

in tempore Advisory

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Dr Michael Vertigan AC
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Review of Governance Arrangements for Australian Energy Markets
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Dear Dr Vertigan

Comments on Draft Report

The Panel is to be commended for correctly identifying some key concerns with Australian Energy Markets, the reform thereof and governance of its major institutions.

Thanks to disruptive technology and effectual – albeit still incomplete – deregulation, consumers have far greater control over how their energy is delivered and consumed. It's therefore certainly true the sector, particularly electricity, is facing a period of unprecedented change, one that coincides with some disturbing trends: a “strategic policy deficit” and a “diminished sense of common purpose”.

What's profoundly disappointing, then, is how the Panel has shirked any attempt to examine how this might have come to pass. Absent an honest assessment, free of the prevailing groupthink, it's difficult to see how its recommendations will change anything of consequence.

Successful governance indeed depends upon establishing institutional structures capable of withstanding the competing interests of “politicians, sellers, buyers, bureaucrats, intellectuals and so on”. It's also fair to say the architecture for energy is, in a broad sense, sound. There's a need for a rule-maker, an entity to administer these rules and another to independently operate the National Electricity Market (NEM).

The problem lies in who these institutions are accountable to.

Existing arrangements are sustained by a backward-looking inertia that feeds relentless conflict, rooted in an obsession with rules and control. And the energy policy clique lacks the strategic nous to rectify this, given none of its members – including the Panel, it would seem – are up for confronting the truth.

The Panel, at page 13 of its Draft Report, conducts a brief but flawed analysis of what constitutes the “long-term interests of consumers”. What is its meaning? How it is to be interpreted?

The question is metaphysical, without an answer, by definition. That’s the beauty of the free market. The long-term interests of consumers are becoming too dynamic – invisibly so, if we invoke Adam Smith’s analogy – for a pre-emptive interpretation. The market works precisely because the coming together of demand and supply involves intangible considerations, insights that are subjective and immeasurable. Sure, the quantifiable aspects of Science are necessary for market efficiency. But ultimately it’s the Art that adds value. This is why the goal of reform is to relieve well-meaning but naïve regulators of the requirement to pontificate on what is efficient.

Alas, liberating the demand side of the electricity market is but half the story. It will fail if NEM participants aren’t given matching flexibility to respond to the preferences of consumers now free to use alternative supplies that can be tailored to individual needs.

It’s this new-found competitive pressure on the traditional supply chain – large-scale generation delivered through an interconnected national grid – that renders the current system of governance dysfunctional.

In Chapter 4, the Panel describes the primary task of the Australian Energy Regulator (AER) as assessing the cost-price-service trade-offs that must be made by network businesses. It cites a Productivity Commission claim that “(ever more) complex regulatory and institutional arrangements” have at times “been inimical to consumers’ interests”.

Though clearly not alone in this regard, the desire of the Panel to identify “opportunities to increase the AER’s effectiveness” based on “best practice regulation” is delusional, and irresponsibly so. What we quaintly call the “regulatory challenge” of second-guessing efficient network pricing and investment, is actually, in principle, an impossibility. It always has been, as there is no rational means to force or control Art. It’s just that up until a few years ago, the cost of this self-deception was less than the benefits accrued from fostering competition in the wholesale energy market.

But things are now different. The NEM is extremely competitive, in and of itself. In addition, the supply chain as a whole faces an external threat, on the margin, from its very own customers.

What hasn’t changed is the hubris within policy and regulatory circles. And, unfortunately, an ignorance of how the NEM has evolved and the nature of its concluding stage.

In response to the Energy Network Association’s concern at the impact of regulation on the ability to finance long-lived sunk network infrastructure, the Panel (p. 48):

... simply notes that the observed shifts in energy service provision and in business models may make the assessment of what constitutes ‘investment efficiency’ even more contested than it has been in the past.

This demands much, much more than noting. It’s the crux of the matter, the core reason why, I would argue, the Panel was established in the first place.

Rather than pursue an “expanded explanation” of long-term consumer interest, perhaps the Panel could ponder for a moment why views on efficiency are so contested. If it did, it might conclude it’s due to networks coming under mounting pressure to perform, to provide efficient transport services to users within the supply chain, lest consumers opt out and the NEM collapse.

It’s striking when one stops to think about it critically. All the hand-wringing. The costly, say-nothing-new reviews of whether the regulatory regime for electricity is fit for purpose. Death spiral scenario testing. Hair-splitting, self-important, academic blathering over WACC technicalities. And, of course, the quest for the holy grail: an objective mechanism to write-down network assets to fair “market value”. Even this review. They’re all products of a suppressed awareness that electricity networks are, in a real world sense, no longer monopolies.

Yet the establishment, fearing its own redundancy and what it can’t control, is closed to such logic – and the related thought that government efforts to protect consumers have become a basis for confused accountabilities and divisiveness.

A diminished sense of common purpose within the electricity industry stems from the inability of the market institutions to foster cooperative relationships. They are industry focussed but for the benefit of external stakeholders. The AER, for instance, stands over network businesses arbitrating on risk, return and various other issues that should be negotiated commercially with the co-dependent users of the supply chain. Regulation is now a barrier to networks accepting market risk and optimising their infrastructure in the interests of the whole.

