

26 September 2008

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**ENA Response to the Ministerial Council on Energy, AEMO Establishment Paper
*Legislative Framework: Statement of Proposed Approach***

The Energy Networks Association (ENA) welcomes this opportunity to respond to the Ministerial Council on Energy (MCE) paper on the *Australian Energy Market Operator (AEMO) Establishment – Legislative Framework: Statement of Proposed Approach*.

ENA is the peak national body for Australia's energy networks which provide the vital link between gas and electricity producers and consumers. ENA represents gas distribution and electricity network businesses on economic, technical and safety regulation and national energy policy issues.

Energy network businesses deliver electricity and gas to over 13 million customer connections across Australia through approximately 800,000 kilometres of electricity distribution lines. There are also 76,000 kilometres of gas distribution pipelines. These distribution networks are valued at more than \$40 billion and each year energy network businesses undertake investment of more than \$5 billion in distribution network operation, reinforcement, expansions and greenfields extensions. Electricity transmission network owners operate over 42,000 km of high voltage transmission lines, with a value of \$10 billion and undertake \$1.2 billion in investment each year.

Please contact Michael Kilgariff of ENA on (02) 6272 1511 or mkilgariff@ena.asn.au should you require clarification on any points in this submission.

Yours sincerely

A handwritten signature in blue ink, appearing to read 'Andrew Blyth', followed by a period.

Andrew Blyth
Chief Executive



ENA Submission – Response to AEMO

Establishment Paper *Legislative*

Framework: Statement of Proposed

Approach

26 September 2008

1. Overview

Key messages

- A stronger framework for ensuring the ongoing cost efficiency of the Australian Energy Market Operator is required
- Costly and intrusive regulatory information powers modelled on those provided to the Australian Energy Regulator are inappropriate for the objectives and role of a national energy market operator
- Industry broadly supports proposals for a carefully staged medium-term transition to national retail gas market arrangements

The Energy Networks Association (ENA) welcomes the opportunity to respond to the Australian Energy Market Operator (AEMO) Implementation Steering Committee (ISC) Paper Australian Energy Market Operator Establishment - Legislative Framework: Statement of Proposed Approach (Statement of Approach) released in August 2008.

Energy network businesses consider many elements of the proposed Statement of Approach are appropriate. Other elements of the proposed approach, however, require further consideration if the goal of a cost-efficient, responsive AEMO delegated with an appropriate set of legislative powers is to be achieved.

ISC has proposed an accountability framework for AEMO that is based on the existing national framework for compliance and dispute resolution established under the National Electricity and Gas Laws. In principle, this appears to be an appropriate starting point. Energy network businesses note, however, that a number of significant extensions to the current compliance framework are under consideration by the Standing Committee of Officials in the context of the National Energy Customer Framework. It is not clear these extensions are practical or justifiable either in the context of the customer energy framework or AEMO's operation.

Ensuring adequate processes and incentives for cost efficiency in AEMO is a critical issue for the entire energy market. In this area, the Statement of Approach does not appear to move beyond quite limited arrangements which fail to guarantee strong ongoing pressures for cost minimisation. Energy network businesses have a number of proposed enhancements to these arrangements which are designed to address risks recognised in economic literature to the responsiveness and efficiency of non-profit firms. These enhancements include guaranteeing fee or revenue ceilings for an initial period of operation, and legislatively mandated competitive tendering obligations.

Energy network businesses are strongly opposed to the proposal in the Statement of Approach to model AEMO's information gathering powers on costly and exceptionally intrusive regulatory information gathering powers designed to apply in the context of access pricing determinations by the AER. This approach is disproportionate to the objectives and functions of the AEMO, and does not appear to have been informed by an assessment of the likely costs and benefits, or the unsatisfactory practical experience to date with these regulatory instruments.

Background

The ENA is the peak national body for Australia's energy networks which provide the vital link between gas and electricity producers and consumers. ENA represents gas distribution and electricity network businesses on economic, technical and safety regulation and national energy policy issues.

Energy network businesses deliver electricity and gas to over 13 million customer connections across Australia through approximately 800,000 kilometres of electricity distribution lines. There are also 76,000 kilometres of gas distribution pipelines. These distribution networks are valued at more than \$40 billion and each year energy network businesses undertake investment of more than \$5 billion in distribution network operation, reinforcement, expansions and greenfields extensions. Electricity transmission network owners operate over 42,000 km of high voltage transmission lines, with a value of \$10 billion and undertake \$1.2 billion in investment each year.

Comments on Key Areas of Proposed Approach

Accountability framework

The accountability framework proposed for AEMO is based on the current national framework for compliance and dispute resolution established under the National Electricity and Gas Laws. In principle, the existing compliance and enforcement framework appears to be an appropriate starting point.

The network sector cannot endorse, however, the application of changes to this framework being developed through the National Energy Customer Framework process being applied to AEMO. Industry has strongly argued that aspects of changes to the current compliance and enforcement regime are disproportionate and flawed, and that a case has not been made for a number of radical extensions to the existing compliance and enforcement arrangements. Examples of areas where significant concerns have been raised are the use of lower courts, and scope for private enforcement actions.

