

# Chapter 7

## The rule-making process and institutional framework

7.1 This chapter examines aspects of the operations and performance of the Australian Energy Market Commission (AEMC) and the Australian Energy Regulator (AER) in detail. In particular, this chapter focuses on the rule-making process, the overall performance of the two organisations and suggestions for changes to the institutional framework.

### Rule-making process

7.2 The AEMC makes and amends the national electricity and gas rules.<sup>1</sup> With the exception of minor matters, the AEMC cannot initiate rule changes itself; it relies on the AER, other stakeholders and interested parties to submit rule change proposals to it.<sup>2</sup> Rule changes can also have their origins in the reviews of aspects of the energy markets that the AEMC undertakes at the request of the COAG Energy Council.

### *Criticism of the AEMC's process and approach*

7.3 The committee received evidence from stakeholders who were dissatisfied by their experiences engaging with the AEMC. The speed of the rule-change process was one aspect that was criticised. The Total Environment Centre drew the committee's attention to a rule change request it submitted in November 2013. Despite being complemented by a similar proposal the COAG Energy Council lodged one month later, the AEMC only opened consultation on the request in February 2015.<sup>3</sup> The Total Environment Centre added that rule change requests typically take two years after the process has formally commenced.<sup>4</sup>

7.4 Mr Oliver Derum from the Public Interest Advocacy Centre explained that he considers the AEMC is 'completely driven by economic theory and ideas about how this all works out there' and 'just do not have regard to the real world'.<sup>5</sup> To support this criticism, his colleague Dr Gabrielle Kuiper noted that the one rule change proposal

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1 Australian Energy Market Commission (AEMC), *Submission 41*, p. 1.

2 Mr Paul Smith, Chief Executive, AEMC, *Proof Committee Hansard*, 17 February 2015, p. 3.

3 Total Environment Centre, *Submission 43*, p. 3; AEMC, 'Rule changes: Demand Management Incentive Scheme', [www.aemc.gov.au/Rule-Changes/Demand-Management-Embedded-Generation-Connection-I](http://www.aemc.gov.au/Rule-Changes/Demand-Management-Embedded-Generation-Connection-I) (accessed 16 March 2015).

4 Total Environment Centre, *Submission 43*, p. 3.

5 Mr Oliver Derum, Senior Policy Officer, Energy and Water Consumers' Advocacy Program, Public Interest Advocacy Centre, *Proof Committee Hansard*, 17 February 2015, p. 16.

consumer groups have put forward 'was roundly rejected by the AEMC'.<sup>6</sup> The proposal, developed by the Consumer Action Law Centre jointly with the Consumer Utilities Advocacy Centre, related to contracts described as 'fixed' where the retailer could still change the electricity price at any time with notification. The rule change proposal sought to prohibit retailers from varying prices during the period of time that the fixed contract covered. Mr Gerard Brody, the chief executive officer of the Consumer Action Law Centre explained the rationale for seeking the change:

We had had a lot of complaints from people who had signed up to a fixed period contract only to have the price change mid-contract. If you look at those contracts, they all have fine print which allows the retailer to do that. We wanted a rule change to stop that practice, and we proposed that to the AEMC.<sup>7</sup>

7.5 The committee was informed that the AEMC rejected the proposal 'on the grounds that you simply needed to provide consumers with further information'.<sup>8</sup> Mr Derum suggested that the AEMC took this approach as it did 'not want to distort the purity of the market and market interactions, so their answer is more information'.<sup>9</sup>

7.6 In addition to what consumer groups considered was an unfavourable outcome, the significant effort involved in seeking a rule change was also noted. The Consumer Action Law Centre outlined its experience in developing this proposal:

We initially scoped that rule change around the middle 2013. Our rule change was researched, and a lot of effort went into it during that year. We submitted the rule change in October 2013. It took 12 months for the rule change process; we did get a decision from the AEMC in October 2014...It is a very lengthy process. It took a lot of resources from a small consumer organisation like ours to run that rule change process. We were able to get some funding support, but it was a significant undertaking for us.<sup>10</sup>

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6 Dr Gabrielle Kuiper, Senior Policy Officer, Energy and Water Consumers' Advocacy Program, Public Interest Advocacy Centre, *Proof Committee Hansard*, 17 February 2015, pp. 15–16.

7 Mr Gerard Brody, Chief Executive Officer, Consumer Action Law Centre, *Proof Committee Hansard*, 18 February 2015, p. 57.

