

7 April 2004



Industry Levy  
C/- MCE Market Reform  
Department of Industry, Tourism and Resources  
GPO Box 9839  
CANBERRA ACT 2601

By e-mail to [MCEMarketReform@industry.gov.au](mailto:MCEMarketReform@industry.gov.au)

Our Ref:

Dear Sir or Madam,

### **COMMENTS UPON MCE DISCUSSION PAPER "APPLICATION OF THE INDUSTRY LEVY TO FUND THE AER AND AEMC"**

Ergon Energy Pty Ltd ("Ergon Energy") welcomes the opportunity to comment upon the "Application of the Industry Levy to Fund the AER and AEMC" discussion paper ("Discussion Paper") recently released by the Ministerial Council on Energy's Standing Committee of Officials ("SCO").

#### **1. Summary of Ergon Energy's Views on the Industry Levy**

Ergon Energy considers the following to be fundamental to an efficient industry levy regime:

- A user pays approach, allocating fees to classes of industry participants based on a detailed cost accounting methodology;
- Ringfencing of costs for the electricity and gas industries;
- Transparency and accountability in the budgeting process;
- Sufficient lead times in any changes in the allocation methodology in the initial transition period and on an ongoing basis.

The Discussion Paper only considers the issues surrounding the industry levy at a high level. Ergon Energy is of the firm view that further consultation with industry must be undertaken once a more detailed industry levy framework has been developed. Ergon Energy is concerned to ensure that this process develops a robust levy arrangement that will not be subject to dispute.

This submission firstly outlines Ergon Energy's views of how a fair and efficient industry levy can be implemented to fund the Australian Energy Regulator ("AER") and the Australian Energy Markets Commission ("AEMC"). Secondly this submission responds to specific issues raised in the Discussion Paper.

#### **2. Benchmarking Efficient Costs**

Whilst we acknowledge that the focus of the Discussion Paper is on the allocation of costs only, we note that it fails to cover the important aspects of the benchmarking of efficient costs and the setting and approval of the AER and AEMC budgets. It is important that the AER and the AEMC are efficient and deliver services at a level of costs which is in line with best practice regulation. Ergon Energy's expectation is that an efficient outcome of these changes would be that the budget for the AER would be substantially less than the sum of the costs of the state based regulators currently undertaking the work that is to be subsumed by the AER (thus ensuring saving are delivered to industry).

### **3. Proposal for Industry Levy Regime for AEMC and AER and Interim Arrangements**

In the long term Ergon Energy supports an industry levy that allocates the reasonable costs incurred by the AER and the AEMC based on the direct costs incurred by them resulting from participant involvement in the NEM. However on an interim basis, until such time as the AER and AEMC are fully established and all gas and electricity functions are subsumed into the AER, we propose that costs are levied through a transitional regime with levy's to electricity participants capped at current levels with the MCE funding all costs of the new regulatory structure above the cap.

#### **3.1 Detailed Methodology in Addition to Higher Level Principles**

The major failing of the existing industry levy provisions under the National Electricity Code ("Code") is the Code's failure to provide a detailed methodology for the implementation and application of the levy.

It is paramount that the new industry levy regime for the AEMC and the AER is clear and specific with respect to the detailed outworking of how the regime is to be applied. The regime should not be limited to high level principles, rather it should deal with the detail of how the funding of the institutions is to be apportioned. The regime should require that the levying entity has little scope to apply its discretion and judgement, thereby promoting certainty and removing the potential of dispute with respect to the application of the levy.

Ergon Energy supports a user pays approach to the industry levy that is clear and simple in its application. As a high level principle user pays should be the *starting point* for a new industry levy regime, however this principle *must* be supported by a detailed framework for its implementation, so that there can be no confusion concerning how the levy is to be apportioned among industry participants. Unless the levy regime includes a robust cost allocation methodology from the outset, the new regime will be subject to the same uncertainty and challenge by industry participants as the levy provisions of the Code have been.

#### **3.2 User Pays versus Direct Allocation to End Users**

Economic efficiency arguments broadly support the assignment of participant fees in this type of situation directly to end-users. Due to (differing) regulatory constraints in each of the five jurisdictions of the National Electricity Market ("NEM"), there are however no clear mechanisms to allow such a pass through to be achieved. Absent a clear mechanism a user pays approach provides simplicity and transparency.

