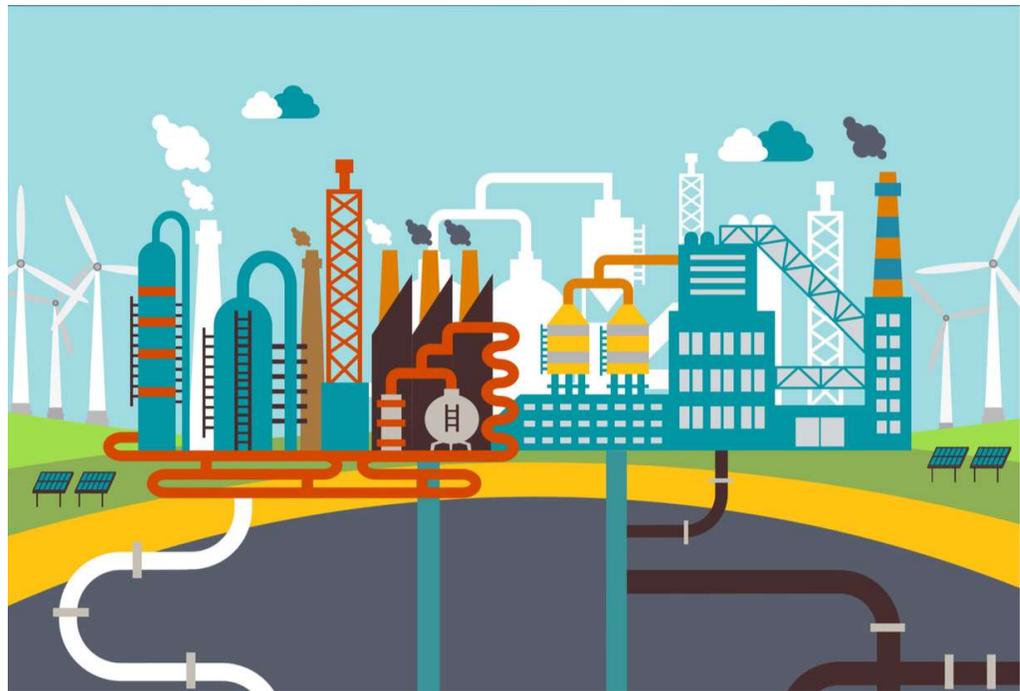




AUSTRALIAN ENERGY POLICY



May 2020

National energy governance
arrangements – The case for reform



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EXECUTIVE SUMMARY

Australia's energy policy and regulatory arrangements are currently being tested through a period of rapid change. Experience to date demonstrates that there are significant emerging risks for Australian energy consumers and Australia's economy. Specifically, given the capital intensive and long-lived nature of energy infrastructure, there is the real risk of being billions of dollars worse off in the future than would be the case if investment in and utilisation of energy infrastructure is efficient.

Avoiding this outcome requires robust governance arrangements that reflect best practice and have the capacity to deal with the complex challenges in realising the objective of maximising consumer economic welfare. It is proposed that changes to the current arrangements and allocation of roles and responsibilities are required to strengthen the quality, timeliness and focus of decision-makers.

Specifically, it is recommended to reform the current governance arrangements by increasing accountability of the institutions and, most importantly, the COAG Energy Council (as lead policy body), separating functional responsibilities where these have inherent conflicts and streamlining agencies to remove duplication in responsibilities. It is further recommended to formalise the role of Energy Consumers Australia, including, among other things, in relation to developing a usable metric for assessing "maximising consumer economic welfare".

The proposed changes, if further developed and implemented, would:

- Provide accountability to COAG for maximising consumer economic welfare
- Strengthen both the definition of governments' policy oversight role and the resources available to governments for strategic policy advice
- Clarify and increase accountability for roles and responsibilities of governments and market institutions
- Facilitate a cooperative governance framework with clear lines of accountabilities and closer ties between the different institutions
- Facilitate a regulatory structure that is strong, consistent and truly nationally focused
- Facilitate a streamlined and more effective policy making and regulatory reform processes.

Further, the proposed amendments, if adopted, would address the identified issues around lack of transparency and responsiveness of the national energy policy and regulatory arrangements. Relevantly, they would refocus the efforts of all parties to the objective of maximising consumer economic welfare and bring the energy policy and regulatory processes in line with best practice regulation.

Report recommendations

Recommendation 1: Accountability of the Energy Council needs to be strengthened by:

- a. COAG holding the Energy Council responsible for its role under the AEMA and outcomes for energy consumers and the economy
- b. COAG holding governments responsible for the collective pursuit of national interest over individual government priorities
- c. COAG to publish a service charter for the Energy Council, which could build on the Strategic Energy Plan
- d. COAG to agree periodically to an agreed program or scope of work
- e. Energy Council being required to annually:
 - i. Report to COAG against agreed program or scope of work
 - ii. Seek revisions to program or scope of work (where necessary)

- f. Energy Council obtaining feedback from market institutions, industry stakeholders and consumers
- g. Energy Council implementing processes to action, where necessary or appropriate, feedback to improve its performance of its functions.

Recommendation 2: Transparency of Energy Council decision-making needs to be improved by:

- a. Energy Council publishing minutes of each meeting and summary of feedback for out of session decisions
- b. Energy Council publishing and routinely updating information on its work program and relevant contacts.

Recommendation 3: Integrity of the Energy Council needs to be improved by:

- a. The appointment of an independent, non-government chair
- b. Energy Council publishing a code of conduct
- c. Energy Council commitment to the four principles of integrity: (1) a clearly defined purpose, (2) enhancing legitimacy, (3) commitment to being a trusted partner, and (4) strengthen robustness of decision-making.

Recommendation 4: Stewardship of the Energy Council needs to be improved by:

- a. Establishing an independent policy body to support its functions
- b. The independent policy body applying a stewardship model in the development of policy advice
- c. The independent policy body would be accountable to the Energy Council for the quality of its policy advice.

Recommendation 5: Efficiency of the Energy Council needs to be improved by:

- a. Focusing on strategic, longer-term, systemic and structural energy issues that affect the public interest
- b. Delegating other national policy, legislative and governance matters to the independent policy body
- c. Providing authority to the independent policy body to perform its delegated functions and issuing guidance around how the body is expected to exercise its powers.

Recommendation 6: Leadership of the Energy Council needs to be improved by:

- a. A commitment and program to drive internal culture of leadership
- b. A commitment and program, with the support of the independent policy body, to perform its policy, legislative and governance functions
- c. A commitment and program to maximise the effectiveness of the governance arrangements across the sector
- d. Strengthening its leadership through strategic consideration of applying authentic, adaptive and complexity leadership approaches in its performance of its functions.

Recommendation 7: The legislative framework applying to the provision of energy services across Australia should:

- a. Promote the interests of Australia as a whole
- b. Accommodate necessary differences, due to geography, environment or historical developments
- c. Prevent individual governments to acting unilaterally to alter the operation of the frameworks

- d. Limit individual governments, with the agreement of the Energy Council, capacity to alter the operation of the national frameworks to identified circumstances.

Recommendation 8: A single national legislative framework should apply to the provision of energy services across Australia that is:

- a. Set out at the *highest* level (Australian Government) in line with the updated subsidiarity principle
- b. Applied equally by all state and territory governments
- c. A principles-based approach to regulation, to apply in all situations
- d. Complemented by national, jurisdictional or market-specific arrangements (the split between national, jurisdictional and market responsibilities to be determined by applying the subsidiary principle)
- e. Supplemented, as appropriate, by detailed rules, official guidance and facilitation of dialogue between the regulator and regulated entities.

Recommendation 9: The split between national and state/ territory functions under the AEMA should be reviewed with the paramount principle being that everything should be a national function unless there are clear benefits to consumers with retaining state/ territory responsibility.

Recommendation 10: Institutional responsibility for policy advice and development should be separated from institutional responsibility for rule-making:

- a. The relevant bodies having clearly articulated responsibilities and necessary authority.
- b. The national energy laws should be amended to reflect the new delegation of responsibilities and to clarify the rule change process in relation to policy developed by the independent policy body.

Recommendation 11: The expectation that the AER should provide advice should be formalised.

Recommendation 12: Options for ensuring the AER is fully resourced for its functions should be explored and implemented as soon as practical.

Recommendation 13: The matters raised in the Parer and Scales Reviews should be revisited as part of the Energy Council's Strategic Energy Plan particularly the scope of the national energy regulator's role.

Recommendation 14: System operation and market operation functions should be separated with allocation of system operation responsibilities explored. Options could include, but not be limited to:

- a. An independent system operator
- b. Allocation of system operation functions to transmission and distribution network businesses, with oversight by a central institution.

Recommendation 15: Legal and financial liabilities of parties for maintaining system security should be reviewed to ensure that these provide an appropriate balance between incentivising system security and minimising distortions in the energy markets.

Recommendation 16: The Energy Council should recommit to effective governance and legislative framework principles and apply these in relation to system security arrangements in Australia.

Recommendation 17: The market operator should periodically report on its activities and only undertake tasks outside of its core responsibilities where they do not conflict with those responsibilities and are undertaken on a contractual basis.

Recommendation 18: The market operator should be responsible for procurement of market services and the development of innovative products, within the constraints of the rules.

Recommendation 19: The system operator should be responsible for system planning.

Recommendation 20: The effectiveness of the system planning arrangements under the rules should be periodically reviewed against whether these are maximising consumer economic welfare over the long term.

Recommendation 21: The role and responsibilities of the ESB should be reviewed in light of proposed general reforms to the governance arrangements.

Recommendation 22: The ESB should not be the independent policy body and its provision of advice should be limited to matters arising in the performance of its energy security functions.

Recommendation 23: Responsibility for technical standards for the planning, design and operation of critical elements of the power system and advice on the safety, security and reliability of Australia's energy systems should be consolidated into a single body that is independent of AEMO.

Recommendation 24: The role of ECA should be expanded and, for the Energy Council and market institutions, formalised to include development of tools to enable effective consumer engagement and measures for determining and reporting on consumer economic welfare.

Recommendation 25: ECA should periodically report to COAG (through the Energy Council) on whether consumer economic welfare has been maximised.



INTRODUCTION

Australia's energy markets and systems are facing a time of rapid change, both due to new and emerging technologies and changes in the regulatory frameworks and market arrangements. Large scale supply disruptions, concerns about energy affordability and identified market dysfunction are indications that now is a critical time to make sure the energy policy and regulatory arrangements are appropriate, adequate and functional.

The risks of ineffective arrangements are to make energy inaccessible, unaffordable and unreliable for Australian consumers. This could detrimentally affect Australia's economy and Australians' quality of life.

The current energy market and policy arrangements arose from the national reforms in the 1990s to improve the productivity and efficiency of services in Australia (the National Competition Policy). In the seminal review of competition policy in Australia, it was recognised that the purpose of competition policy is to facilitate effective competition (to promote efficient outcomes and economic growth) coupled with regulatory and policy measures to promote or protect public benefits.¹ Within this context, the ultimate aim of the resultant energy reform programme was to maximise the economic welfare of Australians over the long term.²

Over the years, the reform programme has resulted in individual state and territory arrangements being replaced by national regulatory frameworks, independent institutional arrangements, energy-specific consumer protections and clear and transparent reform processes. Specifically, this covers:

- Establishment of the National Electricity Law, Regulations and Rules; the National Gas Law, Regulations and Rules; and the National Energy Retail Law, Regulations and Rules
- Establishment of the Australian Energy Regulator (AER), Australian Energy Market Commission (AEMC) and Australian Energy Market Operator (AEMO)
- Establishment of independent rule change processes
- Establishment of simple and complementary statutory objectives.

The following paper analyses the effectiveness of the current governance arrangements implementation and evaluation, applying to the energy sector in Australia against the objective of maximising consumer economic welfare. It builds on the current body of knowledge and sets out options for going forward. This paper is intended to provide insights into the current arrangements and inform future reforms.

BACKGROUND

Public policy is the means by which governments maintain order or addresses the needs of its citizens. Public policy is generally used to describe a collection of laws, mandates, or regulations established through political processes.