The status and scope of these changes is yet to be finalised or announced, and their appropriateness for application to AEMO's functions hence cannot be assessed.

Cost recovery

Energy network businesses are concerned to ensure a framework that not only provides for cost recovery, but which promotes ongoing cost efficiency in AEMO's operations and the realisation of the material efficiency benefits that should arise from movement to a single energy market operator.

The Statement of Approach does not appear to contain sufficient mechanisms to ensure these aims are achieved. It proposes that AEMO will not be required to undertake broad consultation on its budget.¹ Members are proposed to have the right to receive a copy of the proposed budget and to have an opportunity to comment on the proposed budget²

This 'minimalist' framework for budget transparency and accountability is inconsistent with the significant financial obligations the body will place on a significant number of AEMO's owners, and needs to be expanded and more fully specified.

1 MCE AEMO Implementation Steering Committee Australian Energy Market Establishment – Legislative Framework: Statement of Proposed Approach, August 2008, p.14

2 MCE AEMO Implementation Steering Committee (August 2008), p.14

Ensuring efficiency in non-profit firms

AEMO will operate in a number of its functions in a position akin to a 'natural monopoly' firm. This status makes adequate incentives for cost control important. To the extent that AEMO will be a 'not for profit' entity bound by cost-recovery principles, this may lessen concerns over any capacity to exert simple market or pricing power in relation to fees for services AEMO provides.

The not-for-profit status of AEMO will, however, not mitigate any poor incentives for cost control created by any deficient legislative regime. Rather, empirical economic evidence suggests that governments and the community should be especially cognisant of the potential for poor outcomes unless specific measures are adopted. It is recognised, for example that non-profit firms face disadvantages in the ability of their stakeholders to exercise control over management.³ Economic commentators have pointed to a number of other behaviours removed from profit-seeking that may impact on the efficiency of the firm:

For example, management may want to run a large organisation, or support certain causes that contributors do not favour as much as other causes; management can pursue its own goals by taking advantage of customers' relative ignorance. Non-profit organisations are required by law not to pursue profits, but the law does not stipulate specifically what they must pursue.⁴

In these circumstances a key for stakeholder trust in the non-profit body is mechanisms to ensure their objectives are pursued by the body. Economic commentators on the behaviour of non-profit firms observe that:

This will generally happen when consumers have the ability to set the objectives for the non-profit organisation in which they have an interest, and have the ability to oversee it to ensure that it operates efficiently.⁵ (emphasis added)

It is also recognised that the overall performance of non-profit firms can be difficult to measure, reducing the capacity for ensuring efficient operation.⁶ Non-profit firms can be prone to "lock up" capital to a greater extent than is efficient, especially given their prudential obligations matched with a lack of capacity to easily raise additional capital.⁷ Finally, managers of non-profit firms in some cases appear free to adopt a level of risk-aversion which is at odds with efficient commercial practice.⁸

3 Ben-Ner, A "The shifting boundaries of the mixed economy and the future of the nonprofit sector" in *Annals of Public and Cooperative Economics*, 73:2, 2002, p.8

4 Ben-Ner (2002), p.15

5 Ben-Ner (2002), p.15

6 Hansmann, H. *The Ownership of Enterprise*, Harvard University Press, Massachusetts, 1996, p.239

7 Hansmann (1996), p.241

8 Hansmann (1996), 242

Each of these considerations suggest that greater emphasis should be placed on ensuring strict oversight of costs and operating efficiency by the industry members liable for AEMO's operating budget.

Yet guidance in the Statement of Approach on the process of consultation with AEMO members on the budget is less than clear.⁹ For example, it is unclear what type of opportunity to influence the AEMO budget formation or finalisation process is envisaged, and there are insufficient details around the obligation to provide an opportunity for member views to be taken into account for industry to be confident that it will be able to ensure ongoing pressure for organisational efficiency.

It is also unclear what meaningful obligations the statement that existing market operator revenues and fees will be the "benchmark" for the future AEMO imposes.¹⁰

Improved cost efficiency framework required

Energy network businesses consider a stronger legislative and corporate framework is needed to address the issues raised above.

Given the policy decision by MCE that industry will fund the entirety of AEMO's costs, whilst owning a minority of the formal voting rights within the body, industry considers MCE should place significant weight on the views of industry participants on budget and cost accountability issues.

Elements of a stronger framework for cost efficiency should include:

- An initial three year fee or revenue cap (CPI-x) commitment – this would align AEMO efficiency incentives with those of price or revenue regulated entities operating in the energy market, and could operate in line with conceptually similar "efficiency dividend" arrangements in place across Commonwealth, State and Territory public organisations¹¹
- A legislative obligation to competitively tender – this would be a requirement to competitively tender for all major projects undertaken by AEMO over a threshold of \$5.0-10.0 million, to reinforce cost disciplines and reduce concerns relating to poor structural incentives for overall and project cost control
- Enhanced requirements on budget preparation – a more fully specified series of consultation requirements between AEMO and members at both the budget preparation and approval stages

⁹ MCE AEMO Implementation Steering Committee (August 2008), p.14

¹⁰ MCE AEMO Implementation Steering Committee (August 2008), p.14

¹¹ This high level commitment should be incorporated at the level of either the law and rules, but note this proposal does not envisage revenue or pricing oversight of AEMO by the AER

Energy network businesses have two further areas of concern with cost recovery arrangements.

