



## Better regulation program: Consultation strategy

### Andrew Reeves' public forum presentation

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#### Opening address

##### Background on the AER

The AER is Australia's independent national energy market regulator. The AER regulates the wholesale electricity market and is responsible for the economic regulation of the electricity transmission and distribution networks in the NEM. The AER is also responsible for the economic regulation of gas transmission and distribution networks in all jurisdictions except Western Australia.

The focus of today's discussion is on our role in setting revenues and prices for energy network businesses. In electricity, this involves setting the revenues and prices that a network business can earn from transporting electricity to customers. In gas, the AER approves reference tariffs (prices) that pipeline owners can propose in an access arrangement.

The AER regulates over 30 electricity networks and gas pipelines in Australia. We carry out this role in accordance with the National Electricity Rules and National Gas Rules which sit under the National Electricity Law and National Gas Law respectively.

The Energy Regulation Authority (ERA) regulates certain gas transmission pipelines and distribution systems in Western Australia under the National Gas Rules and it too is required to develop Rate of Return guidelines under the Rules. The ERA will be conducting a separate but broadly parallel process to the AER.

##### The key fundamentals haven't changed

Before we get to the changes in the regime stemming from the AEMC's rule changes, it is worth emphasising the key fundamentals of the regulatory framework have not been changed. The clear, consistent and predictable revenue and pricing principles are still enshrined in law.

Both laws contain a set of revenue and pricing principles and an overarching objective to guide us as we carry out our regulatory functions. This clear, consistent and predictable set of revenue and pricing principles is a fundamental part of our regulatory framework. These principles guide the regulator to ensure that networks are able to recover at least their efficient costs and that there are incentives to invest efficiently.

What we saw, and what drove us to submit a rule change proposal, was that the rules that were drafted in 2006 went beyond outlining a process for the regulator to conduct in coming to decisions that were consistent with the revenue and pricing principles. The 2006 rules were developed at a time when there was a perception that investment in critical infrastructure may be insufficient to support

economic growth. In response to the concerns of the time a set of rules were put in place that were explicitly intended to promote network investment by the businesses.

This rules framework supported unprecedented network investment. This network investment amounted to \$42 billion in electricity transmission and distribution investment in the first round of regulatory decisions. While certainty for investment is a critical consideration, the AER considered that it was equally important that the framework supports investment that is necessary, efficient, and valued by consumers.

In 2011, having almost completed the first round of electricity transmission and distribution determinations under the rules, the AER submitted a rule change proposal to the AEMC. Our proposal set out to address weaknesses in the regulatory framework, and also focussed on the efficiency of investment expenditure to prevent consumers paying more than they should.

Among the proposed changes, the AER proposed a consistent approach to setting the rate of return across electricity and gas networks. The AER also proposed changes to improve the processes for stakeholders to provide their views on spending proposals from electricity network businesses. The AER's proposed changes built on our work and approach developed over the last seven years, and also took account of the work and approaches by other utility regulators.

### **The new regulatory framework**

The AEMC published its final rule change determination at the end of November 2012. The changes significantly improve upon the old framework.

Taken as a whole, the new rule framework will give better effect to the National Electricity Objective. In short, the National Electricity Objective set out in the Law is to promote efficient investment in and efficient operation of electrical services in the long term interests of consumers with respect to price, reliability, service and safety.

In our view the changes provide a fresh impetus to focus on the overall objective of making decisions that are in the long-term interests of consumers. That is, decisions that are appropriate for consumers now and into the future. In essence this requires the regulatory process to look not only at the near term impact of proposals but also how these will affect price and service outcomes for customers over a longer period, even beyond the 5 year regulatory period. It is important to keep this longer term perspective in mind when considering improvements to our regulatory approaches.

We consider that the long term interests of consumers is such an important element of this project that we will explore what it means as part of our process. The equipment that we are dealing with are long life assets, and the decisions on whether to invest and how to invest have long term consequences. The relationship between consumers and the network businesses are long term relationships. The relationship between the network businesses and the Regulator is long term and defined in the Law and Rules. In many respects, the regulatory bargain between the Regulator and the network business represents a long term contract with customers. These factors guide how we implement the revised Rules framework.

The main changes concern four key areas of regulation: expenditure assessments, setting the rate of return, enhanced expenditure incentives and improved customer engagement. A further important area will be the work program to implement the outcomes of the AEMC Power of Choice review regarding incentives for Demand Management. There are also some other areas of work that AER staff will cover as we go through our work plans.

