

Review of Governance Arrangements for Australian Energy Markets

Final Report

October 2015

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October 2015

The Hon Josh Frydenberg MP, Australian Government Minister for Resources, Energy and Northern Australia

The Hon Anthony Roberts MP, New South Wales Minister for Industry, Resources and Energy

The Hon Lily D'Ambrosio MP, Victorian Minister for Energy and Resources

The Hon Mark Bailey MP, Queensland Minister for Energy and Water Supply

The Hon Dr Michael Nahan MLA, Western Australian Minister for Energy

The Hon Tom Koutsantonis MP, South Australian Minister for Mineral Resources and Energy

The Hon Matthew Groom MP, Tasmanian Minister for Energy

Mr Simon Corbell MLA, Australian Capital Territory Minister for Environment and Sustainable Development

The Hon David Tollner MLA, Northern Territory Minister for Mines and Energy

The Hon Simon Bridges, New Zealand Minister for Energy and Resources

We are pleased to present the Final Report of the Review of Governance Arrangements for Australian Energy Markets to the COAG Energy Council.

In accordance with the Terms of Reference, this report considers the performance of the current governance arrangements of the Australian energy markets and provides recommendations to the Energy Council on potential areas of improvement to the institutions (AEMC, AER and AEMO) and their oversight by the Energy Council.

We agree that the current arrangements are appropriate and, in general, have served Australia and the energy market participants, including consumers, well. Despite this, the Australian energy markets are facing significant challenges and the structures governing them must be flexible enough to adapt.

The report presents recommendations and suggestions to the Energy Council that, in the Panel's view, will enhance the processes of the institutions, the markets and of the Council itself, improving outcomes for all parties and allowing adaptation as required.

The Panel would like to thank all of the parties who participated in the Review's consultation and submission processes. These contributions

materially assisted the Panel in arriving at the Final Report's recommendations. In particular, the Panel wishes to acknowledge the thoughtful contributions of, and constructive engagement with, the AEMC, AER, AEMO and ECA during the Review. As always, the views and recommendations contained in the report are our own.

Throughout the course of the Review, the Panel was supported by a secretariat provided by the Department of Industry, Innovation and Science. The Panel wishes to acknowledge that support and to thank the members of the secretariat for their commitment and contributions.

Yours sincerely

A handwritten signature in black ink, appearing to read "Vertigan".

Dr Michael Vertigan AC (Chair)

A handwritten signature in blue ink, appearing to read "G. Yarrow".

Professor George Yarrow

A handwritten signature in blue ink, appearing to read "Euan Morton".

Mr Euan Morton

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Abbreviations and acronyms

ACCC	Australian Competition and Consumer Commission
AEMA	Australian Energy Market Agreement
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
APR	Access and Pricing Regulator
COAG	Council of Australian Governments
DNSP	Distribution Network Service Provider
ECA	Energy Consumers Australia
ENA	Energy Networks Association
ESAA	Energy Supply Association of Australia
NEM	National Electricity Market
OECD	Organisation for Economic Co-operation and Development
SCO	Senior Committee of Officials
TNSP	Transmission Network Service Provider

Executive Summary

General

The Panel concludes that the division of functions established by the current governance arrangements for Australian energy markets is fundamentally sound and that Australian energy market governance is amongst best practice internationally. Australia's energy market governance relies on clearly specified and stable policy and appropriate regulatory objectives, delegation of some roles to specialist institutions and importantly, institutional separation.

In this overall structure, scope for improvement exists to adapt to the challenges foreshadowed by two themes that consistently emerged during consultations:

- the pace of change in the energy sector is arguably unprecedented; and
- a 'strategic policy deficit' exists which has led to diminished clarity and focus in roles, fragmentation and a diminished sense of common purpose.

Institutional Roles

COAG Energy Council

The Panel supports the model of having the COAG Energy Council (the Council) as the premier policy leadership body with responsibility for the Australian energy market. To support the Council, the Senior Committee of Officials (SCO) should develop, prioritise and progress issues to support ongoing market reform. This includes developing a strategic work programme for the Council, managing working groups and developing strategic agenda's for Council members.

The Panel observed that the Council and SCO appear to lack a focus on strategic direction and are therefore not providing effective and active policy leadership to the energy sector. Whilst the inherent structure of the Council cannot be altered, the Council can improve the visibility, transparency and accountability of its processes and operations to more effectively progress strategic energy market reform. Clear and rigorous criteria should be established for assessing proposals by jurisdictions who seek derogations from otherwise nationally agreed arrangements.

The Panel recommends the Council develop a greater focus on determining strategic direction and specifying priorities for energy market reform and institute a structure of delegations to address other responsibilities. SCO should present recommendations on strategic direction, priorities and a work programme, with the AEMC taking on an expanded role in initiating the development of this advice. This should include a comprehensive review of the rules and consultation with other institutions and stakeholders.

AEMC

The AEMC's role as rule maker and advisor to the Council is increasingly important in the current dynamic environment, and the Panel recommends that this role be reinforced through greater reliance on this institution for the development of strategic advice.

The Panel recommends that the AEMC should increase the accountability and timeliness of its processes and develop a mechanism to terminate work streams that are no longer appropriate. It should also publish performance metrics to enable more effective oversight by the Council and implement and publish best practice guidelines on its processes.

AER

The Panel considers that the AER Board lacks autonomy over the organisation as it is not in full control of the resources required to achieve its tasks and lacks full independence in decision making; and that its culture is not fully conducive to its regulatory role, due to fact that the culture and skills required to regulate an industry differ from those of a competition law enforcement agency. On that basis, the Panel believes the AER's performance could be strengthened by establishing it as an independent organisation, separating it from the Australian Competition and Consumer Commission (ACCC).

Given the theme of dynamic market change, the Panel believes that periodic external performance reviews of the AER should be initiated: every three to five years by a COAG Energy Council appointed panel of experts.

AEMO

The Panel notes the important and valuable role AEMO plays as an independent system and market operator, and notes that it has performed this

task well in an increasingly challenging environment. The Panel considers that AEMO should not be specifically tasked with policy or market development roles, and that it should be more clearly focused on developing procedures for the purposes of market operation within the energy market. AEMO's contribution to more general market development should be through the AEMC's recommended strategic process.

In relation to roles other than market operations, the Panel's view is that AEMO should only undertake tasks outside of its core responsibilities where they do not conflict with those responsibilities and are undertaken on a contractual basis.

The Panel does not recommend any change to the AEMO's ownership model.

Institutional Funding

The Panel suggests that the funding mechanisms for the AER and the AEMC be reviewed to promote the 'national' character of each institution and to align with the principle that their funding be more closely reflective of resource and/or workload causation. In particular, it considers that the AEMC and the AER should both be funded by all jurisdictions who are members of the COAG Energy Council in a manner determined by the Council. AEMO funding should continue to be on a cost recovery basis.

Institutional Personnel

In order to increase each institution's capability for managing change in the energy markets, the Panel recommends changes to each institution's Board structure.

- AEMC and AER – expanded from three to up to five Commissioners/Board Members – at least three of whom should be fulltime.
- AEMO – individual directors (and the Chair) should be appointed for a term of four years with a maximum of two terms being the general case (and if the Chair is appointed after being a Director, the Chair may still serve two four-year terms – with a combined overall limit of 12 years).

The Panel notes the vital importance of finding appropriately qualified and independent appointees for these roles and that this requires particular effort, rigour and focus in a relatively small market like Australia's. It therefore

recommends that the COAG Energy Council Appointments Selection Panel should continue as part of the appointments process.

Future Energy Market Reviews

In respect of future reviews, the Panel recommends that the COAG Energy Council should assess whether there is a need for another energy governance review in 2023, once any changes implemented from this Review have had a chance to be bedded down.

Recommendations

The following provides a consolidated list of recommendations contained in this report.

Chapter 2: Setting strategy and determining priorities

- 2.1 That the Council, supported by SCO, change its meeting arrangements to enable a greater focus on energy matters of strategic importance.
- 2.2 That the focus of the work of the Council be the determination of strategic direction and the associated work programme to support this direction, with appropriate assignment of tasks to SCO and the AEMC.
- 2.3 That SCO be charged with the responsibility to present to the Council for consideration recommendations on strategic direction and a supporting work programme. The AEMC should be charged with the responsibility for aiding the development of this advice.
- 2.4 That the Council formally delegate the management of the work programme to SCO, including for the provision of reports on its progress.
- 2.5 That SCO be supported by an expanded secretariat located within the Australian Government Department of Industry, Innovation and Science and that the secretariat includes a small number of appropriately qualified officers seconded from Australian Government and state and territory jurisdictions.
- 2.6 That the Council, SCO and the individual institutions each develop arrangements to ensure effective consultation with relevant stakeholders, including other institutions.
- 2.7 That the transparency of the activities of the Council be greatly enhanced through its website, improved communication tools and other appropriate forums.
- 2.8 That the working groups under SCO be given a sunset date of 31 December 2016, and that all groups which have not been formally renewed or re-established by that date through a resolution of the Council, or by delegation, be abolished.
- 2.9 That jurisdictions be permitted to implement derogations from otherwise nationally agreed agreements only if the derogation is targeted and time-limited and contains a commitment for re-evaluation against a 'necessity principle'.

Chapter 3: Rules and rule making

- 3.1 The AEMC's mandate should be revised to include an obligation to prepare a major policy paper every three years containing advice on strategic direction, policy priorities and a work programme. Included in this advice would be a comprehensive review of the rules as a whole to help inform this process. This review should be directed at advising whether the rules are consistent with the strategic priorities, are fit for purpose and are not impeding beneficial and innovative developments in energy markets. In the intervening years, this document should be updated annually to address any major unanticipated changes in the market and advise on their implications for the strategic priorities and facilitate timely adjustments to the work programme. In its discharge of these tasks, the AEMC should demonstrate substantive engagement with all relevant stakeholders, including the AER, AEMO, other relevant institutions, industry participants and consumers.
- 3.2 A 'gateway test' process should be developed by the AEMC in conjunction with stakeholders for Council consideration.
- 3.3 A mechanism should be put in place for terminating rule change processes which are underway but no longer necessary. As with the gateway test, the AEMC should develop a proposal on a workable mechanism for the Council's consideration.
- 3.4 The AEMC should develop a staged review process proposal for broad and complex reviews, for consideration by the Council.
- 3.5 The AEMC should develop a single-step review process proposal for reviews dealing with specific or contained issues, for consideration by the Council.
- 3.6 The AEMC should implement an expedited rule change process for less complex rule changes, and changes should be made to the national energy laws to allow for an increased time-frame range of six to eight weeks for the process.
- 3.7 The AEMC should publish regularly updated timeliness performance metrics on its website, together with reasoned explanations for decisions involving significant time extensions.
- 3.8 The AEMC should implement and publish best practice guidelines for its regulatory processes.
- 3.9 The AEMC should put in place a formal mechanism to enable stakeholders to require the AEMC to sign off on the final guidelines or procedures if they have arisen from an AEMC process, to ensure that they meet the original intent.

- 3.10 The AEMC should implement a ‘clock-start’ provision for rule change processes to improve their accountability. The AEMC would retain the ability to extend time frames for most of the steps for rule change requests by announcing an extension before the expiry of the time frame.

Chapter 4: Regulatory decision-making

- 4.1 The AER should have full management and financial autonomy, which would be most effectively achieved by re-establishing it as a stand-alone regulatory body.
- 4.2 The scope of the AER’s responsibilities should remain as they are; that is, those currently conferred by the relevant statutes.
- 4.3 Decisions on these recommendations should be made as early as realistically feasible to allow the AER Board to plan and manage the re-configuration of the organisation over a suitable period.
- 4.4 The AER should be reviewed every three to five years by a panel of experts appointed by the COAG Energy Council. The experts should be collectively experienced in regulation and have in-depth knowledge of all sides of the relevant markets (consumers, industry and government).

Chapter 5: Market operation

- 5.1 That the role of AEMO as the market and systems operator be defined as:
- facilitating the operation of markets for energy; and
 - promoting the reliability and efficient operation of energy systems and markets.
- 5.2 That the Council issue an AEMO ‘statement of role’ which clearly specifies AEMO’s core role, and includes processes for accessing AEMO’s expertise in market and systems operations and the arrangements under which it is able to undertake other activities.
- 5.3 That all activities that AEMO undertakes outside its core role should be provided on a fee-for-service or other cost recovery basis.
- 5.4 That AEMO remain a not-for-profit company under the *Corporations Act 2001* and that the current mixed ownership model of 60 per cent government and 40 per cent industry is retained.

Chapter 6: Governance processes

Board or Commission composition and related issues

AEMC

- 6.1 That the membership of the AEMC be expanded from three to up to five members, with the chair and at least two other commissioners appointed on a full-time basis.
- 6.2 That one of the new full-time commissioners is assigned specific responsibility for stakeholder consultation relating to the recommended strategic development and review process.
- 6.3 That the agreement of at least two-thirds (rounded up) of participating jurisdictions is required in order for the COAG Energy Council to recommend a person for appointment to a position (including chair) on the AEMC; that the appointments be for five years; and that reappointments be permitted.
- 6.4 That appointments of commissioners to the AEMC continue to be made on the basis of a publicly available statement of the required skills and experience (as detailed in the body of this chapter); and that the Council has regard to succession planning in making appointments.

AER

- 6.5 That the membership of AER be expanded from three to up to five members, with the chair and at least two other members appointed on a full-time basis.
- 6.6 That all members of the AER, including the chair, be appointed (or recommended for appointment, if the AER stays in the ACCC) by the COAG Energy Council with the agreement of at least two-thirds (rounded up) of the COAG Energy Council's participating jurisdictions, and that regardless of AER structure, appointments should be for a period of five years, and that reappointments should be permitted.
- 6.7 That appointments to the AER continue to be on the basis of a publicly available statement of the required skills and experience (as detailed in the body of this chapter) and that in making appointments, the Council should have regard to succession planning.

AEMO

- 6.8 That individual directors be appointed for a term of four years, with a maximum of two terms being the general case. Provision should be made for a director's appointment to be extended past two terms in

specific circumstances. Where a director is appointed as chair, the provision for a maximum of two four-year terms should apply from the point of appointment as chair subject to a maximum overall limit of 12 years.

- 6.9 When making assessments of independence under clause 7.2 of the AEMO constitution, the Selection Panel and the company should make greater use of the permitted discretion to permit the appointment of candidates who have past relationships with the company or a member but where those relationships should not, based on a reasonable assessment of the circumstances, give rise to lack of independence.

Appointment processes

- 6.10 The Selection Panel should continue to be charged with responsibility to make recommendations to the Council for all appointments to institutions and other bodies of the Australian energy market. The composition of the Panel should remain as at present, with a requirement that one member of the Panel, preferably the chair, have acknowledged expertise in governance.
- 6.11 The membership, remit and process of the Selection Panel should be placed on the COAG Energy Council website, along with a schedule of upcoming appointments.
- 6.12 SCO and AEMO should develop an agreed set of operational practices for appointments to the AEMO Board which are designed to satisfy the responsibilities and accountabilities of both the Council and AEMO.

Funding of market institutions

- 6.13 Both the AEMC and AER should be funded by all jurisdictions that are members of the COAG Energy Council in a manner determined by the Council.
- 6.14 The level of stable and reliable funding for operations should be determined periodically at appropriate levels for the institutions to fulfil their responsibilities competently, professionally, efficiently and in a timely manner.
- 6.15 Provisions for adjustment, via institutional applications to the Council, should be included to account for major changes in costs caused by identified non-controllable factors.
- 6.16 When cost increases are clearly attributable, for example, to government policy decisions, the causality principle should be applied to increase the relevant jurisdictions' contribution to funding.

- 6.17 Funding arrangements should take into account the additional roles of the AEMC recommended by the Review.
- 6.18 The Council should give careful consideration to the appropriateness and methodologies for industry contributions. Decisions on such matters should lie with the Council; the AEMC and AER should not have the ability to increase industry contributions or apply levies.
- 6.19 The application of changed funding arrangements should not result in onerous additional overhead requirements for compliance with the resource accountability requirements of multiple jurisdictions.

Future governance reviews

- 6.20 That the Energy Council assesses the requirement for another independent governance review in 2023.

Background

On 11 December 2014, the Council of Australian Governments (COAG) Energy Council agreed to the terms of reference for a Review of Governance Arrangements for Australian Energy Markets (the Review). The Review was initiated in response to a COAG commitment to review the governance arrangements in the Australian energy market five years after the establishment of the Australian Energy Market Operator (AEMO) in 2009. The Review Panel (the Panel) comprises Dr Michael Vertigan AC as Chair, Professor George Yarrow and Mr Euan Morton.

The Energy Working Group is the advisory committee for the Review. The Panel consulted with the Energy Working Group from time to time to provide notice of its advice and to seek feedback.

In short, the Review considers whether:

- the institutional structures, scope and mandates of the three market bodies, AEMO, the Australian Energy Regulator (AER) and the Australian Energy Market Commission (AEMC), and their roles (including division of mandates) as broadly defined remain appropriate;
- the role, operation and responsibilities of the Energy Council, its senior officials and the three market bodies are clear and providing the best outcomes;
- there are opportunities to enhance the way these institutions interact with each other, the Energy Council, senior officials and stakeholders and, if so, how these opportunities could be best pursued;
- the extent of conferral of responsibilities and roles by the Energy Council or individual jurisdictions under these energy market governance arrangements is appropriate; and
- there are opportunities to expedite the Energy Council and the AEMC's energy market reform processes and, if so, how this should be done.

In keeping with the Review's terms of reference, the Panel released an Issues Paper for public comment on 10 April 2015. The Issues Paper was accompanied by substantial public consultation and attracted approximately 50 submissions, which have been published on the COAG Energy Council website.

In July 2015, the Panel released the Draft Report, outlining the Panel's early views on the governance of the Australian energy markets. The Draft Report noted that the draft recommendations presented were preliminary in nature and were subject to further consideration and discussion. The Draft Report was accompanied by substantial public consultation and attracted approximately 40 submissions, which have been published on the COAG Energy Council website.

Final Report

This Final Report reflects the views of the Panel, which have been formed through the Issues Paper and Draft Report as well as the associated consultation and submission processes undertaken throughout 2015.

The Review's full terms of reference are in Appendix A to the report.

Chapter 1: Governance of the NEM in the face of new challenges

Summary

This chapter sets out and summarises the Panel's views on some overarching themes that have emerged during the course of the Review. They are grounded in two observations that were widely shared among stakeholders: an unprecedented pace of change in the energy sector and a perceived weakness in the processes for determining strategic direction and priorities.

The Panel views the division of functions established by the current governance arrangements as appropriate for serving the purposes of the Australian Energy Market Agreement (AEMA) and the relevant national objectives. In particular, the various responsibilities allocated among the Energy Council, the AER, the AEMC and AEMO remain appropriate.

The Panel has nevertheless identified that a number of aspects of the structural arrangements and operations of the COAG Energy Council and the market institutions require attention. The Panel considers that the priority task is to address the way in which strategic objectives and priorities are set, but also considers it to be of high importance that the structural arrangements and institutions governing the national energy markets have the capacity to anticipate and respond to the rapid pace of change the sector is facing.

The Panel has therefore concluded that there is scope for greater clarity on the roles of the various institutions so as to help sharpen their focus on the execution of their respective roles and to strengthen their interactions. The relevant considerations are set out in later chapters of the Final Report.

Evidence and themes presented

In considering both the written and verbal submissions, two strong recurring themes emerged:

- The pace of change in the energy sector has accelerated to a level that is arguably unprecedented. The principal underlying drivers that were most frequently identified were continuing, innovative developments in digital

and renewable technologies and their applications, and in policy responses to the assessed risks of harmful climate change. Either driver would pose major challenges for the energy sector; when taken together, they have created a policy environment that is more onerous and complex than it has ever been.

- There has emerged a 'strategic policy deficit' which has led to tendencies towards diminished clarity and focus in institutional roles, particularly in determining priorities, fragmentation and a diminished sense of common purpose. These problems are most evident at the policy level, but they have also been identified across the market institutions.

While the first of these observations points to underlying drivers of change that are beyond consideration in this review, the Panel notes that governance arrangements can affect sectoral adaptations to changing circumstances. The second observation more directly raises specific matters of immediate concern to the Panel in relation to the current arrangements. Indeed, the Panel has concluded that the Review's principal challenge is developing recommendations that, if implemented, would help address this identified strategic deficit.

The two observations are also interlinked. The Panel is of the view that in the earlier stages of the energy market reform process, strategic priorities were clearer and widely shared, leading to significant improvements in outcomes, but that over time the perceived potential for performance gains has fallen and strategic policy focus has been lost, perhaps aided by the uncertainties that major changes in the economic environment almost necessarily bring with them.

In a slowly changing world, such a slackening in the impetus for reform would not be surprising: if the major gains have been achieved, it is more difficult to command enthusiasm and effort for further initiatives that would likely bring only smaller incremental gains. The main task in such circumstances would be as much to prevent earlier gains from being eroded as to seek out incremental improvements. In both cases, the anticipated benefits and costs would likely be significantly lower in magnitude than in earlier periods.

