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Breakout Session: AEMC's Draft Decision on Rule Change Proposals from the Energy Users Rule Change Committee & AER

Implications of the AEMC's draft rules for consumers

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Many of you would recall the AER Chairman, Andrew Reeves, setting out the rationale for the AER's rule change at last year's EUAA Annual Conference. A year on, we now have the AEMC's draft rules for the economic regulation of Network Service Providers (NSPs) and have seen an unprecedented interest in energy market issues.

The need to ensure consumers are central to the decisions made by the regulator and NSPs, and that they are only paying for services that they value, is something the AER has been advocating for some time. It is central to the various reforms underway. While there are a number of reforms afoot, we consider the draft rules are vital to the reforms that will better align what consumers are willing to pay for the delivery of reliable network services, whilst giving network businesses' certainty that efficient costs can be adequately recouped. The AEMC's draft rules represent a significant improvement to the regulatory regime. These improvements will lead to revenue determinations that more accurately reflect efficient costs, and mean that consumers will pay no more than necessary for the services they require. I cannot comment on likely particular price outcomes. These will vary between service providers in any case. But the rule changes, if implemented, will make a substantial difference to price outcomes in the interests of business and household consumers.

Today I would like to begin with a recap of the rationale behind the AER's rule change proposal, and will then focus my presentation on the implications of the AEMC's draft rules for consumers.

The rationale behind the AER's rule change proposal

From the mid 80's until quite recently Australia enjoyed relatively stable energy prices in real terms. However over the past five years, this situation has changed markedly – with prices rising by some 90 per cent in nominal terms or 60 per cent in real terms across Australia.

This has created unprecedented interest in energy market issues and led to much public scrutiny. The Senate, the AEMC, and Productivity Commission have all been involved in carrying out reviews of the regulatory framework for energy networks. Across these reviews there is a strong consensus that Australians are paying too much for a safe and reliable energy supply.

Many of you would recall that the current rules were developed in 2006 at a time when there was concern that investment in critical infrastructure may be insufficient to support economic growth. It was thought necessary to hard-wire the procedures and factors that the regulator ought to observe in the rules, to prevent the regulator from exercising its discretion in a way that might have created uncertainty about the long term profitability of regulated businesses' investments.

In 2006 when the current rules were being implemented, the AER voiced its concerns that the regulatory framework was likely to alter the balance of interests in favour of the regulated businesses.

The current rules framework has supported unprecedented network investment – to the order of $42 billion in electricity transmission and distribution investment in the first round of regulatory decisions. While certainty for investment is a critical consideration, it is equally important that the framework only 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 current rules, the AER reviewed how the rules had operated over the first five years. We identified a range of issues with the current rules which restricted our ability to make appropriate determinations on efficient costs.

Our experience under the current rules, and our concerns, were such that in September last year, we submitted a proposal to the AEMC to address these weaknesses in the regulatory framework. The EUAA also submitted a rule change proposal.

The four major issues the AER sought to address with the current rules were:

- Restrictions on the ability to scrutinise forecast capex and opex
- Insufficient safeguards against overinvestment
- Rate of return frameworks did not reflect actual financing practices
- Lack of meaningful engagement with stakeholders, particularly consumers.

The AEMC's draft determination in response to the AER and EUAA rule change requests was released last month. I will now discuss the key implications of the draft determination.

Key implications of the draft rules

The AER considers the AEMC's draft rules represent a significant improvement to the regulatory regime. These improvements will lead to revenue determinations that more accurately reflect efficient costs. While there are still some issues that need to be ironed out, the AEMC has largely addressed the key issues the AER identified with the current rules.

Holistic expenditure assessments

Starting with capex and opex forecasts, the draft rules give the AER greater scope to scrutinise spending by network businesses and reject excessive cost forecasts.