### ***Expenditure Assessments***

It is important to note that restrictions on the regulator departing from network spending proposals have been removed.

The new rules improve clarity and remove ambiguities regarding the powers of the AER to interrogate, review and amend capex and opex proposals, including the use of various benchmarking approaches. The AER is also now required to publish annual benchmarking reports, setting out the relative efficiencies of network businesses.

### ***Expenditure Incentives***

The new rules greatly sharpen the incentive on networks to only invest efficiently.

New regulatory tools such as capex sharing schemes and efficiency reviews can be applied more effectively. The AER is also able to apply tools it considers are appropriate in order to ensure that only efficient capex should form part of the regulated asset base.

The AER is also now able to review the efficiency of past capex when assessing expenditure proposals and setting future expenditure allowances.

### ***Rate of Return***

The process for setting the return that networks are allowed to earn on their investments has been made much more flexible.

The new rate of return framework is common to electricity and gas. It requires the AER to make the best possible estimate of the rate of return taking into account market circumstances, estimation methods, financial models and other relevant information.

It also allows the AER to take a range of different approaches to estimate the return on debt component, and to take an open and consultative process to develop its approach to setting the rate of return.

We are confident that this will lead to decisions that much better reflect what is actually going on in borrowing markets.

### ***Customer engagement***

Importantly, the package includes a range of reforms to assist consumers to be involved in the decision making process.

The regulatory determination process is lengthened by four months to expand opportunities for stakeholder involvement. Networks will also now be required to better engage and explain their proposals to their customers prior to submitting them to the regulator. This will mean that the businesses will be more accountable to customers for their prices and for their performance.

### **Better Regulation**

In total, we consider that the new regulatory framework is a significant improvement on the past.

Throughout 2013, we will be working with both consumers and network companies, financiers and investors to develop a series of guidelines that will set out our new approach to regulation using the new rules framework. We have called this reform program the 'Better Regulation Program'. We believe that, through this process, we will be able to develop better methods and processes to achieve the aims of the new rules framework.

To re-emphasise, this program of work will be focussed on the long term interests of energy consumers. We are looking at developing new processes that look not only at each individual 5 year regulatory control period, but also ensure that over the medium to longer term consumers are paying no more than necessary for a reliable supply of energy.

This will require us to develop our regulatory approach to ensure that the settings are right for networks to continue to invest efficiently over the long-term. This will be achieved through providing a robust, transparent and certain framework.

It also requires us to continue to improve our assessment techniques so that we are setting forecasts that consumers can be confident represent the efficient costs of supplying them with a level of reliability that they value.

In addition to the changes brought about by our rule change proposal, the AEMC has also recently finished its power of choice review. We will therefore have a work stream devoted to implementing the outcomes of that review.

## **Our process**

Today we will discuss the Better Regulation Program in broad terms and set out our work program and the consultation process that we are planning over the coming 12 months. We are hoping that this will assist stakeholders in planning their resources to participate in what will be an intensive effort over the next year.

A key element of this consultation will be the use of working groups and other targeted forums where stakeholders will have the opportunity to provide feedback directly to us. This consultation will be inclusive, allowing an open process for relevant matters to be discussed.

Working groups will be chaired by an AER board member and include representatives of interested stakeholders. This approach will enable the AER board to hear directly from stakeholders on the matters of importance to you.

We want to stress the importance of stakeholder feedback, and highlight that the AER will run an open consultation process. All stakeholders are encouraged to provide feedback on these processes over the next 12 months. Together with written submissions on our consultation papers, we will use this feedback to complete final guidelines by the end of November 2013.

Today you will hear a quick overview of each work stream from the project director. There will then be an opportunity to provide feedback on the consultation strategy that we've outlined. I encourage you all to get involved and look forward to the discussion.

## **Concluding comments**

During the process, everything is on the table for discussion including the substance on cost estimates and parameters for rate of return. However, this is not to say that we come with a vacant mind, only an open mind.

We are mindful that there is an opportunity for refinement and improvement in our regulatory processes but there has also been a great deal of work done already. Our work over the next year will build on the work we have undertaken in the past.

Important to our success in this extensive work program will be to hear from all stakeholders on the matters that are important to you. The AER will be providing information on how you can register to receive updates on specific work streams.

Thank you to all of the participants for their involvement today. We are very much looking forward to working with you all closely over the next 12 months and beyond.