In its response to the Panel’s Issues Paper, the AER submitted (p. 13):

... prescriptive rules provide greater certainty and consistency across time and decisions but may mean that the regime is less able to respond in a timely way to new issues as they arise. The trade-off between certainty and flexibility are matters that are taken into account in the context of particular reform proposals and rule changes.

Firstly, rules do not create “greater certainty” for anyone. What formalities and transparency can do, is facilitate less uncertainty. But only up to a point. There is always a gap. And if the Panel wishes to cure the box-ticking and legalistic culture that prevails today, it needs to recommend governance arrangements that allow this gap to be filled by Artistic industry expertise and judgement ahead of the incomplete Science championed by the AER.

Second, the trade-off is not between certainty and flexibility; it’s between (unattainable) control and flexibility. And where that flexibility best resides.

The regime for administering rules within the NEM has become overly complex, overbearing and inimical to consumer (and industry) interests because the AER, by virtue of its *raison d’être*, is prone to believe all Art produced by regulated entities is illegitimate, since this represents its only hope of controlling the situation and thus making good on its ridiculously pretentious mandate. This is not the fault of the AER. The problem lies with the perverse, in-built incentives. As such, giving it more resources, appointing additional members to its Board or separating it further from the ACCC will improve nothing.

The NEM is on the brink of unnecessary additional trauma caused by the systematic overreach of hapless government-dominated agencies unwilling to acknowledge the implications of the radical

free market attributes they helped bring to fruition. Regrettably, those influencing and running these organisations are not known for their irony.

Current governance arrangements are counter-productive because the market institutions affirm an unsustainable mixed message. On the one hand, consumers are empowered. On the other, these same consumers remain, apparently, subject to ruthless economic exploitation, abuse that necessitates additional regulatory power and discretion.

The public interest has already been satisfied by providing real choice on the demand side. So, it's now appropriate the flexibility be transferred from a cynical regulator back to industry so that it can re-establish a shared purpose based on a properly integrated supply chain (note: this does not equate to a return to vertically integrated monoliths). All parties – retailers, generators, network owners – have an incentive to work as a whole, collaboratively. All this requires is governance that promotes at least the prospect of Art being properly recognised as the driver of efficiency. And this will only happen if and when the rule-maker, the rules administrator and the independent NEM operator are, to differing degrees, accountable to industry.

Anything less will end in tears. For shareholders. For consumers. And, therefore, for jurisdictional governments.

The restructuring of the Australian electricity industry initiated in the early-1990s was a bold and necessary move. As shown in the attached graphic, however, there's still one more step to come. Again, there's much irony here. This final stage embodies fully the leap of faith made more than two decades ago under the guise of National Competition Policy. The essence of that policy was always efficiency, something much more than mere competition, formal processes and transparency.

It's time government let go and got with its program. And it's time the Panel showed the imagination and nerve to advise the Energy Council accordingly.

Yours sincerely

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Director

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Evolution of the National Electricity Market

STAGE I: HISTORICAL MODEL

- Vertically-integrated regional monopolies
 - Public Ownership

| Objective | Demand Side | Supply Side | Issues |
|--|---|--|---|
| <ul style="list-style-type: none"> • Regional Development • Employment • Budget (cross-subsidisation) | <ul style="list-style-type: none"> • Limited choice • No price signals • Minimal demand risk | <ul style="list-style-type: none"> • Common purpose • Supply chain/Art focus • Informal relationships | <ul style="list-style-type: none"> • Lack of Science abused • Large users gouged • Inefficient cross subsidies |

STAGE II: NATIONAL COMPETITION POLICY

- Structural separation, regulation of natural monopolies
 - Scale economics through national grid

| Objective | Demand Side | Supply Side | Issues |
|---|---|---|---|
| <ul style="list-style-type: none"> • Wholesale market competition • Transparency • Transfer risk from Government | <ul style="list-style-type: none"> • Some price signals • No retail competition | <ul style="list-style-type: none"> • Formalisation of roles • Competitive tensions • Fragmentation | <ul style="list-style-type: none"> • Shift in focus from integrated to competitive, informal to formal • Industry centric, not customer centric |

STAGE III: POWER OF CHOICE + TECHNOLOGY

- Remove retail constraints
 - Technology facilitates empowerment

| Objective | Demand Side | Supply Side | Issues |
|---|---|---|--|
| <ul style="list-style-type: none"> • Individual consumer choice • Ensure frameworks, institutions are fit for purpose | <ul style="list-style-type: none"> • "Prosumers" compete with NEM • Unprecedented demand risk • Too dynamic for regulators | <ul style="list-style-type: none"> • Regulatory controls feed an obsession with Science • Disconnected supply chain | <ul style="list-style-type: none"> • Customers as competitors and Art > Science too radical for NCP paradigm • Lack of cohesion bad for consumers |

FINAL STAGE: INTEGRATE-COMPETE SUPPLY CHAIN

- Supply-chain-as-a-whole faces external pressure
 - Collaborate without sacrificing competition

| Objective | Demand Side | Supply Side |
|--|---|---|
| <ul style="list-style-type: none"> • Efficiency, through restoration of Art • Real industry accountability | <ul style="list-style-type: none"> • Consumers seek best options between traditional and non-traditional products/services | <ul style="list-style-type: none"> • NEM offers viable alternative • Performance regime driven by industry not government |

Policy elite biggest obstacle to efficiency, as institutional and intellectual inertia is for more competition, formal processes and regulation, when opposite is needed