Inaugural Energy Retail Congress

"The AER and the new regulatory environment"

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Introduction

It is my great pleasure to talk about the Australian Energy Regulator (AER) at this Australian Energy Retail Congress and, in particular, what the establishment of the AER may mean for the energy retail sector.

As most of you would be aware the Australian Energy Regulator and the Australian Energy Market Commission (AEMC) have been only recently established (the AER on 1 July 2005) as part of a new regulatory and governance framework for the industry.

I notice that, in introducing this first session, the brochure for this Congress flags a new era of regulation for the energy market. I think this is truly the case. National regulation of the sector is a very significant initiative indeed and, in the history of the industry, will prove to be one of the more important milestones.

In my presentation this morning I want to talk a little about the role and function of the AER, our priorities and some possible implications and issues for the retail sector.

Energy retailing is a key element of the national market model for provision of energy services, which is a well established but still developing landscape. Effective competition in the provision of energy services is essential to the development of an efficient energy sector. Competitive tension at the retail end energises competitive pressure within the wholesale market, can facilitate efficient use of energy and, above all, is the best vehicle for delivering benefits to customers.

Economic empowerment of end use customers is fundamental to a sustainable efficient energy sector and the ongoing development of a national market for provision of energy services.

In some areas of the NEM, there is evidence of effective retail competition. However, in other areas, this is not the case. I think that, going forward, development of effective retail competition throughout the NEM should be a high priority for both policy makers and the industry.

The role of the AER in the retail sector has yet to be fully defined. Ultimately, the AER will have responsibility for non price retail regulation in the NEM. The exact form of this regulation and the activities that are to be regulated by the AER are somewhat unclear.

Currently, regulatory arrangements differ across the various jurisdictions. The Ministerial Council on Energy has, commendably, tasked itself to harmonise these arrangements and develop a national regulatory framework for energy retailing. This process will presumably play out over the next 18 months or so and will undoubtedly require jurisdictions to pass legislation. However, rationalisation in this area promises to be a considerable step forward in development of the national energy market and the delay in transferring responsibilities to the AER should hopefully be outweighed by a more streamlined regulatory framework across the NEM. I'll comment a little more on this issue later in my talk.

I do note however that reference to retail regulation in the context of a desire for effective retail competition is somewhat of an oxymoron. In general, I view regulation as supporting the competitive market, which is a much better vehicle for delivering efficient outcomes than regulation. Regulation of an area which is fundamentally contestable can be counter productive. In particular, it risks imposing a barrier to entry. This rule applies, in my view to both price and non price aspects of regulation. So if we seek effective competition in the retail energy sector then regulation within this sector of the supply chain should be presumed to be less rather than more.

Accordingly, the immediate challenge for policy makers in developing a national regulatory framework for retail is identifying what aspects of energy retailing should be subject to regulation and what aspects should be left open for competition to deliver. And this should be a matter of ongoing scrutiny as the market matures. I want to say a little more about this issue later.

AER's roles and functions

Simply put, the key principle behind the establishment of the Australian Energy Regulator was that a national energy market needs a national energy regulator.

Different approaches to regulating utilities across jurisdictions distort investment decisions and create unnecessary costs and barriers for utilities operating jurisdictional boundaries.

Despite the fact that gas and electricity has been traded across borders for some time now, giving rise to a national market in both sectors, there are still a dozen or so state and territory energy regulators. The AER will, over the next few years, replace jurisdictional regulators and become a "one stop shop" regulator for the energy sector on a national basis.

A single and independent regulator will reduce regulatory costs and uncertainty to business and allow both gas and electricity markets to develop along, as much as possible, a consistent regulatory framework.

The AER will assume its regulatory functions on a staged basis over approximately a two year period.

At inception on July 1st, (and as of today) the AER has responsibility for –

- Economic regulation for electricity transmission in National Electricity Market jurisdictions
- Monitoring of the NEM wholesale electricity market and
- Enforcing the National Electricity Law, Regulations and Rules.

Currently, the AER has no responsibilities for gas. Rather, gas transmission regulation for all jurisdictions except WA will pass from the ACCC to the AER next year, following the passage of necessary legislation in the various States and Territories.