While this observation may apply to the energy industry for some part of its history, the Panel does not think that this is factually the case in the current environment nor does it think it will apply in the future, precisely because of the first of the two observations: the accelerated pace of change in the

economic context in which the energy sector and its institutions operate. This factor can be expected to increase the differences between the consequences of good policy and poor policy, and between good governance and poor governance. Earlier challenges, the magnitude of which should not be underestimated, may largely have been met, but major current and future challenges need to be addressed. In such circumstances, any sense of a priority/policy setting vacuum should properly be a matter of major concern.

In terms of overall performance, the widening of the potential gap in performance between good and poor policy suggests the existence of opportunities for both significant gains and significant losses relative to the status quo. The potential effects of the ever-widening application of digital technologies illustrate this issue.

On the positive side, these developments open up opportunities for consumer empowerment and choice, for greater consumer protection afforded by increased empowerment and choice, and, more generally, for a substantial increase in the influence of the demand side on market outcomes.

The Panel notes that the establishment of Energy Consumers Australia (ECA) is a positive development for the way in which consumers engage with the institutions and other participants in the national electricity market (NEM), including businesses that bring innovative thinking and innovative products and services to the market. Innovations that are possible because of technological advance are capable themselves of addressing several of the issues and problems that challenge today's policymakers, and it is therefore particularly important that they not be impeded, including by regulatory actions that, in effect rather than by intent, impede their advance. The extent of and speed at which the potential benefits can be achieved will depend, at least in part, on this recognition of the enhanced capacity of the NEM to better serve the long-term interests of consumers through technology, as well as on decisions that are made concerning energy sector policy and governance.

On the negative side, a number of the most radical effects of technological change may occur at the retail level where, to date, the shared common purposes of policies relating to the NEM appear to be more limited than they are at the levels of wholesale markets and networks. There could therefore be greater scope for fragmentation in the setting of policies and priorities, which will unravel the benefits already achieved from the common approach. For example, fragmentation will lead to geographic differentiation in retail market

rules, making entry into retail markets more difficult for new competitors, offering new products and services, and thereby potentially adversely affecting consumers.

The Panel notes that its views on the centrality of the process for setting strategic priorities, on its current weaknesses and on the need for reform reflect the great bulk of opinion put to the Panel during its consultations. In contrast, only a limited number of submissions expressed the view that there were major problems with the current division of functions among the major institutions, and these tended to focus on the suggestion that there would be merits in amalgamating the AEMC and the AER. For reasons given below, the Panel does not consider that such a change would be desirable and in this its views are again aligned with those of the majority of submitters.

Purposes of energy sector governance

Market governance is concerned with establishing and enforcing sets of rules that facilitate exchange transactions between buyers and sellers.

Normal market transactions naturally align decision-making responsibility and consequence, which promotes good decision-making (and, in turn, efficiency). The complexity of energy markets, particularly in electricity, means that sophisticated arrangements, involving several institutions, need to be made to facilitate trade in the market. A governance framework is required to support these arrangements. Just as in more conventional markets, a key aspect of the governance framework is that functions and decision-making responsibilities and accountabilities are structured and assigned, so as to promote a specified, overall objective.

The overall objective for the energy sector in Australia is that the long-term interests of consumers are efficiently served. In a dynamic environment this requires, among other things, that the constant search of market participants and potential participants to discover new and better ways of doing things is not materially impeded. It also calls for a degree of adaptability in the market rules as contexts change, although balance is required here insofar as rules also need to be reasonably stable and predictable over time if they are to serve their purposes—unpredictability in rules, sometimes called ‘regulatory uncertainty’, tends to degrade effectiveness.

The Panel considers that it is important to recognise the fundamental purposes of the existing governance structures because there are ever-

present pressures to seek to use institutional structures as instruments to achieve specific, short-term market outcomes, usually because particular market outcomes would better serve the interests of a particular group that are not aligned with the long-term interests of consumers. These pressures can emanate from many sources: politicians, sellers, buyers, bureaucrats, intellectuals and so on. Effective governance depends on establishing and maintaining institutional structures, including market rules, which are relatively robust in the face of these pressures.

Fragmentation risk

In any multi-jurisdictional system in which governments come together to operate a shared policy and an associated set of governance arrangements, there are issues surrounding the scope for individual jurisdictions to obtain derogations from these frameworks. This is particularly the case in energy, which is politically sensitive, and for which the national framework is a result of consensus negotiations across all jurisdictions. Where jurisdictions are unwilling to cede responsibilities to these frameworks, there is a temptation for them to pursue their own policies, which, in turn, undermine the collective effort. In the energy market, COAG sought to cement this commitment to collective action with a formal agreement between governments, the Australian Energy Market Agreement (AEMA).

The shared (by states and territories) elements contemplated by the AEMA are embodied in the relevant national objectives, in the established governance arrangements and, more widely, in Commonwealth competition law and policy. The general policy stance is towards promoting efficient production, distribution and supply of electricity and gas in the long-term interests of consumers, including by encouraging competition where it is considered feasible.

The principles and structure of energy sector governance

Australian energy market governance, which the Panel believes is in line with, and in some of its elements defines, international best practice, relies on three principles:

- clear specification of limited and stable policy or regulatory objectives;
- institutional separation of the different powers and responsibilities; and

- delegation of legislative (market rule making), executive (administrative, enforcement and operational matters) and quasi-judicial powers and responsibilities to specialist agencies.

The first and second principles merit some initial comments.

National objectives

The Panel considers that there is great merit in specifying overall objectives that are clear, limited in scope and reasonably stable, particularly in an environment where delegation of powers and responsibilities is made to multiple institutions in a multi-jurisdictional framework. Clarity and focus facilitate transparency and accountability. Focus (that is, limited scope) means that regulators are not asked to resolve major policy trade-offs that, in a democratic system, are the proper responsibilities of parliaments. Stability facilitates the formation of the expectations that underpin investments by market participants (and it is noted here that investments in energy-using equipment and, increasingly, energy production are important decisions for end consumers as well as for producers and suppliers). In these circumstances, clear, focused and stable overall objectives also serve to define common purposes and to bind institutions together in a way that is necessary for effective coordination of efforts.

Consideration of possible, substantive changes in the national energy objectives has been raised by a number of submitters, but is not something that the Panel favours. That is because the great weight of international thought and experience would speak against such change, and very compelling reasoning and evidence would be needed to overturn that body of work. No such reasoning and evidence have been put before the Panel.

The Panel notes that pursuit of the long-term interests of consumers does not in any way imply that other policy objectives are unimportant and to be set aside or given low priority. The Panel's view is simply that other objectives are better pursued by other means, not by weakening the focus on a simple, clear and shared objective, which the introduction of multiple objectives would very likely do.

The Panel's view is therefore that, if any changes in national objectives come to be contemplated, they should be confined to adjustments that simply provide less ambiguous expression of the current underlying intent, including by way of supplementary guidance as to meanings. For example, it is possible

that there may not be a shared understanding of how the expression ‘long-term interests of consumers’ is to be interpreted. Although the Panel is of the view that the meaning is clear enough and that the term encompasses the whole stream of future consumer outcomes (in the next year or two, in the medium term, and in the years beyond that), there may nevertheless be merit in making this more explicit. Expanded explanation might help address any existing misunderstandings.

The separation of institutional functions

While the identification and separation of the functions associated with market governance are familiar features of energy systems worldwide, the Australian governance arrangements are more distinctive in the concentration of market rulemaking in a single institution, the AEMC.

Rulemaking is a core function of regulatory processes and it is not unusual to find that, in jurisdictions where it is institutionally combined with price-setting and enforcement functions, some degree of intra-organisational separation exists. That is, the tasks are allocated to particular sections or subgroups of a regulatory agency, reflecting the differences in skills and approaches that are appropriate for the different tasks.¹

In the Panel’s view, the virtue of the Australian system lies largely in its greater clarity in comparison with some of the obvious comparators. This has potential advantages not only in relation to improved transparency and accountability, but also, more fundamentally, in the fact that ‘institutionalising’ or formalising distinct functions tend to increase regulatory certainty. Since these are potentially powerful advantages, the Panel sees only disadvantages in suggestions that the AEMC and AER should be amalgamated.

While submissions indicated general satisfaction with the broad functional divisions embedded in the governance arrangements, they also expressed some concerns. In particular, ‘undue influence’ on the various institutions from external sources was raised as an issue, as reflected in statements such as ‘they are a creature of the Commonwealth’, ‘they are controlled by the states’, ‘their culture is dominated by the ACCC’, and ‘they are captive to industry’. The imputation contained in these remarks, whether direct or implied, was

¹ For example, Ofgem in the United Kingdom operates this way.

that the outcomes and decisions delivered by the institutions are influenced (and biased) by some or other aspect of the structural arrangements.

Although the Panel has not encountered compelling evidence to suggest that 'undue influence' from external sources is a major, systemic problem, and recognises that some level of assertion about influence and bias is unavoidable in contested environments, it has come to the conclusion that *internal* factors and pressures, within regulatory organisations, do show some signs of having detracted from performance to date. Much more importantly, the Panel considers that these influences can be expected to have adverse effects on the capacity to adapt in a rapidly changing economic environment.

This is not, in the Panel's view, a problem deriving from the structure of the governance arrangements, which is based on a logical division of functions that has arguably served to provide checks and balances to the unwanted pressures, but it does point to the desirability of some adjustments to the working arrangements in the individual institutions themselves.

The Panel's approach

The Panel has looked both backward at past performance and, particularly when making recommendations, forward to the challenges that a changing market environment is bringing. The weaknesses in the processes for determining strategic priorities are apparent from both perspectives and, if not addressed, their adverse implications can be expected to increase in the future. Strengthening this aspect of the governance arrangements should therefore be a major priority.

For this to be achieved, it is the Panel's view that fundamental change in the existing institutional structure of energy sector governance is neither necessary nor desirable: the functional division of responsibilities among the various parts of the structure is based on solid principles and is basically sound. The Panel does, however, believe that a number of 're-sets' of specific aspects of the governance arrangements are warranted to improve their capacity to adjust to ongoing disruptive change. The recommended re-sets cover all parts of the institutional set-up, not just the process of determining strategic priorities, because what has worked reasonably well in the past, in more stable conditions, is not necessarily well adapted to the new challenges.

Risk of fragmentation, or an increasing tendency for jurisdictions to introduce bespoke arrangements that have the unintended and unwanted effect of reducing overall national policy effectiveness, is a case in point. The Panel's view is that this is a risk that has been increasing over time and that, while the flexibility afforded by derogations should be maintained, commitment to the AEMA calls for more stringent criteria to be satisfied at least when derogations are sought to be maintained after an initial transitional period.

More generally, many of the changes recommended in subsequent chapters are designed to facilitate greater focus, priority and uniformity in the development of the national energy markets, as well as to enhance consultative processes and their efficiency, transparency and accountability.

The Panel stresses that its recommendations for change do not imply that, in each and every case, there has been a significant past failure that needs to be addressed; although a number of incipient weaknesses in the arrangements have, in fact, been identified. Rather, the common theme is that the recommended adjustments are required to better meet tomorrow's challenges, the centrality of which has, together with the problems surrounding strategic priorities, been so clearly brought to the Panel's attention by a wide range of stakeholders.

Chapter 2: Setting strategy and determining priorities

Summary

The Panel has found that the Energy Council and its Senior Committee of Officials (SCO) are not sufficiently focused on strategic direction and are not providing effective and active leadership in all areas of energy policy. The Panel recommends that SCO be made responsible for making recommendations to Council on strategic direction and the Council's priorities and work programme should be adapted to work in concert with this advice. This function will require SCO to work with the AEMC, which will be charged to develop this advice in consultation with stakeholders. The Panel also recommends that the Council formally delegates the management of the energy work programme, including the provision of progress reports, to SCO.

To improve confidence in this function, and facilitate better stakeholder engagement, the Panel also considers that Council and SCO processes need to be more transparent.

The Panel concludes that:

- to clarify the roles of energy market institutions the Council, SCO and the individual institutions should each develop arrangements to ensure effective consultation with relevant stakeholders and each other.
- to achieve national consistency, as far as possible, time-limited and focused derogations for jurisdictions should be permitted and that, when those derogations are reviewed, a more stringent test should be applied.

COAG Energy Council

Throughout the Panel's consultation processes and in the submissions received to both the Issues Paper and Draft Report, a consistent commentary has been provided that the Council and SCO lack a focus on strategic direction and are not providing effective and active leadership in the energy policy sector. Numerous submissions support the Panel's Draft Report

recommendations on increasing the strategic focus of the Council and SCO.² During consultations, the composition and structure of the Council were identified as a source of this problem; that is, frequent changes in membership and the broad scope of its responsibilities (embracing all aspects of energy and resources) mean that too often the Council lacks ‘corporate memory’ and focus, and is not well positioned to devote the time required to address complex energy policy issues. Further, stakeholders have stated—to the extent that they can judge—that Council agendas are too long and lack clear focus and that the opportunity for early, effective and targeted input to the policy development process does not exist.

The limited visibility of the Council’s activities is a major issue. A strongly recurring theme in submissions was that there is a lack of transparency and accountability in the Council’s work. For example, it is difficult to understand the status of the Council’s implementation agenda, given that there is no public reporting on it. To that end, the recent introduction of a stakeholder ‘roundtable’³ at each Council meeting was viewed favourably by some, but it was suggested by a number of submitters that this was not necessarily an optimal use of time for either participants or Council members and that there would be more effective ways to gain stakeholder input. Many stakeholders supported the Panel’s Draft Report recommendations concerning increased transparency in COAG Energy Council and SCO processes.⁴

It was of particular concern to the Panel that concerns about the Council exist within the national energy market institutions themselves. For example, the AER’s submission to the Issues Paper noted that:

² For example, ResourcesLaw International, Cotton Australia, Grattan Institute, Energy Policy Institute of Australia, EnergyAustralia, NSW Irrigators’ Council submissions to the Review of Governance Arrangements for Australian Energy Markets Issues Paper and Draft Report.

³ Energy Users Association of Australia submission to the Review of Governance Arrangements for Australian Energy Markets Issues Paper, p. 3.

⁴ Grattan Institute, Energy Policy Institute of Australia, Eastern Alliance for Greenhouse Action, Energy Australia, Jemena, Snowy Hydro, The Australian Pipelines and Gas Association, Energy Retailers Association of Australia and Energy Supply Association of Australia submissions to the Review of Governance Arrangements for Australian Energy Markets Draft Report.

... it is not straightforward to understand what the Energy Council's key priorities currently are. Developing these strategic priorities would help guide the Energy Council's work program ... it is not immediately obvious what the key work streams are, how some programs fit into a broader strategic vision, or how work programs are to be progressed. Publishing the Energy Council's strategic priorities on its website would provide stakeholders greater insight into key reform programs. Similarly, publication of the Council's work program, including project timelines and deliverables, would allow stakeholders to consider how current reforms might be related to issues they are interested in and gain confidence that matters were being progressed.⁵

The Panel notes that the lack of a clear direction for the Council, or an active sense of common purpose, whether real or perceived, can have significant implications for reform and market function. For example, a number of stakeholders referred to the difficulties surrounding a national approach where some jurisdictions had either not implemented a Council decision, had only partially implemented a decision or had even, in some instances, reneged on a commitment that had previously been made.⁶

Similarly, submissions asserted that the current processes, which rely heavily on consensus building, can be inflexible and create inefficient delays.⁷ This is particularly the case when that consensus has to overcome the conflicts of interest which arise from state ownership of assets, or bridge many different levels of market maturity. The structure and operation of the SCO and underlying working groups appear to do little to overcome these hurdles.⁸

Delays in decision-making impacts on the ability of the institutions to respond to their obligations in a timely fashion—for example, AEMO noted that it had received terms of reference for projects *after* AEMO had been scheduled to commence the work, affecting the agreed timelines for key deliverables.⁹

⁵ AER submission to the Review of Governance Arrangements for Australian Energy Markets Issues Paper, p. 9.

⁶ Origin Energy submission to the Review of Governance Arrangements for Australian Energy Markets Issues Paper, p. 1.

⁷ For example, AEMO submission to the Review of Governance Arrangements for Australian Energy Markets Issues Paper, p. 11.

⁸ Grattan Institute submission to the Review of Governance Arrangements for Australian Energy Markets Issues Paper, p. 4.

⁹ AEMO submission to the Review of Governance Arrangements for Australian Energy Markets Issues Paper, p. 11.

While criticism is justified, it was clear to the Panel that many parties implied expectations of the Council which are unrealistic in a multi-jurisdictional political–administrative environment.

However, the Panel is satisfied that there is a need for the Council to provide more effective and strategic direction and to make more effective use of its officials and institutions. The Panel is concerned that these issues of Council efficiency be addressed as it concurs with the view that the Council’s role is critical to the effective operation of the market and the performance of the market institutions.¹⁰

The role of SCO and its working groups

The SCO comprises very senior officials in the relevant departments that support the Council’s members. It is not the creation of any formal agreement or the custodian of any formal delegated authority, but does have agreed terms of reference, protocols and processes.

At times, especially during the period when the markets and institutions were being developed and established, SCO has been able to guide and implement difficult and complex national agendas, but at others it has appeared ineffective to external stakeholders.

It was also argued that the way in which SCO undertakes its specific implementation role has been responsible for delaying policy outcomes. It was argued that in some instances in which the Council had provided clear policy intent at the outset, the intent and its unity became diluted during the implementation phase as issues were ‘re-prosecuted’ at SCO or in the working groups below SCO, and that momentum was lost as the process took over.

Assertions were received that the lack of visibility of issue-based working groups below the Council, the lack of transparency of the work of many of these groups along with the lack of visible terms of reference impacted on the understanding of the work of the Council and stakeholder confidence in it.¹¹

¹⁰ AER submission to the Review of Governance Arrangements for Australian Energy Markets Issues Paper, p. 8.

¹¹ Origin Energy submission to the Review of Governance Arrangements for Australian Energy Markets Draft Report, p. 1.

Clarity of energy market institution roles

The Council and SCO have strong capabilities, as do the energy market bodies, but the challenge is to most productively harness their combined capabilities to deliver against national energy policy objectives.

As an example, concerns were raised by industry that it is confusing when the Council tasks the AEMC or AEMO with related tasks on similar topics.

In these instances, their respective roles are not well defined, potentially leading to duplication and lack of effective coordination of advice.

One stakeholder expressed a strong view that it was inappropriate for the Council to task AEMO with any activity, as AEMO's role should be restricted to that of a systems operator.¹²

The Panel's view

The Panel is of the view that the Council is the premier and appropriate body to have overarching responsibility and policy leadership for the Australian energy market, including for enabling cooperation between the Australian Government and state and territory governments. The framework for developing national energy policy is embodied in the AEMA and the objectives contained in that agreement remain appropriate. In the absence of coordinated policy leadership by the Council, it is unrealistic to expect that reforms in the Australian energy market can be effectively delivered by individual bodies.

Based on submissions and consultations, the Panel concludes that Council and SCO operational processes are the priority area for reform. Better coordination and prioritisation on issues that require a cross-jurisdictional approach are essential. The Council's processes (and those of its associated 'back-room' functions and working groups) for meetings and preparation should be reformed so that the Council is able to effectively:

- promote strategic policymaking;
- prioritise key items to achieve the greatest harmonisation benefit;
- oversight delivery of the reform agenda by the three market institutions in a clear and unambiguous manner;

¹² United Energy and Multinet Gas submission to the Review of Governance Arrangements for Australian Energy Markets Issues Paper, p. 5.

- increase transparency and accountability to stakeholders for energy market reform goals; and
- better utilise the collective capabilities of the jurisdictions and institutions to identify and address current and future national policy challenges.

The Panel considers that Council meeting agendas should be targeted at strategic priorities within a broader reform agenda. SCO should be responsible for ensuring that the agendas are both strategic and manageable and provide guidance to the Council on how to navigate the agendas to ensure effective decision-making.

As discussed later in this chapter and in Chapter 3, SCO, using advice developed by the AEMC, should have responsibility for specific proposals on policy and strategic direction submitted to Council for its consideration.

To make these Council processes complete, a structure which encompasses a clear set of accountabilities and delegations to SCO will be required. Specifically, the Panel's view is that the Council should establish a clear set of delegations to SCO accompanied by decision-making powers so that issues of a technical and/or administrative nature are dealt with at SCO level. SCO should be required to report on the exercise of its delegations to each Energy Council meeting.

SCO and the Council are currently supported by an administrative secretariat that has no role in policy development. Support for the work of SCO and the Council as 'entities' is provided principally through the Australian Government Department of Industry, Innovation and Science. If SCO is to perform the expanded role proposed for it, especially that of overseeing and reporting on the delivery of the Council work programme, the question is how this might be done in a way which enhances the national perspective of the work without creating another organisation. The Panel believes that this would best be achieved by expanding the role of the secretariat to support the Council and SCO with a small number of appropriately qualified officers seconded from the Australian Government and state and territory jurisdictions. The creation of such a role was supported by a number of stakeholders.¹³

¹³ For example, Cotton Australia, the Public Interest Advocacy Centre, and the NSW Irrigators Council submissions to the Review of Governance Arrangements for Australian Energy Markets Draft Report.