The effectiveness of public policy is dependent on the governance arrangements underpinning its development, implementation and administration. Public sector governance covers the responsibilities, practices, policies and procedures exercised by an agency to provide strategic direction, ensure objectives are delivered, manage risks, utilise resources and provide accountability for decision-making.³

¹ Hilmer, F.G, Rayner, M.R. and Taperell, G.Q., *National Competition Policy*, Australian Government Publishing Service, August 1993.

² Second reading speech: *National Electricity (South Australia) (New National Electricity Law) Amending Bill*, 9 February 2005, p 1452.

³ APSC, *Building better governance*, 2007.

Ineffective governance can undermine the capacity to deliver successful public policy. As noted by the Australian Government, in relation to partner countries, ineffective governance can take many forms. It can involve, among other things, policies aimed at providing benefits to specific constituencies, rather than promoting public good. Alternatively, access to justice can be poor, particularly for parties without significant economic resources.⁴

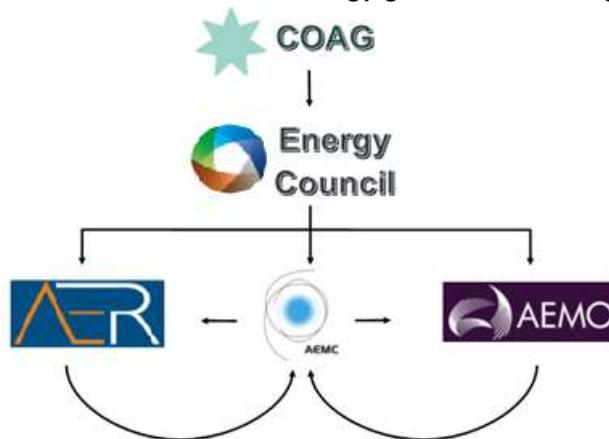
Ineffective governance can lead to poor policy choices that detrimentally affect the achievement of the policy objectives and economic growth. Having effective and robust governance arrangements is therefore fundamental to realising effective public policy.

Current governance arrangements

The regulatory and policy arrangements in the energy sector are a mixture of both state and territory and Commonwealth arrangements. This results in complex legislative frameworks and responsibilities, as well as different decision-making tests and administrative requirements. This complexity is further complicated by the fact that the regulatory and policy arrangements apply to consumers and businesses with significant demographic, geographic and climatic differences.

The current governance arrangements (see Figure 1) arose in response to the 2002 review: *Towards a Truly National and Efficient Energy Market* (the Parer Review) and are set out in a multi-lateral intergovernmental agreement, the *Australian Energy Market Agreement* (AEMA). The AEMA is an agreement between the heads of the Commonwealth and state and territory governments and is formalised under the national energy laws. The arrangements reflect the nature of the energy markets covering multiple jurisdictions and split of responsibilities between the states and territories and the Commonwealth.

Figure 1. Formal national energy governance arrangements



The governance arrangements set out in Figure 1 are characterised by:

- The Energy Council⁵ as the policy body comprised of government officials and provides:
 - Policy leadership
 - Legislative authority over 'Australian Energy Market Legislation'⁶

⁴ DFAT, *Effective Governance Strategy for Australia's aid investments*, March 2015, p 4.

⁵ The term 'Energy Council' is used in this document to refer to the MCE and its successors, the Standing Council on Energy and Resources and the COAG Energy Council. It should further be taken to mean any future ministerial councils established by COAG to perform the statutory and administrative roles and responsibilities of the MCE, in line with any current intergovernmental agreements.

⁶ Australian Energy Market Legislation is defined in the AEMA to mean:

- The *Australian Energy Market Commission Establishment Act 2004* (SA)
- Part IIIA of the *Competition and Consumer Act 2010* (Cth)

- Member governments have legislative responsibility for their jurisdictions' application acts, which may be amended in accordance with the AEMA
- The AEMC as the independent rule maker and policy adviser, who operates independently of government (to avoid conflicts of interest between government and national energy-priorities) but is provided:
 - Direction from the policy body through responses to reviews and public statements
 - Legal instruction from the policy body through statements of policy principles and legislative amendments
 - Directives from the policy body through statements of expectations
- The AER as the independent regulator responsible for applying and enforcing regulations and is provided:
 - Direction from the policy body through responses to reviews and public statements
 - Legal instruction from the policy body through legislative amendments
 - Directives from the policy body through statements of expectations
- AEMO as the market operator with additional responsibilities for system control and national network planning, as well as functions conferred by participating jurisdictions on an opt-in basis, and is provided:
 - Direction from the policy body through responses to reviews and public statements
 - Legal instruction from the policy body through legislative amendments
 - Directives from the policy body through government membership

In August 2017 a new institution, the Energy Security Board (ESB), was established by the Energy Council. The ESB's role is to coordinate the implementation of the reform blueprint set out in the *Independent Review into the Future Security of the National Electricity Market; Blueprint for the future*. The ESB also provides whole of system oversight for energy security and reliability in relevant participating jurisdictions. The ESB comprises an Independent Chair, Independent Deputy Chair and the heads of the AEMC, AER and AEMO.

In 2018, the national energy laws were amended to allow for the South Australian Energy Minister⁷, in line with requirements under the AEMA, to make rules on the basis of advice from the ESB. While the ESB is not a formally (that is, legally) established institution, in the same way as the AER and AEMC are, the Energy Council has issued a terms of reference that sets out the scope of its roles and expectations about how it performs these activities.⁸

-
- Electricity legislation: The legislation giving effect to the National Electricity Market, including the *National Electricity (South Australia) Act 1996*, the *National Electricity (South Australia) Regulations*, the legislation of the other jurisdictions participating in the NEM that applies the NEL, the Regulations and the National Electricity Rules including any associated regulations, as amended by jurisdictions' implementing legislation
 - Gas legislation: The *National Gas (South Australia) Act 2008*, the *National Gas (South Australia) Regulations*, the legislation of the other jurisdictions that applies the National Gas Law, the Regulations and the National Gas Rules including any associated regulations, as amended by jurisdictions' implementing legislation
 - Retail energy legislation: The *National Energy Retail (South Australia) Act 2011*, the National Energy Retail Regulations, the legislation of the other jurisdictions that applies, implements or otherwise gives effect to the National Energy Retail Law, the National Energy Retail Regulations and the National Energy Retail Rules including any associated regulations
 - Implementing legislation that amends the electricity, gas and/ or retail energy legislation to give effect to the AEMA or that confer functions and powers on the AEMC and the AER
 - The National Electricity Law, National Electricity Rules, National Gas Law, National Gas Rules, the National Energy Retail Law, the National Energy Retail Rules and the *National Gas Access (WA) Act 2009 (WA)* as amended from time to time.

⁷ South Australia is the lead legislator and with the other participating jurisdictions (including the Commonwealth) applying South Australian law as a law in their own jurisdictions.

⁸ See

<http://www.coagenergycouncil.gov.au/sites/prod.energycouncil/files/publications/documents/Energy%20Security%20Board%20ToR.pdf>.

Key concepts in effective governance

The following sections set out key concepts relating to effective governance, which will be used in this document for the assessment of governance performance in the energy sector. Relevantly, these capture general governance principles, the nature of governance in liberalised energy markets and governance requirements in periods of rapid change.

Effective governance measures

The Australian Government's 2007 governance framework set out critical measures of effective public sector governance:

- Accountability—being answerable for decisions and having meaningful mechanisms in place to ensure an agency adheres to all applicable standards and decision-making obligations
- Transparency—having clear roles and responsibilities and clear procedures for making decisions and exercising power
- Integrity—acting impartially, ethically and in line with the objectives of the agency and not misusing information acquired through a position of trust
- Stewardship—using every opportunity to enhance the value of public assets and institutions an agency has been entrusted to care
- Efficiency—ensuring the best use of resources to further the aims of the organisation, with a commitment to evidence-based strategies for improvement
- Leadership—achieving an agency-wide commitment to good governance through leadership from the top.⁹

The principles for governance have been refined over time to four core principles:

- Clarity of purpose
- Accountability to the Parliament
- Transparency to the public
- Optimisation of efficiency and performance.¹⁰

As the 2007 principles fit within the four core principles, but provide measurable attributes, the 2007 approach will be used in this paper to assess the effectiveness of the national energy institutions.

Governance and the energy sector

The purpose of energy sector regulation is to maximise consumer economic welfare¹¹ through the establishment of robust incentives that can drive efficient, predictable, commercially sound or viable behavioural responses and provide effective mechanisms for protecting consumer interests where necessary. These principles are the foundation for efficient and timely investment and operational decision-making in liberalised sectors, particularly with decentralised decision-makers.¹²

For this regulation to be effective, governance arrangements must establish clear responsibilities that are aligned with the role and function of each party, so that those parties best able to manage a risks or perform a function at least cost have the authority, means and incentive to act and are held accountable for their actions. Accordingly, the policy principles, legislative framework, market rules and regulatory arrangements should seek to create a mutually reinforcing web of accountability that supports incentives for efficient, timely, innovative and cost-effective behaviours and responses consistent with public interest.¹³

⁹ APSC, *Building better governance*, 2007.

¹⁰ <https://www.finance.gov.au/resource-management/governance/policy/>, accessed 21 October 2019.

¹¹ Second reading speech: *National Electricity (South Australia) (New National Electricity Law) Amending Bill*, 9 February 2005, p 1452.

¹² IEA, *Learning from the blackouts; Transmission system security in competitive electricity markets*, 2005.

¹³ Ibid.

For the energy sector, which underpins both Australia's economy and Australian citizens' way of life, it is critical that the governance arrangements are appropriate for the sector and the challenges it faces, as well as complying with the effective governance principles outlined above. The measure of whether the policy and regulatory frameworks 'maximise consumer economic welfare', therefore, remains a key indicator of the effectiveness of the governance arrangements and will be explored further in this document.

Importance of effective governance for energy sector transition

The energy sector transition, coupled with the broader social, environmental and economic drivers, has created significant complexities around setting policy for and regulating an already complex sector and one which delivers essential services to Australians and Australia's economy. As such, energy sector policy and regulation have the characteristics of what policy-makers label as a 'wicked problem'. That is, situations that:

- Are difficult to clearly define
- May have many interdependencies and are often multi-causal
- Actions to address problems may have negative or unforeseen consequences
- Are constantly evolving
- Are without apparent or clear solutions
- Are socially complex
- Relates to matters where multiple organisations have responsibilities
- Are potentially solved by changing the behaviour or commitment of individual citizens
- Are characterised by chronic policy failure

or some combination of or all of the above.¹⁴

Effective governance, therefore, requires continual and holistic analysis of whether the current governance arrangements are delivering both the principles of good governance and the underlying purpose of energy sector regulation. In terms of the wicked nature of energy sector regulation, it further needs to reflect and be clear about the nature of the problems, competing underlying objectives and the paradoxes that need to be managed and may require a change in regulatory culture and/ or approach. As such, the effectiveness of the current governance arrangements to deal with wicked policy problems is assessed in this document.

ANALYSIS OF CURRENT GOVERNANCE ARRANGEMENTS

The intention of the energy sector governance arrangements (set out above) was to provide a clear delineation of roles and responsibilities that would lead to the continual evolution of the energy markets and national regulatory arrangements. It was recognised that key to meeting the objectives of effective governance is the operation of each of these functions in concert. To any extent that one of the market institutions does not function as intended, individually or collectively, the governance framework will not operate as intended. As noted previously, this can lead to ineffective (and inefficient) regulatory and policy arrangements with detrimental consequences for Australia's economy and energy consumer welfare.

The governance arrangements have been the subject of significant review and reform since the 2002 Parer Review¹⁵ through to the 2015 Vertigan Review¹⁶, which have all built on reforms to establish and strengthen the delivery of the arrangements set out in Figure 1 as an appropriate governance structure.

However, these reviews mainly focused on governance structure and allocation of functions. None of these analyses considered the contribution of the governance arrangements to the outcomes

¹⁴ APSC, *Tackling wicked problems: A public policy perspective*, 2007.

¹⁵ Parer, *Towards a Truly National and Efficient Energy Market*, December 2002.