Under the Australian Energy Market Agreement jurisdictions have also agreed to pass responsibility for regulation of energy distribution and non-price retail regulation to the AER by the end of 2006.

The transition of these functions to the AER will realise many of the benefits envisaged when the AER was created. Up until then, however, we are really adding to rather than being a replacement for the dozen or so State/Territory regulators. So the sooner we can move to the national framework the sooner the benefits will be achieved.

Once this process is complete, across gas and electricity transmission and distribution, the AER will eventually have around forty businesses to regulate which amounts to about 8 major regulatory resets each year.

Electricity Market Monitoring

Market compliance and enforcement is directed toward ensuring the efficient and reliable operation of the electricity market in the interests of all participants. This is an interesting role for the AER outside regulation of the natural monopoly sector, the effectiveness of which will rely on a detailed understanding of the market and strong engagement with market participants. Under the AER there will be greater scrutiny and surveillance of the market. There is an expectation from the policy makers that we do this.

A robust surveillance, monitoring and enforcement mechanism is recognised as necessary for a well-functioning wholesale market for electricity, so this will be a significant focus for the AER. Achieving compliance is in the interests of industry as well as consumers.

The regulatory arrangements for market compliance have been strengthened through amendments to the Trade Practices Act. The AER will have the power to apply directly to a magistrate for the issue of search warrants where it believes there are reasonable grounds there has been or will be a breach or even a possible breach of the National Electricity Law or the Rules.

Under the new regulatory regime, the previously graduated civil penalties scheme has been replaced by a maximum civil penalty of $100,000 and $10,000 for every day during which the breach continues (in the case of a body corporate) and of $20,000 and $2,000 for an individual.

In addition to these penalties, the Court may direct the disconnection of a registered participant's loads or suspend them from purchasing or supplying electricity through the wholesale exchange.

However, the AER will not be out there with a heavy handed approach by aggressively looking for instances to "ping" people. Rather, in the first instance, it's about comprehensive observation of and reporting on the market. In this respect, the AER will continue the NECA practice of releasing a weekly market report. We also propose to release a quarterly and yearly report commenting on key issues for the market and periodic "user friendly" reports targeted to those not directly engaged in the market.

NECA has previously operated a light-handed regime that emphasises voluntary Rule compliance. This is probably an appropriate approach given we seem to have a fairly good track record on compliance within the industry. The outcome I would like to see is a culture of corporate compliance. This is far preferable to an adversarial approach with its consequent costs and disruption. However, for this regime to work effectively, it needs to be complemented by detailed monitoring of participant conduct and effective enforcement.

Hopefully, we can achieve a culture of compliance with the Rules within the NEM. If market participants are operating within the rules, they have nothing to worry about from any enforcement regime. However, where there is evidence of non compliance we will respond quickly and firmly and we will not hesitate to litigate if the matter is sufficiently serious.

Generators, in particular, should ensure that they abide by performance standards that are there to maintain power system security.The AER, as part of its compliance monitoring programme, will be targeting generator performance standard compliance programmes to ensure these arrangements are effective.

The AER has been provided with the ability to take, where appropriate, strong action in the instance of a rules breach. I think the long term integrity of the market requires that the Regulator has this power. However, the best approach is for all industry participants to develop compliance management policies as part of their broader risk management frameworks.

The AER the AEMC and the ACCC

I'd now like to turn to the relationship between the Australian Energy Regulator, the Australian Competition and Consumer Commission and the Australian Energy Market Commission.

The AER is an independent legal entity but a constituent part of the ACCC.

Some may consider this an interesting legal construct, but the AER's legislation is unequivocal in terms of its independence and the AER will be responsible for making decisions on energy regulatory matters independently of the ACCC.

The AER will have its own dedicated staff and other necessary resources and an identity separate from the Commission. Indeed, all 50 or so ACCC energy staff have been allocated to the AER.

Having said this, there are significant benefits from the strong association between the two bodies. The Commission will continue to be responsible for approving mergers, access codes and undertakings, granting authorisations and for investigating and where necessary, prosecuting possible contraventions of the Trade Practices Act. The ACCC will call on AER personnel for input on energy matters that come before it, such as mergers or acquisitions. The AER, in turn, will be able to call on the broader support infrastructure of the ACCC and benefit from its experience in areas such as market monitoring.