Market participants cannot directly and/or easily pass along costs associated with participant fees to end-users consumers. The ability of retailers to pass on participant fee costs depends on whether a customer is a contestable customer and also whether the price paid by a customer is determined by a regulated tariff.

##### **3.2.1 Non Contestable Customers**

If a customer is not contestable, the ability of the retailer to pass on the costs of participant fees (and changes to those fees) depends on the specific jurisdiction in which the retailer operates. The ability of retailers to pass on charges to customers that are protected by price regulation varies depending on the jurisdiction. In all jurisdictions the ability of retailers to pass on these charges is restricted at least in the short term, and would require regulatory review to effect any changes from the current amounts/system.

### 3.2.2 Contestable Customers

The ability of retailers to pass on participant fee charges (and changes to those fees) to contestable customers depends on the contract terms that have been entered into between the retailer and the customer. If the contract is based on a specific price or price profile and there is no ability to pass through any changes in participant fees, then the retailer would have to absorb the costs associated with any increase in participant fees. Even if the retailer has the ability legally or technically to propose passing through the charges, the retailer may nevertheless opt not to pass on those charges due to competitive market pressure (driven by retailers who cannot pass on the fee changes). If there is no specific provision in the contract for the recovery of changed fees, then recovery will be subject to contract renegotiation. Contracts are often annual or multi-year and do not allow for renegotiation of prices mid term. The first opportunity that a retailer would have in this case to recover fee increases would be at the expiration of the existing contract, and then only in relation to the next contract, not retrospectively.

Further contestable customers that do not enter into contract terms with a retailer of their choice are protected by price regulation for so long as they stay with their incumbent retailer. Additionally customers with small annual consumption are protected by standard (or default) tariffs.

For the above reasons, the assignment of participant fees directly to end users is not practicable in the NEM without significant reform and standardisation of jurisdictional price controls. Under the MCE proposals, jurisdiction price control is to remain with the jurisdictions for the foreseeable future and in this regard the ability to pass through costs to customers can be limited in the medium term. This further supports Ergon Energy's argument that a transitional arrangement is required in respect to levying fees on markets participants until such time as retailers can negotiate appropriate pass through mechanisms.

### 3.2.3 The Potential for Double Impost on Retailers

Retailers have entered into long term contracts with generators for the supply of electricity. Economic theory suggests that those contracts will be at prices which (for generators) reflect their longer term costs, which would include any changes to participant fee charges imposed on generators. Similarly economic theory suggests that those costs and the fees payable by the retailers will have been taken into account in the charges raised by the retailers with their customers.

Any change to the existing fee structure that reduces fees payable by the generators and increases the sums payable by retailers creates a distortion. The effect of fees on contracts between generators and retailers will linger, causing retailers with contracts to bear the costs of fees reflected indirectly through those contracts as well as to bear the direct consequence of the shift in fee responsibility from generators to retailers. This is so unless the retailer can pass on the increase, or unless the contracts with the generators are altered to reduce the price payable by the retailer. There is no reason to suppose that this will or can be done.

Likewise, even if retailers were able to pass on the increase, then some customers could in effect be paying "twice". Again this is so unless the contracts between the retailers and the generators are altered to reduce the price payable by the retailers, and further the contracts between the retailers and the customers is similarly altered.

Accordingly, a change in the determination of the fee structure which results in a reallocation of fees from generators to retailers has the potential to cause distortions in price, over the long term. A change in allocations to generators to reflect user pays principles will take a shorter time period to work their way through to customers, as they are incorporated into energy prices.

### **3.3 Implementing a User Pays Cost Recovery Methodology**

Under the new levy regime the AER and the AEMC should be required to implement activity based cost accounting processes from the outset, thereby ensuring all the costs of the institutions can be accurately apportioned between industry participants. This approach has three primary implications:

1. Apportionment of costs between the gas and electricity industries (ie costs associated with the electricity industry should be clearly ring-fenced from costs associated with the gas industry) to provide transparency and avoid cross-subsidisation;
2. Apportionment within the electricity and gas industries between segments of participants (ie between electricity generators/TNSPs/DNSPs/ retailers, and gas suppliers, transmission and distribution companies and retailers.)
3. The costs recoverable from market participants in jurisdiction where Full Retail Competition has not been introduced will necessarily be less, as less regulatory oversight will be required due to the fact that fewer regulatory instruments (or less invasive instruments) exist in those jurisdictions.