¹⁶ Vertigan, Yarrow and Morton, *Review of Governance Arrangements in Australia Energy Markets*, 2015.

from the energy market and regulatory arrangements, which, as identified above, is the objective of the energy policy and regulatory arrangements and, consequently, is a key indicator of effectiveness of the governance arrangements.

High-level analysis of outcomes for consumers in the energy since 2008 indicates the cost of energy services in the participating jurisdictions have been significantly higher than other services in Australia's economy. The increase in costs for energy users and consumers far in excess of revenues or wages provides anecdotal evidence that consumer economic welfare has been detrimentally affected by the energy market and regulatory outcomes.¹⁷

This finding on outcomes from the energy market and regulatory arrangements is an indication of, among other things, potential issues within the national energy governance arrangements. The following section applies the principles of public sector governance identified above to assess the effectiveness of the current arrangements. This analysis explores the operation of the governance arrangements as a whole and the role of the Energy Council (as the principal policy and governance institution) in particular.

Analysis against effective governance criteria

Accountability

Accountability is being answerable for decisions and having meaningful mechanisms in place to ensure an agency adheres to all applicable standards and decision-making obligation. For energy, this measure applies collectively to all the national institutions, where the Energy Council is accountable to COAG and the market institutions are accountable to the Energy Council. Accountability also applies to individual participating governments through their parliaments.

There is no public information available on how the Energy Council is accountable to COAG. While the AEMA requires the Energy Council to report to COAG on the performance of the agreement, there have been no regular public reports on either the reforms progressed by the Energy Council or the effectiveness of the regulatory arrangements. This is concerning, given the prominence of energy policy as a priority for Australian governments. It provides anecdotal evidence of a failure of effective energy governance.

A similar issue emerges in relation to the accountability of the market institutions to the Energy Council. While the AEMC and AER are subject to Statements of Expectations and relevant government obligations in relation to reporting, there is little to no information about how they perform their statutory functions or direction from the Energy Council on whether this is consistent with the AEMA.

There is no comparable Statement of Expectations issued for AEMO. Further, the commitment of the Energy Council to publish a Statement of Role, which would be expected to provide some indication of accountability for AEMO, in 2015 has not yet been realised.

As such, for the AEMC, the AER and AEMO, there appears to be a reliance on the laws themselves to impose accountability, which is both a blunt instrument and inappropriate where greater responsiveness or cultural changes are required.

For individual governments, there is also no clear, consistent and public information about how decision-makers are held accountable for the results of the market and regulatory arrangements. This is neither in relation to decisions where there is jurisdictional authority nor those made through the Energy Council.

The above demonstrates that, at the least, there are gaps in relation to accountability under the current governance arrangements. More concerningly, the above provides a signal that there may

¹⁷ Critical Strategies Group, *National energy policy and regulation – Performance since 2008*, May 2020.

be a critical lack of accountability for decisions made by the Energy Council and the market institutions to respective governments and, consequently, to their citizens.

As a note, accountability also encompasses outcomes from delegated decision-making. This necessitates providing opportunities for those affected by a decision to provide evidence and information on their practical experiences. For energy, affected parties covers market participants, investors and, most importantly, consumers.

There are no clear opportunities for affected stakeholders, particularly consumers, to provide input to decision-makers in a way that enhances their accountability for outcomes from their decisions across the governance framework. Instead legislative processes, such as rule changes, and administrative requirements, such as requiring the market institutions to develop consumer engagement strategies, are relied on. There are therefore accessibility issues that limit accountability of institutions to those affected by their decisions and, as the ultimate beneficiaries or cost bearers, consumers.

Transparency

Transparency involves having clear roles and responsibilities and comprehensive procedures for making decisions and exercising powers. Transparency is generally outwards facing; that is, its purpose is to provide insight into how decisions are made, and by whom, for affected stakeholders outside of decision-making forums. Importantly, transparency leads to predictability in decision-making and has links to accountability and integrity measures.

At a high level, the processes and procedures followed by the market institutions are set out under the national laws and rules. Further, each of the institutions publishes guidelines and procedures to provide additional insights. There have been further attempts by individual institutions to broaden stakeholders', particularly consumers', understanding of their functions, powers and approach.

In terms of clear roles and responsibilities, there are issues around the clear separation of roles and responsibilities under the energy market governance arrangements. This was first recognised in the *Review of Governance Arrangements in Australian Energy Markets*¹⁸, in relation to the AEMC's and AEMO's activities and has been exacerbated with the establishment of the ESB, which is performing tasks that would fall within the Energy Council or the AEMC's roles.

Further, there is a general lack of transparency around the ways the institutions, to varying extents, make their decisions. While the institutions provide information about how they have had regard to feedback from consultation processes in documents supporting their decisions, there remains a lack of information about how decisions were arrived at and how the concept of 'maximising consumer economic welfare' informed their decisions. This affects how predictable decisions are for stakeholders and can negate the value of consultation. It also makes it much harder for the institutions to be held accountable for the effect of their decisions.

The exception is the AER, which provides significant feedback on its decision-making approach. This was largely due to the need to justify its decisions through limited merits reviews. In the absence of such reviews, it will be important for the AER not to lose its rigour in explaining its decisions in the future.

Most critically, there is a lack of transparency the decision-making processes of the Energy Council. Meeting communiques provide little insight on the nature of the Energy Council's discussion and the trade-offs inherent in its decisions. Further, there is a lack of transparency around the split in responsibility between the Energy Council and individual governments. This creates confusion and increases the complexity in regulatory reform, implementation and administration, and for stakeholders attempting to engage with decision-making.

¹⁸ Vertigan, Yarrow and Morton, *Review of Governance Arrangements in Australia Energy Markets*, 2015.

The failure in transparency of Energy Council decision-making has implications for the other energy institutions. Relevantly, there is no transparency in how the Energy Council provides guidance in its role as policy leader nor in its role at the top of the governance hierarchy, leaving the market institutions to pursue their own priorities without a single guiding vision.

The lack of transparency around Energy Council and individual government decision-making is evidence that the effectiveness of the energy governance arrangements has been compromised. Consequently, there is a general need to improve transparency across the national energy institutions and for the Energy Council and participating governments, in particular.

Integrity

Integrity entails decision-makers acting impartially, ethically and in line with the objectives of the agency (or, in the case of national energy policy and regulation, the stated objectives of the AEMA). Integrity of decision-making is something that is becoming increasingly important, as trust in government decision-making has declined globally since the Global Financial Crisis¹⁹, with a similar trend has been observed in Australia.²⁰ Energy Consumers Australia's (ECA's) consumer sentiment surveys reinforce the importance of integrity for energy decision-making.

As noted previously, there is limited information available on the basis of decision-making in relation to energy policy and regulation. What information is available demonstrates significant differences in approaches across the different institutions. Relevantly, the AER tends to provide the most detail on its reasons for adopting a particular approach, while the Energy Council, AEMC and AEMO provide justification in response to feedback from stakeholders, but not as much in relation to the assumptions or trade-offs inherent in their decision-making.

Without information on the matters considered in making a decision it is difficult to perform any overarching analysis of the integrity of the existing governance arrangements and the institutions. However, this gap could, in itself, exacerbate to the lack of trust in decision-making in the energy sector.

Further, the changes occurring within the energy sector due to new technologies, services and products provides additional risks in relation to integrity of decision-making. Specifically, there are real risks of picking winners (or losers) through government policies or regulations that circumscribe access for new entrants or undermine the realisation of the National Competition Policy principles. As such, there is a need to promote and demonstrate integrity in energy decision-making.

Stewardship

Stewardship, in a governance sense, is using every opportunity to enhance the value of the policy and regulatory frameworks. This value is in service of an objective, which, in the case of energy, is to maximise consumer economic welfare.

The ongoing issues around energy affordability and security that have emerged and not been resolved since the implementation of the national frameworks provides anecdotal evidence of a fundamental failure in relation to stewardship.²¹ However, the lack of transparency around how decisions are made by the various institutions makes it difficult to be more precise about the specific nature of this failure.

In general, stewardship is a matter that needs to be advocated in combination with increased transparency and integrity of energy institutions across Australia. In particular, the Energy Council, individual governments and COAG need to provide greater stewardship of energy policy across Australia, to ensure economic welfare it being maximised.

¹⁹ OECD, *Government at a Glance 2013*.

²⁰ See University of Melbourne, The newDemocracy Foundation and the Susan McKinnon Foundation, *Reforming Our Democracy*, 2019 and <https://www.democracy2025.gov.au/>, accessed 5 May 2022.

²¹ Critical Strategies Group, *National energy policy and regulation – Performance since 2008*, May 2020.

Efficiency

Efficiency relates to the best use of resources to further the aims of an organisation, or, in the case of energy, all the institutions collectively, with a commitment to evidence-based strategies for improvement.

The current governance arrangements were an attempt to improve the efficiency of the plethora of energy decision-makers that existed prior to the Parer Review in 2002.²² Even with these reforms, there remains multiple decision-makers in relation to both the national energy frameworks and related state responsibilities. This results in the duplication of activities, with different incentives or decision-making criteria, and a significant burden on stakeholders needing to engage in multiple processes.

As such, the current governance arrangements do not promote efficiencies and are, instead, themselves a barrier to effective and timely decision-making.

Leadership

Leadership involves realising an agency-wide, or, for energy, multi-institutional, commitment to good governance through leadership from the top. In the multi-agency context of the energy sector, this involves both the leadership provided by governments, individually and through the Energy Council, and within the institutions themselves.

As noted previously, there is a lack of information that makes determining whether there is effective leadership in the energy institutions and across the energy institutions difficult. This lack of information is itself an indication of a gap in leadership in energy policy and regulation that is at odds with good governance practices. Further, the Vertigan Review in 2015 identified significant leadership failures, particularly in relation to the Energy Council, which have not been resolved.

Analysis of effectiveness of governance arrangements for liberalised energy markets

Energy policy and regulatory arrangements are intended to deal with complex problems associated with the provision of public goods, managed through shared responsibilities in a liberalised market in a timely, effective and efficient manner. Effective governance arrangements are required to manage structural and market changes, both during 'business as usual' and during periods of significant change.

The purpose of governance in the energy policy and regulation is therefore to:

- Clarify individual and shared responsibilities for system security
- Align accountabilities with functions (for both institutions and industry participants)
- Ensure each parties' responsibilities are clearly described and that each party has the necessary authority to undertake their responsibilities within those boundaries
- Provide strong incentives for effective coordination and information exchange, reflecting the nature of shared responsibilities
- Create transparency and objectivity
- Strengthen coverage, accountability and enforcement to build the credibility of the regime
- Be applied consistently
- Balance market requirements with system security requirements.²³

The challenge is to recognise that the institutional arrangements and the role of the market participants needs to be complementary and incentivised to deliver a common objective. As such, the functions, processes and accountability of the institutions need to reflect similar incentives as

²² Parer, *Towards a Truly National and Efficient Energy Market*, December 2002.

²³ IEA, *Learning from the blackouts; Transmission system security in competitive electricity markets*, 2005.

apply to market participants. Specifically, institutions need to be incentivised to manage risks where they are not exposed to the consequences of making decisions.²⁴

Inadequate governance arrangements have the potential to undermine the effectiveness of energy markets, lead to conservative, politically-driven investments at the expense of consumer economic welfare and/ or to leave the interconnected networks exposed to the risk of substantial power failures. In contrast, effective, appropriate and inclusive governance arrangements create the foundation for developing a mutually reinforcing web of incentives and accountabilities for delivering reliable and secure supplies of energy at a price that is efficient and maximises consumer economic welfare.²⁵

Data provided by the AER in its annual State of the Energy Market publications indicates that the reliability and security of supply had generally improved across the National Electricity Market (NEM) since 2006, albeit with differences between regions. However, after a number of years of more stable outcomes, the cost of transmission outages moved higher in 2015 and 2016 for networks in Victoria, New South Wales and South Australia. In South Australia, in particular, electricity supplies were disrupted, state-wide, with significant economic consequences.²⁶

Both the increased incidence of insecurity and supply disruptions and the interventions by the institutions as a result of this, provide evidence of broad governance failures. In its report on the blackout in South Australia in September 2016, the AER expressly identified the need for greater clarity and transparency about roles and responsibilities and clarifying and addressing gaps in the regulatory framework where there are areas of contention or doubt about how the regulations apply in any circumstance.²⁷

While there have been substantive changes to the rules framework since 2016, there has been no strategic consideration of the governance arrangements across the market institutions and in concert with market participants and whether these contributed to the supply disruptions. Further, reforms pursued to date have not applied the governance principles listed above, which has implications for the integrity of the regulatory arrangements.