This allows both bodies to draw on the same substantial body of specialist skills and knowledge while avoiding costly, and potentially time-consuming, duplication.

There is also a very clear distinction between the roles of the AER as the energy regulator, the AEMC as the rule maker and provider of policy advice to the Ministerial Council on Energy and the ACCC as the competition regulator.

The AEMC will have specific obligations to consult in developing or considering any code changes, and any person, including industry and end-users, may make comments on proposed code changes.

This clear demarcation (particularly between policy and regulation) was a major aim of the new governance framework so each body needs to be conscious of this and perform its respective functions with total independence.

On the other hand, I think there is a strong industry expectation that these three bodies will have strong communication links and co-operate to streamline regulatory decisions. Implementation of arrangements to ensure close association between the three entities is well advanced.

Regulatory policy and review

So the AER is the energy regulator, the ACCC will continue to be responsible for mergers and breaches of the Trade Practices Act and it is up to the MCE, advised by the AEMC, to set broad policy.

And it is in the area of policy, that a number of key industry issues still require resolution. Indeed, it's fair to say that, whilst regulatory governance has been settled, the entire regulatory models for both gas and electricity are still subject to intense review.

The MCE has recently commenced consultation on its response to the Productivity Commission review of the Gas Access Regime and is also considering a harmonisation of gas and electricity regulation across jurisdictions. Exposure draft legislation is proposed for February 2006.

As I have already noted, a national framework for retail regulation is also proposed to be implemented before the AER assumes responsibility for non price retail regulation.

Importantly, there is also the review of Chapter 6 of the NEM Rules to be conducted by the AEMC by mid 2006 which will have a direct bearing on the regulatory framework for electricity transmission and ultimately distribution.

Three key questions that will arise out of these reviews will be:

- How far should we move away from the existing revenue and price setting arrangements in the Rules and the Gas Code?
- In respect of gas pipelines in particular, should there be an introduction of an option for light handed regulation? If so, how is this to be defined, when will it apply (i.e. price monitoring) and who triggers the option?
- Thirdly, what level of prescription should be embedded in the respective code and rules to dictate the regulatory process?

Finally, there is the response to the Prime Minister's Taskforce Report on Export Infrastructure earmarked for COAG consideration in 2006, which may have some bearing on the energy sector.

The bottom line is that whatever comes out of these reviews will bind the AER in terms of its regulatory process. The AER looks forward to timely decisions on these important matters to deliver more certainty to both the industry and the AER in terms of the precise regime for the future, so that we can get on with the job.

The Regulation Debate

The establishment of the AER has come at a time of national public debate about the effectiveness of utility regulation.

I don't think that regulators should be precious about engaging in this debate. Economic regulation of energy infrastructure, in particular, is still a fairly recent phenomenon in this country. It wasn't that long ago that we had energy delivered by vertically integrated State owned monopolies with fully bundled prices and no concept of independent regulators setting revenue or prices for pipes and poles and wires. So generally, I think we have come a long way in establishing the independent regulatory framework, which is to be further developed given regulation is henceforth to be undertaken at the national level.

However, we have now had a decade of experience in economic regulation and it is timely that we reflect on the style of regulation best suited to the changing environment ahead.

In recent years the electricity sector, in particular, has witnessed unprecedented and largely unanticipated growth in peak energy demand, aging electricity assets and virtually zero public tolerance of electricity outages. These factors are driving proposals for very high levels of capital expenditure by network businesses and a reassessment of the price/service trade off for users. Regulation needs to be able to respond to these industry pressures by providing for efficient investment to occur on a timely basis.

I do make the point though that its not a simple matter of higher demand equals more investment; there's a broader efficiency perspective here about national resource allocation in the absence of proper pricing signals to energy users.

The environment in the gas sector is somewhat different. The gas sector has seen development of a number of gas pipelines over the past five or so years. So there is an argument we now have enhanced contestability in some areas for pipeline services. The debate in the gas sector therefore is around a relaxation in the intensity of regulation going forward.

As I have noted, the MCE is addressing changes to the National Gas Access Regime. In the case of electricity, the AEMC review of Parts B and C of Chapter 6 of the Rules will determine the regulation framework for transmission revenue and price setting by mid and end 2006 respectively. It would have been good if that review could have also addressed electricity distribution, rather than have a second process at a subsequent time. From the AER's perspective, having both matters settled prior to the commencement of the next round of revenue resets would have been the best outcome.