The Panel's recommendations related to Council and SCO are primarily structural and functional and the Panel does not see its task as extending into matters of operational detail. However, the Panel suggests that one operational matter that the Council may wish to consider is the provision of delegations for some unilateral decisions to the Australian Government Minister as Chair of the Council. This suggestion is designed to link to and would rely on the advice provided by an expanded council secretariat and is designed to provide for quicker resolution on some process matters.

Transparency, accountability and consultation

The Panel is of the view that there are some easy and early opportunities to address some of the concerns about the Energy Council through improvements to transparency, accountability and consultation processes. Central to the quality of decision-making, and to retaining the legitimacy of the regime, are issues of transparency and accountability.

The Panel's view is that, for the purpose of informing stakeholders of progress against the Council's strategic objectives and supporting work programme, public and clear timelines and reporting against each action item would be useful.

The Council's terms of reference, meeting dates, agendas, any delegations, work programme and reporting against the work programme (for example, in the form of a traffic-light report) should all be easily accessible public documents that improve transparency and allow for formal policy input at the appropriate time (for example, at SCO or Energy Working Group consideration stage).¹⁴

The Panel considers it vital for good decision-making, and improving the authority of the Council, for stakeholders to strengthen their role in informing the Council's decision-making and priority-setting processes. In this respect, the Panel notes criticisms of the lack of ability to directly engage with the Council itself,¹⁵ and of the ad hoc consultation processes of SCO and its working groups. The challenge for the Council and SCO is to adopt

¹⁴ The COAG Energy Council's revised terms of reference are now available on the COAG website at: www.scer.gov.au/about-us/terms-of-reference/.

¹⁵ For example, Alinta Energy, Energy Users Association of Australia, Energy Retailers Association of Australia, and Public Interest Advocacy Centre Ltd submissions to the Review of Governance Arrangements for Australian Energy Markets Issues Paper.

arrangements for stakeholder engagement which are both efficient and effective for the stakeholders and for the Council itself.

Communications tools, particularly websites, should be professionally targeted and refined for improved accessibility. Stakeholder engagement should be complemented with greater visibility of agenda issues and the opportunity for stakeholders to provide more considered comment into ministerial debate. All documentation should be easily accessible to the public, to increase transparency and allow for formal policy input at the appropriate time, including through the expanded AEMC/SCO strategy development role discussed below and in Chapter 3.

Strategy development

For the recommended emphasis on strategy and priorities to be effective, it is essential that the Council be provided with high-quality analysis and advice. While all institutions have the capacity to make a valuable contribution, the Panel considers that the AEMC is best placed to initiate the formulation of strategic priorities. SCO would then take responsibility for specific proposals on policy and strategic direction submitted to the Council for consideration, based on the expert advice of the AEMC. As a consequence, in addition to its other responsibilities, the AEMC should be given an unambiguous obligation to prepare advice on strategic direction and a resulting work programme including the status of Australian energy market development, emerging issues and developments, and recommendations on priority matters.

The Panel envisages that this major initiative on strategic direction and priority setting would take place on a three-year cycle. This would be a separate and expanded process from the AEMC's existing two-year strategic direction work. In the intervening years, a review would be undertaken to determine whether any adjustment to the current strategy and priorities is required. A critical part of the review in these intervening years would be an implementation progress review. An integral part of the three-yearly strategic process would be a holistic review of the rules, which should be directed at advising whether the rules are consistent with the strategic priorities, are fit for purpose and are not impeding beneficial and innovative developments in energy markets.

The success of these arrangements will depend on effective engagement between SCO, the AEMC, the other energy bodies and stakeholders. This is further explored in Chapter 3.

The Panel notes that during the consultation processes there have been calls to establish a separate body under the *Corporations Act* responsible for promulgating national energy policy with, among other things, a chief executive officer and its own staff.¹⁶ As outlined elsewhere in this report, the Panel views the COAG Energy Council as the pre-eminent policymaking body for energy. On that basis, the Panel does not believe that an additional institution is desirable; further, given the Panel's view that the current energy market architecture is basically sound, another institution would be duplicative and unwarranted.

Rationalisation of working groups

In addition to concerns regarding the Council and SCO, the Panel notes that an extensive array of working groups exist, some of which appear to have overlapping responsibilities. The Panel is concerned that, due to the consensus-based decision-making model, inefficiency in processes exists or, at the least, jurisdictions spend a disproportionate amount of time and cost in servicing these groups, particularly for smaller jurisdictions. Both external stakeholders and jurisdictions expressed concerns during consultations about the number and extent of working groups and a view that there is no effective mechanism for testing their continued desirability. Some further questioned whether the working group mechanism was appropriate in all cases.

The Panel has not undertaken a systematic examination of the working groups, but notes that some rationalisation has recently taken place. Despite this, the Panel heard evidence that the current 'task list' of the previous 'Energy Market Working Group' was cumbersome, unmanageable and contained tasks which were not current priorities. On this basis, the Panel is of the view that a systematic review process is required to ensure that the structure of working groups going forward is lean, nimble and fit for purpose. To this end, the Panel recommends that all existing working groups be given a sunset date of 31 December 2016 and that all groups that have not been formally renewed or re-established by that date through a resolution of the Council, or through delegation, be abolished on that date. The Panel further recommends that, for the future, a formal process for sun-setting and review of all working groups be established.

¹⁶ For example, the Energy Policy Institute of Australia, Resources Law International and Public Interest Advocacy Centre submissions to the Review of Governance Arrangements for Australian Energy Markets Draft Report.

Reinforcing the national characteristics of reform

One of the prime purposes of COAG, the Council and its officials is to pursue nationally consistent approaches. In any federal system there will be occasion for individual jurisdictions to pursue arrangements that will differ from a national policy. However, differences can also arise from lack of discipline of jurisdictions, as opposed to arising from considered need.

The Panel has taken it as given that the objective of the Council is for a strong national energy structure with, other things being equal, as few deviations from the common policy as possible.

The challenge that the Panel has confronted is to determine how this objective might best be delivered. One mechanism for doing this is to take a rigid, one-size-fits-all approach that prohibits exemptions; however, even in the unlikely event that such an approach were judged feasible, that would not in itself address the problems arising from decisions in other policy areas developed outside of the national energy governance arrangements (for example, climate change mitigation measures). On the other hand, a heavy reliance on arrangements in which decision-makers can ‘pick and mix’ elements of a notionally shared set of rules also appears to be an unattractive option, as it risks fragmentation—national rules that are not shared are not really national rules at all and any value attaching to shared rules tends to be lost.

In the Draft Report, the Panel foreshadowed a ‘necessity principle’ to promote energy market consistency, the purpose of which was to ensure that jurisdictions provide evidence that its specific favoured objective could not be achieved by other means with a lesser impact on the effective functioning of the national energy market without imposing disproportionately higher costs on the jurisdiction. During consultations on the Draft Report, the Panel heard evidence that such a high bar may have perverse or unintended impacts which would increase the risk of more and more serious derogations, and therefore be less effective in achieving consistency.

It was put to the Panel during consultations that many derogations arise from uncertainty about the impact of a rule change when it is first introduced and from a desire of a jurisdiction to protect a particular policy. However, it was further submitted that after the rule change is implemented it is frequently the

case that the concerns regarding its application in a particular jurisdiction are shown to be unfounded or not of material impact.

On balance, therefore, the Panel has concluded that it is preferable to have an approach to derogations which is less restrictive at the outset. The Panel recommends that derogations be permitted initially only if the derogation is carefully targeted and time limited, with a maximum of three years, and the jurisdiction undertakes to review the derogation at the end of that time. Also during this three year period, derogations should be carefully assessed at SCO level to ensure that they are not unnecessarily or overtly distorting to the national energy market. At the time of the expiry of the initial derogation, the more stringent 'necessity criterion' should be adopted in the review; that is, that the specific favoured objective could not be achieved by other means with a lesser impact on the effective functioning of the national energy market without imposing disproportionately higher costs on the jurisdiction. A more stringent review at the end of the initial period is appropriate since, by that time, there will be actual evidence available of the impact of the rule and the effect of the derogation. SCO should seek the advice of the AEMC to assist in its examination of derogations which jurisdictions propose to continue after the initial period.

Recommendations

The Panel's recommendations are as follows:

- 2.1 That the Council, supported by SCO, change its meeting arrangements to enable a greater focus on energy matters of strategic importance.
- 2.2 That the focus of the work of the Council be the determination of strategic direction and the associated work programme to support this direction, with appropriate assignment of tasks to SCO and the AEMC.
- 2.3 That SCO be charged with the responsibility to present to the Council for consideration recommendations on strategic direction and a supporting work programme. The AEMC should be charged with the responsibility for aiding the development of this advice.
- 2.4 That the Council formally delegate the management of the work programme to SCO, including for the provision of reports on its progress.
- 2.5 That SCO be supported by an expanded secretariat located within the Australian Government Department of Industry, Innovation and Science and that the secretariat includes a small number of appropriately qualified officers seconded from Australian Government and state and territory jurisdictions.
- 2.6 That the Council, SCO and the individual institutions each develop arrangements to ensure effective consultation with relevant stakeholders, including other institutions.
- 2.7 That the transparency of the activities of the Council be greatly enhanced through its website, improved communication tools and other appropriate forums.
- 2.8 That the working groups under SCO be given a sunset date of 31 December 2016, and that all groups which have not been formally renewed or re-established by that date through a resolution of the Council, or by delegation, be abolished.
- 2.9 That jurisdictions be permitted to implement derogations from otherwise nationally agreed agreements only if the derogation is targeted and time-limited and contains a commitment for re-evaluation against a 'necessity principle'.

Chapter 3: Rules and rule making

The Panel recommends that the AEMC's mandate should be revised to include an obligation to develop a major policy paper on strategic direction, priorities and a Council work programme every three years as the basis for SCO to make specific recommendations to the Council. Included in this advice would be a comprehensive review of the rules as a whole to help inform this process.

The Panel recommends that the AEMC demonstrate substantive engagement with the AER, AEMO and other relevant institutions for rules and review processes, and improve communications with all stakeholders.

The Panel also recommends that changes are made to the AEMC rule change and review processes to increase timeliness and streamline discussion with the Council. These include implementing a mechanism for terminating rules and different types of review processes depending on the complexity of the topic.

The AEMC

The AEMC was established in 2005 as part of energy market reforms that were recommended by the then Ministerial Council on Energy in December 2003.¹⁷ It has been progressively taking on more responsibilities¹⁸ in keeping with the expanded scope of national energy laws.¹⁹ The Panel understands that the original intent of these reforms was in part to concentrate technical advisory expertise in a single location as a resource for the national policy agenda and to enable arm's-length mechanisms for subordinate legislation to evolve in response to market requirements. These roles are sometimes referred to as the AEMC's 'market development' and 'rule-maker' functions.

¹⁷ Ministerial Council on Energy, *Report to the Council of Australian Governments—Reform of Energy Markets*, December 2003.

¹⁸ AEMC submission to the Review of Governance Arrangements for Australian Energy Markets Issues Paper, p. 12.

¹⁹ The National Electricity Law is contained in a schedule to the *National Electricity (South Australia) Act 1996*, the National Gas Law is contained in a schedule to the *National Gas (South Australia) Act 2008* and the National Energy Retail Law is contained in a schedule to the *National Energy Retail Law (South Australia) Act 2011*.

In general, the Panel found that most stakeholders were confident about the AEMC as an organisation and about the quality of its work. Stakeholders thought the AEMC was strong in its economic skill set, although they considered there were areas where its processes could be improved to make them timelier, to provide greater access to industry, commercial and technical experience and to enhance the effectiveness of consumer engagement.

The AEMC is established under the *Australian Energy Market Commission Establishment Act 2004*, a piece of South Australian legislation (as South Australia is the 'lead' jurisdiction for implementing national energy market legislation). Under its establishment Act, the AEMC must comply with the reporting and budget planning processes of the South Australian Government and is subject to audit by the South Australian Auditor-General.²⁰ The transparency of its processes brings significant accountability to its operations. In addition, the AEMC is required to conform to South Australian freedom of information legislation. The AEMC is also subject to an annual Statement of Expectations from the Energy Council, which requires the AEMC to publish a Statement of Intent outlining its response to the Statement of Expectations, including reporting on key performance indicators. The AEMC is jointly funded by all state and territory jurisdictions on a per capita basis (the Australian Government does not contribute).

In the Issues Paper, the Panel discussed the role and the functions of the AEMC. However, it is appropriate to reiterate the rationale for the separation of institutional roles and provide some comment on this arrangement.

An independent rule maker

The establishment of a national rule maker independent of energy ministers was a deliberate act by COAG. The intention was for energy ministers to establish the laws as enacted by each jurisdiction so that gas and energy markets would operate in a largely self-evolving manner supported by effective market regulation. The model embraced by COAG was also designed to overcome the inefficiencies of having a multitude of state-based rule makers and regulators, which would have inevitably eroded consistency over time. The Panel is of the view that the original rationale for the structure

²⁰ Section 25 of the *Australian Energy Market Commission Establishment Act 2004 (SA)*.

has been amply demonstrated, and no stakeholder has suggested returning to the state-based model.

Some stakeholders have suggested possible synergies from combining the rule maker (AEMC) and the rule enforcer (AER).²¹ Other stakeholders emphatically submitted that the separation of the energy institutions was a strength of the current governance arrangements and should not be tampered with.²² The Panel is of the view that the AER and the AEMC should remain separate as they carry out fundamentally different roles: each has a different focus on its core work, requiring different skills and different discretions. The Panel is satisfied that there is a framework to enable cooperation on matters as required.²³ The separation of the rule making and rule enforcement functions, the independent regulatory authorities and the availability of a merits review appeals regime are key elements of the governance of the energy market which help establish credibility with investors and provide them with the confidence to invest in the sector.

The strategic role of the AEMC

During consultations, many stakeholders suggested an expansion of the AEMC's role. In particular, there was support for the AEMC to take a stronger role in assisting the Council to set policy, strategy and priorities in the energy market and to be given a clearer directive to undertake market development work.²⁴ The issue of market development will be discussed further in Chapter 5.

As described in Chapter 2, the Panel recommends a greater role for the AEMC in assisting SCO and, in turn, the Council, in setting strategy and determining priorities.

As described in Chapter 2, the Panel recommends that the AEMC's mandate be revised to include an obligation to prepare a major policy paper every three

²¹ For example, the Public Interest Advocacy Centre Ltd and Energy Users of Australia Association made this suggestion in both the Issues Paper and Draft Report submissions to the Review.

²² For example, Energy Networks Australia and Financial Investor Group submissions to the Review of Governance Arrangements for Australian Energy Markets Issues Paper.

²³ The Panel notes that there is a memorandum of understanding between AEMO and AER/AEMC.

²⁴ For example, Jemena, Snowy Hydro Limited and APA Group submissions to the Review of Governance Arrangements for Australian Energy Markets Issues Paper and Draft Report.

years containing advice on strategic direction, policy priorities and a work programme. The AEMC should maintain effective consultation with SCO throughout the process of developing this advice.

The Panel notes that the AEMC already publishes the report *Strategic Priorities for Energy Market Development* every two years and that it encompasses some of the work required for the policy advice the Panel has recommended. While it would be reasonable to expect that the currently produced document would have been influential in the Council's strategic processes, this does not appear to be the case. This may be because the paper is regarded as a statement by the AEMC of its own priorities only or, perhaps more importantly, because there has been no process for it to be made influential in the work of the Council.

As part of the recommended policy development process, the AEMC would conduct a comprehensive review of the rules as a whole to help inform the process. This review should be directed at advising whether the rules are consistent with the strategic priorities, are fit for purpose and are not impeding beneficial and innovative developments in energy markets. The Panel sees opportunities in this review to:

- link areas for recommended rule development with priorities so that the rules facilitate the early availability of technological improvements; and
- align the 'expedited rule change' and 'preferred rule' options more closely to established strategic priorities.

In the intervening years, the policy paper should be updated annually by the AEMC and SCO to address any major unanticipated changes in the market, advise on their implications for the strategic priorities and facilitate timely adjustments to the Council's work programme.

In its discharge of these tasks, the AEMC should demonstrate substantive engagement with all relevant stakeholders, including the AER, AEMO and other relevant institutions, industry participants and consumers. It is important that the various perspectives from stakeholder groups and institutions are presented. As technology changes, innovations are likely to come from an increasingly diverse range of sources and it is therefore important that the AEMC include processes for stakeholders to inject innovative thinking into the

agenda. Several submissions to the Draft Report supported this recommendation.²⁵

In practice, change is likely to be driven most by the implications and opportunities for technological innovation, which are typically better understood by market participants. The Panel considers that the AEMC, is best placed to initiate discussion (and coalesce the views of stakeholders in the context of the existing rules to identify policy priorities) about the regulatory changes most needed to advance the National Electricity Objective (NEO), National Gas Objective (NGO) and National Energy Retail Objective (NERO).

The Panel considers that the expanded workload is unlikely to increase resource requirements as the additional activities should enable the AEMC to better direct its remaining resources to a more focused work programme.

Improving the timeliness of AEMC processes

One of the recurring themes on the performance of the AEMC is the timeliness of rulemaking and reviews. Rule changes can be proposed by anyone (bar the AEMC except on non-material changes) and the rule change process is governed by statutory timelines. Once the AEMC completes a review, it may recommend a rule change to the Council; the Council then considers it and submits it back to the AEMC. Once submitted, the separate rule making process commences. Review processes allow for AEMC discretion, depending on the terms of reference.

The Panel notes that delays have arisen from both the Council and AEMC processes, and is mindful that haste is not always a virtue; however, it considers that an excerpt from Ergon Energy's submission to the Issues Paper neatly summarises the concern of stakeholders:

²⁵ For example, Energy Retailers Association of Australia, Energy Consumers Australia and Jemena submissions to the Review of Governance Arrangements for Australian Energy Markets Draft Report.

... Ergon Energy considers that there are opportunities to improve the rule making process administered by the AEMC. In particular, there are often delays in the progression of some rule change proposals, which in a dynamic market, result in regulation not keeping pace with changes in the industry. A key example of this is the Power of Choice Review, which commenced when demand was a significant issue and hence recommended reforms aimed at addressing demand. However, a delay to the implementation of the reforms has seen their decreasing relevance in the current environment of substitution.²⁶

The Panel views timeliness as a case of balancing speed in decision-making against the risk of error. In some cases, the length of the AEMC processes has meant that the market has moved on without resolution of the policy issue being addressed, to the point where the issue has lost relevance.

Irrespective of whether or not the duration of past AEMC processes has caused harm, the Panel considers that much greater attention must be paid to the speed of reform because both the pace of change and the likely irreversible adverse consequences of inaction or delay have increased significantly.

It is also evident that as processes lengthen they become harder to manage. The reality is that functions are undertaken by people and people move on from roles; so, quite apart from the consequences of delay, errors can be induced due to the erosion of corporate knowledge. This is not a criticism of the AEMC but a reality that all organisations must cope with. The market is moving in a direction in which delays will probably cause more harm than less.

The AEMC acknowledges that there is frustration on the part of stakeholders about the timeliness of processes. The AEMC asserted that these delays resulted from the requirements for procedures set out in the laws, the complexity of issues, the level of stakeholder interest and occasionally processes outside of the AEMC's control, including significant delays in the Council's consideration of tasking or recommendations. On average,

²⁶ Ergon Energy submission to the Review of Governance Arrangements for Australian Energy Markets Issues Paper, p. 3.

combined AEMC and Council processes were stated to take about 17 months.²⁷

There is no doubt that the inherent complexity of the issues contributes to the length of time taken to complete reviews. However, it is also possible that the AEMC and SCO could work more closely to accelerate Council consideration of less complex or more urgent issues. It is also possible that a range of measures could be taken to bring greater urgency to the rule making and review processes.

The Panel is attracted to suggestions, including those made by the AEMC, on how some aspects of this could be improved. These improvements are discussed in more detail below.

Self-initiation of rule changes

During consultations, stakeholders raised the possibility of the AEMC initiating its own rule changes outside of minor error correction and non-material tasks. The rationale was that if the AEMC were given this power it would be able to initiate a rule making process and then implement rules, taking a more proactive role in shaping the energy market. The Panel sees this outcome as problematic, as it would allow the AEMC to set policy direction in the energy market, which is against the spirit of the existing institutional functional separation and in particular the desire to augment, not displace, the Council's leadership.

The Panel is therefore of a mind to maintain the prohibition on the AEMC proposing its own rule changes, as this puts the onus for rule change development on stakeholders other than the AEMC.

The need for a gateway test

The Panel was particularly interested in the concept of having some form of initial or testing process, at the earliest opportunity, for both rule making and reviews, to identify and prioritise rule change proposals for commencement

²⁷ AEMC submission to the Review of Governance Arrangements for Australian Energy Markets Issues Paper, p. 19. The submission states that it takes the AEMC nine months to complete a review (from receipt of the terms of reference to provision of final advice). It can then take another eight months for the Council to respond to the review recommendation. See Appendix B for more information on AEMC time frames on rule-change requests. Time frames for AEMC reviews are governed by their specific terms of reference.

and discard ideas that do not have sufficient merit (against the strategic priorities) so that resources may be focused elsewhere. This 'gateway test' would investigate the practical application of a proposed rule to consider whether it should proceed to a fuller review. The formal rule making process and the legislative rule that would be developed for this arrangement would need to be fashioned accordingly. Such gateway tests would help energy market bodies to focus on responding to the most pressing issues, and would go some way to addressing the high administrative costs incurred by stakeholders in relation to market reviews and rule changes.