8 Dr Gabrielle Kuiper, Public Interest Advocacy Centre, *Proof Committee Hansard*, 17 February 2015, p. 16.

9 Mr Oliver Derum, Public Interest Advocacy Centre, *Proof Committee Hansard*, 17 February 2015, p. 16.

10 Mr Gerard Brody, Consumer Action Law Centre, *Proof Committee Hansard*, 18 February 2015, p. 57.

7.7 The Energy Users Association of Australia (EUAA) also remarked on the resource-intensive nature of mounting a rule change bid. The EUAA's chairman, Mr Brian Green, advised that the EUAA found the process 'extremely expensive and very restrictive'. For example, the EUAA had to engage a consultant in the United Kingdom to advise it on the proposal as the consultants in Australia who were familiar with the issues targeted by the rule change proposal were 'conflicted because they were engaged at some point by generators or networks'. Mr Green added that ultimately the EUAA's proposal was amalgamated into another put forward by the AER.<sup>11</sup>

7.8 Mr Green concluded that while the entire process is 'extremely cumbersome' at present, in his view there 'is considerable room to be able to streamline and simplify the processes without losing any of the rigour of the process'. The EUAA called for streamlining of the process and noted that it would welcome 'the establishment of a group that could look at this issue and put forward changes in a far more timely fashion'.<sup>12</sup>

### **Effectiveness of the current regulatory system**

7.9 Several stakeholders commented on the number of regulatory and rulemaking bodies, the various jurisdictions to which they belong, and the overall complexity of the framework. For some, this was a key weakness of the system.

7.10 The Total Environment Centre pithily summed up the 'national' approach to electricity market regulation as 'fragmented and cumbersome', a mixture of 'part state and part federal; part public and part private'.<sup>13</sup> Mr Bruce Mountain remarked that Australia's framework is based on 'elaborate and bureaucratic rules-based arrangements',<sup>14</sup> and that he is not aware of another country that 'prescribes economic regulation of electricity utilities in this way'. Mr Mountain provided the following insight into the approach used in other countries:

The [European Union] asked member states recently to explain their regulatory frameworks. The Brits had a reason to jot down on a couple of pages how they regulate. In essence, it was, 'We consider the long-term interests of consumers in setting our regulatory framework.' The regulator has regard, as it ought to, to a wide range of factors—the cost of capital, the asset valuation—and makes decisions on those as a broad package. This is a holistic, complex business that has many levers to pull. It should have the ability to pull all of those levers and make a decision and not have constrained 'Look at this and don't look at that, and when you look at this you must do it like this and you must do it like that. And if you wish to

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11 Mr Brian Green, Board Chairman, Energy Users Association of Australia (EUAA), *Proof Committee Hansard*, 18 February 2015, p. 21.

12 Mr Brian Green, EUAA, *Proof Committee Hansard*, 18 February 2015, p. 21.

13 Total Environment Centre, *Submission 43*, p. 2.

14 Mr Bruce Mountain, *Submission 19*, pp. 23–24.

change it, then go through a rule change process separate to the existing form.'...In the [United States of America] they have some broader-level objectives, they have more policy objectives and they have a lot of history of what they have done, so there are legal arguments on historical decisions that are weighed in a regulatory framework, but that does not impinge on the authority of the regulator to make a decision.<sup>15</sup>

7.11 The chief executive of the AEMC, Mr Paul Smith, noted that the framework reflects the fact that it is multi-jurisdictional. The AEMC reports to the COAG Energy Council because 'the legislative power in relation to energy sits with the states and territories, so, in order for the rules that we make to have effect, that needs to be under legislation supported by the state and territory parliaments'.<sup>16</sup> Whether this framework could be changed was questioned; Mr Mountain told the committee it was his understanding that the creation of the AEMC as a rule-maker was intended to alleviate state governments' concerns about the regulation of their network service providers by the AER, a Commonwealth body.<sup>17</sup> Mr Mountain commented that 'it is perfectly understandable that states should want to circumscribe' the AER:

The income from electricity utilities is a major source of income for state governments, the single largest of their government owned businesses. The debt held by the network owned business is by far the biggest allocation of state government borrowing.<sup>18</sup>

7.12 Ms Michelle Groves, the chief executive officer of the AER, noted that the roles and structure of the various institutions is a policy decision. However, within this framework she noted that the bodies work cooperatively with 'fairly extensive memorandums of understanding between us to ensure there is close cooperation and no gaps between the work we each do and that each of us is informed by the other's work'.<sup>19</sup>

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15 Mr Bruce Mountain, *Proof Committee Hansard*, 18 February 2015, p. 65.

16 Mr Paul Smith, Chief Executive, AEMC, *Proof Committee Hansard*, 17 February 2015, p. 6.

17 Mr Bruce Mountain, *Submission 19*, p. 23.

18 Mr Bruce Mountain, *Proof Committee Hansard*, 18 February 2015, p. 62.

19 Ms Michelle Groves, Chief Executive Officer, Australian Energy Regulator (AER), *Proof Committee Hansard*, 18 February 2015, p. 7.

## The AEMC's and AER's performance

7.13 This section considers the performance and accountability of the AEMC and the AER. Specific issues discussed include the AER's funding, the level of consumer input in the decision-making processes and governance of the AEMC and the AER, and the accountability frameworks that the two bodies are subject to.