The challenge for the policy makers will be what is the best form of regulation for going forward? And in this respect we need to get the right perspective of the regulatory problem.

The intense media debate earlier this year that utility regulation was severely constraining investment was a gross exaggeration. Certainly the facts surrounding electricity and gas transmission do not support this claim. Since 1999, ACCC regulation of electricity transmission has accommodated over $4.5 billion in investment.

The record in gas has been even more impressive. According to the pipeline industry association's own figures, 14,000 km of new transmission pipelines have been laid in Australia since 1997. This amounts to a doubling in the length of transmission pipelines in Australia to 28,000 km in just seven years.

Meanwhile the capital market data reflects that utility assets have significantly outperformed. Over the ten years to June 30 2005, the Australian UBS Utilities Index (comprising almost totally of energy assets) has generated a compound annual return of 22.9% compared to the S&P's ASX 200 Accumulation Index return of 12.2%. Over FY 2004/05 the difference is more pronounced: 39.8% compared to 26.4%.

It is relevant that a national press club forum last week, present at which were major players in the regulatory reform debate, unanimously concluded we have no infrastructure crisis.

This said, there are indeed infrastructure issues in some states which are driving higher investment imperatives and we shouldn't be shirking from debating how the quality of regulation can be improved.

The question in my view is not one about a regulatory induced infrastructure crisis in energy but rather should be: are there deficiencies in the regulatory arrangements and practices not conducive to timely investment going forward? And, further, what do we need to do to update the regimes and the way they are interpreted by regulators to achieve regulatory best practice?

These are the relevant questions.

My response is that there are indeed some aspects of regulation we need to review to improve the existing framework. This said, and whilst recognising the issue for gas pipeline access is somewhat different, I would be surprised if the electricity sector advocates a substantial departure from the building block, CPI – X methodology for establishing allowable revenue. I would expect the focus to be more on refinements to that model whilst possibly providing for a move to more productivity based models over time.

AER and Regulation

The NEM and gas sector have achieved major gains over the past decade. However, the industry has reached a new stage in its life cycle. The competitive reforms have released some significant gains in prices, productivity and service levels by better utilisation of existing assets. But we now need significant infrastructure investment across the sector. ABARE for example has forecast a need for infrastructure investment of $30 billion over the next 15 years. The regulatory framework needs to recognise this. So some change in regulatory approach and perhaps style is necessary.

The establishment of the AER as a specialist and national energy regulator presents an opportunity for this change to happen.

The AER is keen to make improvements to regulatory practice when the quality of regulation can be enhanced.

Our first initiative has been to release a compendium of regulatory guidelines for electricity transmission. This publication gathers together, in one document, the suite of regulatory guidelines developed by the ACCC, including the Statement of Regulatory Principles (SRP), Service Standard Guidelines, Ring-fencing Guidelines, Information Requirements and the Post Tax Revenue Model and associated handbook.

This compendium will be the starting point of the AER's approach to regulation which will be developed over time in consultation with industry. The compendium will be updated accordingly, particularly in response to the outcomes on the AEMC's Chapter 6 review, and as the AER builds on this policy base.

We propose to develop and compile a similar set of guidelines for gas and electricity distribution when the AER assumes regulatory responsibility of these areas.

Already we are looking at how we can streamline regulation and improve the quality of regulation into the future. Using the SRP model as the start we are interested in:

- Shortening the time taken to conduct reviews
- Ensuring there processes for undertaking reviews are well defined up front and not changed
- Streamlining information requirements
- Strengthening the incentive arrangements and looking at ways to make regulation less intrusive and
- Exploring better and more efficient processes for stakeholder consultation.

I emphasise this doesn't mean we compromise robust analysis. Rather, it's about getting the right pitch below which costs and delays in analysis outweigh the benefits.

In the final analysis, the regulatory process should facilitate the operation of the market. It shouldn't be seen as a dampener to efficient investment occurring within the natural monopoly part of the chain. But consistent with the new market objectives it's also about achieving a reasonable balancing between the interests of service providers and consumers. We want to provide an environment that supports efficient investment, but this doesn't mean going soft on the industry. We need to promote and ensure that consumers share in efficiency gains.

