that the AER was originally conceived as a separate energy sector specific agency. However, the Parer Review Panel emphasised that the location of the regulator 'is not the key issue.'<sup>31</sup> Rather the Parer Review Panel argued that the key elements of their proposal were for 'a single Australia-wide electricity and natural gas regulator, with ... a charter that extends to distribution and retail currently carried out by state and territory based regulators.'<sup>32</sup>

The creation of the AER as an independent decision making body captures the benefits of a single, national energy regulator proposed by Parer, while having institutional links with the ACCC captures the benefits of multi-utility regulation promoted by Hilmer.

The AER believes that there is a range of significant benefits from these current institutional arrangements which were not adequately explored by the PC. Technological change, consumer expectations, liberalised markets and the scope and complexity of economic regulation requires an extremely high level of coordination between the regulatory, competition and consumer protection functions. The current model, which internalises coordination within the AER and the ACCC, provides a highly effective and efficient way of managing this task for the following reasons.

### **Consistency of regulatory decision-making across sectors**

The AER believes that the current institutional arrangements facilitate a consistent and co-ordinated approach to regulatory decision-making across sectors. While all infrastructure industries have unique features, many of the economic regulation issues raised are similar across a range of regulated industries. As all industries compete for investment capital, inconsistent approaches to issues such as the valuation of capital could lead to distortions and inefficient investment.

The AER notes that a similar approach has been traditionally been adopted at the state level. State regulators (such as the NSW Independent Pricing and Regulatory Tribunal and the Victorian Essential Services Commission) have traditionally been responsible for regulation across a range of infrastructure industries.

### **Complementary expertise, competencies and knowledge**

The AER and ACCC have both regulatory and enforcement responsibilities and those are natural complements to each other.

Network regulation is a core competency of the ACCC in the performance of its regulatory functions in respect of the communications, rail, ports, water and postal services. Similar analytical approaches and thinking are required in regulating the monopoly elements of the energy industry.<sup>33</sup>

In a similar vein, the AER has consumer protection and education responsibilities under the National Energy Customer Framework that complement the ACCC's responsibilities under the *Australian*

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<sup>30</sup> Hilmer, F.G., M. Rayner and G.Taperell (1993), *National Competition Policy*, p.327

<sup>31</sup> Parer, W., P. Breslin, R. Sims and D. Agostini (2002), *Towards a Truly National and Efficient Energy Market*, p.84.

<sup>32</sup> Parer, W., P. Breslin, R. Sims and D. Agostini (2002), *Towards a Truly National and Efficient Energy Market*, p.84.

<sup>33</sup> In a report to COAG, the MCE noted that '[t]he proposed staffing arrangements will allow the AER and AEMC to be provided with the best available expertise from the ACCC, other regulatory bodies and elsewhere': Ministerial Council on Energy, *Report to the Council of Australian Governments: Reform of Energy Markets*, 11 December 2003, p 16.

*Consumer Law*.<sup>34</sup> The ACCC also uses the AER's energy expertise to inform its consideration of and decision-making in competition law issues in the energy sector.

Further, the current model achieves significant economies of scale and scope. The AER draws on the ACCC's specialised legal and economic advice and administrative corporate resources.

### ***A pro-competitive culture***

The current model encourages a 'pro-competitive' culture. This was a fundamental argument supporting the model arising from the Hilmer Review.<sup>35</sup> Separating the competition elements from the economic regulatory functions risks moving the focus from the important competition objective of economic regulation.

### ***International experience***

Consistent with recent international experience, some countries are contemplating or implementing similar institutional arrangements, the latest being Spain.<sup>36</sup> A decision to combine competition, economic regulation and consumer protection in the Netherlands is due to take effect in January 2013.<sup>37</sup> The United Kingdom and New Zealand are also examples of countries that are moving towards agency consolidation.<sup>38</sup> Other countries have also developed umbrella organisations to bring different regulators together to exchange information and coordinate for consistency, such as Germany.<sup>39</sup> The international trend is towards consolidation and there is no international evidence of organisations moving from their existing structures into more narrowly defined units.

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<sup>34</sup> See, e.g., *Competition and Consumer Act 2010* (Cth), Schedule 2 (*Australian Consumer Law*), Part 2-1 (misleading and deceptive conduct) and Part 2-3 (unfair contract terms).

<sup>35</sup> Hilmer, F.G., M. Rayner and G.Taperell, 1993, *National Competition Policy*, Canberra, AGPS, Chapter 9.

<sup>36</sup> European Commission, *Assessment of the 2012 National Reform Programme and Stability Programme for Spain*, 5 May 2012, p 22.

<sup>37</sup> Netherlands Competition Authority, *Press Release: Bill on ACM Establishment Act submitted to the Dutch Parliament*, 29 February 2012; Netherlands Consumer Authority, *2012-2013 Agenda*, p 6.

<sup>38</sup> Infrastructure Consultative Committee, *Final Report of the Infrastructure Consultative Committee*, 5 June 2009, pp 59 and 60.

<sup>39</sup> In Germany the Federal Network Agency is primarily responsible for economic regulation of gas, electricity, rail, post and telecommunications services: see Infrastructure Consultative Committee, *Final Report of the Infrastructure Consultative Committee*, 5 June 2009, p 60.