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Industry Levy
C/- MCE Market Reform
Department of Industry, Tourism & Resources
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Dear Sir/Madam

Application of the Industry Levy to fund the AER and AEMC

NRG Flinders appreciates this opportunity to comment on the application of the proposed industry levy to fund the Australian Energy Regulator (AER) and Australian Energy Market Commission (AEMC).

Background & Context

At the outset, it is noted that the creation of the AEMC and AER effectively subsumes roles and functions previously performed by the National Electricity Code Administrator (NECA) and the Australian Competition and Consumer Commission (ACCC).

It is noted that the ACCC essentially operates as a taxpayer funded body, whilst NECA has derived its funding from participant fees levied entirely on the spot market purchases of market customers (ie retailers). The adjustment impacts and equity implications involved in shifting this cost burden under a revised funding framework must therefore be given serious consideration in the fee setting process.

Regulatory Role

The purpose to which funding is put is fundamental to an efficient cost recovery process. The nature of the functions to be performed by the new bodies is therefore a key consideration in designing the funding levy.

Unlike other institutions within the market framework with an operational focus (ie NEMMCO) the need for regulatory functions arises in most part due to the occurrence of instances of market failure (ie externalities, information asymmetries, imperfect competition, public goods, etc). At a basic level, regulatory measures are driven by a desire to correct or address these imperfections, with the form of response influenced also by the policy objectives of Governments.

In a broad sense, funding approaches can be divided into either a 'causer pays' or 'beneficiary pays' philosophy, or a mixture of both. The nature of the regulatory role has particular implications for these approaches.

An efficient causer pays framework relies on the ability to clearly define a group or class of stakeholder giving rise to the need for the particular cost incurred. Efficiency also demands that this group should be in a position to modify or change its behaviour in response to the allocated costs, so that only the efficient level of cost is ultimately incurred.

It is unclear that either of these conditions is met in the national energy market. The need for regulatory functions appears to arise due to features inherent in the market, rather than the actions or behaviour of a particular component of the value chain. It would also appear that market participants have little or no ability to influence the level of regulatory effort through their discretionary decisions or behaviour. This removes any benefit that should flow from the efficiency signal provided by causer pays fees, and simply distorts the cost structure of segments of the value chain. This would appear to severely limit the scope for any effective and meaningful causer pays approach. It is also noted that participants appear to have no control or influence over the annual budgets of the regulatory bodies.

An efficient beneficiary pays framework requires that the ultimate beneficiaries of the effort on which costs are expended can be clearly identified. Ideally, these beneficiaries should also be in a position to modify or alter their behaviour when exposed to these full costs so that only an efficient level of cost is incurred by the benefiting party, consistent with the underlying benefit obtained.

These conditions would appear to be more closely satisfied in the energy market. The ultimate beneficiaries of regulatory activities undertaken to correct or address perceived market imperfections are clearly end consumers. Similarly, in a theoretical sense it is end consumers that, when exposed to the full cost of the regulatory effort involved in the efficient and effective operation of the market in which they are engaged, are in a position to tailor their level of consumption to a level commensurate with the level of benefit they derive.

From this perspective, this would tend to suggest that the majority of the costs incurred by new regulatory bodies should efficiently be levied as closely as possible to the end of the value chain. It is also noted that regulatory effort has aspects of a public good – it is not possible to exclude particular consumers in the market from gaining the general benefits of efficient regulation. This

would suggest that costs should be allocated as broadly as possible so as to avoid distortions and most closely align the funding requirement to the ultimate beneficiaries.

Within the above framework, it may be possible in limited instances to assign costs related to specific activities to the relevant source. A possible example is the regulation of natural monopoly segments of the industry such as network services. The above approach would suggest that efficiency would be served by allocating these costs as closely as possible to the beneficiaries of this activity at the end of the value chain (ie network users). However, aside from exceptions such as these, in the absence of a detailed cost breakdown, it would appear that the vast bulk of the expected costs can not meaningfully be applied to particular segments and could more accurately be regarded as benefiting end users as a whole.