It is also relevant to note, the congruence of events leading to the blackout in South Australia, and the current focus in the energy policy space on energy security, were not recent developments. Governments have been grappling with the management of system security in liberalised energy markets since the 1990s and the management of intermittent generation in interconnected systems since the early 2000s. The failure to develop a strategic policy approach and to respond effectively to changes in the generation mix, is further evidence that the current governance arrangements are not appropriate to deliver the objective of maximising consumer economic welfare in periods of rapid change.

Implications during the energy sector transition

The energy sector transition is being driven by the development and commercialisation of new technologies, products and services. This has given rise to new parties operating under the national energy regulatory arrangements in a way that was not previously considered by policy or rule makers.

This shift away from the historical production of energy by large participants that is then transmitted to population centres through high voltage networks to population centres has created further complexities for energy policy and regulation. Relevantly, there are new technologies and services that can be used as an alternative to the traditional supply-focused industry structure, which creates new and conflicting incentives and priorities. As such, energy policy and regulation comes within the

²⁴ Ibid.

²⁵ Ibid.

²⁶ AER, *State of the Energy Market 2018*.

²⁷ AER, *The Black system event compliance report—Investigation into the pre-event, system restoration, and market suspension aspects surrounding the 28 September 2016 event*, 2018, page 189.

scope of a 'wicked' policy problem; that is, complex problems beyond the capacity of any one organisation to understand and respond to, often with disagreements about the causes and best way to resolve them.²⁸

Addressing wicked problems requires successfully working across organisational boundaries and having effective engagement in policy and regulatory decision-making and implementation. Further, wicked problems need innovative and comprehensive strategies, rather than solutions, that can be refined or readily reviewed in light of practical experience. This is a challenge to using traditional approaches to decision-making, which underlines the importance of effective governance arrangements.²⁹

Traditional policy approaches follow an orderly and linear process: working from problem to solution. This typically involves understanding and defining a problem, gathering data and other evidence, development of and costing a reform, identification of outcomes and outputs and then implementation. However, this approach does not work in relation to wicked problems, because of the interactions between causal factors, conflicting policy objectives and contention over appropriate solutions.³⁰

Under the current governance arrangements, there is a continued focus on the 'right' questions or trying to narrow down the scope of work to make it feasible to consider using traditional approaches. This approach lends itself to adversarial claims about the nature of the issues and possible solutions, without necessary regard to the underlying dynamics and, in particular, the competing priority tensions. Further, while a traditional approach can resolve aspects of a wicked problem in the short term, the approach to resolution can exacerbate the issue over the long term due to unintended consequences.³¹

There has been significant work on how to manage wicked policy problems through adopting fit-for-purpose strategies, not considering aspects of the issue in isolation, the need for innovation and flexibility, and working across organisations.³² From a practical perspective, this could entail recognition of the underlying policy tensions, developing mutual understandings and genuine interaction across perspectives, a more adaptive and transparent approach that is not about 'finding solutions'.

Such an approach would necessitate a shift to the cultures of the various institutions under the current governance arrangements to a principles-based approach to policy and regulation that is capable of being flexible and adaptive to changing conditions. However, the failures within the energy governance framework means such a shift is unlikely under the current arrangements, which may have implications for the effectiveness of reforms in the context of the energy transition.

DISCUSSION OF UNDERLYING GOVERNANCE ISSUES

The following explores the current governance arrangements for the purpose of characterising critical areas for reform to address the issues identified in the previous section.

COAG Energy Council

The Energy Council is, in essence, a political body, operating with the social license afforded to its composite elected governments. It is imbued with the authority delegated by individual governments to act on their behalf in areas of agreed responsibility (set out in the AEMA).

Relevantly, the Energy Council is intended to act on behalf of COAG, with each individual minister separately accountable to their own parliaments. The intent was for anything set out in the AEMA to

²⁸ APSC, *Tackling wicked problems; A public policy perspective*, 2007.

²⁹ Ibid.

³⁰ Ibid.

³¹ Ibid.

³² Ibid.

prevail over individual governments' political interests, while matters outside of the AEMA were either determined to be state or territory responsibilities or matters to be settled through the Energy Council in the national interest.

The failures identified in the *National energy policy and regulation – Performance since 2008* demonstrate that the objectives set out in the AEMA have not been realised. As the institution with responsibility for delivering the objectives of the AEMA, the Energy Council has not acted in the way intended under the AEMA. Specifically, the intention to overcome individual governments' interests in favour of the national interest has not been realised; that is, the incentives afforded decision-makers under the current governance structure are not effective.

Moving away from the Ministerial Council approach, however, would be inappropriate. The political nature of its role means that its responsibilities cannot be delegated to an independent market body. However, there are ways that the institutional arrangements across the energy sector could be strengthened to better support the Energy Council, which is discussed further separately.

The following applies the principles of good governance to identify necessary changes to the way the Energy Council acts in performing its agreed functions and powers.

Accountability

At the highest level, the Energy Council is accountable to first ministers through COAG. This involves COAG holding the Energy Council responsible on matters within its jurisdiction and towards the objectives in the AEMA being realised. Specifically, the Energy Council should be responsible to COAG for pursuing, implementing, monitoring, evaluating and refining (as necessary) national energy policy, governance and legislation.

There is little evidence that COAG routinely provides any oversight of the Energy Council's roles and responsibilities. Further, COAG has not provided guidance to the Energy Council in light of market or regulatory outcomes. For example, there has been no change in COAG's delegation of responsibilities to the Energy Council in light of the identified 'dysfunction' of Australia's gas markets. Nor has COAG issued directives in the context of significant electricity supply disruptions or unaffordable and unsustainable increases in consumer prices.

The absence of this oversight by COAG has led to the situation where the Energy Council is not being held accountable, but individual ministers remain firmly accountable to their Parliaments. The result is individual government priorities are being pursued over the national interest, to the detriment of realising the objective of maximising consumer economic welfare.

A further source of accountability for the Energy Council is to its stakeholders, including the market institutions, industry participants and consumers, in the performance of its functions and in the market and regulatory outcomes. However, there is little evidence that stakeholder feedback has informed the Energy Council's approach to performing its role and responsibilities.

There is, therefore, a case for strengthening the accountability of the Energy Council (and participating members) to both COAG and to its stakeholders.

Recommendation 1: Accountability of the Energy Council needs to be strengthened by:

- a. COAG holding the Energy Council responsible for its role under the AEMA and outcomes for energy consumers and the economy
- b. COAG holding governments responsible for the collective pursuit of national interest over individual government priorities
- c. COAG to publish a service charter for the Energy Council, which could build on the Strategic Energy Plan
- d. COAG to agree periodically to an agreed program or scope of work
- e. Energy Council being required to annually:
 - i. Report to COAG against agreed program or scope of work
 - ii. Seek revisions to program or scope of work (where necessary)
- f. Energy Council obtaining feedback from market institutions, industry stakeholders and consumers
- g. Energy Council implementing processes to action, where necessary or appropriate, feedback to improve its performance of its functions

Transparency

Energy policy, legislation and governance are complex and technical. However, the implications of decisions relating to policy, legislation and governance can be wide-ranging and significant for affected parties and the economy more broadly. The complexities associated with energy policy, legislation and governance can create barriers in stakeholder access and engagement, which could be improved through greater transparency in underlying assumptions and trade-offs in decision-making.

The complexity means it can be onerous to identify the implications for consumer economic welfare, and stakeholders' interests more broadly, from policy or regulatory reform. However, this should not be a barrier to necessary reform. It is inappropriate to have policy, legislation and governance to remain 'fixed' in place, as this would not reflect or may impede the natural evolution of the sector and the economy. Due to the potential ramifications of changes, it is therefore necessary to provide predictability in how decisions are made.

However, the Energy Council's decision-making is opaque. There is little public information about how it approaches decisions and the trade-offs considered. Publication of communiqués setting out the decisions arrived at do not provide necessary details for sector stakeholders to know how decisions are made, nor for COAG to hold the Energy Council to account for its decisions.

Transparency in decision-making was one of the key criticisms raised in submissions to the *Review of Governance Arrangements in Australian Energy Markets*.³³ The need for greater transparency is intensified during periods of rapid change, as is the case in both electricity and gas sectors. There is little evidence that the Energy Council has improved the transparency in its decision-making since the *Review of Governance Arrangements in Australian Energy Markets*, which could be expected to exacerbate the policy uncertainties felt by stakeholders.

Recommendation 2: Transparency of Energy Council decision-making needs to be improved by:

- a. Energy Council publishing minutes of each meeting and summary of feedback for out of session decisions
- b. Energy Council publishing and routinely updating information on its work program and relevant contacts

³³ Vertigan, Yarrow and Morton, *Review of Governance Arrangements in Australia Energy Markets*, 2015.

Integrity

Integrity of decision-making is critical for maintaining the confidence of participants in the sector and to retain the social-license for the Energy Council's role as decision-maker. As noted previously, there is a general lack of trust in public decision-makers. The lack of transparency and accountability of the Energy Council identified above has the potential to significantly further undermine the Energy Council's integrity, beyond the general distrust in governments.

Integrity in public governance can be delivered through application of four key principles:

1. Having a clearly defined purpose

Pursuing clear shared purposes drives institutional 'performance', that is, delivering on stated outcomes. Performance, in turn, is a key determinant of public trust.³⁴ As such, an effectively performing Energy Council is important for institutional, industry and consumer confidence.

However, while performance is important, trust in public institutions ultimately depends more on 'process' rather than outcomes. This is not merely because people expect and value process from government, but also because it is not always possible to effectively judge outcomes.³⁵

2. Legitimacy of the institution

Legitimacy of an institution relates to the concept of trust. That is, trust that its processes will result in a law that applies equally to all and no one is disadvantaged and trust in the impartiality of decisions. Impartiality relates to independence, neutrality and the absence of bias when exercising discretion.³⁶

Trust can also be enhanced by the involvement of stakeholders in policy process, which can facilitate an understanding of the compromises inherent in policy decision-making and by real or perceived procedural fairness.

3. Commitment to being a trusted partner

Public institutions need to be trusted not only by the general public but also by those they partner with to deliver their stated outcomes.³⁷ For energy, this covers the market institutions, industry stakeholders and energy consumers.

In this context, trust is determined less by the general features of performance and policy, and more by whether they can be relied upon to fulfil the specific commitments they have with each actor.³⁸ As such, for energy, the Energy Council being a trusted partner is key to an effective governance framework.

4. Robustness of decision-making

The key feature of robustness is availability and access to appropriate accountability mechanisms. Accountability mechanisms are a necessary feature for trust in government over the long run. Their effective vigilance incentivises public institutions to live up to both performance, process values and commitments, and validates (dis)trust perceptions.³⁹

Delivering on the above integrity principles is complicated for the Energy Council. Some participating jurisdictions are also owners of energy infrastructure, which leads to conflicts of interest in their decision-making. In addition, the split of responsibilities between individual governments and the Energy Council can result in conflicting or poorly defined purposes.

³⁴ Kirby and Webbe, *Being a trusted and respected partner: the APS integrity framework*, March 2019.

³⁵ Ibid.

³⁶ Ibid.

³⁷ Ibid.

³⁸ Ibid.

³⁹ Ibid.

Improving the accountability and transparency of the Energy Council's decision-making may go some way to address these concerns. However, real and perceived conflicts of interest associated with infrastructure ownership are likely to require additional reforms to the Energy Council's structure.

Relevantly, with the Australian Government's purchase of the New South Wales and Victorian Governments' shares in Snowy Hydro, its incentives in energy policy, legislation and governance have changed. This change means retaining its role as chair of the Energy Council could undermine the integrity of the Energy Council through a real or perceived conflict of interest. Similar conflicts also occur in some state and territory governments.

