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Industry Levy
C/- MCE Market Reform
Department of Industry, Tourism and Resources
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By email: MCEMarketReform@industry.gov.au

esaa Submission on Application of the Industry Levy

Thank you for the opportunity to provide comment on the March 2004 Discussion Paper on applying the industry levy to fund the AER and AEMC.

After considering the Discussion Paper and the December 2003 Ministerial Communique, esaa's summarised position is:

- The decision to impose new taxes on the energy market participants to fund market development and regulatory activities is flawed because the beneficiaries of the compulsory market arrangements and the associated regulation are the consumers, not the individual energy supply businesses;
- The various options presented for characterising costs and allocating responsibility for collecting the tax are complex and inefficient;
- Should governments decline to accept that these activities are more appropriately taxpayer funded then in esaa's view a single taxation measure for each of the electricity and gas industries that is simple, transparent, administratively simple, competitively neutral and makes the consumer directly responsible for its total cost is required; and
- a mechanism that involves government and industry in establishing and reviewing the performance measures and associated annual budgets for the AEMC, the AER and the cost recovered energy market components of the ACCC is needed to ensure a culture of constant improvement in regulatory performance.

Our detailed submission is attached for your consideration. I would be pleased to elaborate or clarify any points with you.

Yours sincerely

A handwritten signature in black ink, appearing to read "Brad Page", written in a cursive style.

Brad Page
Chief Executive Officer

A Beneficiary Pays Approach

In announcing the decision to fund market development and regulatory agency costs from taxes and charges to be imposed on market participants, Ministers provided no indication of the basis on which this decision was taken. In the absence of this, esaa presumes that Ministers were of the view that the beneficiaries of the activities are the market participants and that they should therefore meet the costs of the activities. The recently released Discussion Paper does not contradict this presumption, and in many ways confirms it. It advocates that taxes and charges be applied on the basis of those responsible for their being incurred as this will influence their behaviours in the areas of appealing decisions, bringing forward code change proposals and avoiding regulatory attention. This is stated to be economically efficient.

esaa believes that such a philosophy is flawed and that the imposition of taxes and charges on the energy market participants to fund rule making and regulation is inappropriate.

The electricity and gas market arrangements in Australia are a construct of the participating governments. In electricity, the market arrangements are compulsorily applied to the electricity supply industry. In natural gas, the application of third party access laws are also compulsory. Those pipelines not covered by the law generally achieve that status by application to the Minister whose decisions are appealable to the Australian Competition Tribunal. Energy market participants do not cause market development and regulatory costs to be incurred. The mandatory application of government directed market arrangements causes the costs. Ordinarily, government intervention to cause markets to develop and operate is unnecessary in a market based economy such as Australia's. However, governments in Australia have concluded that the introduction of compulsory market arrangements benefit the broader economy. This is recognised by governments where they state that:

*"The primary objective is to promote the long term interests of consumers with regard to the price, quality and reliability of electricity and gas services."*¹

Clearly, the market arrangements are for the benefit of consumers and do not have a focus on benefiting market participants. In other words, the benefits achieved from the application of compulsory market arrangements to the energy sector is a public good, given that electricity and gas consumers have a near perfect correlation with the broader community. Energy market participants are generally highly constrained in their ability to capture private benefits as a result of the market arrangements and the associated regulatory activities, including retail price controls in many instances.

Economic theory supports that the most efficient and appropriate funding for public good activities is through government appropriation. In the case of energy markets, this is the costs of creating, maintaining and regulating the mandatory market arrangements. While the case studies attached to the discussion paper indicate a variability in government regulatory funding arrangements, the existing regulatory agencies at the Commonwealth level and in the large east coast States are all funded directly by government appropriations. In some cases, levies and fees are then charged to individual market participants, but these taxes fall a long way short of meeting the costs involved. The National Electricity Code Administrator is an exception to this, though it is not a government regulatory authority.

Given that governments overtly acknowledge that the beneficiary of these market arrangements is the consumer, it is appropriate that market development and

¹ "Streamlining of the Code Change Process" Ministerial Council on Energy Standing Committee of Officials, March 2004 p8

regulatory costs should be borne either directly by governments on behalf of the consumers, or that they are recovered via taxes imposed directly on the consumers of gas and electricity. To do otherwise is economically inefficient and a further deterrent to investment in the Australian energy sector.

Nonetheless, in making this submission, esaa recognises that governments face significant budget challenges and that wherever possible action will be contemplated to directly attribute and recover the costs of services provided to identifiable sectors. Should governments insist on applying new taxes to the energy sector to fund public good activities, then esaa proposes that this should only be done as a last resort and that the arrangements should:

1. be simple, transparent, and required to be explicitly sourced from consumers as the ultimate beneficiary;
2. result in lower cost and higher quality regulatory outcomes; and
3. recompense the energy market participants for all costs associated with collecting the tax.

Cost Classification and Disaggregation

The Discussion Paper indicates that the costs involved in market development and regulation can be disaggregated in several ways. It distinguishes costs based on drivers and their classification as fixed, variable, joint, common or sunk.

