

May 2015

Australian energy markets: governance arrangements need a shake-up

Tony Wood, Grattan Institute submission to the COAG Energy Council's Issues Paper, "Review of Governance Arrangements for Australian Energy Markets"

Name: Tony Wood

Title: Program Director, Energy

Organisation: Grattan Institute

There are no restrictions on publication of this submissions or requirements for anonymity. The submission contains no personal information of third party individuals.

1 Summary points

- Current governance arrangements have underpinned the successes of energy market reforms over the last 20 years. But, they have also contributed to some of the more recent failures and a review is timely.
- The COAG Energy Council, as currently structured, is unlikely to deliver on its primary role of driving effective market reforms due to politicisation, conflicts of interests and the complexity of supporting organisations. Reform at this level is necessary.
- The definition and separation of the roles of the AEMC and AER has become a barrier to effective ongoing market reform, and some form of integration is likely to be an improvement.
- The processes by which specific changes to market rules are required to effect market reform is cumbersome from initiation to implementation. It needs to be streamlined.

2 Introduction

This submission from Tony Wood of the Grattan Institute responds to the Issues Paper released by the Panel appointed by the COAG Energy Council (CEC) to review the governance arrangements for Australian energy markets.

Grattan Institute is an independent think-tank focused on Australian domestic public policy. It aims to improve policy outcomes by engaging with both decision-makers and the community.

We understand that the Issues Paper is seeking input on general matters and answers to specific questions raised. This submission addresses both of these requests, although specific questions are addressed only where we have supportable views or answers.

The current governance arrangements have delivered many of the benefits expected when the major transformations of the 1990s were initiated following the Hilmer Review. Positive reforms have included privatisation, competition, integration of electricity and gas and creation of semi-national markets have been delivered.

The Review is timely. The recent Energy White Paper neatly brought together a summary of the current status of Australian energy markets and regulation in 2015 and some of the immediate policy challenges. There are major challenges in electricity and gas markets and in the integration, or absence thereof of energy and climate change policy. These issues have major implications for the ongoing delivery of reliable, affordable energy and a successful transition to a low-carbon energy market..

The focus of the White Paper on the primacy of markets is welcomed. However, there are issues of market failures and barriers that can only be addressed by governments. In addition, the last five years have highlighted several critical areas where weaknesses in the current governance of the markets has contributed to poor outcomes and where the governance arrangements could and should be improved to ensure that the energy markets are robust to their purpose in the future.

In reviewing the history of energy market reforms in Australia, we highlight:

- Failure to complete the privatisation of energy supply assets in several jurisdictions and to end all retail price regulation.
- Failure to make significant progress on more open and transparent gas wholesale and transport markets
- Positive outcomes from the reform of NEMMCO's structure and governance arrangements
- Poor electricity and gas network pricing outcomes that resulted in very high price increases over the last 5 to 9 years, partly attributable

to the complexity of the interaction between the AEMC and the AER.

- Failure of the energy markets to incorporate the environmental externality of climate change

The current governance arrangements have contributed to these issues. The creation of the AEMC and AER as rule maker and rule enforcer respectively is not without logic and merit. There are many bodies where such separation of roles is successful, including in major sports codes and in the UK. However, in a practical sense, the poor outcomes that have been delivered to the detriment of Australian energy consumers in regard to network pricing can be partly attributed to failure of either body to take responsibility for these outcomes or for the two collectively to do so.

Our criticisms of the governance arrangements contained in this submission are just that and are not, and should not be interpreted to be, criticisms of the management and staff of the institutions. In our interaction with these people we have found them to be consistently well-qualified and committed to their tasks, although we suspect that would also share our criticisms of the governance arrangements in many cases.

3 Specific questions

3.1 COAG Energy Council

3.1.1 Issues

While the CEC has played a generally successful role in effecting oversight of the three energy market institutions, there is evidence that the CEC has failed in several critical areas:

- It has failed to accommodate the diversity of interests of the participating jurisdictions, most notably in failing to deliver on the privatisation and retail price decisions.
- It has allowed its own agenda to become overwhelmed by excessive activities and process. It has failed to prioritise issues and focus on delivered outcomes in exercising its primary (and originally sole) focus of energy market reform.
- There is little evidence that the CEC effectively holds itself or the market institutions accountable for delivery of energy market

reforms.

- It has been captured by the multiple and complex minutiae on an agenda dominated by officials, all of whom are no doubt qualified and well-intended, but who together produce an agenda that has become unmanageable. The SCO has become excessively large, complex and cumbersome in supporting the CEC.
- The CEC works closely and directly with the SCO and the three institutions (AEMC, AER and AEMO), but apparently in an informal and unstructured way with market participants. The participation of market participants via its 40 per cent representation on the AEMO Board was a positive reform, but is insufficient and too remote from the CEC.
- The creation of the ECA is a positive step. It is far too soon to make any judgements as to whether this model will address the challenges in previous attempts to promote the long-term interests of consumers.

3.1.2 Responses to questions

Energy markets have evolved dramatically over the last decade with partial privatisation, retail competition, industry restructuring, technology developments and supply/demand changes. The evolution of a truly national market and the ongoing conflict of interest held by several jurisdictional governments suggests that the current CEC structure is not fit for its purpose. Jurisdictional responsibility for project approvals and similar localised issues is appropriate. In a national market, jurisdictional responsibility for reliability standards, retail price setting and related issues is not.

It is difficult to convene a body of ministers of the Commonwealth, state and territory bodies on a regular basis that can be expected to discharge the complexity of the current role. This is exacerbated by the conflicts of ownership and inconsistent jurisdictional agendas. This is further complicated when state or territory governments introduce policies that directly impact or interact with the national energy markets. Possible solutions could be to change either the structure or role of the CEC or to consider a fundamentally different body.