The role of the chair of the Energy Council is important in providing leadership and timely decision-making. As the Energy Council is a cooperative forum, the chair is also integral in holding individual governments to account. As such, the assurance of actual independence of the Energy Council chair is important in guaranteeing trust in the Energy Council as an institution.

Recommendation 3: Integrity of the Energy Council needs to be improved by:

- a. The appointment of an independent, non-government chair
- b. Energy Council publishing a code of conduct
- c. Energy Council commitment to the four principles of integrity: (1) a clearly defined purpose, (2) enhancing legitimacy, (3) commitment to being a trusted partner, and (4) strengthen robustness of decision-making

Stewardship

Stewardship entails looking beyond immediate challenges to the medium and long term to identify and meet future challenges. As such, it is more strategic and less reactionary. Commitment to the principle of stewardship is an integral part of effective governance arrangements. Further, for a sector with long-term investments and broad economic importance, ongoing and continued commitment through the Energy Council to stewardship is critical to realising the objectives set out in the AEMA.

Governments around the world have explored the application of the stewardship concept, with New Zealand moving to a stewardship approach in significant reforms to their public service to strengthen the quality of advice. New Zealand's Policy Project was launched in 2014 with the hope of "lifting the policy game across the system".⁴⁰

The Australian energy policy landscape faces similar sorts of challenges, with the *Review of Governance Arrangements in Australian Energy Markets* identifying the need for high-quality analysis and advice.⁴¹ The Energy Council adopting and committing to a strategic and considered approach to policy advice, such as that adopted in New Zealand, could lead to systemic improvements in policy capability and a sound model of systemic intervention that policy leaders could use to achieve better results for their governments and their citizens.⁴²

Of relevance in the New Zealand context is the highly devolved nature of its public service. For the Energy Council, a similar devolution in the provision of policy advice could support the national character of its role.

This role is currently being performed by the ESB. However, the membership of the ESB, with the heads of the other market institutions, have no expertise or role in considering public policy and public benefits of reforms or law changes and may have conflicts in interest that may affect their participation.

⁴⁰ Washington and Mintrom, *Strengthening policy capability: New Zealand's Policy Project*, March 2018.

⁴¹ Vertigan, Yarrow and Morton, *Review of Governance Arrangements in Australia Energy Markets*, 2015, p 35.

⁴² Washington and Mintrom, *Strengthening policy capability: New Zealand's Policy Project*, March 2018.

For example, in implementing the Finkel Review recommendations, the ESB is required to undertake analysis that involves trade-offs between energy security, on the one hand, and costs for consumers, on the other. Such trade-offs are generally the responsibility of policy-makers, as they are able to be held to account for their decisions through their governments or parliament. There is no such accountability for the ESB's decisions or its member agencies.

There remains a clear need for a policy body, with appropriate authority and accountability, to provide leadership from a public policy perspective. This is currently a gap within the existing governance arrangements.

As with the proposed approach to having an independent chair, an independent policy body, with appropriate authority and resourcing, using the stewardship model in developing advice, would address some of the conflicts between the role of ministers within the Energy Council and in their governments. It would further address the gap in the current governance arrangements and provide an additional source of information about the effectiveness of the market and regulatory outcomes to COAG.

There are benefits associated with this body being separate to the market institutions. Specifically, the independent policy body would be able to consider matters outside of the national frameworks and would have no conflicts around providing advice on the regulatory arrangements under the national energy laws (which set out the scope of the market institutions national functions and powers).

The independent policy body could be broadly based on the body established to support the NEM Ministers Forum. That body comprised policy advisers from each participating government, who had been seconded to the body. This policy expertise was augmented by technical, economic and broader policy experts from the market operator, industry, the ACCC and independent consultants. The body could further work with energy policy and regulatory bodies, globally, to leverage off international experience and policy work.

Recommendation 4: Stewardship of the Energy Council needs to be improved by:

- a. Establishing an independent policy body to support its functions
- b. The independent policy body applying a stewardship model in the development of policy advice
- c. The independent policy body would be accountable to the Energy Council for the quality of its policy advice.

Efficiency

Efficiency, in a governance sense, involves the best use of resources and evidence-based approach to governance improvements. In terms of the Energy Council, efficiency has two aspects: the efficiency of its own role and the efficiency of the national governance arrangements, as a whole. The following focuses on the efficiency of the Energy Council as the inefficiencies in duplicative responsibilities under the governance arrangements are explored separately below.

The *Review of Governance Arrangements in Australian Energy Markets* recommended changes to the Energy Council's processes so it is able to effectively:

- Promote strategic policymaking
- Prioritise key items to achieve the greatest harmonisation benefit
- Oversight delivery of the reform agenda in a clear and unambiguous manner
- Increase transparency and accountability to stakeholders for energy market reform goals

- Better utilise the collective capabilities of the jurisdictions and institutions to identify and address current and future national policy challenges.⁴³

This more strategic approach is consistent with the Energy Council's role in the AEMA. However, adopting a purely strategic leadership role is limited by a number of underlying or minor considerations that fall within the scope of the Energy Council's roles and responsibilities and that cannot easily be delegated to one of the market institutions, such as:

- Mechanical changes to the laws
- Monitoring and evaluation of the performance of the policy, legislative and governance frameworks
- Incremental reforms to the policy, legislative and governance frameworks
- Identification of matters to be taken to the Energy Council.

Focusing on strategic leadership could be more manageable if the Energy Council could delegate these roles, with appropriate powers and guidance, to an appropriate body. The nature of this role, as one of public policy, would fit best within the independent policy body. While the *Review of Governance Arrangements in Australian Energy Markets* considered a role of this type could be performed by the AEMC,⁴⁴ the nature of the decisions (public policy) and possible conflicts in the AEMC being responsible for legislation that bounds its delegated discretion argues in favour of a body separate from the market institutions.

Recommendation 5: Efficiency of the Energy Council needs to be improved by:

- a. Focusing on strategic, longer-term, systemic and structural energy issues that affect the public interest
- b. Delegating other national policy, legislative and governance matters to the independent policy body
- c. Providing authority to the independent policy body to perform its delegated functions and issuing guidance around how the body is expected to exercise its powers

Leadership

Leadership involves clearly communicating strategy, culture, values and behaviours, and by demonstrating how these are embedded throughout the organisation. It has two elements from a governance perspective. Firstly, it entails establishing, maintaining and committing to a culture of good governance, throughout an organisation and led from the top. The second aspect involves promoting a similar culture across the energy sector: that is, in the market institutions the Energy Council has oversight of and in industry stakeholders.

There is no public information about how the Energy Council performs this leadership role. Further, there is no public information about the effectiveness of the Energy Council's leadership role nor whether the Energy Council has considered its leadership in a strategic or functional way.

There is a significant body of work on effective leadership from a governance perspective. Contemporary thinking explores the concept of leadership in different contexts and from different perspectives, rather than the historical approach of seeking 'one true theory' of leadership. This has led to the identification of three approaches to leadership:

1. Authentic leadership

Authentic leadership focuses on transparent and ethical leader behaviour and encourages open sharing of information needed to make decisions while accepting followers' inputs.

2. Adaptive leadership

⁴³ Vertigan, Yarrow and Morton, *Review of Governance Arrangements in Australia Energy Markets*, 2015, pp 32-33.

⁴⁴ Ibid.

Adaptive leadership focuses on leadership as a practice to be used in situations without known solutions.

3. Complexity leadership

Complexity leadership focuses on interdependent agents who are bonded in a cooperative dynamic by common goals, outlook, need, etc.⁴⁵

These three approaches to leadership are complementary and provide opportunities for strategic consideration and application of leadership principles in a governance sense. A combination of the above, periodically reviewed and refined, as necessary, could enhance the effectiveness of the Energy Council's leadership responsibilities.

Recommendation 6: Leadership of the Energy Council needs to be improved by:

- a. A commitment and program to drive internal culture of leadership
- b. A commitment and program, with the support of the independent policy body, to perform its policy, legislative and governance functions
- c. A commitment and program to maximise the effectiveness of the governance arrangements across the sector
- d. Strengthening its leadership through strategic consideration of applying authentic, adaptive and complexity leadership approaches in its performance of its functions.

Legislative approach

The current legislative approach applied in energy evolved through the development of the interconnected electricity system and market and gas markets. The legislative frameworks were therefore developed in an organic way, based on building on and adapting the existing legislative architecture rather than imposing significant regulatory costs (for governments and industry) by fundamental changes in approach.

However, this approach has contributed to the costs faced by the market institutions and industry participants in understanding the scope of their legal obligations across individual states and territories, under the national energy laws and under Commonwealth legislation. It has further added to administrative complexity, which, in turn, impacts on the resources required by the market institutions in performing their national functions and powers.

A principles-based analysis of the location and nature of legislation at different levels of government could help to identify simplifications to the legislative arrangements, thereby reducing compliance, regulatory and enforcement costs. Further, reforming the legislative approach could support and reinforce the proposed changes to the governance arrangements, thereby assisting the enhanced role of the Energy Council and other energy institutions.

Principles for legislative authority

The Federation Principles are the guiding principles for cooperation as communicated by the Premiers and Chief Ministers in 1991 and still provide a framework for cooperation by governments. The four principles are:

- Australian nation principle: all governments in Australia recognise the social, political and economic imperatives of nationhood and will work cooperatively to ensure that national issues are resolved in the interests of Australia as a whole.
- Subsidiarity principle: responsibilities for regulation and for allocation of public goods and services should be devolved to the maximum extent possible *where this is consistent with the national interest, and except where:*

⁴⁵ APSC, *Thinking about leadership; A brief history of leadership thought*, March 2018.

- i. *there are significant interjurisdictional spillovers associated with the provision of goods or services at the sub-national level*
- ii. *there are sizeable economies of scale and scope arising from central provision or organisation or readily identifiable areas of shared or common interest*
- iii. *different rules or regulations are likely to give rise to high transaction costs with insufficient offsetting benefits*
- iv. *the costs of administering the function is not able to be supported by the assigned level of government;*

so that government (as a whole) is accessible and accountable to those affected by its decisions.

- Structural efficiency principle: increased competitiveness and flexibility of the Australian economy require structural reform in the public sector to complement private sector reform: inefficient Commonwealth-State division of functions can no longer be tolerated.
- Accountability principle: the structure of intergovernmental arrangements should promote democratic accountability and the transparency of government to the electorate.⁴⁶⁴⁷

The above principles provide a sound starting point for considering the effectiveness of the current split in the legislative responsibilities.

Application of Australian nation principle

The range of instruments and the ways there are to amend the operation of the national energy laws, rules and regulations place individual government interests over the national interest. Specifically, the legislative arrangements allow individual jurisdictions to act unilaterally, without any recourse through COAG or the Energy Council.

This has occurred both at state and Commonwealth level. For example, the Australian Government removal of its consent for limited merits review occurred without the agreement of the Energy Council and in spite of ongoing work within the Energy Council to reform the national regime. Similarly, individual governments' renewable energy policies undermined the market signals associated with the wholesale market.

The national energy legislative frameworks, therefore, are not supporting the realisation of the Australian nation principle. In particular, there is scope for actions of the individual governments to compromise the effectiveness of the national arrangements without reference to maximising consumer economic welfare.

In addition, the national arrangements only apply where states and territories choose to adopt them. While this allows for design of regulatory frameworks to accommodate local needs, it creates additional barriers for parties who may otherwise opt to participate in different states or territories. Without the economies of scale available for participants in the national market, participants in state-based markets could have higher operating costs, which get passed through to consumers in terms of higher prices.

⁴⁶ Productivity Commission, *Improving Commonwealth-State Relations, Shifting the Dial: 5 year Productivity Review, Supporting Paper No. 14*, 2017.

⁴⁷ Since the 1990s, Productivity Commission noted the application of the subsidiarity principle was refined with broad support for assigning responsibility to the highest level of government and assigning roles to the level of government able to finance its assigned functions (changes in italics).

Recommendation 7: The legislative framework applying to the provision of energy services across Australia should:

- a. Promote the interests of Australia as a whole
- b. Accommodate necessary differences, due to geography, environment or historical developments
- c. Prevent individual governments to acting unilaterally to alter the operation of the frameworks
- d. Limit individual governments, with the agreement of the Energy Council, capacity to alter the operation of the national frameworks to identified circumstances.