### *Overall views on performance*

7.14 The evidence received about the performance of the AEMC and AER was generally balanced, objective and recognised that the institutions were required to perform their tasks within a framework they did not establish. It is important to note that a number of stakeholders were quick to express confidence in the officers working at the various regulatory and rule-making institutions. For example, UnitingCare commenced its submission by 'recognising the calibre of staff' at the AER, AEMC and the Australian Energy Market Operator (AEMO). UnitingCare expanded on that comment with the following statement:

Experience of working with these organisations and their staff has always been very constructive and we strongly value the contribution that individual staff make to the organisation and to their endeavours to meet the National Energy Objective.<sup>20</sup>

7.15 The independence of the regulator and the rule-making body was presented as being a fundamental strength of the system. For example, the AEMC emphasised how its commissioners are protected from external pressures:

In relation to the appointment of our commissioners, I think probably an analogy for a commissioner would be with a Director of Public Prosecutions or an Auditor-General. Once they are appointed, they are appointed for a specified term, and they can only be dis-appointed, in effect, for some sort of gross misconduct or something like that. Their terms cannot be ended in relation to the merits of particular decisions or if a minister had a view that a particular decision was not appropriate.<sup>21</sup>

7.16 The transparency of the regulatory system's objectives and processes was highlighted as another key strength. The AEMC noted that once a rule change proposal is lodged, whether the change is made is the AEMC's decision alone; that is, 'there is no further process whereby the state governments must approve or sign off or have any direct power to change a rule change once we have made it'.<sup>22</sup>

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20 UnitingCare Australia, *Submission 60*, p. 1.

21 Mr Paul Smith, Chief Executive, AEMC, *Proof Committee Hansard*, 17 February 2015, p. 6.

22 Mr Paul Smith, AEMC, *Proof Committee Hansard*, 17 February 2015, p. 6.

7.17 The AEMC highlighted other aspects of its operations that ensure the decision-making process is transparent. These include that:

- the objectives the AEMC assesses decisions against, such as the national electricity objective, are transparent given they are set out in legislation;
- any person or organisation other than the AEMC may lodge a rule change;
- generally two stages of consultation take place when the AEMC is undertaking a rule change process and responses to the consultation are published on the AEMC's website; and
- the AEMC publishes 'an extensive decision document...explaining the reasons and explaining how we have taken account of stakeholders' comments in those processes'.<sup>23</sup>

7.18 The outcome of an AEMC review conducted at the request of the COAG Energy Council was also considered. While the AEMC acknowledged that the COAG Energy Council could ignore or delay action on recommendations that the AEMC made following a review, it emphasised that the framework ensures 'there is no veto by energy ministers'. The AEMC argued that any group interested in the AEMC's recommendations could submit them as a rule change proposal. An AEMC officer provided an example of this occurring in practice:

On power of choice, for example, the Total Environment Centre picked up part of our recommendations and beat ministers to it and sent in a rule change themselves based on our recommendations. So if energy ministers do not pick them up there is nothing that stops someone saying, 'I think that's a good idea. Here's a rule change to do it.' So...there is no veto by energy ministers.<sup>24</sup>

7.19 Submitters provided comments specifically about the AER. Mr Bruce Mountain acknowledged that the AER 'has a difficult job to do' as it is tasked with 'making very tough decisions on the distribution of resources and taking on very powerful vested interests'.<sup>25</sup> While the AER's status as an independent statutory authority was acknowledged, it was also suggested that the AER has limited authority and this was a possible reason why optimal outcomes were not being achieved. To support this argument, Mr Bruce Mountain recited a long list of things the AER cannot do:

It cannot choose, for example, to fundamentally change the regulatory regime. It cannot say: 'I do not want to do a five-yearly price cap; I want to do an annual cap. I do not want to set caps on revenues and prices; I want to look at your actual expenditure. I want to treat government utilities differently from private firms.'...It cannot set the security and planning standards that the networks are told to build their lines to. That massively

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23 Mr Paul Smith, AEMC, *Proof Committee Hansard*, 17 February 2015, p. 6.

24 Mr Richard Owens, Senior Director, Transmission and Distribution Networks, AEMC, *Proof Committee Hansard*, 17 February 2015, p. 10.

25 Mr Bruce Mountain, *Proof Committee Hansard*, 18 February 2015, p. 62.

impacts the expenditure program and is a major reason for the change in those programs...It cannot revalue assets in any terribly meaningful way. To some degree it can with most recent assets, but on the fundamental asset base it cannot. It cannot vary the indexation of the asset values over time, which, at the moment, are indexed by CPI. It cannot say, for example, 'I wish to not index them...It has incomplete control of the cost of capital. It has some level of control over it but it is incomplete. It has the prospect of review of individual decisions but it cannot review the total decision. It cannot take ownership into account as a major variable and it does not set prices or tariffs.<sup>26</sup>