The Panel sees some merit to this proposal, particularly in the light of the greater prioritisation that will naturally come through the Council's consideration of the recommended structured strategic review and determination of priorities. Early engagement could focus the AEMC on the benefits and pitfalls of rule changes and reviews early on in the process, and a decision could be made on whether to pursue a line of enquiry or not. To ensure that this mechanism is not used inappropriately, the use of the gateway test could be reported to the Council in a transparent fashion.

The Panel recommends that a gateway test process be explored by the AEMC and be developed in conjunction with stakeholders for Council consideration. Several submissions to the Draft Report agreed with this recommendation as long as there was significant stakeholder involvement in its development and it was not a bureaucratic hurdle.²⁸ The AEMC submission to the Draft Report agrees with the recommendation to develop a gateway test process.²⁹

Increasing active process management

A related issue which was the subject of some recurring commentary by submitters was whether there should be a mechanism to stop a rule or review process once it has commenced, particularly on the grounds that it is no longer required:

²⁸ For example, APA Group, Snowy Hydro Grid Australia, Ergon Energy submissions to the Review of Governance Arrangements for Australian Energy Markets Draft Report.

²⁹ AEMC submission to the Review of Governance Arrangements for Australian Energy Markets Draft Report, p. 6.

... the inability of rule change proponents to dismiss existing proposals in consideration of policy or other changes that have impacted the future need for the proposal has also resulted in regulation not keeping pace with changes in the industry.³⁰

The Panel considered that this was likely to be an issue in the energy market, particularly in the light of rapidly evolving technologies and business models, and was surprised to find that there were no formal processes in place that allow the termination of a rule change process outside of the initial consideration by the AEMC. The AEMC may decide not to commence the rule making process in respect of a rule change proposal on grounds such as that the proposal lacks the information as set out in the Regulations, is misconceived, or lacks substance and is outside the AEMC's rule making remit. The Panel considers that it would be wise to have a formal mechanism in place to review and stop a rule change process mid-stream if it were no longer fit for purpose or required.

The Panel considers that explicit provision for such an option should be incorporated into the rule making framework. This does not necessarily mean that a detailed process needs to be created to fit every situation. As with the gateway process, affected stakeholders will also need to be closely consulted, and the operation of the process should be transparent and accountable.

The Panel therefore recommends that a mechanism be put in place for a rule change process to be terminated.³¹ As with the gateway test, the Panel recommends that the AEMC develop a proposal on a workable mechanism for the Council's consideration.

³⁰ Ergon Energy submission to the Review of Governance Arrangements for Australian Energy Markets Issues Paper, p. 3.

³¹ The Panel notes that the COAG Energy Council can direct the AEMC to cease a review at any time, but considers it useful that an internal, AEMC-driven process should also be implemented, given the Council's limited visibility (and conversely, AEMC's detailed knowledge) on the detail of rule changes.

Staged review as suggested by the AEMC

For market reviews, the Panel was attracted to the AEMC's proposal for a two-staged review,³² particularly for broader topics. Subject to any terms of reference, the two stages of the review could be:

- Stage 1: The AEMC considers the problem, analyses the options and makes recommendations to the Council on further market development requirements. The AEMC seeks Council input on its recommendations and approval to progress to the next stage.
- Stage 2: Upon agreement from the Council, the second stage of the review considers implementation issues, including the development of rules (and other instruments, if required).

The AEMC has suggested this approach to improve the timeliness of the consideration and completion of reviews and rule change requests flowing from those reviews. Also, this approach would provide an appropriate checkpoint for the Council after the AEMC completes the first stage of a review. It envisages that, if the Council could submit a rule change proposal back to the AEMC upon receipt of the outcomes from Stage 2 of the review within six months, the AEMC would commit to having the rule change completed within six months. A quick response from the Council would mean that the stakeholder consultations included in Stage 2 (before the rule change process starts and before the review goes to the Council for the second time) could more likely be relied on as current and make a six-month rule making process more achievable.

The AEMC identifies additional benefits with this approach:

- there would be more frequent opportunities for the Council to determine policy priorities as it would provide input between Stages 1 and 2;
- issues for review may be progressed more logically and methodically, with higher level issues being dealt with first and on their merits, with implementation issues kept separate and less likely to cloud policy debate;
- stakeholder engagement would be clearer, more focused and certain at each stage;

³² AEMC submission to the Review of Governance Arrangements for Australian Energy Markets Issues Paper, p24

- stakeholder consultation during a specific implementation phase would be more effective where the Council has approved the policy position; and
- a six month rule making process would be more achievable.

The Panel agrees that there are some merits to this approach of separating policy from implementation issues, particularly in the context of rule changes, which might have wide-ranging consequences. However, it has some concerns that this approach would have the unintended consequence of deferring consideration of implementation issues to Stage 2, irrespective of whether there may be ‘low-hanging fruit’ to access early. Conversely, there is also a risk of the Stage 1 report pursuing irrelevant directions in the absence of grounded and substantial stakeholder consultation.

While the Panel is mindful of criticisms of AEMC processes, and cautions against prescriptive changes on matters as heterogeneous as rule changes, it concludes on balance that reducing the length of the review process from 27 months to 21 months (as estimated by the AEMC³³) and reducing duplication in consultation efforts by introducing a staged review process would be significant improvements.

The Panel therefore recommends that the AEMC develop a staged review process proposal for broad and complex reviews, for consideration by the Council. The Panel hopes this will help to alleviate some stakeholder concerns on this process that were presented in submissions to the Draft Report.

Single-step response to AEMC reviews

The AEMC also proffered a single-step process for progressing rule changes which address specific issues arising from its reviews. In essence, it argued that an AEMC recommendation from a review should include a draft rule change for the Council’s consideration in the review’s final report in cases in which the translation of the review outcomes into rules is straightforward.

³³ ‘The AEMC typically takes nine months to undertake a review which then typically takes the Council eight months to action. The AEMC then spends another 10 months undertaking the requested rule changes, bringing the total time to approximately 27 months. In the new approach, the AEMC’s review timeline is not altered but the Council’s decision-making is reduced to six months and the AEMC’s rule-making process is also shortened to six months thereby reducing the overall time taken to 21 months.’ AEMC submission to the Review of Governance Arrangements for Australian Energy Markets Issues Paper, p. 24.

This approach would enable the Council to consider the report and the draft rules in one step. If the Council submits the rule change request to the AEMC within six months, the AEMC would commit to a six-month rule making timeline. If the Council did not agree with the review recommendations and/or draft rules, it would direct the AEMC to undertake further work or develop its own rule change request within a reasonable time.

It is reasonable to assume that some time savings could be achieved under this one-step process and that the other expected benefits of stakeholder momentum, clarity of roles and instructions and leaving senior officials free to work through policy issues would make the process more efficient. The Panel is also attracted to the AEMC's estimate that this could potentially reduce time frames by six months.³⁴

The Panel recommends that the AEMC develop a single-step review process proposal for reviews dealing with specific or contained issues, for consideration by the Council.

Expedited rule making process

Rule change requests can currently be processed under an expedited process (within six weeks) where they are non-controversial or urgent within the meaning of the energy laws.³⁵ The AEMC is already looking to apply this process more, as the decision to use this mechanism rests with the AEMC. It has trialled this process and has found that in some cases, while the issues are clear, appropriate time is still required to consider submissions from consultation. This results in a time frame longer than the stipulated six weeks. To address this, the AEMC has proposed that it is more likely to be able to use the expedited rules process if the prescribed timelines are extended by two weeks to allow appropriate consideration of submissions.

The Panel recommends that the AEMC continue, where appropriate, to use an expedited rule change process for less complex rule changes, and that changes be made to the national energy laws to allow for an increased time-frame range of six to eight weeks. The Panel considers that the transparency

³⁴ AEMC submission to the Review of Governance Arrangements for Australian Energy Markets Issues Paper, p. 26.

³⁵ For example, section 96 of the National Electricity Law. These provisions are mirrored in the National Gas Law (section 304) and National Energy Retail Law (section 252).

of the process together with the enhanced interaction between the AEMC, SCO and the Council provides adequate accountability for these measures.

Communication: notice of time frames for rule changes and reviews

Another common thread raised in consultations related to frustration with the lack of transparency in the process and notice of AEMC time frames for rule changes and reviews. Consultations and submissions³⁶ indicated a perception that the AEMC works at its own pace, without regard to what is happening in the industry. Many stakeholders stated that they did not know how the processes worked, or whether the AEMC reported or was held accountable to anyone for its time frames. The Panel agrees with the suggestion that a 'start the clock' provision upon receipt of a rule change request be created for the AEMC to improve this accountability (noting that the AEMC would retain the ability to extend time frames for most of the steps for rule change requests by announcing an extension before the expiry of the time frame).

Additionally, the Panel notes that information on timeliness is not readily accessible and recommends the reporting of clearer and more regularly updated timeliness performance metrics on the AEMC's website, accompanied by reasoned explanations for extensions in time frames. The publication of such information should not deter warranted extensions, but should be seen as a way of assisting stakeholder engagement with the rule change process and of providing material of relevance to wider evaluations of AEMC performance.

³⁶ For example, Ergon Energy, Snowy Hydro Limited and Australian Pipelines and Gas Association submissions to the Review of Governance Arrangements for Australian Energy Markets Issues Paper.

Effectiveness of consultation

Some stakeholders have questioned whether the AEMC has predetermined directions for rule changes and suggested that consultation processes have little influence on outcomes; for example:

... the AEMC shows a tendency to act as a 'black box' when developing responses to rule proposals and GDFSAE supports engaging industry to discuss the issues and concepts identified in a rule change earlier in the process. Presently, there is a sense that the AEMC generally decides the direction of rule changes prior to engaging with industry and industry engagement is a form of risk management.³⁷

The Panel notes that the AEMC produces a great deal of written material and strives to communicate its decision-making processes to all its stakeholders in comprehensive reports and updates on its website. Levels of satisfaction with the AEMC differed across stakeholders – in general, the electricity sector was more positive about its engagement with the AEMC than other sectors. The Panel noted that for some stakeholders the detail and comprehensiveness of the AEMC's reporting may have detracted from the effectiveness of its communication at times.

Good communication between an organisation and its stakeholders is vital to the proper functioning of and confidence in the organisation. There was a persistent thread in comments from stakeholders that the AEMC currently does not strike an appropriate balance *between listening and convincing*. It was suggested that the AEMC needs to be informed by and respond to external expertise and insights to a greater degree.

The Panel notes that the AEMC is seeking to improve its communication with stakeholders, especially informal communication³⁸. The AEMC is undertaking stakeholder surveys on a regular basis to gauge its own effectiveness and is

³⁷ GDF Suez Australian Energy submission to the Review of Governance Arrangements for Australian Energy Markets Issues Paper, p. 3.

³⁸ In its 2014 Statement of Intent, the AEMC listed a key priority is to provide stakeholders with effective channels to present views, recognising the need for stakeholders to feel they have been listened to.

beginning to provide informal explanations of decisions with key stakeholders on decisions as they are published.³⁹

A dichotomy emerged during the Panel's consultation process in relation to the communication between the AEMC and its stakeholders. Anecdotally, industry in general thought the AEMC consulted well and found that, in comparison to the AER, it was much better with its communication. In contrast, consumer groups were of the view that the AEMC did not communicate as well as the AER.

Evidence of AEMC decision-making and cost–benefit analysis

Some stakeholders shared with the Panel their concerns about a general uncertainty about what level (if any) of cost–benefit analysis the AEMC undertakes in reaching its decisions and whether it applies best regulatory practice procedures, which typically include clear problem definition, assessments of non-regulatory options and effective stakeholder engagement. A perceived lack of transparency in the application of the rule making test under the law and rigour in good regulatory practice raised issues of confidence in their minds.

The Panel therefore welcomes the AEMC's proposal to publish guidance to stakeholders on the principles that it relies upon in making decisions, including in relation to such matters as the significance that it attaches to implementation and administration costs, how it approaches the assessment of potential costs and benefits that are not readily quantifiable, and the basis on which it seeks to balance the potential quantifiable and non-quantifiable effects of rule changes under consideration.

Delegated rule making

In considering rule making activities, a number of submitters provided advice to the Panel on rule-like development activities which were not being undertaken by the AEMC. This included the development of significant guidelines by the AER, which may be a consequence of an AEMC rule

³⁹ AEMC submission to the Review of Governance Arrangements for Australian Energy Markets Draft Report, pp. 8–9.

change outcome, and, to a lesser extent, procedure development functions of AEMO.

While recognising the pragmatism of handing technical detail to technical experts, the Panel noted that these tasks could sometimes be significant in reaching national energy market objectives, but devoid of oversight by the AEMC or the Council. Effective consultative processes may also be lacking. It is therefore perhaps not surprising that some stakeholders have raised concerns about guideline and procedure development.

The Panel recognises that this is a balance, and that one reason for the AEMC's delegation is that it is not the repository of all the necessary technical expertise. However, the Panel considers that it would be useful to establish a mechanism whereby stakeholders could require the AEMC to review AER guidelines and AEMO procedures where a rule change has required that these guidelines or procedures to be created or amended, to confirm that the final outcomes meet the original intent. The Panel notes that there is unlikely to be a case to review purely administrative procedures. However, where procedures or guidelines have significant implications the review would provide an important mechanism to ensure that the delegated instrument adequately conveyed the AEMC's intent.

The Panel recommends that the AEMC put in place a formal mechanism to allow stakeholders to request that the AEMC sign off on the final guidelines or procedures if they have arisen from an AEMC process, to ensure they meet the original intent.

Recommendations

The Panel's recommendations are as follows:

- 3.1 The AEMC's mandate should be revised to include an obligation to prepare a major policy paper every three years containing advice on strategic direction, policy priorities and a work programme. Included in this advice would be a comprehensive review of the rules as a whole to help inform this process. This review should be directed at advising whether the rules are consistent with the strategic priorities, are fit for purpose and are not impeding beneficial and innovative developments in energy markets. In the intervening years, this document should be updated annually to address any major unanticipated changes in the market and advise on their implications for the strategic priorities and facilitate timely adjustments to the work plan. In its discharge of these tasks, the AEMC should demonstrate substantive engagement with all relevant stakeholders, including the AER, AEMO, other relevant institutions, industry participants and consumers.
- 3.2 A 'gateway test' process should be developed by the AEMC in conjunction with stakeholders for Council consideration.
- 3.3 A mechanism should be put in place for terminating rule change processes which are underway but no longer necessary. As with the gateway test, the AEMC should develop a proposal on a workable mechanism for the Council's consideration.
- 3.4 The AEMC should develop a staged review process proposal for broad and complex reviews, for consideration by the Council.
- 3.5 The AEMC should develop a single-step review process proposal for reviews dealing with specific or contained issues, for consideration by the Council.
- 3.6 The AEMC should implement an expedited rule change process for less complex rule changes, and changes should be made to the national energy laws to allow for an increased time-frame range of six to eight weeks for the process.
- 3.7 The AEMC should publish regularly updated timeliness performance metrics on its website, together with reasoned explanations for decisions involving significant time extensions.
- 3.8 The AEMC should implement and publish best practice guidelines for its regulatory processes.
- 3.9 The AEMC should put in place a formal mechanism to enable stakeholders to require the AEMC to sign off on the final guidelines or

procedures if they have arisen from an AEMC process, to ensure that they meet the original intent.

- 3.10 The AEMC should implement a 'clock-start' provision for rule change processes to improve its accountability. The AEMC would retain the ability to extend time frames for most of the steps for rule change requests by announcing an extension before the expiry of the time frame.

Chapter 4: Regulatory decision-making

Summary

The Panel's view is that the AER's role will increase in complexity and breadth due to the changing nature of the market environment. On this basis, it is important to ensure that the AER is as independent, adequately resourced and as organisationally capable as possible. The Panel believes that the most effective way to facilitate this is to separate the AER from the ACCC. This would provide the AER with full management and financial autonomy and the capacity to ensure that its organisational culture is well aligned to its role.

On the basis of the AER's past performance, and given the future challenges which it will have to confront, the Panel is also recommending a full performance review (in addition to the appellate process and self-monitoring now undertaken) of the AER every three to five years.

The AER

In its deliberations, the Panel has been mindful of the central, national role that a regulator such as the AER plays in the effectiveness of energy market governance arrangements. This is not unique to Australia; the Panel has an affinity with the view expressed by the OECD:

How a regulator is established, directed, controlled, resourced and held to account—including the nature of the relationships between the regulatory decision maker, political actors, the legislature ... judicial processes and regulated entities—builds trust in the regulator and is crucial to the overall effectiveness of regulation.⁴⁰

The AER was established in 2004 to focus on the 'economic regulation of electricity wholesale and transmission networks and key rule enforcement functions'.⁴¹ A primary goal was to promote consistency and reduce barriers to entry by reducing the number of regulators.⁴² In broad terms, the AER was to be the regulator of functions agreed by the Council to be part of the national framework. It was agreed that the Australian Government would be

⁴⁰ OECD, *The governance of regulators: OECD best practice principles for regulatory policy*, OECD Publishing, 2014, p. 15.

responsible for funding of the AER on the basis that jurisdictions fund the AEMC. The AER's functions include:

- setting the prices charged for using networks to transport energy to customers;
- monitoring wholesale electricity and gas markets to ensure suppliers comply with the legislation and rules, and taking enforcement action where necessary;
- regulating retail energy markets in Queensland, the Australian Capital Territory, South Australia, Tasmania (electricity only) and New South Wales and managing the energy price comparison website Energy Made Easy; and
- assisting the ACCC with energy-related issues arising under the Competition and Consumer Act, including enforcement, mergers and authorisations.⁴³

The Panel notes that the AER is subject to a Statement of Expectations from the Energy Council. Like the AEMC, the AER is required to publish a Statement of Intent every financial year outlining its response to the requirements set out in the Statement of Expectations, including reporting against key performance indicators.

Performing an increasingly complex regulatory role

In examining the AER's role the Panel has been particularly mindful of the consensus view that the energy sector is undergoing a period of unprecedented change to which, like other institutions, it will need to adapt. A central question that the Panel has therefore asked itself is 'How well positioned is the AER to make the necessary adaptations that will be required?' This is different from asking 'How well has the AER performed to date?', although the latter question clearly has bearing on the former.

⁴¹ Ministerial Council on Energy, *Report to the Council of Australian Governments: Reform of energy markets*, 11 December 2003, p. 9.

⁴² W. R. Parer, D. Agostini, P. Breslin and R. Sims, *Towards a truly national and efficient energy market*, 2002.

⁴³ www.aer.gov.au/about-us (accessed 25 May 2015).

The AER's primary, distinct task can be summarised as regulating network access (prices and standards) to promote efficiencies that serve the long-term interests of consumers. Relevant specific efficiencies fall in areas such as reliability of supply, service enhancements and investment in new capacity (including consideration of timeliness)⁴⁴, all of which can benefit consumers but can also affect the level and time profile of consumer prices. There is therefore a challenge in assessing the relevant trade-offs; for example, is new investment warranted because, although it might raise costs and prices in the near future, its longer term consumer benefits more than offset any shorter term detriments?

This challenge was identified in the Energy Networks Association (ENA) submission to the Panel, which drew specific attention to additional relevant considerations of regulatory credibility, regulatory certainty and efficient financing, each of which also has implications for consumer prices as well as for the AER's ability to adapt to changing circumstances:

*A strong, credible and effective energy regulator promotes the long-term interests of consumers by promoting efficient pricing and investment outcomes, lowering regulatory risk, and facilitating the efficient financing of long-lived sunk network infrastructure serving current and future consumers.*⁴⁵

The Panel notes that the observed shifts in energy service provision and in business models will likely make the assessment of what constitutes 'investment efficiency' even more contested than it has been in the past.

The Panel also notes that a driver of much of the recent public attention paid to the AER's regulatory role has been the increased significance of the network component costs in rapidly rising consumer energy bills. For example, between 2007–08 and 2012–13, the nominal average electricity bill for a New South Wales household doubled, while at the same time, the network component of that bill increased by 130 per cent.⁴⁶

⁴⁴ Ministerial Council on Energy, *Report to the Council of Australian Governments: Reform of energy markets*, 11 December 2003, p. 7.

⁴⁵ ENA submission to the Review of Governance Arrangements for Australian Energy Markets Issues Paper, p. 8.

⁴⁶ Productivity Commission, *Electricity network regulatory frameworks*, Vol. 1, Inquiry Report No. 62, 9 April 2013, p.4; Kai Swoboda, 'Energy prices: The story behind rising costs', in *Parliamentary Library Briefing Book: Key Issues for the 44th Parliament*, 2013, p. 106 (see:

The Productivity Commission has been prominent among the critics of the performance of existing governance arrangements in relation to network access regulation. It has expressed the view that:

The fundamental objective of the National Electricity Market (NEM)—the need for efficient investment in, and operation of, electricity networks in the long term interests of consumers—has been frustrated by flaws in its (ever more) complex regulatory and institutional arrangements. Indeed, at times, policy developments have been inimical to consumers’ interests, resulting in price rises that cannot be justified.