In esaa's view, the approach taken in the Discussion Paper to the classification of costs is an interesting exercise, but in practice would prove to be of little benefit and would result in on-going disputation among stakeholders and governments on the classification of costs, especially if this was the determinant of sector specific tax imposition. Little is likely to be achieved for very significant administrative effort in establishing and running a complex system.

It is important to note that in practice almost all of the market development and many of the regulatory activities are not easily attributed to single sectors. The vast majority of code changes to date in both gas and electricity have attracted direct advocacy and submission from all sectors. This is not surprising given the integrated nature of the supply chains and the impact on market outcomes that changes in any single sector can have.

However, the costs of rule making and regulation should be separately identified for the electricity and natural gas industries. The codes relating to each of the industries are significantly different in their scope and complexity. Accordingly, the cost to develop, maintain and apply regulation can reasonably be expected to be different under each Code. Cross subsidising rule making and regulation costs between electricity and gas would not be appropriate.

Points of Tax Imposition and Collection

The Discussion Paper canvasses that the recovery of costs could be handled in a variety of ways: by individual supply chain sectors meeting their assessed costs, by a single supply chain sector meeting all costs for the industry and via fees for specific services.

In deciding on the appropriate point of incidence for the collection of the tax, esaa is strongly of the view that this must be on the basis of economic efficiency, maintenance of competitive neutrality and ability to directly cause the consumer to pay the tax. Imposing the tax at multiple points in the supply chain will be

unnecessarily complex, administratively resource consumptive and difficult to ensure pass through to the consumer.

esaa therefore advocates that the final arrangements must ensure that one sector in each of the electricity and gas industries is chosen for the imposition of the tax and that the costs incurred by the businesses in collecting and remitting the tax are fully reimbursed. The chosen sector must be able to clearly understand the basis on which the tax is to be imposed and collected and must be explicitly authorised to pass the cost through the supply chain to the consumer. We also contend that the tax should be on a specific rate basis, such as cents per KWh and cents per GJ consumed to ensure horizontal equity between consumers.

Fees for Service Activities

esaa doubts that there are particular activities likely to be undertaken by AEMC and the AER that are in the nature of services for which specific amounts could be directly charged to the affected sector, parts of it or an individual company. Examples of the regulatory reset process for a network business, changing the regulatory price control arrangements for gas pipelines and the costs of an individual appeal against a decision are cited in the Discussion Paper.

As a matter of principle, fees for services are generally appropriate where there is a clearly identified service to be performed in accordance with well established rules and the service receiver is also the beneficiary of the outcome. An example of where fees for service for mandatory regulatory services are appropriately imposed is for export inspection activities for agricultural products. The Australian Quarantine and Inspection Service (AQIS) provides inspection and certification services to exporters where their products require independent government health and safety certification by the importing country. These services are provided and charged to the exporter according to the specific requirements of the importing country. There are appropriately constituted consultative arrangements for the exporters to interface with AQIS on inspection requirements and the resulting costs that are to be recovered. Importantly, the fees for service are levied on the beneficiary of the service as it enables them to trade with their export destination.

Conversely, in the energy market context and in the examples cited, there are few similarities. Regulatory processes in both electricity and gas are focused on consumer, not provider, benefit. The processes are managed and directed by the regulator, who is not accountable for the individual costs incurred in the particular matter, nor the time taken to bring the matter to conclusion. Experience with the current market regulatory arrangements is that regulators contribute far more to the cost and time taken to resolve matters than do the businesses subject to regulation. To burden individual businesses or sectors with further costs over which they have little control or influence is counter-productive and does not contribute to achieving lower cost and higher quality regulatory outcomes.

Improving Regulatory Performance

In considering the imposition of a new tax to fund regulatory and market development activities, a very significant aspect of the operation of the new structures is yet to be addressed – how to improve regulatory performance. The Discussion Paper at page 5 lists providing an incentive for the AEMC and the AER to be financially responsible and fulfil their legislative responsibilities in an independent manner as one of the objectives for the funding mechanism. esaa contends that this is a useful start, but needs to be broadened as it does not also seek continual improvement of regulatory decision making processes and therefore performance. esaa also notes

that the discussion paper is silent on how to achieve the relatively limited objective provided.

The Ministerial Council on Energy will each year approve the budgets of the AER, AEMC and presumably the cost recoverable energy market elements of the ACCC. These budgets will then be funded through new tax rates established each budget year. esaa is particularly concerned that this process does not include any role for the energy industry participants to review and comment on the proposed budgets. There is also no detail provided on how Ministers will establish, preferably in conjunction with industry, the performance standards required of the agencies, how the agencies' performance against these standards are reported and assessed, and what the consequences may be for failure to achieve their performance standards.

By removing the direct cost burden for these activities from Government, the incentive to apply strict budget review and performance measures is weakened, leaving industry potentially exposed to declining regulatory performance and the consumer to increasing costs for no benefit.

esaa therefore advocates the establishment of a joint government / industry mechanism that promotes a culture of continuous regulatory performance improvement and cost containment that meets the needs of both government and industry. Such a mechanism would enable Ministers to be directly informed of industry experiences with regulatory activities, establish performance standards for regulators that all parties could understand and assess performance against and give a sound basis to the establishment of annual budgets for the relevant bodies.