7.20 Major Energy Users also emphasised that the AER is constrained in that it can only act within the National Electricity Rules (NER) and because network service providers 'only have to provide the information that is required by the NER, and in the format that the NER require'. It concluded that if the NER 'are deficient in a way that prevents the AER from exercising sensible regulation, then this is a flaw in the rule setting process rather than in the regulatory process'. Further, it argued that any shortcomings in the way network services providers interact with the AER, as well as the other issues being examined by this inquiry, are due to weaknesses in the NER (of which it considers there are many) rather than being a result of other causes such as how the AER regulates.<sup>27</sup>

7.21 The Consumer Action Law Centre similarly argued that criticism of the AER is misplaced if it does not recognise the AER is limited by the rules it administers. The Centre remarked that:

The success of appeals by businesses suggests that the AER did endeavour to limit businesses' revenue, but many of its decisions were wound back due to unfavourable rules.<sup>28</sup>

7.22 The Agriculture Industries Electricity Taskforce also noted that the AER has limited authority. Overall, as the AER is the regulator of regulations developed by the AEMC, the Taskforce considered that 'the AER has a subservient, constrained role'.<sup>29</sup>

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26 Mr Bruce Mountain, *Proof Committee Hansard*, 18 February 2015, p. 62. A similar point was made in the Agriculture Industries Electricity Taskforce' submission. See *Submission 20*, pp. 17–18.

27 Major Energy Users, *Submission 7*, p. 2.

28 Consumer Action Law Centre, *Submission 20*, p. 6.

29 Agriculture Industries Electricity Taskforce, *Submission 20*, pp. 17–18.

### ***AER resourcing***

7.23 During this inquiry, a variety of stakeholders observed that there were clear financial incentives for network companies to use their resources to overwhelm the regulator and challenge its decisions. Given this, whether the AER was resourced appropriately was a topic that was discussed. For example, in its submission, Cotton Australia questioned whether the AER had sufficient resources to consider and analyse the information it receives to ensure the determinations it makes are 'fair and balance the investment and expenditure needs of the networks, with the community's need for reliable, secure and affordable electricity supply'.<sup>30</sup>

7.24 Ms Cally Wilson, the former employee of Energex who made public her concerns about data manipulation and other practices at Energex, told the committee:

I think the AER is very much understaffed and underfunded at present. If you look at the AER's budget versus a company such as Energex's, it is clearly not resourced enough to be able to take on such a large corporation. And Energex is only one of a multitude of corporations.<sup>31</sup>

7.25 When questioned about the AER's resources, its chief executive officer noted that generally all regulators would like more resources. However, Ms Groves added that the AER has 'fairly significant resources' in terms of its 'very experienced staff', ability to access independent consultants and its effective regulatory tools.<sup>32</sup> Ms Groves also noted that the AER had established 'a technical advisers group'. This group is intended to provide the AER with:

greater industry expertise, particularly in power system engineering. The members of this group bring a wealth of knowledge and over 100 years of combined industry experience to the AER, and have significantly enhanced the internal expertise that we had already developed.<sup>33</sup>

7.26 Finally, Ms Groves noted that the AER's capabilities have been enhanced as a result of the recent rule changes, as the AER can use 'the methods and tools that we think are appropriate...and are consistent with the sorts of tools and processes that energy economic regulators around the world use'.<sup>34</sup>

7.27 The AER board has also been recently supplemented as, following the most recent appointments made in 2014, it now comprises three full-time members. Previously, the AER board had two full-time members and one part-time member.

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30 Cotton Australia, *Submission 3*, p. 3.

31 Ms Cally Wilson, *Proof Committee Hansard*, 24 March 2015, p. 3.

32 Ms Michelle Groves, AER, *Proof Committee Hansard*, 18 February 2015, p. 4.

33 Ms Michelle Groves, AER, *Proof Committee Hansard*, 18 February 2015, p. 2.

34 Ms Michelle Groves, AER, *Proof Committee Hansard*, 18 February 2015, p. 4.

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### *Consumer input*

7.28 Some of the recent efforts to enhance the representation of consumer interests in the determination process, such as the creation of the AER's consumer challenge panel and the replacement of the AEMC's consumer advocacy panel with Energy Consumers Australia, were noted in Chapter 6. However, some submitters argued that consumers should be represented more explicitly in the AEMC's and AER's governance arrangements and decision-making processes. For example, the Total Environment Centre argued that the AEMC and the AER's board are made up of 'industry insiders with no consumer representation'.<sup>35</sup> The concern about the composition of the AEMC's and AER's governing bodies followed the criticisms outlined previously in this chapter that the two institutions are too focused on abstract perceptions of economic efficiency, rather than the actual experiences and preferences of consumers.

7.29 The EUAA argued that consumer representation on the governing bodies of both organisations is necessary 'to deliver improved governance and more balanced decision making for these institutions'.<sup>36</sup> Mr Robert MacKenzie, a director of Canegrowers Isis, focused on the AER and suggested that the AER needs energy user representation on its board so that it is 'able to give proper consideration to its pricing impact on customers'.<sup>37</sup>

### *Accountability and assessment of performance*

7.30 An effective regulatory system requires the decision-making institutions within it to have the ability and willingness to assess their past performance. Robust external scrutiny of the rule-makers and regulators is also required. The following paragraphs consider the accountability of the AEMC and the AER.