The pace of market developments and technology changes has meant that the CEC struggles to maintain relevancy, let alone pre-empt external factors. This is further exacerbated by the lack of a regular and focused interface with market participants.

The activities of the SCO seem to overwhelm the CEC without developing a prioritised agenda with a management process for the delivery of agreed actions.

It is unclear whether the policy oversight role of the CEC in regard to the three market institutions is effective. Given that each has its own

governance structure, the oversight role of the CEC should be focused on delivery of the reform agenda and less on the actions and processes.

Climate change, environmental and social policy are strongly intertwined with energy policy in major specific areas. Feed-in tariffs, energy efficiency targets and recent moves to renewable energy targets and plans are examples. Moratoria on CSG development and disconnected review of development regulations continue a history of disjointed and expensive environmental and health and safety policy and regulations. Development of an integrated climate and energy policy structure is critical and should be a high priority for the CEC.

3.1.3 Recommendations

- Restructure and redefine the role of the CEC.
- Consider the amalgamation of the AEMC and AER, establishing a single institution responsible for both setting the rules and enforcement of the regulations.
- Establish a new body to become the implementation institution for the CEC. The new body would hold the regulator accountable and in turn be accountable to the CEC. The CEC would retain an oversight and monitoring role.
- If state and territory governments retain legislative capacity in areas of policy that impacts on or interacts with the national markets, then a structured process needs to be developed to manage both the intended and unintended consequences. Harmonisation is an ideal, if idealistic objective.
- The scope of issues considered by the SCO, and even its ongoing existence, should be reduced to develop a manageable agenda for the CEC that prioritises national energy market reform.
- The Panel should undertake an international review of energy market governance. We do not have a comprehensive view of alternative models, but note the similarities and differences with the UK. We caution that the replication of specific elements of any model, commercial or regulatory, outside the environment for which it was created is fraught with risk and needs to be undertaken with full consideration.

3.2 AER

3.2.1 Issues

The recent history of price increases in the network businesses and subsequent rule changes indicate that the AER has failed in its primary role. Further evidence of this failure lies in the high returns that the network businesses have generated for their shareholders over recent years, despite the inherently low risk nature of the businesses. The question arises as to whether the fault lies primarily with the rules and/or resources given to the AER, or with the AER itself. Part of the problem lies with the five-year regulatory cycle and part with the AER's historical inclination to favour investment for reliability over price. There is some evidence that both of these have turned around in recent rule changes and AER determinations, but the final evidence remains outstanding.

The Panel should consider the clear conflict of interest where regulated businesses are owned by jurisdictions very negatively.

3.2.2 Recommendations

- The Panel should consider alternatives to the current model of regulator and rule maker.
- The AER should be held more directly accountable for quantified outcomes from its regulatory determinations
- If the CEC's oversight role in regard to the AER is maintained, then a formal process to eliminate the conflict of interest where regulated businesses are owned by jurisdictions should be developed, assuming some jurisdictions refuse to privatise,.
- There should be a structured move to harmonise national energy sector policy and regulation. This includes economic regulation, reliability, health and safety, consumer protection and climate change. Whilst the role of the AER could be expanded, it is likely that maintaining the AER as a dedicated financial regulator is preferable. Reliability standards should also sit with the AER.

3.3 AEMC

3.3.1 Issues

The AEMC's role seems to hover between that of the CEC and the AER, in a way that has become increasingly cumbersome. A reversion of the rule-making role to the jurisdictions would not be appropriate.

The timeliness of the AEMC's process for rule changes is a commonly identified concern which we share. The rate of change in financial markets, in physical market dynamics and technology mean that what once may have been acceptable, no longer is.

It seems like the AEMC has become focused on a level of theoretical academic nicety such that it becomes disconnected with the needs of the market and its participants. For example, when a recent rule change was released on the introduction of cost-reflective electricity network tariffs, specialists in the businesses expressed a concern that the determination was bordering on incomprehensibility.

The process by which rule changes are initiated and in which the AEMC cannot initiate a rule change may have formal merit but seems to be unnecessarily convoluted at a practical level.

3.3.2 Recommendations

- The role of the AEMC should be re-cast in a shake-up of the CEC, AER and AEMC. The focus needs to be on timely rule changes, market development and economic regulation to address the evidence of poor and untimely outcomes of recent years. The CEC could focus only on oversight of the institutions with a major focus on delivery of a prioritised set of outcomes and to act as a clearing house for energy policy development.
- The processes for initiating and undertaking a rule change should be reviewed and streamlined.

3.4 AEMO

3.4.1 Issues

AEMO has been plagued in recent years by the accuracy of the forecasts that were embodied in its gas and electricity statements of opportunities. The moves to publish the detailed assumptions in its projections and to deliver an annual forecasting report are positive.

The transmission planning role has been problematic for some years in that the process that begins with problem identification and ends with construction and commissioning when new investment is undertaken is quite disjointed and should be revisited.

The gas market remains poorly developed, and replication of the Wallumbilla trading hub should be a priority.

Some of the functional responsibility of AEMO in the gas market does seem to reflect a residue of previous state models, particularly VENCORP.

3.4.2 Recommendations

- Revisit the national transmission planning role of the AEMO with a view towards more efficient implementation.
- Rationalise the gas market role of AEMO to one of national consistency
- Further open the extent to which AEMO makes consumption and supply data openly available.

For any queries, please contact:

Tony Wood

Program Director, Energy

Grattan Institute