...

Given that networks are a natural monopoly, economic regulation (and its varying supporting institutions) will need to play a continuing role in networks. This is why it is imperative to improve the arrangements.⁴⁷

The Panel found that at least some of this general concern was directed at the performance of the AER to date, although not all submissions took care to distinguish between the underlying drivers of price changes, including movements in consumer prices versus movements in network costs, or the variation in network costs across states. These are matters of considerable interest to the Panel, since they bear on the extent to which any overall performance effects can reasonably be attributed to aspects of the conduct and structure of the AER. The Panel’s focus on the AER has been to identify opportunities to increase its effectiveness going forward, in a changing market environment, based upon recognised principles of best practice regulation.

Principles of best practice regulation

The OECD’s recent best practice framework for regulatory policy⁴⁸ suggests a range of factors that are potentially relevant to the governance of the AER. The Panel’s consideration has focused on key themes which emerged from

http://www.aph.gov.au/About_Parliament/Parliamentary_Departments/Parliamentary_Library/pubs/BriefingBook44p/EnergyPrices (accessed 25 May 2015).

⁴⁷ Productivity Commission, *Inquiry Report into Electricity Network Regulatory Frameworks*, Vol. 1, No. 62, 9 April 2013, p. 4.

⁴⁸ OECD, *The governance of regulators: OECD best practice principles for regulatory policy*, OECD Publishing, 2014.

consultations: organisational independence and financing, and management and organisational culture and skills. However, the Panel also heard consistent commentary that the AER's consumer engagement practices, while noticeably improved in the recent past, require further enhancement.

Although the elements above were not initially developed with the issue of regulating in conditions of disruptive change to the forefront, the Panel nevertheless considers they are directly relevant to questions concerning adaptability and effectiveness in such conditions.

Organisational independence and financing

Organisational independence and financing are important for ensuring that decisions that should properly be governed by established, settled public policy objectives—as, for example, are set out in the energy legislation—are not subject to undue influence or 'capture' (a strong form of influence) by other agendas. The principal concern in most of the international literature on regulatory independence is that decisions may come to be unduly influenced by other parts of the wider governmental system, most notably by the short-term, often changeable, 'immediate priorities' of the executive arm of government (that is, politicians), by other government agencies (pursuing alternative objectives) and by bureaucrats in all agencies, not least in the regulatory agencies themselves.

The Panel's view is that undue influence, from any of a number of sources, is an ever-present risk in regulatory practice, but that no single structure (drawn from the diverse international models available) can entirely eliminate the risk. All that can realistically be done is to establish a system of checks and balances that fits with the wider governance structure of the relevant jurisdiction and is capable of substantially impeding the development of major harmful imbalances in influence.

In the specific context of relevance—characterised by a period of rapid change in the market environment—the undue influence issues are of heightened significance. On the one hand, there is particular need to avoid undue influence from factors that might create a bias towards inertia and reliance on 'business as usual' approaches, since that would impede adaptation to the new environment. On the other hand, there is a need to 'manage regulatory change' in ways that do not undermine regulatory

certainty and credibility, outcomes that would similarly impede market development, albeit in different ways.

Management and organisational culture and skills

In relation to management issues, the general international picture exhibits greater commonalities. There is general agreement on the importance of the skills, expertise and experience of regulatory staff, and also of organisational culture, for the effective conduct of regulation. The Panel notes that the importance of these factors can be expected to be higher when the market and technological environment in which regulation is conducted is subject to rapid change.

Network regulation in particular requires a distinctive blend of skills and a particular culture, since in this activity the regulator is very frequently *substituting* its own economic decisions in relation to matters that would normally be settled by a market. This is very different from, say, the legislative task of establishing rules or the enforcement of competition law. In other words acting *as a substitute for* and *serving as a complement to* market exchange and initiative are different roles.

The Panel received a range of views on the AER's performance to date, including the view that the AER should be required to report against the performance metrics in the Australian Government Regulator Performance Framework.⁴⁹ The Panel observed the inevitability of negative commentary, as this is inherent in the tasks that the AER undertakes. However, there are wider questions on the AER's performance that relate to its management and organisational culture which concern the AER Board and the influence of the ACCC on the AER's culture.

The AER Board

Regarding the AER Board, the Panel notes that it received no significant criticisms of the qualities or capacities of the existing Board, which comprises regulators with considerable non-AER experience and of high quality. It does, however, consider it unreasonable to require the AER's three members to

⁴⁹ For example the Energy Networks Association, NSW DNSPs and Grid Australia submissions to the Review of Governance Arrangements for Australian Energy Markets Draft Report. The Panel understands that the Department of the Treasury, within which the AER sits, has exercised its right to exempt the AER from this framework. However, the AER has indicated that it will apply the principles of the framework to its reporting.

provide adequate attention and oversight to the complex informational tasks involved in pricing and access regulation, and this point applies with greater force if the AER is to continue to operate with a wider range of energy industry responsibilities.

The depth and availability of expertise of the Board will be crucial determinants of the success of adaptive organisational change, particularly if the consumer information deficit is to be addressed. This was recommended both by the Competition Policy Review and by other stakeholders, including the Total Environment Centre, Grid Australia and the ENA.⁵⁰ Additional members would bring an expanded skills range to the AER in areas such as distributed energy and consumer market research. The size and composition of the AER Board are addressed in Chapter 6.

The Panel does not, however, think that board expansion will be sufficient on its own to meet the challenges lying ahead. The success of regulatory organisations with the best of leaderships can be confounded by the existence of bureaucratic inertia in other parts of the organisation, combined with a variety of constraints on the capacity to address such inertia. It is therefore the Panel's principal conclusion in relation to the AER that the Board should be afforded the resources and independence (from all other agendas, whether originating from within government or from without) to develop the kinds of organisational culture favourable to the effective discharge of its core functions. This conclusion motivates the Panel's specific recommendations.

In addition to these considerations, the Panel considers that the AER should be subject, from time to time, to an independent performance assessment. This matter is addressed below. Depending upon the future relationship of the AER and ACCC, there may also be advantage in a more immediate review of whether the AER is currently subject to influences that unduly bias it towards an overly 'rigid' and/or 'defensive' organisational culture.

⁵⁰ *Competition Policy Review: Final report*, March 2015, p. 81; Total Environment Centre submission to the Review of Governance Arrangements for Australian Energy Markets Issues Paper, p. 4; Grid Australia submission to the Review of Governance Arrangements for Australian Energy Markets Issues Paper, p. 8; ENA submission to the Review of Governance Arrangements for Australian Energy Markets Issues Paper, p. 9.

AER organisational cultures

The question of organisational culture underlies staffing matters, including the skills, expertise, experience and incentives of employees of a larger government agency entrusted with the pursuit of other policy objectives and agendas. The ACCC is rightly proud of its ‘pro-market’ and ‘pro-consumer’ stance, but the fact remains that the core functions of a network regulator (even if it undertakes wider regulatory roles within an industry) involve the *substitution* of an administrative determination for a market outcome precisely because the market outcome is considered likely to be unsatisfactory, and this requires a particular approach. It also requires a culture that is favourable to coalescing perspectives from several disciplines, given the relatively wide range of skills and expertise that are relevant to decisions. In effect, regulatory price determination has to perform the same information discovery and aggregation functions as a competitive market—a distinct and difficult task.

In relation to price reviews in the energy sector—the only sector on which it is in a position to form a view—the Panel agrees with the Competition Policy Review that ‘the culture and analytical approach required to regulate an industry differ from those typically characteristic of a competition law enforcement agency’.⁵¹

Conversely, the Panel also notes that, less ‘typically’, the balance in skills between more routine and repetitive tasks and what might be called ‘change management’ can, in current circumstances, be expected to be rather different between a competition law enforcement body agency and an effective energy regulator. On this point, the Panel is particularly cognisant of the general argument that innovation and adaptation is better addressed by smaller organisations and teams than by larger, more bureaucratic organisations.

Consumer engagement

The Panel notes there have been recent significant changes in how the AER undertakes consumer engagement. These include improved consultation processes—the Consumer Challenge Panel and the Customer Consultative Group—and the development of a Stakeholder Engagement Framework

⁵¹ *Competition Policy Review: Final report*, March 2015, p. 80.

which allows the AER to consider stakeholder views when assessing its own performance. The Panel received positive comments from some submitters, particularly consumer bodies on these developments and is of the view that there have been significant improvements in consultation processes.

Notwithstanding these significant investments in engagement, the Panel also noted persistent questions about the likely efficacy of these process changes in leading to better outcomes. For example, Grid Australia's submission states that:

... there remains considerable ambiguity and uncertainty in what will satisfy the AER under its consumer engagement guidelines and how it accounts for an NSP's consumer engagement in its regulatory determinations; and a greater focus on consumer engagement has resulted in much less engagement between the AER and NSPs throughout the process.⁵²

The Energy Supply Association of Australia (ESAA) asserted that the AER's consultation processes are not as developed as, for example, the AEMC's and that therefore there is minimal scope for industry input.⁵³ These views highlighted the contrasting perspective raised earlier in this report; that consumer groups were generally more satisfied with their engagement with the AER while the industry was generally more satisfied with its engagement with the AEMC.

The Panel believes that it is too early to form a judgement about the effectiveness of the changes. While better engagement processes are certainly capable of contributing to better outcomes, in the end good engagement should be judged by the contribution it makes to the underlying policy objectives. Customer representatives are not necessarily representative customers, with all their individual differences, and it is the latter which should be the focus of informing regulatory decision-making.

The Panel's view is that the effectiveness of consumer engagement is likely to be heavily influenced by the skills, expertise and organisational culture of the AER. A critical weakness of monopolised markets is that, compared with competitive markets, there is a lack of pressing incentives to discover what it

⁵² Grid Australia submission to the Review of Governance Arrangements for Australian Energy Markets Issues Paper, p. 7.

⁵³ ESAA submission to the Review of Governance Arrangements for Australian Energy Markets Issues Paper, p. 5.

is that consumers, with all their individual differences, actually want (for example, in the energy markets, what they would be willing to pay for variations in service offerings). Put another way, for want of incentives, monopolies tend to be deficient in conducting market research. The Panel's conclusion is that what matters most in this area is that the AER puts at the heart of its work the discovery of customer preferences, whether by direct engagement or by providing incentives to network operators to more effectively discover consumer preferences.

AER independence, resourcing and staffing

The issue of the current and future structure of the AER was discussed at length by stakeholders, and a full spectrum of views was presented to the Panel.⁵⁴ The independence of the regulator, in perception as well as in fact, is a primary theme of international studies on good regulatory governance because reputation and credibility are critically important factors for effective regulation.⁵⁵ As indicated, the operative notion of independence includes a lack of undue influence from differing agendas emanating from other government agencies, as well as from transient political priorities and from interest groups outside government.

Structural issues aside, it is tempting to link all issues of AER capacity to its level of resourcing, and this certainly featured prominently in submissions.⁵⁶ In particular, an often cited reason for retaining the current organisational arrangements (put particularly by the ACCC and the AER themselves) is efficiency in the use of human resources and shared services.

⁵⁴ The Panel heard many views on this issue in submissions. They included strong support for separation (e.g. AGL, Energy Networks Association), support for the Competition Policy Review recommendation to establish a stand-alone access and pricing regulator (APR) (e.g. Alinta Energy, Hydro Tasmania, GDF Suez), strong refutation of an APR (e.g. Australian Pipelines and Gas Association, APA Group, Business Council of Australia, Energy Retailers Association of Australia), and satisfaction with the current structure (e.g. Origin, Australian Gas Networks).

⁵⁵ OECD, *The governance of regulators: OECD best practice principles for regulatory policy*, OECD Publishing, 2014, p. 54.

⁵⁶ Many organisations commented on AER funding options, including SACOSS, Cotton Australia, the NSW DNSPs, AGL, ERAA, Grid Australia, the Energy Networks Association, the Centre for Energy and Environment Markets UNSW, the ACCC and the AER, in their submissions to the Review of Governance Arrangements for Australian Energy Markets Draft Report.

The Panel considers, however, that claims of efficiency and synergies in human resources and property management have not, in fact, been substantiated and that consideration has not been given to the extent to which such efficiencies could be secured under an alternative structure where the AER exists independently of the ACCC. The Panel notes, for example, that there would be no barrier to the ACCC and the AER cooperating on leasing arrangements if they were independent organisations; nor would there be a barrier to secondment opportunities to address peaks in demand for specialised legal skills, particularly in a transitional period. Similarly, the Panel is not convinced that there are significant ‘cross-organisational’ benefits for staff career development that would be undermined through the separation of the AER from the ACCC.

However, the Panel considers that the key issue for the AER’s organisational structure is to facilitate the desired culture within the AER. In the Panel’s view, establishing the AER as a stand-alone body will encourage it to adopt a culture that vigorously pursues and promotes information discovery, and adapts and adjusts to the new challenges that are being set for the energy sector, consistent with its role as an economic regulator, as opposed to the ACCC, which is predominantly an enforcement body across the economy as a whole.

Alternative structural models

The organisational independence of the AER

As has just been discussed, there was considerable attention in submissions and during consultations on the AER’s relationship with the ACCC.⁵⁷ Having heard and carefully considered the arguments, which have been well rehearsed in other Australian energy policy contexts, the Panel has reached the conclusion that the national energy policy objectives are not as well served as they might be by the status quo because of skills, expertise and cultural issues. The Panel acknowledges that the very nature of this finding cannot be backed by definitive evidence. Waiting for definitive evidence to

⁵⁷ There were varied opinions on the suggested separation of the AER from the ACCC. In their submissions to the Review of Governance Arrangements for Australian Energy Markets Draft Report, some stakeholders supported the separation (e.g. the Energy Efficiency Council and the Energy Networks Association), others thought further evidence was required (e.g. Cotton Australia) and others were strongly opposed (e.g. the Consumer Action Law Centre, the Major Energy Users, the AER and the ACCC).

emerge is akin to waiting for mistakes to occur or asserting what errors might not have been made under a different structure. The Panel notes that this question concerns governance and culture, which are very different issues to, for example, market outcomes.

Seen in this light, the alternatives available appear to be:

- greater separation of AER activities within the ACCC (analogous to greater 'business separation' in a company context), principally directed at cultural, resourcing and staffing issues, including at board and senior staff levels;
- a stand-alone AER as purely energy regulator; or
- separation from the ACCC, but as part of access and pricing regulatory activities in other sectors, as proposed by the Competition Policy Review.

Each of these alternatives would constitute, in its own way, a response to the skills, expertise and cultural issues outlined above, and each could potentially see some narrowing of AER activities (more specifically consumer and competition functions could remain with the ACCC, along with price monitoring and surveillance of those markets that are open to competition). Each option is discussed below.

Enhanced independence while retaining the ACCC linkage

This option has the advantage of requiring least disturbance to the status quo, but that is also its chief limitation. The Panel gives great weight to the consensus view of submitters that the energy sector is facing a period of considerable change and challenge and that a significant enhancement in the AER's organisational capacity to adapt is required if national objectives are to be well served. What might be considered synergies from being part of a larger organisation in a more static context can, when organisational adaptation is required, be a source of barriers to change.

The Panel recognises that there is a trade-off here and that a judgement is needed to resolve it. Any movement towards giving the AER greater managerial autonomy, including the option of enhanced autonomy within the ACCC, may imply the potential sacrifice of some organisational synergies. The Panel is not convinced that these losses are a factor of major significance, whereas the Panel is convinced that an upgrading in the AER's

organisational capacity is of major importance for the achievement of the national objectives.

A stand-alone AER

The simplest and most comprehensive means to tackle the identified problems would be to reconstitute the AER as an independent organisation. The issue for the Panel is therefore whether there are material drawbacks in taking the extra step.

A number of possible objections were raised during the consultation process, the first of which is the administrative cost of effecting such a change. As outlined above, the Panel is of the view that the costs of institutional change have not been substantiated in light of the alternatives available.

Another objection to a stand-alone AER is that it would be more vulnerable to 'industry capture' than is the case under current arrangements. This concern has been raised, for example, in the Competition Policy Review, a recent paper by the Monash Business Policy Forum and a submission to the Review by the Consumer Action Law Centre.⁵⁸

In this context, the Panel notes that the chief motivation for seeking independence in regulatory agencies is to protect decision-makers from the unwanted intrusion emanating from other parts of the government system as a whole; that is, to prevent 'political or bureaucratic capture'.

In the Panel's view, despite the stream of economic literature that is concerned with 'industry capture', there is a dearth of evidence to suggest that this has been a significant problem in jurisdictions that are the most obvious comparators with Australia. In the United Kingdom, for example, industry capture has hardly appeared as an issue, whether in relation to large, conglomerate regulatory bodies or to much smaller, more specialised agencies.

The Panel considers that the Australian energy governance system has more checks and balances built into it than most comparable systems. All

⁵⁸ *Competition Policy Review: Final report*, March 2015, p. 80; Monash Business Policy Forum, *Rationalising rustic regulators: How should Australia's national economic regulators be reorganised?*, July 2014, p. 10; Consumer Action Law Centre submission to the Review of Governance Arrangements for Australian Energy Markets Issues Paper, p. 12.

good-practice arrangements are characterised by appellate mechanisms, but Australia has the extra protection afforded by the separation of market rule making from the decision-making process for pricing and access issues. In this context, clear thinking and a sharp focus for a regulatory body will do much to protect it from the risk of capture by any particular stakeholder constituency.

The Panel therefore concludes that, particularly if others of its recommendations are adopted, there is no substantiated basis for concern about industry capture and that a stand-alone AER would better facilitate the effective management of access and pricing regulation in the face of the challenges that lie ahead. This is the Panel's preferred option.

Part of a new access and pricing regulator

The Panel notes that the Australian Government has yet to respond to the Competition Policy Review recommendation to establish a stand-alone access and pricing regulator (APR). Since decisions on that possibility are contingent on wider policy considerations, the Panel's comments on this option are necessarily limited in scope. The main point is that the Panel considers that its views on the desirability of greater managerial autonomy for the AER are paramount.

The scope of the AER's activities going forward

A core function of an economic regulator in a sector such as energy is making pricing (or revenue allowance) and access decisions. However the current responsibilities of the AER cover a wider range of matters and this raises questions of whether this is appropriate and, if not, where these additional responsibilities should lie. There is a trade-off between the functional focus of a specific task (such as pricing regulation) and the broadening of the energy regulator's role to encompass matters such as those the AER currently undertakes.

The Competition Policy Review contemplated that these additional responsibilities should lie with the ACCC. The Panel notes the views expressed during consultations that, with continuing technological and market developments, the boundaries between pricing and access issues and some other regulatory activities may become blurred. The Panel was also mindful that there is no clear dividing line for the splitting of functions between the

energy regulator and the ACCC. The absence of a clear division inevitably means avoidable confusion could easily be created from the allocation of existing regulatory functions.

In general, the Panel's view is that the AER is best structured as an energy-specific industry regulator, given the challenges that are facing the sector and the increasingly complex and interrelated tasks that the regulator is required to perform. The Panel's view is that a sector-specific regulator is a better proposition than the model proposed by the Competition Policy Review, where, depending on the nature of the decisions required, which might be interrelated, market participants would be required to interact with separate regulators.

If the AER is to be a separate entity, in the Panel's view, the AER should retain all of its current functions conferred on it by the relevant statutes. The ACCC would continue to perform energy-related functions that arise under the *Competition and Consumer Act 2010*.

Broadly, however, the Panel considers that the governance arrangements and regulatory structures more generally should be robust, meaning that they must be appropriate for addressing a relatively wide range of possible outcomes. The Panel is content with the AER retaining its existing network, wholesale and retail functions for the immediate future. These functions can then be adjusted through changes in the national laws, regulations and rules when, in the light of market developments, that is judged to be desirable (for example, when a previously monopolistic activity transitions to being competitive). Such matters could be addressed via the strategic priorities process that the Review proposes.

Implementation

The Panel has received submissions arguing that now is not a good time to subject the AER to disruptive organisational change because the AER is fully stretched by its existing activities, including its defence of price determinations against appeals made to the Australian Competition Tribunal. Given that a re-configuration of the AER will necessarily take some time (a period of around two years might be indicated for operational reasons) the Panel sees no reason to delay the policy decision. Indeed, it considers a planned transition to new arrangements now is better than a hasty transition in response to a major performance failure in the future.

Consequences of separation: additional budget and staffing aspects

It has been put to the Panel that the overall quantum of resources required to support a stand-alone entity would be significantly larger than that currently required for the AER leveraging off ACCC resources. Again, however, this argument appears to rest on static 'business as usual' presumptions and ignores the profound changes that the sector is undergoing. Those changes require a management style, culture and skill set that are capable of adapting according to a set of transparent, easily understood principles that are capable of sustaining regulatory certainty even as things change. The Panel is aware of no evidence that substantiates a view that this adaptability is more likely to be achieved by locating the AER within the ACCC, which is a much larger organisation with a broader range of objectives and preoccupations.