#### *Ex-post performance assessment*

7.31 Ex-post assessments of decisions can be particularly beneficial in the regulatory environment. Comprehensive assessments of past decisions can inform and improve future decision-making while also helping to foster a culture of continuous improvement. In turn, this may help the regulator's credibility among the entities it regulates and in the community more generally. In the context of electricity regulation, ex-post reviews could consider the assumptions made in the AER's benchmarking process in light of actual outcomes.

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35 Total Environment Centre, *Submission 43*, p. 3.

36 Energy Users Association of Australia, *Submission 17*, p. 19.

37 Mr Robert MacKenzie, Director, Canegrowers Isis, *Proof Committee Hansard*, 16 February 2015, p. 27.

7.32 Given that perceived weaknesses with the AEMC's past decisions can be addressed by asking the AEMC to consider a rule change, which would necessitate an examination of its past decision, this issue appears to be more applicable to the AER. The AER was asked whether it compared its theoretical benchmarking model with what actually happened during the regulatory control period. In response, Mr Sebastian Roberts, a general manager at the AER, advised that when considering operating expenditure the AER uses data it has collected over eight to ten years to compare the costs across the different network companies. This information has been applied in the draft determinations for New South Wales and the Australian Capital Territory for the 2014–19 regulatory period, resulting in substantial cuts in operating expenditure proposals 'ranging up to 38 per cent'.<sup>38</sup>

#### *Current accountability framework*

7.33 Both the AEMC and the AER are subject to clear accountability frameworks, however, reflecting the different jurisdictions in which they are established and how they are funded, they have separate lines of accountability.

7.34 The AEMC is accountable to the COAG Energy Council. The AEMC's chief executive explained that the AEMC provides reports to the Council twice a year on the AEMC's work program, activities and how the AEMC has fulfilled its mandate. The COAG Energy Council is also responsible for approving the AEMC's annual budget.<sup>39</sup>

7.35 As an independent Commonwealth statutory authority, the AER is accountable to the Australian Parliament. Ongoing parliamentary oversight of the AER is undertaken through the scrutiny associated with the budget process and the requirement that an annual report on the AER's activities be presented to the Parliament. The AER falls under the Treasury portfolio and the responsible minister is currently the Minister for Small Business. The AER has been issued with a statement of expectations by the Australian Government and has responded with a statement of intent.<sup>40</sup>

7.36 The AER is a constituent part of the Australian Competition and Consumer Commission (ACCC); consequently, the AER's staff, resources and facilities are provided by the ACCC. The ACCC and the AER present a combined annual report, although the AER prepared an additional annual report covering just its operations for the first time following the 2013–14 financial year. The AER attends the Senate Economics Legislation Committee's estimates hearings along with the ACCC.

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38 Mr Sebastian Roberts, General Manager, Networks, AER, *Proof Committee Hansard*, 18 February 2015, p. 9.

39 Mr Paul Smith, AEMC, *Proof Committee Hansard*, 17 February 2015, p. 7.

40 The AER's statement of intent may be viewed here: [www.treasury.gov.au/~media/Treasury/Policy%20Topics/Public%20Policy%20and%20Government/Statements%20of%20Intent/Downloads/PDF/AER\\_Statement\\_of\\_Intent.ashx](http://www.treasury.gov.au/~media/Treasury/Policy%20Topics/Public%20Policy%20and%20Government/Statements%20of%20Intent/Downloads/PDF/AER_Statement_of_Intent.ashx).

7.37 In addition to the AER's accountability to the Commonwealth, the multi-jurisdictional COAG Energy Council has also outlined its expectations of the AER. In March 2014, the COAG Energy Council issued a statement of expectations about the AER's roles and responsibilities, relationship with government and relating to issues of transparency and accountability. In response, the AER has published a statement of intent.<sup>41</sup>

7.38 The Consumer Action Law Centre noted that moves to enhance the framework for assessing the performance of regulators were occurring in other sectors. The Centre noted that the Financial System Inquiry recently recommended that the financial regulators (such as the Australian Securities and Investments Commission and the Australian Prudential Regulation Authority) be subjected to a regular performance review.<sup>42</sup> Specifically, that inquiry recommended that a new Financial Regulator Assessment Board would review the performance of the financial sector regulators on an annual basis. The regulators' performance would be assessed against their statutory mandates and the priorities identified in their statements of intent.<sup>43</sup> Further, each of the regulators should undertake six-yearly capability reviews to 'ensure they have the required skills and culture to maintain effectiveness in an environment of rapid change'.<sup>44</sup>