Application of subsidiarity principle

In general, the national energy law approach reflects the unaltered subsidiarity principle from 1991; that is, devolution to the *lowest* appropriate level (states and territories). However, this approach has not supported the delivery of the national interest, in practice, as:

- The frameworks do not apply nationally
- There are significant differences in the ways the frameworks operate in different jurisdictions
- There are limitations in the institutional arrangements (specifically, the rule-maker is a state-established body rather than Commonwealth entity) that impede the express consideration of the national interest in the maintenance, development and implementation of the national frameworks.

In large, this has been due to the frameworks not being designed to apply nationally. The nature of the frameworks, being technical, detailed and prescriptive, means that their application could result in significantly detrimental impacts for consumers in some states or territories. Even where the national frameworks do currently apply, there is an added burden on individual governments to closely monitor changes to the national energy rules to determine whether there is a need for jurisdictional modifications.

The national energy rules were designed and have subsequently been revised to apply in the context of the interconnected systems in south eastern Australia. This means aspects of the rules are not relevant in other energy systems and, particularly in gas, a range of regulatory approaches are used within a single framework to deal with jurisdictional differences.

This has led to regulatory complexity in energy regulation across Australia, with associated costs for industry participants and regulatory bodies. These costs are passed on to energy consumers, through their energy bills and through the support of the market institutions. It also presents an opportunity cost associated with the current complex regulatory approach rather than effective, well-designed, nationally applying energy frameworks.

Adopting a truly national energy regulatory framework would also be likely to address the transactional costs for market participants to operate in different markets and provide services to different systems across Australia. Relevantly, with the growing cost effectiveness of standalone systems against grid-supplied power, such a national framework could apply equally to consumers in remote areas, connected to non-interconnected systems or connected to interconnected systems.

However, for this to be effective, the regulatory framework would need to be articulated at an appropriate level. It would not be sensible to have wholesale market arrangements apply in systems without a wholesale market. Such differences could be addressed under a principles-based approach to regulation; that is, one that focuses on outcomes rather than approach.

The effectiveness of the application of a principles-based framework could depend on the successful and ongoing integration with relevant state and territory policy and legislation. This would necessitate retaining the current policy and legislative authority within the Energy Council (albeit, strengthened, as discussed above). Further, it would require the independent policy body to provide

advice to individual governments, through the Energy Council, in relation to policy or regulatory reforms with implications for the energy sector.

Recommendation 8: A single national legislative framework should apply to the provision of energy services across Australia that is:

- a. Set out at the *highest* level (Australian Government) in line with the updated subsidiarity principle
- b. Applied equally by all state and territory governments
- c. A principles-based approach to regulation, to apply in all situations
- d. Complemented by national, jurisdictional or market-specific arrangements (the split between national, jurisdictional and market responsibilities to be determined by applying the subsidiary principle)
- e. Supplemented, as appropriate, by detailed rules, official guidance and facilitation of dialogue between the regulator and regulated entities.

Application of structural efficiency principle

The current approach to energy regulation has evolved from purely state and territory-based regulation to a mixture of Commonwealth and state/territory responsibilities. The Commonwealth's involvement arose from the competition payments to drive the competition reforms, and was cemented in establishing the Australian Energy Regulator as an Australian Government agency. The Commonwealth's role was most recently reinforced through policy commitments to reduce energy prices and improve the reliability of supplies.

This has led to duplication in roles between the Commonwealth, state and territory governments and the Energy Council (as the institution responsible for 'national' policy, legislation and governance). There are, therefore, inefficiencies between the activities pursued by individual governments, horizontally and vertically, in the regulation of energy supplies.

The best, and most efficient approach, would be to adopt a single regulatory framework with no need to allocate responsibilities to other levels of government. However, application of this approach to energy may result in a lack of visibility around necessary trade-offs at a more localised level to realise the overarching objective of maximising consumer economic welfare. A first principles analysis of the split in responsibilities would, therefore, be useful.

The AEMA currently describes matters coming within the scope of the 'national' frameworks as:

- Governance of the energy markets
- Economic regulation across energy markets
- Planning and development of electricity transmission networks
- Participation of energy users in the markets
- Increasing the penetration of natural gas
- Addressing greenhouse emissions from the energy sector.⁴⁸

Within the single, national regulatory framework applying across Australia, these matters would remain within the national jurisdiction.

The application of the national laws to services more directly affecting consumers through the establishment of distribution and retail functions, led to the AEMA further clarifying national and state and territory responsibilities. In general, the matters specified in the AEMA as national functions could come within scope of matters regulated under the single, national regulatory framework applying across Australia. However, as a principles-based approach to regulation, the level of detail and content of the regulatory frameworks would be expected to differ to those currently set out under the national energy laws and rules.

⁴⁸ Australian Energy Market Agreement, paragraph 2.1(b).

Some of the matters set out as state/ territory functions have already migrated to being regulated under the national energy laws. As such, there is value in revisiting the allocation of these functions under the single, national regulatory framework applying across Australia from first principles.

Recommendation 9: The split between national and state/ territory functions under the AEMA should be reviewed with the paramount principle being that everything should be a national function unless there are clear benefits to consumers with retaining state/ territory responsibility.

Application of accountability principle

The accountability of the Energy Council to the electorate has been explored in an earlier section. In terms of the accountability for the legislative arrangements, specifically, there are similar issues. That is, under the applied law approach, no single government authority can be accountable for reforms pursued by the Energy Council, as a whole. Further, the delegation of rule-making to the AEMC has, in practice, led to a reduction in democratic accountability and transparency of government to the electorate.

To a large extent, this is a fact of cooperative legislative frameworks and cannot be resolved legislatively. However, there are legislative approaches that could improve both accountability and transparency.

Relevantly, a single, highest level of legislative responsibility (as recommended above) would assist in providing a single point of responsibility. With governance measures to improve access for consumers, allowing for the provision of feedback and the distribution of information, a single, national, principles-based regulatory framework could better meet the accountability principle.

Australian Energy Market Commission

One of the key achievements of the governance reforms in the 2000s was the establishment of an independent rule maker and policy advice body in the AEMC. However, in practice there have been some complexities associated with the combination of the rule-making and policy advice roles. These complexities have been exacerbated by the establishment of the ESB, whose role, in part, duplicates the responsibilities of the AEMC.

The amalgamation of the rule making and policy roles of the AEMC and duplication of responsibilities could undermine the effectiveness of the national energy governance arrangements in the future, particularly in light of the significant challenges of regulating a rapidly changing sector.

This is due to the different drivers and good governance processes associated with policy development compared to rule-making. Policy development relates to the articulation of objectives, principles and priorities, while rules implement the stated policy. Policy, therefore, provides an overarching framework, which regulations then deliver.

This role for policy is, in a government context, reflected in the way it is approached and treated. Relevantly, there are formal processes and minimum requirements that must be complied with to make sure that:

- The policy problem is clearly articulated and, where possible, costed
- All feasible options are identified
- All affected parties are identified and consulted
- Potential costs and risks are identified and, if possible, quantified
- The preferred option is identified and recommended to decision-makers.⁴⁹

The process is subject to two levels of independent scrutiny. Firstly, a separate body (the Office of Best Practice Regulation for Australian Government and COAG decisions) reviews the policy

⁴⁹ See material at <https://www.pmc.gov.au/regulation/guidance-policymakers>, accessed 11 May 2020.

process to ensure it complies with minimum requirements. Secondly, any proposed policy is only a recommendation and must be agreed to and implemented by an authorised decision-maker.

However, under the national frameworks for energy, the AEMC both provides advice to the Energy Council and is the delegated rule-maker. This creates an inherent conflict between these two roles, where the advice to the Energy Council includes recommended changes to the rules. Relevantly, it could limit the options being considered and costed, to the detriment of robust and fully-informed decision-making.

The current governance approach means there is an assumption that for matters of significant policy, the AEMC would conduct a review and provide advice to the Energy Council, who would then consider this advice and submit a rule change, and potentially provide a statement of policy principles, back to the AEMC to progress. However, without a legislated process or overarching policy direction issued through statements of policy principles, in practice it is within the AEMC's discretion to determine how it approaches matters of significant policy.

Further, the legislated rule change process can have serious implications for the AEMC's considerations during its processes. Relevantly, it means that significant attention is given to settling the policy intention during the process, at the expense of a streamlined and efficient process for developing, consulting on, refining and finalising rules.

From a whole of framework perspective, this contributes to ineffective governance. Specifically, the lack of direct or mandated input from the Energy Council and state, territory or Commonwealth government officials or officers in the AEMC's processes means the regulations established by the AEMC cannot have regard to their interaction with other laws, areas of relevant policy and international obligations. This is because the AEMC is limited under law as to what it is able to consider and there are limitations in sharing of legal advice between entities without waiving legal privilege.

The lack of policy guidance from the Energy Council also means the AEMC is conservative in its approach to rule making. Specifically, it requires evidence of policy failure, which means its processes are backward-looking and reactive, with the resultant rules difficult to change, even where it is at the expense of consumer welfare.

This regulatory inertia could have significant implications for consumer outcomes in light of the structural change in the sector that is currently underway. If the AEMC is constrained, or perceived to be constrained, in what it can consider, there may be significant opportunity costs associated with the rule change process set out in the national energy laws.

Effective energy governance, therefore, would be supported by the separation of the AEMC's policy and rule-making functions, with the policy function to clearly falling within the responsibility of the independent policy body proposed above.

Recommendation 10: Institutional responsibility for policy advice and development should be separated from institutional responsibility for rule-making:

- a. The relevant bodies having clearly articulated responsibilities and necessary authority.
- b. The national energy laws should be amended to reflect the new delegation of responsibilities and to clarify the rule change process in relation to policy developed by the independent policy body.

Australian Energy Regulator

The AER was established to initially have responsibility for economic regulation of electricity wholesale and transmission networks and key rule enforcement functions. This responsibility was extended to the national regulation of distribution and retailing (other than retail pricing)

progressively from 2008. These reforms were part of the suite of measures to establish a new national energy legislative framework and governance arrangements (covering the MCE, AEMC and AER) agreed by COAG in 2003. At that time, it was further agreed that the AER would operate within an enhanced framework of accountability to governments and market participants through clear consultation, reporting and transparency obligations and accessible avenues of appeal against regulatory decisions.⁵⁰

Among other things, the key benefits associated with the move to a national regulator for energy were identified as:

- Providing a consistent source of focused regulatory advice to inform government policy making
- Greater regulatory consistency to assist in the development of national energy markets.⁵¹

It was clear that the AER had been intended to use its expertise to inform policy makers, both within the NEM and beyond and the AEMC. However, in practice, the AER has had to be strategic in its approach to providing data and advice, due to resource limitations and the ever evolving scope of its responsibilities.

This has been to the detriment of developing a body of evidence for assessing the effectiveness of the national frameworks and to the timely reform of the national rules. A fully resourced and functional AER will be critical to the ongoing evolution of Australia's energy markets and to realising the aim of maximising consumers' economic welfare.

Recommendation 11: The expectation that the AER should provide advice should be formalised.

Recommendation 12: Options for ensuring the AER is fully resourced for its functions should be explored and implemented as soon as practical.

In addition, the reform to the national legislative frameworks proposed above provides an opportunity to consider the scope of the AER's jurisdiction and whether this best reflects the need of the Energy Council and individual governments. Relevantly, the Parer Review had identified the scope of the AER's responsibilities to include the:

- Regulation of energy services beyond the NEM
- Role of the National Competition Council and ministers for gas coverage
- Setting entry and exit licence conditions
- Setting of technical standards for the planning, design and operation of critical elements of the power system which are material to the security of the system.⁵²

The market and governance arrangements have moved significantly since the Parer review. However, some of the key failures identified in the review remain relevant, including:

- The energy sector governance arrangements are confused, there is excessive regulation, and perceptions of conflict of interest.
- There is insufficient generator competition to allow Australia's gross pool system to work as intended.
- Electricity transmission investment and operation is flawed, and the current regions do not reflect the needs of the market.
- The financial contracts market is extremely illiquid, in part reflecting large regulatory uncertainty.
- There are many impediments to the demand side playing its true role in the market.