A key theme from the draft rules is a focus on the 'overall' expenditure needs of a business. This approach is strongly supported by AER. The current rules effectively require the AER to undertake a bottom up analysis of NSPs' revenue proposals. Further, several provisions of the current rules, have constrained the AER's ability to diverge from network businesses' cost forecasts. In particular, the former requirement that distribution business's capex and opex proposals can only be amended to the extent necessary to enable them to be approved has now been removed.

The implication of this aspect of the rules for consumers is that the draft rules will improve the AER's ability to assess and replace NSPs' operating and capital expenditure forecasts. The new, more holistic approach to revenue determinations will increase the AER's ability to benchmark and consider the interaction between the different building block components to substitute its own cost estimates, where appropriate.

Stronger incentives for efficient investment

A problem with the current rules is that they do not provide incentives for firms to improve their capex efficiency. All capex regardless of its efficiency is automatically rolled into the regulatory asset base (RAB). Since network businesses can then earn a return on capex, this creates an incentive for firms to overinvest. The implication of the AEMC's draft rules is that the AER will have the ability to carry out *ex-post* reviews of NSPs' capex and preclude inefficiently incurred capex from the RAB, and also apply capex sharing schemes. In the case that a NSP spends more than its allowed capex, the AER will be able to review the excess expenditure and preclude any inefficient expenditure from the RAB. This will create incentives for NSPs to carefully consider the necessity of any expenditure above their capex allowance, as they will not be compensated if it is found to be inefficient.

Consistent and flexible rate of return framework

The AEMC's draft rules require that the rate of return is set on a 'determination by determination' basis for all NSPs. This approach allows for both consistency and flexibility in rate of return determinations for electricity and gas network service providers. The current rules for determining the rate of return are different for gas, electricity transmission, and electricity distribution. Having a single framework minimises the risk of distortions in capital allocation and investment decisions between the different industry sectors.

The draft rules also provide the AER with the flexibility to respond to market developments when determining what an appropriate rate of return should be. The 'determination by determination' approach ensures that the regulator is better able to respond to changes in financial market conditions. This will help to ensure that rate of return decisions are reflective of NSPs actual financing costs.

Greater opportunities for consumer engagement

One of the greatest weaknesses with the current regulatory framework is that it does not readily accommodate or encourage consumer engagement.

The AEMC's draft determination provides several measures that facilitate greater information and consumer engagement in the network regulatory decision making process. Some of these measures include:

- more time in the regulatory process for stakeholders to prepare submissions,

- the inclusion of overview papers with a consumer focus,
- guidelines on regulatory processes,
- benchmarking reports, and
- the requirement that the AER consider the extent NSPs have consulted with customers when assessing revenue proposals.

In essence, the initiatives proposed by the AEMC are intended to promote an interactive process in which consumers, the AER and NSPs are all involved in ensuring the NSPs are providing services that are valued by consumers. For example, in setting capital and operating expenditure allowances, the AER will also be able to consider the extent to which businesses have engaged with consumers. We consider this to represent a significant improvement over the current arrangements. This will create an incentive for NSPs to focus more on increasing consumer welfare by providing the services most valued by customers.

More importantly, it will introduce into the system a measure to allow direct negotiation between customers and their respective NSPs. Also we have seen that some major users have been under stress due to rising tariffs. Though the current rules allow for NSPs to negotiate tariffs with major users, we have not seen NSPs engaged in this. This is another aspect of the framework that could benefit from greater engagement with end users, and a more flexible approach by NSPs.

Closing remarks

While some in the audience may be disappointed that the draft rules have not accepted all of their proposed changes, I consider that the AEMC's draft rule is a very significant step forward.

The current rules have focused on the promotion of investment, but have not adequately dealt with the efficiency of that investment. The balance of interests under the regime has been in favour of regulated businesses, rather than consumers. The AEMC's draft rules will help restore the balance between end users and NSPs by ensuring consumers do not pay more than necessary for the delivery of reliable services whilst giving network businesses' certainty that efficient costs can be adequately recouped. We can be more confident that both of these requirements can be met under the draft rules — and that is the challenge — to ensure that the rules allow the regulator to strike that balance.