For the reasons expressed above, the Panel is not of the view that its recommendations necessarily involve a significant increase in funding requirements. What is important is that the AER Board has greater flexibility in the deployment of resources. In this context, the Panel notes that the challenge of improving resourcing to attract skilled employees is going to arise regardless of any institutional change. Indeed, the AER, operating within its existing funding limits, has already undertaken work to expand its technical capabilities in some areas. Going forward, AER staff will need the skills to better understand innovation across all aspects of the energy sector in order to adapt regulatory processes and to articulate and explain how the relevant regulatory decisions serve the long-term interests of consumers.

Should a stand-alone AER be established, it seems to the Panel that the bigger immediate issue is the source of its funding, especially consideration of options where funding responsibility is more closely aligned with cost causation. This issue is addressed in Chapter 6.

Periodic review of AER performance

The Panel is mindful of a certain level of stakeholder disquiet with the outcomes of past price reviews and, while recognising that some friction is fairly normal in such matters, it takes the view that there is scope for improvement. The need for improvement has been recognised by the AER, which has sought to improve its own performance monitoring. It now has

several internal performance assessment benchmarking tools that are used to measure aspects of performance. Monitoring is based, among other things, on key performance indicators, budget and parliamentary accountability, stakeholder views, judicial reviews, and organisational health indicators.⁵⁹ However, these metrics are mostly based on material generated via internal processes, which are themselves worthy of external scrutiny.

The Panel notes that the AER has participated extensively in appeals arising from the Limited Merits Review regime. However, the AER has found that review outcomes can reflect a range of factors (such as uncertainty about rules and disagreements on the issues) and that challenges under the rules have become fewer over time.⁶⁰ Moreover, since appeals are backward looking, they are not well suited to identifying performance weaknesses that need to be addressed now in order to secure better decisions in the future. Likewise the Panel considers that the Australian Competition Tribunal processes that the AER has participated in are not a useful vehicle for performance assessment as they are not able to help the AER identify systemic cultural or organisational issues.

The Panel therefore believes that, if international best practice standards are to be met, a mandated, periodic and external performance review of the AER is needed to supplement the feedback derived from appellate processes and self-monitoring.

The external aspect is important because AER members are an integral part of the decision-making process, they are not in a position to undertake an independent review as might occur in a corporate environment. As a result, the Panel has recommended an external review process for the AER to be conducted every three to five years.

As the Panel sees it, there are two options: performance assessments undertaken by an independent expert panel that is assembled by the Energy Council or assessments by the Productivity Commission.

While each of these suggestions has merit, the Panel is of the view that the Productivity Commission may not have the requisite expertise in place to

⁵⁹ AER submission to the Review of Governance Arrangements for Australian Energy Markets Issues Paper, p. 10.

⁶⁰ AER submission to the Review of Governance Arrangements for Australian Energy Markets Issues Paper, p. 10 and p. 11.

undertake this role. The energy sector is composed of complex systems about which depth of understanding is required, even when the focus of assessment is on matters that may be relatively specific or have more generic aspects, such as how the regulatory agency is managed or how the cost of capital is assessed.

The Panel favours reliance on independent, ad hoc panels of expert peers. The composition of the panels could be varied to reflect what, in the light of informed but prima facie opinion, are the aspects of performance most capable of being improved.

In appointing a panel, it would be for the Council to ensure that appropriate non-conflicted people are selected for this role. It is also important that, collectively, panel members should have regulatory experience and in-depth knowledge of all sides of the relevant markets (consumers, industry and government) in order to be able to assess performance against the national energy objectives, the achievement of which depends on multi-sided contributions.

The Panel therefore recommends that the AER be reviewed every three to five years by a panel of experts appointed by the COAG Energy Council. The experts should be collectively experienced in regulation and have in-depth knowledge of all sides of the relevant markets (consumers, industry and government).

Recommendations

The Panel's recommendations are as follows:

- 4.1 The AER should have full management and financial autonomy, which would be most effectively achieved by re-establishing it as a stand-alone regulatory body.
- 4.2 The scope of the AER's responsibilities should remain as they are; that is, those currently conferred by the relevant statutes.
- 4.3 Decisions on these recommendations should be made as early as realistically feasible to allow the AER Board to plan and manage the re-configuration of the organisation over a suitable period.
- 4.4 The AER should be reviewed every three to five years by a panel of experts appointed by the COAG Energy Council. The experts should be collectively experienced in regulation and have in-depth knowledge of all sides of the relevant markets (consumers, industry and government).

Chapter 5: Market operation

Summary

The Panel's views on AEMO are that it is performing its functions well, but there is room to improve the clarity of AEMO's role, with particular focus on AEMO's 'market development' role. The Panel therefore recommends that AEMO's fundamental role be specified in a way which is consistent with it being an independent market and systems operator, and it should only have regulatory and statutory roles which are consistent with this role. The Panel does not intend that AEMO be excluded completely from the policy development process of governments, but rather that the terms of its participation should be more clearly specified and guided.

With respect to transmission network service provider functions, the Panel's view is that AEMO should only undertake tasks outside its core responsibilities where they do not conflict with those responsibilities and are undertaken on the basis of contractual arrangements. The Panel recommends no changes to AEMO's ownership framework.

The role of AEMO

AEMO was established to manage the NEM and gas markets from 1 July 2009, significantly changing the operational architecture of national energy markets. The company operates the wholesale and retail electricity and gas markets across eastern and south-eastern Australia. This includes the NEM, with AEMO assuming the role previously played by the National Electricity Market Management Company; the Declared Wholesale Gas Market in Victoria; the gas Short Term Trading Market; the Wallumbilla Gas Supply Hub; and energy retail markets. AEMO also oversees the system operations and security of the NEM power system and the Victorian Gas Declared Transmission System.

To ensure the ongoing stability of the NEM, AEMO operates the interconnected NEM power system from two control centres located in different states. Both centres operate 24 hours, 7 days a week, and are equipped with identical technology, so that electricity supply remains constant and secure, even in unexpected circumstances.

An independent systems operator such as AEMO is an integral part of the structure of energy market systems. Submissions expressed general support for AEMO as systems operator, and many expressed the view that it had performed its role to a generally high standard⁶¹; objective measures of system performance support that view. However, the Panel also noted consistent questions about AEMO's role in policy development, particularly in relation to that of the AEMC, and the appropriateness of AEMO exercising its monopoly over data and operational systems to develop mechanisms which also expand its operational network.⁶²

AEMO as market and systems operator

The submissions to the Review indicate that stakeholders generally consider that AEMO has performed its operational functions well⁶³, including by developing a strong market operator capability and giving stakeholders great confidence in system security.⁶⁴ According to the AER, the energy market operator 'has provided a national, independent focus to network planning and provided greater transparency around planning outcomes' since its establishment.⁶⁵

Alongside generally very positive views about AEMO, stakeholders expressed a number of concerns about AEMO's performance, including that AEMO may not be responsive to changing energy market dynamics, that it is captured by incumbent market participants, that at times it may not be adequately resourced and that it lacks an appreciation of consumer issues.⁶⁶

⁶¹ Origin submission to the Review of Governance Arrangements for Australian Energy Markets Issues Paper, p. 3.

⁶² Jemena submission to the Review of Governance Arrangements for Australian Energy Markets Issues Paper, p. 7.

⁶³ AGL Energy Ltd submission to the Review of Governance Arrangements for Australian Energy Markets Issues Paper, p. 4; Major Energy Users Inc. (MEU) submission to the Review of Governance Arrangements for Australian Energy Markets Issues Paper, p. 59.

⁶⁴ EnergyAustralia submission to the Review of Governance Arrangements for Australian Energy Markets Issues Paper, p. 14.

⁶⁵ AER submission to the Review of Governance Arrangements for Australian Energy Markets Issues Paper, p. 4.

⁶⁶ Cotton Australia submission to the Review of Governance Arrangements for Australian Energy Markets Issues Paper, p. 9; MEU submission to the Review of Governance Arrangements for Australian Energy Markets Issues Paper, p. 59; Alternative Technology Association submission to the Review of Governance Arrangements for Australian Energy Markets Issues Paper, p. 3; Alternative Technology Association submission to the Review of Governance Arrangements for Australian Energy Markets Draft Report, p. 2.

Assertions regarding a lack of responsiveness to changing energy market dynamics are not unique to AEMO but are of concern to the Panel in respect of the operation of market institutions generally. Those concerns are considered throughout the report.

The Panel notes that recent initiatives by AEMO are designed to enhance the quality of its consultation with stakeholders, including consumer groups. Submissions to the Issues Paper are generally supportive of the improvements AEMO has made to its consultation processes. AEMO has established a number of working groups⁶⁷ in an effort to ensure that stakeholders have the opportunity to participate in the ongoing planning, development and operation of the energy market. Some of these groups facilitate consultation with government representatives as well as industry representatives.

The recently established Consumer Forum has been welcomed by consumer groups. However, the Panel noted a belief in some groups that AEMO has demonstrated a reluctance to promote reforms that are intended to benefit consumers, such as by improving consumer access to data and opening the market to new products and services that compete with existing energy businesses (which are, for the most part, AEMO members).⁶⁸

AEMO policy and market development

There is a lack of consensus and a degree of ambiguity about the extent to which AEMO should be involved in both policy development (through the COAG Energy Council) and market development activities.

⁶⁷ www.aemo.com.au/About-the-Industry/Working-Groups (accessed 8 July 2015).

⁶⁸ For example, Alternative Technology Association submission to the Review of Governance Arrangements for Australian Energy Markets Issues Paper, p. 3.

The ENA has questioned AEMO's involvement with COAG Energy Council work programmes such as the Renewables Study, the Wallumbilla Gas Supply Hub and the rule change proposal to introduce a demand response mechanism.⁶⁹ As Australian Gas Networks notes:

*... AEMO should focus its resources and expertise on fulfilling its core role as a responsive and efficient provider of market operational services. Implicit in this, market development and policy advice should continue to sit with the AEMC.*⁷⁰

The Panel notes that the AEMA is very clear in identifying the AEMC, not AEMO, as responsible for 'energy market development at a national level, including in respect of the National Electricity Rules, the National Gas Rules and the National Energy Retail Rules'.⁷¹

During consultations, multiple stakeholders asserted that 'market development' was being undertaken by AEMO, perhaps without a specific mandate from the Council. A large number of stakeholders pointed to a lack of clarity regarding the institutional responsibility for market development functions as being confusing and challenging for the delivery of market objectives, and that resolving this uncertainty would be a useful contribution the Review could make.

During consultations, a number of stakeholders also pointed to concerns that there is insufficient coherence between AEMC and AEMO involvement in policy related activities. While there are virtues in having multiple sources of independent advice, this issue was raised consistently enough to raise concerns that this was a source of inefficiency and ineffectiveness.

Some of the confusion may well emanate from the lack of clarity in the governing instruments of the markets. Under the AEMA, AEMO is responsible for the day-to-day operation and administration of both the power system and electricity wholesale spot market in the NEM, the retail electricity markets, the retail and wholesale gas markets and other support activities. However, AEMO's role, as articulated in the National Electricity Law and the National Gas Law, could be construed to be broader than that contemplated by the

⁶⁹ ENA submission to the Review of Governance Arrangements for Australian Energy Markets Issues Paper, p. 14.

⁷⁰ Australian Gas Networks submission to the Review of Governance Arrangements for Australian Energy Markets Issues Paper, p. 3.

⁷¹ Clause 5.1 of the AEMA.

AEMA. AEMO's legislative functions (in the case of electricity and gas) include a reference to 'promoting the development' of the operation and administration of the wholesale exchange and gas markets.⁷²

A further explanation for the confusion and overlap is that AEMO's functions have increased due to the evolution of the markets. The predecessors to the current market institutions were initially conceived for electricity markets which were predominantly government-controlled and not part of a competitive market. However, over time, with the development, by the private sector, of a competitive gas market, the roles of the institutions have been extended to include the gas market. The Panel further notes the inherent difference between the electricity and gas markets. For example, the supply of and demand for electricity in the NEM is unlike supply and demand in gas, in that electricity supply and demand must be very closely matched in real time. The Panel heard some criticism that AEMO applied conceptual frameworks suitable for electricity markets to gas issues and that this led to inefficient outcomes. The Panel therefore sees opportunities to realign AEMO's role with its responsibilities as specified in the AEMA.

The institutional framework was developed when the electricity sector consisted of centralised generation transmitted to consumers. A number of technologies have since emerged which are having significant impacts on the sector—smart meters, solar PV systems and energy storage systems. The market development role that institutions should play with respect to these later changes has not always been clear.

It has further been suggested to the Panel that the AEMC's electricity industry expertise was not initially matched by an equivalent level of expertise in the gas industry and that this created a vacuum, to which AEMO responded.

Whatever the accuracy of those observations and assertions, it is evident that lack of clarity in the current arrangements has contributed to ineffectiveness in the policy development process, uncertainty as to institutional responsibilities, disharmony between the AEMC and AEMO, and concern within industry. The Panel is of the view that these matters can be addressed by clarifying the extent to which AEMO is drawn into the COAG Energy Council policy development process and the extent to which it participates in 'market development'.

⁷² Section 49 of the National Electricity Law and section 91A of the National Gas Law.

The Panel's view is that AEMO's regulatory and statutory roles should be specified in a way which is consistent with its function as the independent market and systems operator. However, the Panel does not intend that AEMO be excluded completely from the policy development process of governments, and this is explained further below.

The Panel's conclusion is that the role of AEMO as the market and systems operator should be aligned with the AEMA and described as:

- facilitating the operation of markets for energy; and
- promoting the reliability and efficient operation of energy systems and markets.

Adopting this description does not, of itself, resolve the confusion in respect to AEMO's role in market development given the reference to 'promoting the development' of operations in AEMO's statutory functions.⁷³ However, AEMO's central focus should be on operations and it is entirely appropriate that it have the major role in developing procedures for the purpose of market operation within an established system of trading. AEMO's involvement in market development outside of this scope should only be through specific commissions initiated by the Council or AEMC or contractual arrangements with other parties.

The Panel wishes to ensure that AEMO continues to provide input into policy processes, given AEMO's expertise in market and systems operations. The Panel considers that the quality of proposals submitted to the Council will be diminished to the extent that this capability of AEMO is not recognised and accessed. However, the chief vehicle for this input should be the new strategic priorities process that the Panel recommends, which, if it is to be as credible and influential as intended, requires AEMO's full commitment. The clear conclusion arising from these views is that the arrangements envisaged by the Panel will not be effective if the working relationship between the AEMC and AEMO (and for that matter also between AEMO and the AER) is not cooperative and consultative.⁷⁴

⁷³ Section 49(1)(b) of the National Electricity Law and section 91A(1)(b) of the National Gas Law.

⁷⁴ ENA submission to the Review of Governance Arrangements for Australian Energy Markets Issues Paper, p. 14; Snowy Hydro Limited submission to the Review of Governance Arrangements for Australian Energy Markets Issues Paper, pp. 1–2.

The Panel recommends that an AEMO ‘statement of role’ be drafted and approved by the COAG Energy Council. The statement of role would explain how this role is consistent with the AEMA, the National Electricity Law and AEMO’s constitution. The statement of role should also contain provisions for occasions when the Council wishes to commission AEMO advice, including provisions for opening up such services to potential competition from other providers where feasible, and for an accompanying payment for service.

Other AEMO functions

Aside from its market operation functions, AEMO has the role of the transmission network service provider (TNSP) for Victoria. As part of this role, AEMO works with industry to plan the development of Victoria’s transmission infrastructure and oversee new capacity and connections to the electricity transmission system. AEMO also advises the South Australian Government on the long-term development of the South Australian grid.

Stakeholders have noted that AEMO’s role as Victoria’s TNSP could be perceived to reduce its independence in its role as ‘national planner’ and affect its interaction with the other national energy market institutions.⁷⁵ As Snowy Hydro argues, this anomaly makes AEMO a participant:

*... in the market which it operates. Furthermore, it is also a not for profit organisation which appears to conflict with the incentive schemes for network businesses which use financial incentives to motivate TNSPs.*⁷⁶

The Panel, however, notes that some stakeholders are of the view that AEMO’s TNSP role in Victoria has resulted in positive outcomes and could be extended nationally.⁷⁷ In addition, the Alternative Technology Association argued that altering AEMO’s Victorian TNSP role to achieve ‘uniformity for its own sake’ could lead to unintended consequences.⁷⁸

⁷⁵ MEU submission to the Review of Governance Arrangements for Australian Energy Markets Issues Paper, p. 60.

⁷⁶ Snowy Hydro submission to the Review of Governance Arrangements for Australian Energy Markets Issues Paper, p. 2.

⁷⁷ Energy Users Association of Australia submission to the Review of Governance Arrangements for Australian Energy Markets Draft Report, p. 17.

⁷⁸ Alternative Technology Association submission to the Review of Governance Arrangements for Australian Energy Markets Draft Report, p. 4.

Consistent with the view expressed in the previous section, the Panel does not regard it as appropriate that such state-specific responsibilities should be part of the core responsibilities of AEMO. However, so long as it can be demonstrated that they are not in conflict with those core responsibilities and, where feasible, the relevant activities are open to competition, it is entirely appropriate for them to be undertaken by AEMO on a commercial fee-for-service basis or through other appropriate cost recovery mechanisms. The Panel notes that some stakeholders are supportive of this recommendation while others see the TNSP matter as a non-issue.⁷⁹

In arriving at this recommendation, the Panel is not seeking to prevent AEMO from continuing to fulfil its current roles in South Australia and Victoria. The Panel notes that these services are currently paid for by market participants, in the case of South Australia, and by consumers (through transmission charges), in the case of Victoria. The Panel is also mindful of the AusNet Services warning 'that it would be necessary to consider the issue more holistically and taking all of the advantages and disadvantages of the current arrangements and experience with its operation into account before drawing any conclusions about the need for change'.⁸⁰

A primary concern of the Panel is to have the core responsibilities of AEMO understood to help ensure that activities outside of those core responsibilities do not create conflicts of interest, ensure that they do not involve any leveraging of a privileged monopoly position and are fully funded by the party responsible for causation of the costs. This approach will ensure that there is no cross-subsidy of these activities from market participants.

Minter Ellison's submission notes that there are some AEMO legacy licensing exemption matters that could be transferred to the AER (or its successor).⁸¹ The Panel agrees that, where appropriate, such legacy functions should be

⁷⁹ Snowy Hydro submission to the Review of Governance Arrangements for Australian Energy Markets Draft Report, p. 3; Australian Pipelines and Gas Association submission to the Review of Governance Arrangements for Australian Energy Markets Draft Report, p. 5; AGL submission to the Review of Governance Arrangements for Australian Energy Markets Draft Report, p. 3.

⁸⁰ AusNet Services submission to the Review of Governance Arrangements for Australian Energy Markets Draft Report, p. 9.

⁸¹ Minter Ellison submission to the Review of Governance Arrangements for Australian Energy Markets Issues Paper, p. 4.

transferred to the AER or other appropriate bodies. The Panel notes that certain stakeholders support this recommendation.⁸²

AEMO ownership structure

AEMO is a company limited by guarantee incorporated under the *Corporations Act 2001*. The ownership of AEMO is divided between government members (with 60 per cent of voting rights) and industry members (with 40 per cent of voting rights). Government members include NEM jurisdictions and the Australian Government, and industry members include registered participants in the electricity and gas markets and the National Gas Bulletin Board.

According to AEMO, both its government and its industry members 'have similar rights to company shareholders other than as varied by the AEMO Constitution'.⁸³ However, there are some key differences. AEMO members are not able to obtain a financial return from the ownership of the operator, given the company's not-for-profit status. AEMO members are also not able to appoint directors directly to the Board. AEMO members' involvement in the appointments process is limited to endorsing candidates recommended by the Energy Council Selection Panel because the power to determine directors who are to be appointed resides with the COAG Energy Council.

The shared ownership structure of the national market operator has been raised in a number of submissions. For example, the ESAA argues:

*The ownership and governance of AEMO should be reconsidered now that the market has matured. The need for ongoing government ownership should be tested and consideration should be given as to whether any changes should be made to AEMO's corporate governance, for example the make-up of the board.*⁸⁴

Certain stakeholders have argued that the energy industry's contribution to AEMO's funding is not reflected in its ownership share. Some stakeholders

⁸² For example, the Australian Gas and Pipelines Association (p. 5) and AGL (p. 3) submissions to the Review of Governance Arrangements for Australian Energy Markets Draft Report.

⁸³ AEMO submission to the Review of Governance Arrangements for Australian Energy Markets Issues Paper, p. 4.