⁵⁰ Ministerial Council on Energy, *Report to the Council of Australian Governments; Reform of Energy Markets*, 11 December 2003.

⁵¹ Parer, *Towards a Truly National and Efficient Energy Market*, December 2002.

⁵² *Ibid.*

- There is insufficient competition in the east coast gas market, and too much uncertainty surrounding new pipeline development.
- Greenhouse responses so far are ad hoc, and poorly targeted.
- The NEM is currently disadvantaging some regional areas.⁵³

Consequently, there is value in revisiting both the matters raised in the review and the scope of the AER's jurisdiction as part of the broader consideration of national energy governance arrangements and the ongoing work on the future of the energy markets.

Recommendation 13: The matters raised in the Parer and Scales Reviews should be revisited as part of the Energy Council's Strategic Energy Plan particularly the scope of the national energy regulator's role.

Under a principles-based approach to regulation, there would be a strong need for mutually reinforcing accountabilities between the rule-maker and the regulator. Specifically, the rule-maker would need to be accountable to the regulator that the rules provide enough guidance about how the implementation of the rules would or would be likely to maximise consumer economic welfare. Similarly, the regulator would need to be accountable to the rule-maker that, in the application of the rules, the approach adopted by the regulator is or is likely to maximise consumer economic welfare.

While such mutual accountabilities would come within the scope of the existing memorandum of understanding between the AEMC and AER, the need for more formal or legalised arrangements could be considered in the context of broader reforms to the governance arrangements and need for similar arrangements between the other institutions.

Australian Energy Market Operator

The role of AEMO has expanded over time to include overseeing the operations and security of the NEM and the Wholesale Energy Market (WEM) in Western Australia, as well as the Declared Transmission System in the Victorian Declared Wholesale Gas Market. AEMO also manages the gas Short Term Trading Market, the Gas Supply Hubs and Pipeline Capacity Trading, as well as retail markets in electricity and gas.⁵⁴

The challenges facing the energy sector in relation to changes in technologies and exposure to international markets has made the effective performance of AEMO's roles and responsibilities critical. However, it is unclear how the different aspects of AEMO's roles, collectively or individually, are maximising consumer economic welfare or the duplication of roles identified in the Vertigan Review⁵⁵ has been addressed.

Further, the establishment of the ESB in 2017 provides anecdotal evidence of a gap in the security arrangements under the previous governance structure. This gap is at odds with AEMO's own stated vision about its role, where it recognises, in light of the "high commercial value and provide critical [energy] services to the community", "governments need to have confidence in AEMO's capability to act to maintain power system security and reliability".⁵⁶

The following explores these matters from a high level in relation to AEMO's different roles, as it may have significant implications for industry and consumer costs.

⁵³ Ibid.

⁵⁴ <https://aemo.com.au/about/what-we-do>, accessed 5 May 2020.

⁵⁵ Vertigan, Yarrow and Morton, *Review of Governance Arrangements in Australia Energy Markets*, 2015.

⁵⁶ AEMO, *AEMO Governance Review*, August 2013.

System operator

The vulnerability of Australia's energy systems to sudden shocks has long been the focus of policy makers. Relevantly, the promotion of system security and responsibility for maintaining reliability were key considerations in the establishment of the system operation role within AEMO (initially through NEMMCO) and the Reliability Panel, respectively.

These matters will be even more important going forward, with the energy transition providing both opportunities and challenges in system management at all levels. The dysfunction of the security and reliability frameworks in the 2016 and 2017 blackouts, the establishment of an additional body with responsibilities for security in the ESB and the lack of confidence in the regulatory arrangements to maintain electricity supplies with generation closing down demonstrates problems with the suite of reliability and security mechanisms in place.

As noted above, critical to providing confidence in AEMO's role is the need for transparency and integrity in the performance of AEMO's different roles. However, there is no public information about the way the system is operated by AEMO, relevantly, how trade-offs are made between its system operation and other functions.

This means there is no clarity around how in performing its national functions, individually or in combination, AEMO is having regard to maximising consumer economic welfare. It also undermines the governance arrangements, where it is not possible for the Energy Council to provide direction about whether AEMO's prioritisation of any of its functions over others is appropriate. As such, greater transparency and accountability around system security is necessary to determine whether consumers economic welfare is being maximised.

However, even with more information available, there are conflicts between AEMO's market operation and system operation roles that are not readily resolved. Specifically, AEMO faces financial risks in its market operations that, under the *Corporations Act 2001* (Cth), AEMO must manage, including through its system operation function.

This conflict could be resolved by allocating system operation to a body independent of price setting. While this would lose some of the synergies in AEMO's existing functions, this would be offset by greater transparency, accountability and confidence in the governance arrangements.

Further, there is no reason the market operator must also be the system operator or that there is a single system operator. Internationally, transmission networks perform system operation roles. With the growing need for active management of energy flows in the distribution networks, a similar approach could provide value for Australia's transmission and distribution systems. Such a course would be consistent with the Energy Council's historical preference to promote consistency between regulation of transmission and distribution.

Recommendation 14: System operation and market operation functions should be separated with allocation of system operation responsibilities explored. Options could include, but not be limited to:

- a. An independent system operator
- b. Allocation of system operation functions to transmission and distribution network businesses, with oversight by a central institution.

Recommendation 15: Legal and financial liabilities of parties for maintaining system security should be reviewed to ensure that these provide an appropriate balance between incentivising system security and minimising distortions in the energy markets.

It is important to provide effective governance by clarifying roles, responsibilities and accountabilities within a legal framework that provides comprehensive coverage and enables

effective enforcement. The NEM system failures in 2016 and 2017 and the establishment of the ESB provides anecdotal evidence that this condition has not been met in Australia.

The Energy Council should recommit to effective governance and legislative framework principles, as an appropriate metric for measuring performance and enforcing system security responsibilities in the future. As a starting point, the Energy Council should undertake comprehensive analysis to ensure these are being delivered, even in the absence of governance reforms.

The IEA has identified that an effective legal and regulatory framework should:

- Clarify individual and shared responsibilities for system security
- Align accountabilities with functional responsibilities resulting from unbundling
- Ensure the boundaries of authority to act are specified for each party and that parties have sufficient authority to undertake their responsibilities within those boundaries
- Provide strong incentives for effective coordination and information exchange, within the value chain and across systems spanning multiple control areas, reflecting the shared nature of responsibility for aspects of system security
- Create transparency and objectivity given the potential commercial implications of system operators' action in competitive energy markets
- Strengthen coverage, accountability and enforcement to help reinforce incentives for providing appropriate levels of system security and to build the integrity of the regime
- Be applied consistently
- Balance market requirements for network capacity with system security requirements.⁵⁷

Recommendation 16: The Energy Council should recommit to effective governance and legislative framework principles and apply these in relation to system security arrangements in Australia.

Market operation

AEMO's roles in market operation differ substantially between electricity and gas and between the NEM and WEM.

AEMO manages both the wholesale electricity markets in the NEM and WEM, as well as the retail markets that underpin the wholesale markets. As part of the WEM, AEMO also operates the Short Term Energy Market, an energy-only forward market to support trading around bilateral contract positions.

Most wholesale gas is sold under bilateral arrangements between producers, retailers and major users. AEMO operates a number of wholesale markets including the Declared Wholesale Gas Market in Victoria, Short Term Trading Market hubs in Sydney, Brisbane and Adelaide, the Gas Supply Hub in Wallumbilla and Moomba, and a pipeline capacity auction and trading platform that supports secondary trading and encourages gas and pipelines to be used efficiently.

The Vertigan Review identified, among other things, the important and valuable role AEMO plays as market operator, and noted that it has performed this task well in an increasingly challenging environment. However, it also considered AEMO should be more clearly focused on developing procedures for the purposes of market operation within the energy market.⁵⁸

⁵⁷ IEA, *Learning from the blackouts; Transmission system security in competitive electricity markets*, 2005.

⁵⁸ Vertigan, Yarrow and Morton, *Review of Governance Arrangements in Australia Energy Markets*, 2015.

The Vertigan Review further recommended, in relation to roles other than market operations, 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.⁵⁹ There is therefore value in the provision of additional transparency around the nature of AEMO's non-market operation roles, to ensure that potential conflicts of interests are able to be identified and managed in a timely way.

Recommendation 17: The market operator should periodically report on its activities and only undertake tasks outside of its core responsibilities where they do not conflict with those responsibilities and are undertaken on a contractual basis.

Ancillary and emergency services

The transition of Australia's energy markets, specifically the uptake of new technologies with different technical characteristics, means there is a growing need for more flexible and responsive technologies for managing system security. This is demonstrated in Australia by the increased number of interventions of AEMO in the market through directions to market participants and deployment of ancillary and emergency services.⁶⁰

From a first principles perspective, the nature and role of such interventions need to be explored and assessed against the underpinning purposes of energy sector regulation (see section on *Governance and the energy sector* above). To the extent that it is not, prescriptive, ad hoc or short-term interventions are likely to be pursued, at the expense of long-term economic efficiency and consumer welfare. The risk of these sorts of interventions with long-term detrimental consequences are exacerbated during periods of substantial or rapid change.

While interventions in the market, particularly in relation to the direction of ancillary and emergency services, could be considered to come within the scope of system security functions (discussed above), significant benefits can be accrued from market-based procurement of such services. Relevantly, market-based mechanisms typically allow for more efficient, innovative and better targeted provision of system security at least cost and help to improve the flexibility and efficiency of system management.⁶¹

The development of innovative financial products could assist in minimising costs to consumers during periods of rapid transition and in support of system operation. There is a clear role for the market operator in providing quality and timely information to stakeholders and in identifying opportunities for new markets or products. Further, where there is scope under the rules, the market operator could help develop new markets and, where there are regulatory barriers, provide advice or submit a rule change request to the rule maker.

Recommendation 18: The market operator should be responsible for procurement of market services and the development of innovative products, within the constraints of the rules.

System planning

The Finkel Review identified the need for a more strategic approach for the coordination of generation and transmission investment in the NEM, and to ensure security and reliability are maintained.⁶² This was a similar finding to the Scales Review in 2007, which identified a strong case

⁵⁹ Ibid.

⁶⁰ AER, *State of the Energy Market 2018*, p 105.

⁶¹ IEA, *Learning from the blackouts; Transmission system security in competitive electricity markets*, 2005.

⁶² Finkel, Moses, Munro, Effenev and O'Kane, *Independent Review into the Future Security of the National Electricity Market; Blueprint for the future*, 2017.

for the establishment of a more coordinated strategic approach to the development of the energy sector.⁶³

Globally, the consideration of need for centralised system planning has been vexed, with different approaches being adopted internationally. Historically, the NEM relied on the identification of opportunities and the relevant network provider making the commercial decision about whether to proceed with the investment. This approach recognised the network provider was best placed to understand the need for investment, thereby ensuring consumers would not be faced with the risk of funding stranded assets.

It was intended the risk of necessary investment not occurring would be minimised by allocating the AEMC last resort planning powers. The last resort planning powers would allow the AEMC, in certain circumstances, to require a transmission network provider explore an identified transmission investment need. It was considered this would impose an appropriately sized incentive on the transmission provider to consider investments with market benefits, by requiring it to justify not pursuing an identified investment.

This power has never been tested and has now been augmented by the new Integrated System Plan framework coming out of the Finkel Review. The ESB has developed rule changes to be enacted by the Energy Council on Converting the Integrated System Plan into Action. These changes are intended to:

- Convert the requirement for AEMO to prepare the National Transmission Network Development Plan each year into a new regime for AEMO to prepare an Integrated System Plan at least every two years including a draft stage allowing consultation
- Integrate the Integrated System Plan with existing planning processes conducted under the rules by transmission network providers, such as the production of Transmission Annual Planning Reports
- Change the regulatory investment test rules for Integrated System Plan projects to streamline the process, recognising the work already done by the Integrated System Plan and avoiding duplication of planning and modelling by the transmission network providers
- Enable Integrated System Plan projects that have passed the regulatory investment test to be able to commence a revised contingent project process.⁶⁴

In addition, the Victorian Government has amended the operation of the National Electricity Rules in its jurisdiction. Under the Victorian arrangements, the Victorian energy minister to direct the construction of new transmission lines or upgrades to existing lines, even where these have failed the economic efficiency tests under the national rules.⁶⁵

In combination, the above provides anecdotal evidence of a lack of confidence in the system planning arrangements under the national frameworks. However, the issues that are aimed at being addressed under the new arrangements relate to system security rather than delayed or poorly timed network investment.