We consider it appropriate to allocate costs to classes of participants that interact with the AEMC and the AER in relevantly similar ways as a result of participants' operational factors that mean they have similar implications for the costs that will be incurred by the new statutory bodies. Multiple market participants will interact with the AER and the AEMC in relatively similar ways. Hence it is reasonable to group Market Participants in to classes if they share reasonably homogeneous characteristics and where their interaction with the AER and AEMC have the same or similar cost implications for these institutions. To extend this approach to the new regulatory regime would require that costs be allocated between generators, TNSP, DNSPs and retailers (where retailers have costs apportioned on a per customer basis.)

### **3.4 Allocation of Fixed Costs**

Any costs that cannot be allocated on the basis of the user pays cost allocation methodology, (eg fixed costs) should be allocated to industry participants in the same proportions as the variable costs as discussed above.

### **3.5 Approval and Publication of Annual Budgets**

The relevant institutions should be required to publish before the beginning of each financial year (say 3 months prior) a budget of their revenue requirements for the coming financial year. This is currently required under the Code (for NEMMCO and NECA) and provides some transparency in the budgeting process. It is important that industry has an opportunity to comment upon the quantum of the budget for these institutions and the apportionment of the budgeted costs between specific functions and industry sectors. Additionally budgets should be subject to approval by the MCE one month prior to the financial year to which they relate.

### **3.6 Changes in Allocation Methodology and Pass Through to Customers**

On a periodic basis the allocation methodology should be reviewed to ensure that it continues to remain relevant. We suggest that an appropriate review period would be not less than 5 years to ensure stability in the fee structure. This allows participants to order their commercial and regulatory affairs to minimise the adverse financial impacts of a particular fee determination. Unless there is sufficient lead time, unexpected changes in participant fee structures are likely to have an adverse

impact on profits for retailers and other market participants unless there is an ability within the jurisdictional regulatory framework to pass these charges through to customers.

### **3.7 Addition of Industry Participants and New Jurisdictions**

The industry levy regime will need to be able to take into account the addition of the gas industry and the introduction of new jurisdictions. A user pays approach provides the flexibility to incorporate the addition of new industry participants and jurisdictions efficiently by simply adding additional industry segments or participants to the cost accounting framework. The addition of new participants and jurisdictions also highlights the need to keep costs allocation for gas and electricity tightly ringfenced. The complexity of allocating establishment costs to industry sectors as they fall under the auspices of the AER and the AEMC's jurisdiction further strengthens Ergon Energy's proposal that the initial two years of costs (incorporating establishment costs) be capped, with the MCE absorbing costs above the cap.

## **4. Specific Issues Raised in the Discussion Paper**

### **4.1 Funding of Disputes**

We note with concern the proposal to levy costs such as those associated with dispute resolution on parties the subject of the dispute. A blanket approach to costs of this nature is inappropriate, particularly in circumstances where a market participant was successful in a dispute with the AER or the AEMC. Additionally a fee structure should not act as an impediment to a party initiating a legitimate dispute. Costs should be borne by each party severally, except where a different allocation is made by the Courts. Importantly the AER and the AEMC should not be able to recover their costs for disputes in which they have been unsuccessful, via any additional levy on market participants. This should ensure that commercial drivers are placed on the AER and the AEMC when considering whether or not they should pursue a dispute.

### **4.2 Alternative Revenue Streams**

We note the comment that alternative revenue streams of the AER and AEMC derived from activities such as publications need to be considered. Whilst we agree, industry should not be required to fund any loss making activities.

## **5. Conclusions**

Ergon Energy has proposed some key principles to guide the structure of the industry in the long term. Additionally Ergon Energy also considers that there is a need for a transitional period where costs are capped at current levels.

We would be pleased to discuss the comments contained in this submission if required. In this regard, please do not hesitate to contact me on 07 3228 8134 or Michael Callow on 07 3228 8259.

Yours sincerely

**Rebecca Pickering**  
**Manager Regulation**