First, it is proposed to provide the AEMO with a power to initiate market development related projects, maintaining a previous capacity for NEMMCO to undertake such projects.¹² Industry supports other elements of the rule that provides for recovery of cost associated with changed functions or powers. The scope of potential 'market development projects' appear to be wide, however. In addition, the continued availability of this self-initiated funding route appears to be inconsistent with the agreed role and funding of the Australian Energy Market Commission as the national market development body.¹³

Second, there is a lack of clarity over the proposal that AEMO should have the capacity to "anticipate" budget requirements for functions associated with energy market reform.¹⁴ The circumstances in which it is envisaged this power would be used, and how it would operate, are not defined in the Statement of Approach. It is important that any such mechanism does not undermine the stronger budget accountability measures that should apply to AEMO which are detailed above.

Information gathering powers

Applying an inappropriate model for information powers

The Statement of Approach proposes the creation of new market wide information collection devices modelled on Regulatory Information Notices and Orders current applied by the AER to regulated network service providers.¹⁵

This would be an unwarranted step and contrary to the recognised special circumstances that were the MCE's stated rationale for creation these powers – that is, the need for the AER to seek detailed cost and other business-specific information for their particular access pricing determination functions in the specific context of ensuing efficient access prices.

Using the same intrusive and detailed information gathering mechanisms for distinct system operation or national transmission planning functions would be disproportionate to the relevant objectives and risks. The approach fails to account for the different roles of the Australian Energy Regulator and AEMO, which is not an economic regulatory or enforcement body.

In addition, industry considers the use of these instruments in the regulatory access pricing context has been costly and inefficient and does not provide a sound default model for how market-wide information gathering should operate. Energy network businesses consider that the ISC should examine in detail the operation of Regulatory Information Notices and Orders applying to network service providers and reconsider whether these are appropriate powers to introduce for the functions of AEMO.

¹² See National Electricity Rules Clause 2.11.1(ba)

¹³ See MCE Report to Council of Australian Governments, 11 December 2003, p.5

¹⁴ MCE AEMO Implementation Steering Committee (August 2008), p.14

¹⁵ MCE AEMO Implementation Steering Committee (August 2008), p.21

Applying Regulatory Information Instruments under the National Electricity Law has created quite onerous information compliance requirements that were not previously required for business planning processes or normal operations. The experience to date has not been favourable. Information requirements are extensive and substantial consultation has been required to address practical issues in responding to information requests in the format the AER has required.

Rather than the use of an inappropriate model for market wide information powers required by AEMO, energy networks consider a better approach would be specification by ISC of the particular types of information likely to be necessary for the conduct of AEMO's functions. This could allow legislation and rules to include tailored, less intrusive, and more specifically limited powers linked directly to AEMO's functions.

Providing for extension of information powers by rules and confidentiality

The ISC proposes that the legislative framework should provide for the extension of the range of parties subject to legislatively granted information powers by rule-making.¹⁶ Energy network businesses are opposed to this proposal, as it is inconsistent with the MCE's established market governance arrangements, which provide that significant obligations on parties should be placed directly in the Laws.

Providing for the rules to extend powers expressly granted by the Parliament would reduce transparency of the policy framework and effectively blur the distinction between the Ministerial Council on Energy and Ministers as high level policy makers, and the AEMC as rule maker. A legitimate role for rules to play in this scheme is to elaborate upon and provide mechanisms for the definition of information sought, not substantively extend legislative obligations onto additional parties.

Confidentiality and information sharing powers between AEMO and other bodies in its national transmission planner role needs further consideration given the commercially sensitive nature of information that could be accessed using Market Information Orders or Notices. In this context, energy network businesses consider the principle that information collected by the AEMO should only be able to be used for the purpose for which it was collected.

Gas retail market rules and functions

Energy network businesses are generally supportive of the approach to gas retail market functions and rules set out in the Statement of Approach.

In particular, the introduction of the procedures mechanism into the national framework is supported, as well as the development of a set of principles to achieve an effective future split of rules and procedures.

¹⁶ MCE AEMO Implementation Steering Committee (August 2008), p.22

The decision to move existing jurisdictional rules into the national framework with minimum required changes for AEMO to administer is a sound and achievable first step. However, the prospect of AEMO being required to follow multiple jurisdictionally diverse rule change procedures appears to be complex, resource intensive and not consistent with movement to a national framework. Although the benefits and strengths of existing rule change processes are recognised, the medium-term goal (e.g. within 3 years) should be the development of a single consistent national market rule making process.

In the interim, an option that should be consider is the formation of a single market rule change process which draws directly on the recommendation of parties currently forming the relevant jurisdictional market rule change committee. This would ensure that market rule changes in any particular jurisdiction drew on those with direct expertise and commercial exposure to the issues at hand.

A further design consideration in developing national market rules is that they should not apply to the extent they override terms and conditions of Access Arrangements, or jurisdictional safety requirements.