Confidence in the national arrangements could be restored by having effective and strengthened system security arrangements. This would be augmented by sound planning arrangements, where the focus of planning and investment frameworks should be on maximising consumer economic welfare and the periodic assessment of the effectiveness of these arrangements.

⁶³ Scales, *Energy Reform - The way forward for Australia*, 2007.

⁶⁴ <http://www.coagenergycouncil.gov.au/publications/consultation-draft-isp-rules>, accessed 5 May 2020.

⁶⁵ *National Electricity (Victoria) Amendment Bill 2020*, as commenced on 24 March 2020.

Recommendation 19: The system operator should be responsible for system planning.

Recommendation 20: The effectiveness of the system planning arrangements under the rules should be periodically reviewed against whether these are maximising consumer economic welfare over the long term.

Energy Security Board

The ESB was established by the Energy Council in August 2017. The ESB's role is to coordinate the implementation of the reform blueprint published in the Finkel Review and to provide whole of system oversight for energy security and reliability to drive better outcomes for consumers.⁶⁶ The ESB brings together the experience and insights of the other market institutions, which recognises the shared responsibility for system security.

The first of these roles, the implementation of the Finkel Review reform blueprint, requires the ESB to act as policy adviser to the Energy Council. While the expertise of the market institutions is a valuable contribution to this process, it raises two critical issues.

Firstly, the role of the ESB as policy advisor duplicates the role of the AEMC under current arrangements. Duplication of roles of this nature was identified as a significant area requiring reform in the Vertigan Review.⁶⁷ Industry concerns about this duplication have also been raised in relation to ESB's rule making responsibilities.⁶⁸

Secondly, the ESB has no clear lines of accountability to energy consumers. Relevantly, unlike the other market institutions, the ESB is not required to have the national energy objectives as the principal basis for its decision-making. This means it would not be possible to determine how, if at all, the ESB's performance of its role maximises consumer economic welfare.

As currently constituted, the ESB's activities does not preclude the Energy Council from having to undertake additional work to be satisfied that implementing the recommendations would or would be likely to maximise consumer economic welfare. This has implications for energy stakeholders, who may need to provide significant additional inputs into separate ESB and Energy Council processes.

In addition, the ESB would need significant reform and resourcing to operate as the independent policy body and clear direction about the nature and scope of its role. However, its second area of responsibility appears to better align with the responsibilities of the system operator, which could be in conflict with its responsibilities for policy advice as its focus would be on maximising system security rather than consumer economic welfare (with its necessary trade-offs).

Recommendation 21: The role and responsibilities of the ESB should be reviewed in light of proposed general reforms to the governance arrangements.

Recommendation 22: The ESB should not be the independent policy body and its provision of advice should be limited to matters arising in the performance of its energy security functions.

⁶⁶ <http://www.coagenergycouncil.gov.au/market-bodies/energy-security-board>, access 5 May 2020.

⁶⁷ Vertigan, Yarrow and Morton, *Review of Governance Arrangements in Australia Energy Markets*, 2015.

⁶⁸ See for example, Electricity Network Association's submission on exposure draft of *Statutes Amendment (National Energy Laws) (Rules) Bill 2017* at <http://www.coagenergycouncil.gov.au/sites/prod.energycouncil/files/publications/documents/Energy%20Networks%20Australia%20-%20Submission%20NEL%20%28Rules%29%20Bill%202017.pdf>

Reliability Panel

The focus of the Reliability Panel's work is on determining standards and required to deliver a secure, reliable and safe power system in the most efficient way. The Panel also performs detailed monitoring, analysis and consultation.

The NEL sets out the key responsibilities of the Panel. These include:

- Monitoring, reviewing and reporting on the safety, security and reliability of the national electricity system
- Providing advice in relation to the safety, security and reliability of the national electricity system, at the request of the AEMC.

The Panel's work program is set by requirements in the National Electricity Rules and through terms of reference received from the AEMC.

The functions of the Panel have not been reviewed since the Parer Review, when it was considered as part of a broad review into national energy governance arrangements. The Review recommended the responsibility for the setting of technical standards for the planning, design and operation of critical elements of the power system which are material to the security of the system be shifted to the national regulator. The Review concluded that it is appropriate that such technical standards be set independently of AEMO (then NEMMCO), although the close involvement of AEMO in the process remains vital. The allocation of this function to the regulator was in line with the broader review recommendation to streamline the governance arrangements to minimise the number of regulatory authorities stakeholders have to engage with, reduce administrative complexity and avoid confusion about allocations of responsibility.⁶⁹

With the establishment of the ESB, there is a case to review the roles and responsibilities of the Panel. Further, if the governance arrangements for energy are reformed, as recommended in this paper, the location of the Panel as part of the AEMC should be revisited. A better approach to the current arrangements would be to have the one appropriately constituted agency responsible and accountable for energy security, rather than it being split across three different bodies (the Panel, ESB and AEMO).

Recommendation 23: Responsibility for technical standards for the planning, design and operation of critical elements of the power system and advice on the safety, security and reliability of Australia's energy systems should be consolidated into a single body that is independent of AEMO.

Energy Consumers Australia

ECA was established by the Energy Council in 2015 as an advocate for consumers as small business. ECA has core functions in research, consumer advocacy and grant funding activities. The Energy Council considered the establishment of ECA was an important step towards increasing consumer advocacy on national energy market matters of strategic importance and material consequence for energy consumers.⁷⁰

Retail consumer and small business interests have historically been under-represented in policy development, regulatory reform and decision-making.⁷¹ This is, in part, due to the difficulties for consumers to engage with the complexities of the regulatory and market arrangements. However, there has also been a lack of market participant willingness to engage on behalf of their consumers

⁶⁹ Parer, *Towards a Truly National and Efficient Energy Market*, December 2002.

⁷⁰ KPMG, *Review of Energy Consumers Australia; Final Report – Effectiveness of Rules and Functions*, March 2019.

⁷¹ *Ibid.*

and, as noted previously, a failure to expressly consider consumer economic welfare by decision-makers under the current governance arrangements.

The role of ECA is critical and was recognised as effective by KPMG.⁷² However, there is scope for ECA's role to be expanded and, for the Energy Council and market institutions, formalised to include development of tools to enable effective consumer engagement (that is, engagement that leads to actionable outcomes) and measures for determining and reporting on consumer economic welfare that reflect the changing needs of consumers over time.

This latter role will become increasingly relevant as new technologies and products will lead to the escalation in differentiation between the needs of different types of consumers and 'prosumers'⁷³. It further could provide a valuable indication to COAG as to whether the objectives of the national energy arrangements have been realised.

Recommendation 24: The role of ECA should be expanded and, for the Energy Council and market institutions, formalised to include development of tools to enable effective consumer engagement and measures for determining and reporting on consumer economic welfare.

Recommendation 25: ECA should periodically report to COAG (through the Energy Council) on whether consumer economic welfare has been maximised.

PROPOSED NEW GOVERNANCE STRUCTURE

The above analysis demonstrates there are barriers within the existing governance arrangements to realising the objective of maximising consumer economic welfare. As such, there is a need for substantial reform. Relevantly, the current governance arrangements undermine the gains identified in the Parer Review:

- An independent regulator that is accountable to all participating jurisdictions
- A reduction in the number of regulators with which energy business have to do business
- A consistent source of focussed regulatory advice to inform government policy making
- Greater regulatory consistency to assist in the development of national energy markets
- Significant reductions in energy businesses' regulatory compliance costs and greater incentives for the growth of national energy businesses
- More streamlined rule change processes.⁷⁴

Simple tweaks to the current arrangements would not be sufficient to drive necessary cultural changes. There has been an understandable historical approach to consider the allocation of functions in the context of existing institutional arrangements, as the cost of reform could be material.

However, this approach does not account for the nature of the new functions, any conflicts with other institutional responsibilities, or the institution's capacity to perform the function within its resourcing levels. In addition, this approach fails to account for the need for or capacity of the institution's culture to change to accommodate the requirements or considerations inherent in a new function. In turn, this could lead to increased costs or inefficient or ineffective outcomes.

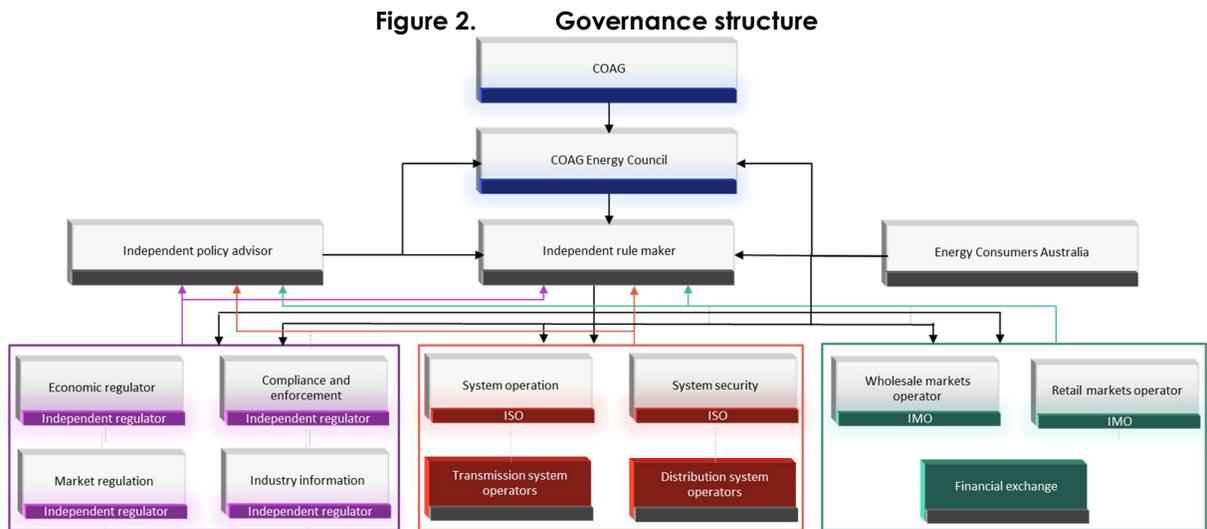
A better approach would be to consider the allocation of roles and responsibilities from a first principles perspective. In light of the analysis above, it is proposed to change the current governance arrangements by increasing accountability of the institutions and, most importantly, the Energy Council (as lead policy body), separating functional responsibilities where these have

⁷² Ibid.

⁷³ That is, consumers who also produce energy.

⁷⁴ Parer, *Towards a Truly National and Efficient Energy Market*, December 2002.

inherent conflicts and streamlining agencies to remove duplication in responsibilities. These proposed changes are represented pictorially in Figure 2.



The specific accountabilities and organisations could be developed further, in combination with changes to the level of legislative responsibility. The specific reforms should entrench the basic building blocks of good governance, individually and across the energy institutional arrangements as a whole:

- Strong leadership, culture and communication
- Appropriate governance committee structures
- Clear accountability mechanisms
- Working effectively across organisational boundaries
- Comprehensive risk management, compliance and assurance systems
- Strategic planning, performance monitoring and evaluation
- Flexible and evolving principles-based systems.⁷⁵

In combination, the proposed changes, if further developed and refined, would:

- Provide accountability to COAG for maximising consumer economic welfare
- Strengthen both the definition of governments' policy oversight role and the resources available to governments for strategic policy advice
- Clarify and increase accountability for roles and responsibilities of governments and market institutions
- Facilitate a cooperative governance framework with clear lines of accountabilities and closer ties between the different institutions
- Facilitate a regulatory structure that is strong, consistent and truly nationally focused
- Facilitate a streamlined and more effective policy making and regulatory reform processes.

⁷⁵ Ibid.