7.39 The COAG Energy Council is considering the effectiveness of the current accountability and governance framework. A review of the governance arrangements commenced in February 2015 and is due to report in September 2015. The review has been tasked with:

- considering the performance of current governance arrangements for energy markets; and
- providing advice on potential areas of improvement to the institutions and their oversight by the COAG Energy Council'.<sup>45</sup>

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41 AER, *Statement of intent 2014–15*, [www.aer.gov.au/sites/default/files/AER%20Statement%20of%20Intent%20in%20response%20to%20the%20COAG%20Energy%20Council%27s%20Statement%20of%20Expectations\\_0.pdf](http://www.aer.gov.au/sites/default/files/AER%20Statement%20of%20Intent%20in%20response%20to%20the%20COAG%20Energy%20Council%27s%20Statement%20of%20Expectations_0.pdf) (accessed 31 March 2015).

42 Mr Gerard Brody, Consumer Action Law Centre, *Proof Committee Hansard*, 18 February 2015, p. 57.

43 The Australian Government issues independent statutory authorities with public statements of expectations, which the authority responds to via a statement of intent.

44 Financial System Inquiry, *Final report*, November 2014, pp. 236, 239.

45 Department of Industry, *Submission 34*, p. 17; COAG Energy Council, *Review of governance arrangements for Australian energy markets: Terms of reference*, <https://scer.govspace.gov.au/files/2014/12/Governance-Review-terms-of-reference-FINAL1.pdf> (accessed 16 March 2015).

## Proposed consolidation of rule-making and regulatory functions

7.40 One of the fundamental features of the current institutional framework is that the rule-making and regulatory functions are separated: one organisation (the AEMC) makes the rules while another (the AER) implements them. Several submitters expressed doubt about the merits of continuing this arrangement and suggested that the AEMC and AER should be amalgamated into one organisation. A starting point for this argument was that the approach in Australia's NEM was unique:

The EUAA believes that there is a fundamental problem with a governance structure that separates the design and implementation of the rules. As far as the EUAA is aware, no other country has applied this separation of powers.<sup>46</sup>

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Australia is, as far as I know, unique internationally in having separate institutions responsible for the design and implementation of regulation. This institutional bifurcation reflects part of the Commonwealth-state bargain that resulted in the transfer of the implementation of economic regulation from state commissions to the AER. The institutional separation of design and implementation and as part of this, the codification of regulation in the Rules, has constrained the AER as intended.<sup>47</sup>

### *Arguments for and against the proposal*

7.41 One rationale put forward for amalgamating the AEMC and the AER was based on perceived faults identified about the AEMC's approach and actions. The Consumer Action Law Centre argued that 'the AEMC were strong proponents of restricting the AER in its ability to regulate the network businesses through providing detailed prescription in the rules'. The Consumer Action Law Centre observed that 'it seems...that the public and political pressure to deliver consumer outcomes is placed on the AER as regulator, rather than the AEMC as rule-maker'. As a result, the Centre questioned whether a separate rule-maker was ultimately in the long-term interests of consumers; at the very least, the Centre argued that accountability is 'diluted between two different organisations'. The Centre considered that replacing the two separate institutions with one that both makes and administers the rules could potentially be an improvement as the new institution would be clearly accountable for regulatory outcomes.<sup>48</sup>

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46 EUAA, *Submission 17*, p. 19.

47 Mr Bruce Mountain, *Submission 19*, p. 23.

48 Consumer Action Law Centre, *Submission 20*, p. 7.

7.42 The Total Environment Centre commented that it 'was not always clear' why the AEMC and AER were separate. However, its criticism was directed at the approach both organisations have taken when exercising their functions. It argued that the AEMC 'operates under a very narrow interpretation of the long-term interest of consumers; everything is reduced to economic efficiency, when clearly consumers have non-economic interests as well'. In relation to the AER, the Total Environment Centre claimed that the regulator 'generally interprets its mandate very narrowly and prescriptively'.<sup>49</sup>

7.43 A representative of the New South Wales Irrigators' Council suggested that the AEMC was 'one step removed' from the determination process, which may have allowed it to maintain 'a very black-and-white understanding of economic regulation'.<sup>50</sup>

7.44 The committee also heard from submitters critical of how the separation of the AEMC and AER weakens the overall rule-making process and slows down efforts to improve the system. For example, Dr Gabrielle Kuiper from the Public Interest Advocacy Centre told the committee that her organisation was 'disappointed' that changes to demand management incentives had to wait until the AEMC makes a decision on a rule change. As a consequence, determinations currently being made by the AER, which will be in place for the next five years, will not address the changes sought by the Centre. Dr Kuiper explained:

...the AER has said in its draft determinations that it is proposing not to prepare a new demand management incentive scheme until such time as the AEMC has been through the rule change process on demand management. The AER's argument is that a revenue determination process is not a rule-setting process so we should wait for the AEMC. However, the question is: what recourse do consumers and consumer advocates have if the AEMC is not performing its functions in a timely manner?<sup>51</sup>

7.45 The amalgamation of the AEMC and the AER could support other changes to address what submitters considered were fundamental problems with the current framework, such as those regarding the regulation of state government-owned companies that were examined in Chapter 5. Mr Mountain argued that 'bifurcation between design and execution' of the rules does not make sense for private or government-owned distribution companies. However, he proposed that a combined AEMC and AER body would regulate only privatised networks; government-owned distributors could instead be regulated directly by their state government owners.