⁸⁴ For example, ESAA submission to the Review of Governance Arrangements for Australian Energy Markets Issues Paper, p. 5.

have claimed that, as industry pays for AEMO, it should have more control over AEMO's activities. Their argument is that this presents an issue of equity, given that AEMO operates on a cost-recovery basis and fully recovers its operating costs through fees paid by market participants. Due to this arrangement, a number of submissions argue for a change in AEMO's ownership structure to reflect its funding structure.⁸⁵

From the perspective of some industry stakeholders, the '40 per cent ownership of AEMO by industry is largely meaningless and provides the appearance of joint ownership without delivering any of the benefits to industry'.⁸⁶ It is argued that increasing industry ownership would make AEMO's ownership structure more equitable and improve industry input to the organisation.⁸⁷ The ENA argues that an industry-owned market operator is consistent with trends to divest government ownership and notes that this model has been implemented in other countries, such as the United States.⁸⁸

The Panel notes that there is a degree of confusion between the rights that might accrue to industry participants from their equity stake in AEMO and any rights that it might be argued should relate to the fact that industry meets all of the costs of the operation of AEMO. In the Panel's view, in relation to the core, AEMA-consistent responsibilities defined above, the user-pays characteristic funding for the operations of AEMO results from normal business practice and does not warrant consideration in terms of control. Market participants in their role as members agree to adhere to the AEMO constitution and any other rules, by-laws, policies or other standards prescribed by AEMO from time to time and guarantee to contribute to the AEMO's costs and liabilities in the event of AEMO being wound up.⁸⁹

The Panel concludes that the ownership structure is not the basic cause of industry dissatisfaction with the AEMO governance arrangements.

⁸⁵ Energy Retailers Association of Australia submission to the Review of Governance Arrangements for Australian Energy Markets Issues Paper, p. 2.

⁸⁶ Australian Pipelines and Gas Association submission to the Review of Governance Arrangements for Australian Energy Markets Issues Paper, p. 16.

⁸⁷ AGL submission to the Review of Governance Arrangements for Australian Energy Markets Issues Paper, p. 4; Hydro Tasmania submission to the Review of Governance Arrangements for Australian Energy Markets Issues Paper, p. 2.

⁸⁸ ENA submission to the Review of Governance Arrangements for Australian Energy Markets Issues Paper, p. 14.

⁸⁹ See the AEMO website for more detail: www.aemo.com.au/About-AEMO/Membership (accessed 8 July 2015).

Concerns more commonly cited by industry members are about the lack of control industry members have in relation to board appointments and about the extent of work undertaken by AEMO that is not strictly within its remit but that has a direct impact on AEMO's costs and thus on the charges which industry bears.

On the other hand, other stakeholders speak in favour of the joint ownership arrangements and advocate a larger government ownership presence. It has been argued that government ownership in the AEMO assists with the accountability of the organisation.⁹⁰ As stated above, some stakeholders, such as consumer groups, are concerned that the industry membership of AEMO has created a culture with an inherent bias towards industry interests and that increasing industry ownership would strengthen that perception. A proportion of stakeholders were also accepting of the structure as is.⁹¹

The Review has considered the full range of views on the AEMO ownership structure. While the Panel considers that a very good case could be made for a properly structured independent system and market operator to be privatised, no persuasive evidence was presented which warrants a change to the existing 60 per cent to 40 per cent ownership split at this time. Specifically, the Panel does not recommend a change to full industry ownership or, for that matter, full government ownership. At best, the ownership structure is a second order issue. The principal issues are greater precision in the role of AEMO and, as discussed in Chapter 6, the structure and appointment of its Board. The Panel notes that some stakeholders are disappointed by this approach while others are satisfied with retaining the status quo.⁹²

The approach that the Panel has recommended, for AEMO's core responsibilities to be specified and for all other activities to be treated on a fee-for-service basis, and where possible subject to competitive challenge, would address industry concerns about how the costs of additional activities are paid for. The Panel is also conscious that AEMO's operations should be

⁹⁰ South Australian Council of Social Service submission to the Review of Governance Arrangements for Australian Energy Markets Issues Paper, p. 3.

⁹¹ MEU submission to the Review of Governance Arrangements for Australian Energy Markets Issues Paper, p. 59.

⁹² ERAA submission to the Review of Governance Arrangements for Australian Energy Markets Draft Report, p. 5; Hydro Tasmania submission to the Review of Governance Arrangements for Australian Energy Markets Draft Report, p. 1; MEU submission to the Review of Governance Arrangements for Australian Energy Markets Draft Report, p. 34.

structured so that it is capable of transitioning to full private ownership if future expansion opportunities are best pursued in a private ownership model.

AEMO Board and governance structure

AEMO operates under the governance of its Board, which comprises nine skills-based non-executive directors and the Managing Director/Chief Executive Officer. The day-to-day management of the company is delegated to the Managing Director with support from board committees as appropriate. The Panel notes that AEMO directors are subject to *Corporations Act 2001* obligations.

As noted above, members do not directly appoint AEMO directors. Some stakeholders suggested aligning the AEMO appointments process with corporate practice⁹³, while others submitted that AEMO's governance arrangements could be improved by embedding greater industry representation in its Board.⁹⁴ Conversely, other stakeholders argue for the inclusion of consumer representatives and other types of industry members in the AEMO Board.⁹⁵ The Panel does not support the appointment of 'representative' directors. The Panel notes that current industry directors are prohibited from representing their industry interest and are bound by the corporate law duties to act in the best interest of the company. However, the Panel recognises the concern expressed in some submissions that directors should be drawn from a wider pool.

While the Panel notes that the structure of AEMO is not a direct analogue to a listed company and that the process for the appointment of directors to the AEMO Board is unusual, it is not persuaded that there is any benefit to be gained by seeking to more closely align the process with conventional corporate arrangements, especially given the role that AEMO plays in the Australian energy markets. The more critical issue is to ensure that those

⁹³ ENA submission to the Review of Governance Arrangements for Australian Energy Markets Issues Paper, p. 14.

⁹⁴ Grid Australia submission to the Review of Governance Arrangements for Australian Energy Markets Issues Paper, p. 10; Business Council of Australia submission to the Review of Governance Arrangements for Australian Energy Markets Issues Paper, p. 5.

⁹⁵ Ethnic Communities' Council of NSW submission to the Review of Governance Arrangements for Australian Energy Markets Issues Paper, p. 4; South Australian Council of Social Service submission to the Review of Governance Arrangements for Australian Energy Markets Issues Paper, p. 3; Total Environment Centre submission to the Review of Governance Arrangements for Australian Energy Markets Issues Paper, p. 4.

processes are designed to ensure that high-quality candidates are appointed and that the Board collectively has the required spread of skills and experience.

Specific recommendations regarding the governance of AEMO are in Chapter 6.

Recommendations

The Panel's recommendations are as follows:

- 5.1 That the role of AEMO as the market and systems operator be defined as:
 - facilitating the operation of markets for energy; and
 - promoting the reliability and efficient operation of energy systems and markets.
- 5.2 That the Council issue an AEMO 'statement of role' which clearly specifies AEMO's core role, and includes provision for accessing AEMO's expertise in market and systems operations and the arrangements under which it is able to undertake other activities.
- 5.3 That all activities that AEMO undertakes outside its core role should be provided on a fee-for-service or other cost recovery basis and should, where feasible, be open to competition.
- 5.4 That AEMO remain a not-for-profit company under the *Corporations Act 2001* and that the current mixed ownership model of 60 per cent government and 40 per cent industry is retained.

Chapter 6: Governance processes

Summary

The Panel concludes that there is scope to increase the number of commissioners for both the AER and the AEMC, given the increased scope of both the AER's and AEMC's functions envisaged through the Review and within the broader energy market context. Further, all appointments to both the AER and AEMC should be made jointly through the COAG Energy Council, removing the distinction between Australian Government and state and territory government nominees.

The Panel recommends changes to make the Selection Panel processes more transparent, and that all jurisdictions should fund both the AEMC and the AER.

The Panel also recommends that the Energy Council consider another governance review in 2023.

Board or Commission composition and related issues

AEMC

The AEMC currently has three commissioners: one is the full-time chair; the other two are part-time commissioners. One commissioner is recommended for appointment by the Australian Government, and the other two are recommended by the states and territories. As the AEMC is established under South Australian law, the South Australian Governor formally appoints the commissioners to their positions.⁹⁶ Appointments are for up to five years (or up to three in the case of some part-time commissioners), and there is no restriction on subsequent reappointments. Commissioner appointments are made in accordance with the *Australian Energy Market Commission Establishment Act 2004 (SA)* and the AEMA.⁹⁷

The Panel notes that the split in responsibility for appointment of commissioners (between the Australian Government and state and territory

⁹⁶ Section 12 of the *Australian Energy Market Commission Establishment Act 2004 (SA)*.

⁹⁷ Clause 7.1 of the AEMA.

governments) reflects the history of the development of the market institutions. While the appointees are not intended to be representative of the jurisdictions responsible for their appointment, some stakeholders interpret it that way. The Panel considers, however, that the AEMC has now matured as an organisation, as has the energy market, and as a result recommends that the distinction between the Australian Government and state and territory government commissioners be abolished and that all AEMC commissioners be recommended for appointment by the Energy Council collectively.

During its consultations, the Panel received commentary that the current three-commissioner structure of the AEMC did not provide adequate oversight or diversity of background and experience appropriate to the range of projects for which the AEMC is responsible.⁹⁸ Concern was also expressed during consultation sessions that the current structure and arrangements did not adequately provide for succession planning.

The Panel is also conscious that these concerns would be compounded if its recommendations for additional activities are accepted. Reflecting on the workload and like organisations, the Panel therefore considers that the appointment of additional commissioners is warranted and recommends that the number of commissioners be increased to ‘up to five’, with the chair and at least two other commissioners appointed on a full-time basis.

The Panel notes the expectation that the AEMC will expand its stakeholder consultative activities, especially with consumers, and that its recommendations in respect to strategy development and review processes will increase both expectations of, and workload for, AEMC. As a consequence, the Panel recommends that one of the new full-time commissioners be assigned specific responsibility for stakeholder consultation relating to the recommended strategic development and review process.

The Panel is aware that there are formal and clearly specified Energy Council protocols to manage the appointment of AEMC commissioners. In addition, the AEMC has internal guidance documentation on the desired objectives, accountabilities and capabilities of an AEMC commissioner.⁹⁹ Neither the protocols nor the AEMC documentation are currently publicly available; while

⁹⁸ For example, the United Energy and Multinet Gas submission to the Review of Governance Arrangements for Australian Energy Markets Issues Paper.

⁹⁹ AEMC internal guidance document, ‘Candidate briefing—AEMC chair/commissioner’.

that does not appear to have undermined confidence in the appointments process, the Panel sees no reason why they should not be published on either one or both the Energy Council and AEMC websites.

For the AEMC, knowledge, skills and experience in governance, strategy, stakeholder engagement and the energy industry are required of all commissioners. According to the AEMC internal guidance documentation, the Commission is to have a desirable mix of:

- knowledge and experience of competitive energy markets and electricity and gas system operations;
- knowledge and experience of consumer protection principles, laws and practices;
- commercial and financial market experience as it applies to investment and operational decision-making in energy businesses;
- commercial experience in the energy sector;
- knowledge of the principles and practice of regulatory economics and competition policy as applied in the public utility sector generally;
- knowledge and experience in the preparation or application of law and rules and regulations of the market or market conduct;
- familiarity with and understanding of government processes and intergovernmental relations;
- experience at an executive level, including the ability to appoint and evaluate the performance of staff;
- ability to provide direction and input into strategic organisational decisions so that the AEMC can be run to carry out its role in accordance with all necessary requirements, including its mission and vision; and
- ability to identify key risks to the organisation in a wide range of areas, including legal, compliance, reputation, and to monitor risk and compliance management frameworks and systems.

The Panel notes that this specification of capabilities is extremely comprehensive and sees no reason to suggest that it be changed.

The Panel's recommendations in respect of AEMC governance are as follows:

- 6.1 That the membership of the AEMC be expanded from three to up to five members, with the chair and at least two other commissioners appointed on a full-time basis.

- 6.2 That one of the new full-time commissioners is assigned specific responsibility for stakeholder consultation relating to the recommended strategic development and review process.
- 6.3 That the agreement of at least two-thirds (rounded up) of participating jurisdictions is required in order for the COAG Energy Council to recommend a person for appointment to a position (including chair) on the AEMC; that the appointments be for five years; and that reappointments be permitted.
- 6.4 That appointments of commissioners to the AEMC continue to be made on the basis of a publicly available statement of the required skills and experience (as detailed in the body of this chapter); and that the Council has regard to succession planning in making appointments.

AER

The AER Board currently has three full-time members, including the chair; one (who is also an ACCC commissioner) is appointed by the Australian Government, and two are appointed by the states and territories. Appointments are for up to five years, and there is no restriction on subsequent reappointments. These stipulations are outlined in the AEMA¹⁰⁰ and reflected in the *Competition and Consumer Act 2010*.¹⁰¹

The Panel's recommendation in Chapter 4 is that the AER become a stand-alone entity and no longer be a constituent part of the ACCC. The Panel's consideration of governance arrangements for the AER in this chapter are intended to apply regardless of whether its recommendation for a stand-alone AER is accepted.

The Panel believes that, in line with its recommendation for the AEMC, division of responsibility for the appointment of members of the AER between the Australian Government and state and territory governments is no longer necessary or appropriate. In particular, for a stand-alone AER, it would no longer be appropriate for the Australian Government to appoint one member who must be a member of the ACCC.

¹⁰⁰ Clause 7.3 to clause 7.6.

¹⁰¹ Sections 44AM, 44AP, 44AR.

During the Panel's consultations, stakeholders expressed the view that the current structure and membership of the AER are not sufficient to provide direct oversight of the range of matters for which the AER has responsibility.

Similarly to the AEMC, the AER is likely to experience an ever-increasing workload due to the pace of change in the energy market. In addition, the AER will be taking on regulatory responsibilities concerning the Northern Territory and Western Australia in the near future which will bring additional workload onto existing AER members. The Panel sees utility in increasing the number of AER members from three to up to five, for similar reasons to those for the AEMC; that is, increasing the number will build capability and assist in succession planning. The chair and at least two other members should be appointed on a full-time basis.

Existing arrangements for the appointment of the AER board members are skills based and rely on requirements contained in the Competition and Consumer Act. Section 44AP(3) of the Act states that:

A person is not eligible for appointment as a State/Territory AER member unless the person, being a person who has knowledge of, or experience in, industry, commerce, economics, law, consumer protection or public administration, has been nominated for appointment in accordance with the Australian Energy Market Agreement.

Similar criteria apply to the AER member appointed by the Australian Government.

Documentation for recent appointments to the AER includes the following statement in respect to knowledge, skills and experience:

- a good understanding of the energy industry in which the AER operates;
- well-developed strategic planning skills;
- an outstanding reputation and collegiate style; and
- a commitment to sound corporate governance practices and the highest standard of integrity and ethics.

In addition, applicants will need to have a sound knowledge of the operation and application of the national electricity and national gas laws and associated rules and relevant sections of the Competition and Consumer Act.

The selection criteria are:

- leadership skills, demonstrating capacity to develop a balanced, independent and consultative approach;
- outstanding reputation and collegiate style;
- sound corporate governance practices, integrity and ethics;
- knowledge of the operation and application of the relevant legislation;
- knowledge of and experience in the principles and practice of regulatory economics as applied in the public utility sector;
- knowledge of or experience in industry, commerce, law, public administration or consumer protection;
- a vision for and strategic perspective on the AER's role and functions;
- understanding of the environment in which the AER operates;
- commercial acumen and the ability to respond to strategic and operational issues;
- influencing and analytical skills; and
- independence from and credibility with energy market stakeholders and participants.

Independence of the chair and members is particularly important. The absence of conflicts of interest, especially within the energy sector, is required. Stakeholders expect a high level of personal integrity and ethics to underpin decision-making by this national regulator.¹⁰²

With the exception of the need for board members to have an appreciation of the challenges of running a business in a regulatory environment, the Panel regards this statement of knowledge, skills and experience as sufficient to ensure that the collective capability of appointees to the AER is appropriate, especially if used in conjunction with a skills matrix which identifies the particular areas of expertise that need to be addressed when a new appointment is being made. The Panel believes that it is good governance practice that the statement be publicly available.

¹⁰² AER Candidate Information Pack (Chair), July 2014, pp. 14–15.

The Panel's recommendations for AER governance are as follows:

- 6.5 That the membership of AER be expanded from three to up to five members, with the chair and at least two other members appointed on a full-time basis.
- 6.6 That all members of the AER, including the chair, be appointed (or recommended for appointment, if the AER stays in the ACCC) by the COAG Energy Council with the agreement of at least two-thirds (rounded up) of the COAG Energy Council's participating jurisdictions, and that regardless of AER structure, appointments should be for a period of five years, and that reappointments should be permitted.
- 6.7 That appointments to the AER continue to be on the basis of a publicly available statement of the required skills and experience (as detailed in the body of this chapter) and that in making appointments, the Council should have regard to succession planning.

AEMO

The governance arrangements of AEMO are more complex than those for the AEMC and AER, as it is a corporate entity limited by guarantee under the *Corporations Act 2001* and has obligations under that legislation.

There is an inherent tension between AEMO's ownership status within the energy market (with oversight by the Energy Council) and its corporate status. Some stakeholders expressed the view that AEMO's governance processes should be allowed to proceed as though it were an ordinary company, so that board appointments would be in the hands of the company and its members.¹⁰³ Others expressed the view that the governments' role should be increased. In the Panel's view, there is no easy or clean resolution of these divergent views and, in any event, the current structural arrangements of AEMO are not a complete analogue for those of a listed company. The Panel's view is given AEMO's unique membership structure, the recruitment process is not that of a normal *Corporations Act* company and the Selection Panel has a critical role to play in ensuring an appropriate pool of qualified candidates is considered. This is discussed in more detail below.

¹⁰³ For example, Australian Pipelines and Gas Association, Energy Retailers Association of Australia, ENA and Origin submissions to the Review of Governance Arrangements for Australian Energy Markets Issues Paper.

The AEMO constitution provides that the number of directors shall be at least five but not more than 10, including the chair and the managing director. At least three directors, but not more than six, must have industry experience (as defined in the constitution).¹⁰⁴ The Panel notes that these provisions provide sufficient flexibility for the COAG Energy Council and the company to ensure the appointment of a board with appropriate capability.

The AEMO constitution specifies the list of skills and experience that the Board should possess.¹⁰⁵ It requires the appointment of:

... a board of Directors that (as a whole) possesses the following core skills and experience:

- (a) strategic expertise—the ability to review the strategy through constructive questioning and suggestion;*
- (b) accounting and finance—the ability to read and comprehend the company’s accounts, financial material presented to the Directors, financial reporting requirements and some understanding of corporate finance;*
- (c) legal—the Directors’ responsibility involves overseeing compliance with numerous laws as well as understanding an individual director’s legal duties and responsibilities;*
- (d) managing risk—experience in managing areas of major risk to the organisation;*
- (e) managing people and achieving change;*
- (f) experience with financial markets;*
- (g) experience in similar organisations or industries;*
- (h) information technology—the ability to govern significant investment in information technology to ensure appropriate capital and operational expenditures in line with the company’s object;*
and
- (i) economics and public policy.*

¹⁰⁴ Article 7.1(c).

¹⁰⁵ Schedule 2 of the AEMO constitution.

In addition, the Energy Council Appointments Selection Panel¹⁰⁶ must ensure that:

... the Nominees recommended will enable the board of Directors (as a whole) to have significant experience (“Industry Experience”) in:

- (a) operation of the National Electricity Market;*
- (b) operation of the various gas markets in Australia;*
- (c) understanding of the planned reforms to the electricity and gas markets in Australia and the reform agenda of Council of Australian Governments and the Ministerial Council on Energy;*
- (d) energy systems planning;*
- (e) power and gas system security;*
- (f) prudential management;*
- (g) forecasting and reliability in relation to supply/demand;*
- (h) application of the various regulatory regimes to the Company and the energy markets generally, including the National Electricity Law, the National Gas Law, the Rules and Procedures under those Laws and the procedures adopted by the market operators, and the context of the regulatory framework for the gas and electricity industries;*
- (i) incident investigation;*
- (j) experience in the operation of market administrators and operators in the electricity and gas industries, and the need to develop a “customer-focussed” organisation;*
- (k) experience in and understanding of the usage and issues of the various classes of consumer of gas and electricity, including an ability to develop competing positions into a hierarchy of needs;*
- (l) experience in the operation of regulated entities;*
- (m) understanding of the government and political processes in the energy industry;*
- (n) understanding of remote areas to ensure minor states and regional Australia are represented; and*
- (o) understanding of the particular requirements for stakeholder engagement in an energy market operator, where stakeholders include governments through the Council of Australian Governments, the Ministerial Council on Energy and individual jurisdictions, market participants, energy users and regulators.*

¹⁰⁶ The COAG Energy Council has a COAG Energy Council Appointments Selection Panel that provides recommendations to the Council on appointments to AEMO, the AER, Energy Consumers Australia and the AEMC. These are made on the basis of a uniform set of procedures for council appointments to these bodies.

This statement of skills and experience for AEMO directors is very detailed. AEMO has stated that it continues to see considerable value in the skills based assessment for board appointment and maintains that the diversity of skills has strengthened the robustness of its decision-making processes.¹⁰⁷

The Panel is of the view that no significant benefit would be gained by either condensing or expanding the list, but that the selection process should ensure that appropriate weight is given to the various elements.