By way of precedent, arguably the most directly comparable regulatory body at the present point in time is NECA. In this regard it is noted that under the established fee setting process in the NEM, the entire cost base of NECA has been regarded as fixed and common, and not capable of attribution to individual or classes of Code Participants. The detailed fee setting process concluded that there was no basis on which to allocate its costs to key activities or outputs. Accordingly, NECA's funding requirements are derived from unit fees levied on the wholesale energy purchases of retailers.

Practical experience would also suggest that the role for discretionary service fees in the functions provided by regulatory bodies is extremely limited (eg fees for publications, consultation forums, applications, etc).

Other Factors

As reflected in the discussion paper, the design of a fee structure should also be guided by a number of further considerations:

- Simplicity, transparency and predictability – ultimately the fee structure should be easy to interpret and apply, should be commonly understood across the market, should be transparent, and should be possible to forecast from year to year with a high degree of accuracy. This suggests that preference should be given to simple, visible and stable fee structures.
- Competitive neutrality – it is clearly desirable to avoid any artificial distortions between energy types and fuel sources through the imposition of regulatory costs. In this regard it must be recognised that electricity generation is a competitor to gas production to some extent as a secondary energy source. This suggests that preference should be given to equal apportionment of costs across energy markets in a commodity neutral and fuel neutral manner, ideally through unitised costs.
- Cost minimisation – the collection of the required funding should be conducted in a manner that results in minimal collection costs and unintended distortions through the value chain, recognising that all costs of the energy sector are ultimately borne by the consumer. This

would suggest that fees should be levied as close to the end of the value chain as possible, in a manner straightforward to administer and enforce, such as unitised costs, utilising existing collection mechanisms wherever possible. This also implies that clear pass through mechanisms should be in place to enable participants in regulated market segments to efficiently recover these externally imposed costs.

- Equity – is best served by imposing the funding requirement as broadly as possible in a manner that avoids wealth transfers and the creation of ‘winners and losers’ across the market based on differential impacts and a differing ability to absorb cost increases. This suggests the need to recover costs as closely as possible to the end of the value chain, and underlines the importance of providing effective pass through mechanisms.

Other Issues

The scale and scope of the changes introduced in the new fee structure adopted to fund the new regulatory bodies will dictate the level of transition required to minimise adjustment impacts. This is consistent with the principles of cost minimisation, stability and certainty for industry participants. At a practical level, this also enables implementation of any new revenue collection systems, depending on the complexity of the framework chosen.

At a broader level, the funding examples appended to the discussion paper highlight the need for greater alignment and consistency of cost recovery mechanisms across equivalent regulatory bodies operating within the national energy market. This would assist in preventing distortions and arbitrary barriers to operation in neighbouring regions, and foster greater competition and efficiency across the market.

In terms of review mechanisms, it is difficult to perceive how a robust and commonly accepted fee structure could become out of date. By the same token, it is conceivable that significant changes may occur to the regulatory framework governing the market at some point in the future.

On this basis, in addition to a sunset date (eg 5 years) the MCE may wish to consider including certain trigger events that could give rise to a need for the fee structure to be reopened, such as a significant increase in the budgetary requirement of the regulatory bodies, a substantial change in the statutory functions of the regulatory bodies, the addition of further regulated industries or industry segments, and so forth.

Conclusions

The nature of the regulatory role suggests that the application of an industry levy to fund the new bodies should be aligned as closely as possible to the ultimate beneficiaries of the regulatory effort, in the interests of an efficient and robust cost recovery framework.

The supporting objectives of simplicity, transparency, predictability, neutrality, cost minimisation, and equity suggest a broadly based cost recovery platform based on unitised fees,

levied as closely as possible to the end of the value chain. Explicit pass through mechanisms are essential if this is to be achieved efficiently with minimal distortions, particularly for regulated industry segments such as network businesses. It is also noted that the current funding of NECA provides a clear precedent for cost recovery as the most directly comparable regulatory body.

Appropriate transitional arrangements should be adopted depending on the scale of the changes introduced, and consideration should be given to appropriate 'trigger events' for early review of the accepted fee framework. More broadly, opportunities should also be taken to achieve greater alignment of cost recovery methods across equivalent regulators operating in the national energy market over time.

Yours sincerely

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