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49 Total Environment Centre, *Submission 43*, p. 3.

50 Ms Stefanie Schulte, Policy Manager, New South Wales Irrigators' Council, *Proof Committee Hansard*, 17 February 2015, p. 25.

51 Dr Gabrielle Kuiper, Public Interest Advocacy Centre, *Proof Committee Hansard*, 17 February 2015, p. 16.

7.46 Mr Mountain concluded that under this model there would be no need for 'elaborate and bureaucratic rules-based arrangements'. Mr Mountain added that his proposal reflected 'the standard model for ownership-differentiated regulation prevalent in the United States and much of Europe'.<sup>52</sup>

7.47 Arguments in favour of retaining the separation of the AEMC and the AER were presented mainly by the AEMC itself. The chief executive of the AEMC noted that rule-making and regulation are 'different functions' that, in his view, require 'different considerations, different analysis and different knowledge and skill'.<sup>53</sup> He added:

We feel that there can be some advantages, and there are some advantages, to a rule maker separate from the person administering the rules. We are not charged also with implementing the rules so we can have a look and say whether these are working effectively and take a view on how they are being applied in practice.<sup>54</sup>

7.48 The chief executive officer of the AER, Ms Michelle Groves, added that the AER participates 'very strongly in AEMC processes', ensuring that when the AEMC is considering a rule change, it has the input of the regulator' who applies these sorts of rules on a day-to-day basis'. Ms Groves noted that ultimately any change to the institutional framework would be a decision for COAG.<sup>55</sup>

### ***Consideration of the AER and the AEMC by other inquirers***

7.49 At this point, it is useful to note that other significant inquiries have considered the respective functions and responsibilities of the AER and the AEMC. When it explored the issue in 2013, the Productivity Commission (PC) provided the following summary of the arguments for and against amalgamating the AEMC and the AER:

In principle [combining the AER and the AEMC]...could promote closer interaction, communication and coordination between the 'regulators' and the 'rule makers', which could lead to better quality rules and decisions being made. Currently, lack of coordination and overlap of AEMC and AER activities has been seen as problematic...However, this option also raises potential conflicts of interest for the rule makers in the merged agency. For instance, they may be influenced to make rules that ease the task of the regulators in the agency, rather than being beneficial for the wider community.<sup>56</sup>

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52 Mr Bruce Mountain, *Submission 19*, pp. 23–24.

53 Mr Paul Smith, AEMC, *Proof Committee Hansard*, 17 February 2015, p. 11.

54 Mr Paul Smith, AEMC, *Proof Committee Hansard*, 17 February 2015, p. 10.

55 Ms Michelle Groves, AER, *Proof Committee Hansard*, 18 February 2015, p. 7.

56 Productivity Commission (PC), *Electricity networks regulatory frameworks*, vol. 2, April 2013, p. 780.

7.50 The PC concluded that changes to the memorandum of understanding in place between the ACCC, AEMC and the AER might better address concerns about coordination and overlap in activities.<sup>57</sup>

7.51 The PC also considered whether the AER should remain as part of the ACCC. While it decided that the AER should remain located within the ACCC,<sup>58</sup> this issue has arisen again as part of the independent competition policy review chaired by Professor Ian Harper. The Harper Review recommended that a single national access and pricing regulator should be established. It envisaged that such a body which would assume the AER's functions and the relevant functions of several other bodies, such as the ACCC's telecommunications access and pricing functions. In its final report, the Harper Review argued that providing the access and pricing regulator with responsibilities across multiple industries was a key feature of its proposal, as it 'would avoid the possibility of an industry-specific regulator being susceptible to "capture" by the regulated industry'.<sup>59</sup>

7.52 Given the Harper Review took place while this inquiry was underway (the Harper Review's draft report was issued in September 2014), it is not surprising that some submissions commented on the proposal for a single pricing and access regulator. In its submission to this inquiry, the Consumer Action Law Centre argued against the proposed change, as it considered 'there is much consumer benefit from economic regulation working in tandem with consumer and competition regulation'.<sup>60</sup> It added that competition, consumer protection and economic regulation in the energy sector are functions that are 'inextricably linked and are based on an economic understanding that fair and effective markets are in the long-term interests of consumers'.<sup>61</sup>

### **Committee view**

7.53 The timeliness of the process for making changes to the NER is of significant concern to the committee. The process appears drawn out at every step. An AEMC review may first need to provide evidence that a rule change is required. A rule change proposal then needs to be developed and lodged with the AEMC. The AEMC then needs to initiate the rule change process and conduct consultation before making a decision. Even rule change requests lodged by the COAG Energy Council do not appear to be dealt with expeditiously. Accordingly, the committee considers the rule change process should be more responsive.