The application of the definition of director independence was also raised with the Panel during the Review.¹⁰⁸ In summary, the definition specifies that to be classed as independent a person must not:

- currently be associated directly with a member;
- currently be employed by the company or a member, or a former employee of either unless a period of three years has elapsed since that employment ceased;
- have been, within the past three years, a principal of a material professional adviser or consultant to the company or a member;
- be either be a material supplier or customer of the company or a member, or associated with either; or
- have a material contractual relationship with the company.¹⁰⁹

The provisions in the definition relating to present and past employees, associates and material professional advisers and consultants are not dissimilar to those which apply to listed companies generally. Other parts of the provisions are quite restrictive, such as those which relate to past associations with members and customers. These restrictions were referred to by stakeholders during the Panel's consultations as unduly restricting the pool of available director candidates with contemporary industry experience. The Panel agrees with that assessment.

¹⁰⁷ AEMO submission to the Review of Governance Arrangements for Australian Energy Markets Issues Paper, p. 6.

¹⁰⁸ AEMO submission to the Review of Governance Arrangements for Australian Energy Markets Issues Paper, p. 7.

¹⁰⁹ AEMO constitution, schedule 2—clause 1.

The Panel considered whether to finesse the definition of independence, particularly by varying the three-year qualifying period for different past associations with the company. However, the Panel concluded that there was little substantive basis on which to do so. However, the Panel noted that there is provision for the Selection Panel to be ‘satisfied on reasonable grounds that the Director is independent despite the existence of one or more of these circumstances’.¹¹⁰

Notwithstanding the common tendency of decision-makers to strictly apply the specifics of rules such as these and thus avoid the exercise of discretion, the Panel encourages the Selection Panel and the company to make greater use of this provision when making assessments of independence under clause 7.2 of the AEMO constitution. This would ensure that candidates who have past relationships with the company or a member but where those relationships should not, based on a reasonable assessment of the circumstances, give rise to lack of independence, are considered for appointment.

The final matter which was drawn to the Panel’s attention was the term of appointment (currently three years, with a maximum of two terms permitted).¹¹¹ The Panel regards these arrangements as unduly limiting. To better facilitate the development of corporate knowledge and to assist in succession planning, the Panel believes that a standard four-year term is to be preferred.¹¹² Limiting appointments to a maximum of two terms is appropriate as a general case, although there should be provision to enable a further appointment where a special case can be made for that appointment.

In the case of an existing director being appointed as chair, the provision for a maximum of two four-year terms should apply from the point of appointment as chair, although an overall limit of three terms should apply. To avoid doubt, this means that an existing director who is appointed as chair can exceed the normal maximum tenure period but with an overall limit of 12 years.

The Panel’s recommendations for AEMO governance are as follows:

6.8 That individual directors be appointed for a term of four years, with a maximum of two terms being the general case. Provision should be

¹¹⁰ AEMO constitution, schedule 2—clause 1.

¹¹¹ AEMO constitution, section 7.5 and section 7.6.

¹¹² AEMO submission to the Review of Governance Arrangements for Australian Energy Markets Issues Paper, p. 7.

made for a director's appointment to be extended past two terms in specific circumstances. Where a director is appointed as chair, the provision for a maximum of two four-year terms should apply from the point of appointment as chair subject to a maximum overall limit of 12 years.

- 6.9 When making assessments of independence under clause 7.2 of the AEMO constitution, the Selection Panel and the company should make greater use of the permitted discretion to permit the appointment of candidates who have past relationships with the company or a member but where those relationships should not, based on a reasonable assessment of the circumstances, give rise to lack of independence.

Appointment processes

The Ministerial Council on Energy (now the COAG Energy Council) initially established the Energy Council Appointments Selection Panel (Selection Panel) to assist in recommendations for directors to be appointed to the inaugural AEMO Board. The Selection Panel consists of at least five members, two nominated by industry, two appointed by the Council and a chair appointed by the Council. The members have generally had senior experience in business, industry and government, including in the energy industry.

The Selection Panel is specified in the AEMO constitution as the Board Selection Panel¹¹³ and has been involved in all subsequent appointments to the AEMO Board. The ambit of the Selection Panel was subsequently extended by the Council to include appointments to the AEMC, the AER and Energy Consumers Australia. It should be noted that there are differential appointment processes for each institution, even though they all utilise the Selection Panel. In the view of the Panel, as confirmed by discussions during the Review, the Selection Panel represents excellent practice and helps overcome the complexities of an otherwise political process.

The Panel supports the continued involvement of the Selection Panel for appointments to institutions and other bodies of the Australian energy market. While there may be debate about the nominal composition of the Selection Panel, there is no way that its membership could be specified to satisfy every stakeholder, short of creating a panel of unmanageable size. The central role

¹¹³AEMO constitution, section 7.3.

of the COAG Energy Council in appointing the Selection Panel should provide sufficient assurance as to the appropriateness of its membership. The Council should, however, ensure that at least one member of the Selection Panel, preferably the chair, has acknowledged expertise in governance.

The Selection Panel must work with the chairs of the bodies for which recommendations for appointment are being made to determine the skills and experience being sought from the appointee, based on the skills and experience specification for the body and the skills matrix for the remaining board members. The Selection Panel should consult with the chair during the process, except where the appointment is for the chair (in which case appropriate consultation with other members would be required), but the chair should not be a formal part of the selection process.

For all of the institutions, other than AEMO, the Selection Panel process is relatively straightforward, as all of the appointments being considered are government appointments. A considerable degree of complexity is introduced for appointments to AEMO due to its corporate status. Through consultations and representations the Panel has been made aware that there are tensions in the application of the arrangements at present.

The tensions appear to be largely operational, but are nonetheless significant. A number of questions have been raised, including who should appoint the search consultant, whether the AEMO nominations committee should determine the list of candidates to be considered by the Panel, when should ministers and/or jurisdictional representatives become involved, how should the list of potential appointees to be considered by the COAG Energy Council be compiled, what is the appropriate involvement of the AEMO Board and officers in the process, and what is the extent of the powers of the Selection Panel?

It appears to the Panel that insufficient attention has been devoted to reaching agreement on how to synthesise the processes used for corporate board appointments with those used for government appointments. The best way to resolve this issue would be for SCO and AEMO to develop an agreed set of operational practices designed to satisfy the responsibilities and accountabilities of the parties. This is an operational matter as the Panel views the structural arrangements as sound.

To enhance the transparency of the appointments process, the terms of reference and membership of the Selection Panel, along with a list of upcoming appointments, should be published on the Council's website.

The Panel's recommendations for the appointments process are as follows:

- 6.10 The Selection Panel should continue to be charged with responsibility to make recommendations to the Council for all appointments to institutions and other bodies of the Australian energy market. The composition of the Panel should remain as at present, with a requirement that one member of the Panel, preferably the chair, have acknowledged expertise in governance.
- 6.11 The membership, remit and process of the Selection Panel should be placed on the COAG Energy Council website, along with a schedule of upcoming appointments.
- 6.12 That SCO and AEMO develop an agreed set of operational practices for appointments to the AEMO Board which are designed to satisfy the responsibilities and accountabilities of both the Council and AEMO.

Funding of market institutions

AEMO is currently funded through cost-recovery from participants, the AEMC is funded by contributions from state and territory jurisdictions on a per capita basis, and the AER is funded entirely by the Australian Government as part of the ACCC.

The current arrangements for AEMO are entirely consistent with its role as system and market operator, and the Panel sees no basis for changing those arrangements. As recommended in Chapter 5, cost recovery from market participants should cover only AEMO's activities as a market and systems operator, including, for example, advice on procedural matters to the AEMC. Costs for other activities such as the provision of policy advice and systems planning for other individual jurisdictions should be recovered through fee-for-service or other arrangements.

The current arrangements for the AER and AEMC do not appear to accord with the principle that funding responsibility should rest with those who determine resource requirements or workload. For both bodies, it is jurisdictions, either collectively or individually, which generally determine work programmes and resourcing requirements, but in neither case are all members of the Energy Council responsible for funding. This lack of

alignment is particularly acute for the AER, where decisions are significantly driven by state and territory jurisdictions which bear no financial responsibility for the funding consequences of those decisions.

Based on both this view of accountability and the belief that the governance design should reflect a greater national character, the Panel is of the view that both the AEMC and the AER should be jointly funded by the Australian Government and all participating state and territory jurisdictions in a manner determined by the COAG Energy Council. This reflects the Panel's view that, to the extent that the original agreement by the Australian Government to fully fund the AER was an incentive for state and territory participation, that incentive is no longer appropriate because the market and the institutions have matured. As part of decisions on funding arrangements, the Council should consider whether there are appropriate opportunities for seeking contributions from market participants or other parties in the energy markets.

The Panel sees a need to build into this process a level of stable and reliable funding for operations. It would be disastrous for the Australian energy market to have institutions that cannot rely on being funded adequately to do their work and that must live 'hand to mouth'. Funding should be determined periodically at appropriate levels for the institutions to fulfil their responsibilities competently, professionally, efficiently and in a timely manner.

Because the work programmes of the AEMC and AER are driven externally, provisions for adjustment, via institutional applications to the Council, should be included to account for major changes in costs caused by identified non-controllable factors. The Panel recommends that when cost increases are clearly attributable, for example, to a particular policy decision of a particular government, the causality principle should be applied to their contribution to increased funding. This will minimise the potential for jurisdictions to shift the costs of their projects to national bodies and to create a resource drain in the institutions to the detriment of the management of the Australian energy market.

The Panel is also of the view that multi-source funding has potential 'diversification' advantages over time, in that base funding flows may become more stable and assist forward planning. In addition, temporary fluctuations in resource requirements—such as could be caused by a major programme or an unavoidable bunching of price reviews—might more easily be accommodated, and any tendency towards undue influence or capture arising

from control of funding by a particular interest would be mitigated. This would include potential conflicts of interest arising from jurisdictions funding the AER when AER decisions have significant revenue ramifications for jurisdictions with government-owned infrastructure.

The Panel recommends that the Energy Council give careful consideration to the appropriateness of and methodologies for industry contributions. The Panel is of the opinion that the AER and the AEMC should not have delegated power to increase industry contributions or apply levies, since that would reduce incentives for the conduct of cost-efficient regulation.

At present, the AEMC is required to satisfy the accountability, compliance and audit requirements of South Australia, while the AER is required to satisfy those of the Australian Government. In the application of changed funding arrangements, particular care will be required to ensure that onerous additional overhead requirements for compliance with the resource accountability requirements of multiple jurisdictions are not introduced.

The Panel's recommendations for funding are as follows:

- 6.13 Both the AEMC and AER should be funded by all jurisdictions that are members of the COAG Energy Council in a manner determined by the Council.
- 6.14 The level of stable and reliable funding for operations should be determined periodically at appropriate levels for the institutions to fulfil their responsibilities competently, professionally, efficiently and in a timely manner.
- 6.15 Provisions for adjustment, via institutional applications to the Council, should be included to account for major changes in costs caused by identified non-controllable factors.
- 6.16 When cost increases are clearly attributable, for example, to government policy decisions, the causality principle should be applied to increase the relevant jurisdictions' contribution to funding.
- 6.17 Funding arrangements should take into account the additional roles of the AEMC recommended by the Review.
- 6.18 The Council should give careful consideration to the appropriateness and methodologies for industry contributions. Decisions on such matters should lie with the Council; the AEMC and AER should not have the ability to increase industry contributions or apply levies.

6.19 The application of changed funding arrangements should not result in onerous additional overhead requirements for compliance with the resource accountability requirements of multiple jurisdictions.

Future governance reviews

In any functioning system, there is a need for continual evaluation of the performance of its constituent entities. Some submissions called for institutions to have annual or more frequent reviews of individual performance.¹¹⁴ The Panel is cautious, however, not to significantly increase the risk of ‘review fatigue’ in the governance system. It expects that every well-managed organisation will have its own internal performance review processes and that, if concern about the effectiveness of those processes develops into a major issue, the COAG Energy Council could mandate appropriate actions in response.

The Panel is most concerned with ensuring that:

- overall rule making is keeping pace with changes in the market and industry environment;
- the regulatory framework is contributing to rather than inhibiting the operation of the energy markets and demonstrating an adaptive capacity to respond to emerging and foreseeable challenges;
- the systems and markets are operating in ways that facilitate innovations; and
- the overall governance structure, including oversight, is working effectively.

The Panel believes that the recommendations in this report, if accepted, will deliver a framework that will contribute to these goals.

With respect to the overall framework, the Panel does not wish to be prescriptive about periodic reviews of governance. The current Review is the result of a commitment by COAG, which does not require future reviews. The Panel is of the view that the need for another governance review should be considered by the COAG Energy Council in 2022 to be conducted in 2023. In suggesting this timing, the Panel believes that another review should not

¹¹⁴ Energy Networks Association and NSW DNSP submissions to the Review of Governance Arrangements for Australian Energy Markets Issues Paper.

take place until two cycles of the strategic priorities and work plan undertaken by the AEMC (if accepted and implemented) recommended by the Review have been 'bedded down' and become normal features of the regulatory landscape. The gap between reviews should also be long enough to allow for multiple regular energy market processes to occur.

6.21 That the Energy Council assesses the requirement for another independent governance review in 2023.

Appendix A: Terms of reference

Review of Governance Arrangements for Australian Energy Markets—Terms of reference

Context

In its April 2007 response to the report of the Energy Reform Implementation Group, the Council of Australian Governments (COAG) committed to a review of energy market governance arrangements five years after their commencement. These arrangements include the national regulator (AER¹¹⁵), rule maker and market development body (AEMC¹¹⁶) and market and system operator (AEMO¹¹⁷) overseen by a ministerial council now known as the COAG Energy Council (the Energy Council). With the creation of the final of these institutions—AEMO—in 2009, this review is now due.

The review is intended to examine the broad energy market institutional structure created by COAG as well as the legislative framework that establishes and assigns functions to institutions.

In broad terms, the Energy Council considers the intent of the COAG reforms was to improve the performance of national energy markets by establishing institutions that were subject to collective oversight by all participating jurisdictions. This would require a high level of clarity and predictability of roles, robust institutional characteristics, appropriate and proportional powers and mandates, appropriate delegation of technical and regulatory change processes, appropriate staffing and resourcing, with clear and agreed levels of accountability. While each institution was created in a different model, the Energy Council retained policy oversight including for the legal frameworks and plays a key role in appointment arrangements.

While the Energy Council considers that the energy market governance framework has performed well, there has been significant evolution in the national energy laws, including the creation of gas and retail laws, changes in gas and financial markets, and changes in the way electricity is generated,

¹¹⁵ Australian Energy Regulator.

¹¹⁶ Australian Energy Market Commission.

¹¹⁷ Australian Energy Market Operator.

transmitted and used. These have created challenges for each institution not anticipated at the time of establishment and so a review of the governance regimes is timely.

The review

The review is to consider the performance of current governance arrangements for energy markets and provide advice to the Energy Council on potential areas of improvement to the institutions and their oversight by the Energy Council.

The review should seek to identify governance arrangements that support market outcomes that are in the long term interests of consumers, as stated in the National Electricity Objective (NEO), the National Gas Objective (NGO) and the National Energy Retail Objective.

It should consider, in the light of experience and expected changes in the policy, regulatory and operational environment for the national energy market, whether:

- the institutional structures of the three market bodies (AEMO, AER and AEMC), and their roles as broadly defined remain appropriate
- the broad scope and division of mandates of each institution remains appropriate
- the role, operation and responsibilities of the Energy Council, its Senior Officials, and the three market bodies including the current roles and responsibilities of these parties are clear and providing the best outcomes
- there are opportunities to enhance the way these institutions interact with each other, the Energy Council, Senior Officials, and stakeholders and if so how these opportunities could be best pursued
- the extent of conferral of responsibilities and roles by individual jurisdictions under these energy market governance arrangements is appropriate
- there are opportunities to expedite the Energy Council and AEMC's energy market reform processes (see below), and if so how this should be done.

The review should consider the issues raised in the review undertaken by AEMO of its governance in 2013 and the findings of the Productivity Commission's 2013 Electricity Network Regulatory Frameworks Report. In light of that report's findings on AEMC processes and energy market

governance the review should explore actions to expedite energy market reform processes and whether it is possible to incorporate less formal processes to achieve policy objectives.

The review should be informed by extensive consultation. While it is not the intention to extensively research or replicate international models, these could be drawn on where appropriate.

This work should also be informed by, but not duplicate, any reviews of individual agency resourcing and capacity. An examination of the AER's resources, independence and operational arrangements was foreshadowed by COAG in 2012, and views relevant to this question may be canvassed as part of the present review. However, structural separation of the AER from the Australian Competition and Consumer Commission is not current Commonwealth policy, and a revision to the Commonwealth's position would require compelling new evidence in the context of the evolving energy market.

The review will not consider energy market institutions in Western Australia, except to the extent to which the Western Australian energy market might reasonably affect the outlook for the existing national institutions.

Outcomes

The review will produce a draft report and a final report to Energy Council by September 2015. Unless specifically excluded, the draft and final reports will be published.

Process

The review will be conducted by a panel comprising persons with appropriate expertise in Australian energy markets and governance issues, supported by a Secretariat coordinated by the Commonwealth Department of Industry.

The review will be funded from the Energy Special Account.

An advisory committee will be established comprised of members nominated by participating jurisdictions. The reviewers will consult with the committee from time to time to provide notice of its advice and to seek feedback. A draft work plan and timeline is set out below.

Activity	Due by
Terms of Reference approved by the COAG Energy Council	December 2014
Expert review panel identified and services procured	January 2015
Review commences	February 2015
Issues paper	March–April 2015
Public consultation on Issues Paper	April–May 2015
Progress report to the COAG Energy Council	May–June 2015
Draft report to the advisory committee	July 2015
Public consultation on Draft Report	August 2015
Final report to the COAG Energy Council	September 2015
The COAG Energy Council’s response	December 2015

Appendix B: AEMC standard rule change process

The rule change process must be undertaken within statutory time frames under the national energy laws: the National Electricity Law (NEL), the National Gas Law (NGL) and the National Energy Retail Law (NERL).

The infographic below is from the 2013–14 AEMC annual report (p. 26) and shows the time frames for the rule change process. The time frames are mirrored in the NEL, NGL and NERL.

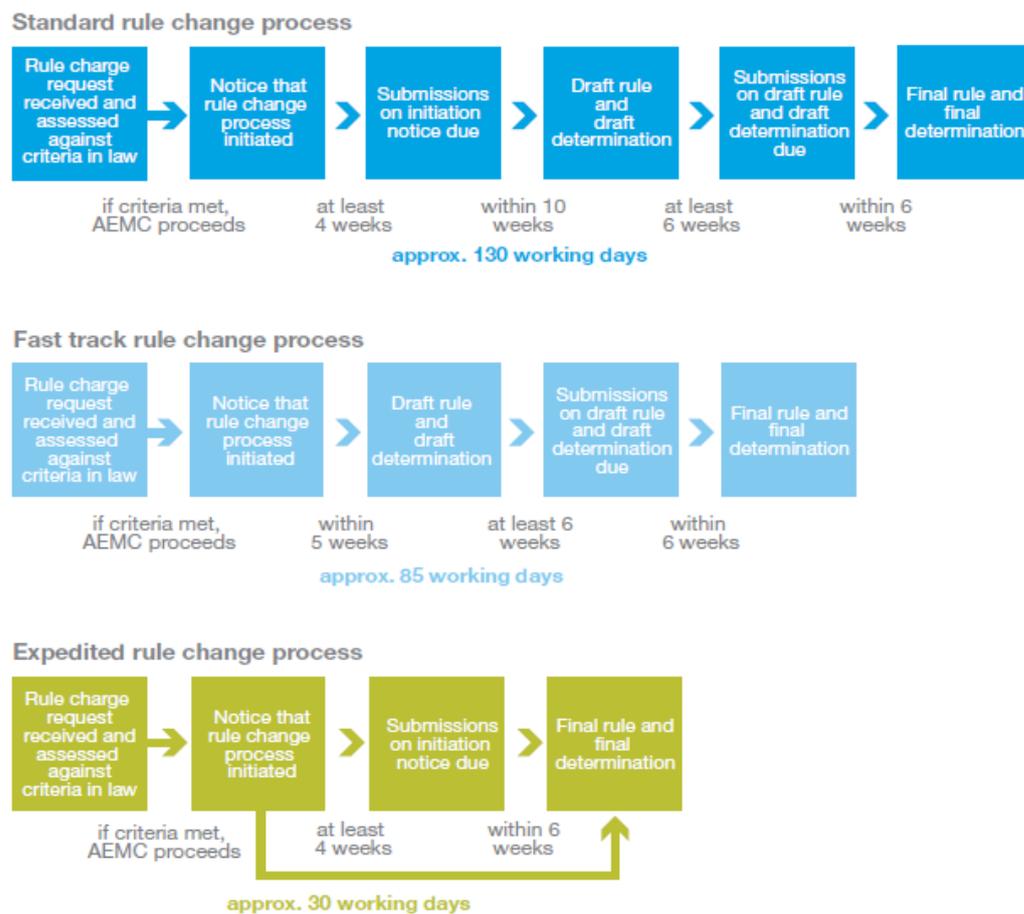


Figure 13 – Managing rule making timeframes