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57 PC, *Electricity networks regulatory frameworks*, vol. 2, p. 780.

58 PC, *Electricity networks regulatory frameworks*, vol. 2, p. 784.

59 Competition Policy Review, *Final report*, March 2015, p. 80.

60 Consumer Action Law Centre, *Submission 20*, p. 6.

61 Consumer Action Law Centre, *Submission 20*, p. 7.

7.54 The committee also considers that the AEMC should have a role in enhancing policy coordination more generally.

### **Recommendation 8**

**7.55 The committee recommends that the Australian Energy Market Commission is provided with the ability to initiate a rule change process without being required to receive a rule change request from an external party.**

### **Recommendation 9**

**7.56 The committee recommends that the Australian Government pursue, through the COAG process, amendments to the National Electricity Law to require that the Australian Energy Market Commission must commence public consultation on a rule change request within a prescribed period of time if the rule change request has been lodged by the COAG Energy Council.**

### **Recommendation 10**

**7.57 The committee recommends that the Australian Government pursue, through the COAG process, an agreement that any Commonwealth, state and territory energy policy schemes and measures that may have implications for the National Electricity Market or network efficiency must be referred to the Australian Energy Market Commission for formal advice regarding the likely effects on the long-term interests of consumers.**

7.58 The committee carefully considered proposals to change the framework of rule-making and regulatory institutions involved in the National Electricity Market. Both the proposal to amalgamate the AEMC and the AER that many submitters advocated and the Harper Review's recommendation that a single national access and pricing regulator should be established are intriguing ideas. Given that the Australian Government is already considering the Harper Review's proposal, the committee draws the Government's attention to the issues outlined in this report about the performance of the AER and the implications of rule-making and regulatory functions being performed by different agencies. The committee also notes that should the Government decide to establish a single access and pricing regulator, it is essential that the agency's electricity regulation responsibilities are appropriately resourced and prioritised.

### **Recommendation 11**

**7.59 In light of the recommendation made by the Competition Policy Review (Harper Review) regarding a single national access and pricing regulator, the committee recommends that the Australian, state and territory governments consider:**

- **the potential efficiencies and other advantages of a single national access and pricing regulator; and**
- **whether such a proposal would be in the long-term interests of consumers of electricity, given the need for a regulator with sufficient expertise to**

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**challenge, when required, well-resourced electricity network service providers.**

7.60 Electricity regulation frameworks are marked by asymmetries: the regulated entity will always have more resources and better information compared to the regulator. However, as the AER's decisions have significant consequences for all households and businesses in Australia, the committee considers that the AER's standing should be improved by enhancing its expertise and capabilities. For example, the committee has recommended an increase in the number of AER board members and a review of the AER's resources.

7.61 Given the importance of the AER's decisions, the committee also considers there are enhancements that should be made regarding the oversight arrangements for the AER and how the AER receives feedback about its performance. The committee considers the accountability and performance of the AER could be increased by introducing public consultation on the statement of intent the AER prepares in response to the COAG Energy Council's statement of expectations. This consultation process would provide an opportunity for the AER to receive feedback from key stakeholders about its operations and priorities. In addition, the committee considers there are opportunities to enhance the parliamentary oversight of the AER. The committee will write to the Senate Economics Legislation Committee, which has responsibility for the ongoing oversight of the AER, to ask it to consider giving greater prominence to the AER as part of that committee's annual work program.

7.62 While the committee's recommendations in this area assume the continued existence of the AER, they are intended to apply generally to any agency that may assume the AER's functions. In particular, should the Australian Government decide to establish a single national access and pricing regulator as recommended by the Harper Review, the substance of the committee's recommendations should still inform the development of governance, funding and accountability arrangements for the new agency.

### **Recommendation 12**

**7.63 The committee recommends that the Australian Government commission an external review of the capability of the Australian Energy Regulator (AER). The review should consider:**

- **the adequacy of the AER's financial resources;**
- **the effects of the 2014–15 budget cuts; and**
- **whether the AER has the skills and powers needed to perform its functions effectively.**

**Recommendation 13**

**7.64** The committee recommends that the Australian Energy Regulator should facilitate public consultation on the statement of intent it develops in response to the COAG Energy Council's statement of expectations.

**Recommendation 14**

**7.65** The committee recommends that the board of the Australian Energy Regulator should be reformed so that:

- the number of board members is increased from three to five;
- the requirement for a Commonwealth member and two state and territory members is abolished with future appointments based solely on merit;
- all appointments to the board are to be made by the Commonwealth;
- at least one board member is required to have knowledge of, or experience in, consumer affairs in energy matters; and
- at least one board member has expertise in decentralized energy systems and demand management.