I emphasise that achieving some of the above changes will need industry cooperation. For example, the timely provision of information and a willingness to openly engage will be especially important.

Some Retail Issues

I'd now like to make some specific comments about the retail sector.

My first message is that the AER's role in retail regulation has still to be defined. We consider the AER should have responsibility in this area on the basis that we are developing a national market and national oversight of retail is consistent with the agenda. However, just what aspects of retail delivery are to be regulated and what functions are to be ceded to the AER is currently a matter before the MCE. So it's somewhat premature for me to be commenting on the consequences of AER regulation on the retail sector.

Secondly I want to reinforce my earlier point that efficient market outcomes over the longer term requires consumers to fully participate in the market and respond to cost reflective price signals - ditto – there needs to be a process for deregulating prices.

My third message, however, is that industry perhaps needs to do more than simply push for abolition of price controls. It needs to engender confidence in its ability to empower consumers, offer real choice from competitive options and effectively manage some of the more politically sensitive aspects of retail delivery such as customer hardship.

<u>Non – price issues</u>

The energy market reforms were premised on the fact that energy production and retail delivery are contestable and, therefore, should be free of barriers to entry and provide customers with a meaningful choice of supply. However, although the situation varies across regions, it is clear that for retailing we are someway off achieving this aim.

Whilst much of the debate about regulation has been centred on infrastructure, the reality is there exists a significant over regulation of the retail sector characterised, in particular, by a plethora of regulatory instruments and widely different arrangements across jurisdictions.

Whilst there is a common theme across jurisdictions to service standards regulation in respect of such areas as metering, customer transfer codes and marketing conduct, differences nevertheless impose compliance costs on retailers operating across regions.

For example, a concern for a retailer operating nationally is that marketing Codes should align exactly so that (tele-) marketing staff can be trained to a common standard and thereafter operate flexibly across all jurisdictions. Similarly, billing systems should be standardised so as to enable common accounts to be issued. Currently, retailers must determine the most onerous set of jurisdictional requirements and produce systems that can meet that obligation but, in other jurisdictions, these same systems must be capable of removing extraneous information to fulfil the marketing requirements of the retailer. A third area of impact on retailers is the differences in guaranteed service levels and implementation arrangements across jurisdictions. There are also differences in consumer churn arrangements.

The commitment by jurisdictions to develop and implement a national framework for retail regulation is therefore a very positive step. A national regime will certainly reduce regulatory costs and streamline the role of the AER which is to assume non price regulatory responsibility in 2007.

Retail price regulation

Having worked in a number of jurisdictions, I can certainly appreciate that winding back price caps will be much more challenging. As I suggested to an ESAA luncheon in June, the principle should be that where the pre – conditions for effective retail competition are met then price caps should be removed or at least phased out perhaps with some form of monitoring arrangement.

Without going into the detail of defining effective competition, the Victorian region certainly appears to be closest to achieving it.

As at the end of July 2005, according to the 'gross switching figure' from the NEMMCO website 962,230 small electricity customers had switched retailer since the advent of Full Retail Competition in Victoria. This represents approximately 45% of the small customer base. These "switches" comprise all switching, that is switching from the 1st tier retailer to a second tier retailer, and further switching between 2nd tier retailers, as well as switching back to the 1st tier retailer.

According to the statistic which gives the 'net switching' figure, there were 680,530 2nd tier small energy customers at the end of July. So in Victoria, 30% of the small customer base had actually switched to and remain with retailers other than the incumbent in the former host area.

In South Australia, ESCOSA publishes the number of transfers to customer contracts. This figure is useful to identify trends in the take up of market offers but unhelpful in ascertaining the level of new entry into this market over

which AGL prior to FRC had monopoly privileges. Transfers totalling 308,846 had taken place up to the end of July, which represents a figure equal to around 42% of the customer base.

Precise data is unavailable as to what percentage of customers have changed retailer and what part of this percentage represents multiple transfers from one market contract to another market contract. However, there are now a number of active retailers in the SA market, including the Victorian first tier operators, TruEnergy and Origin and it is understood generally that the move to market contracts with 2nd tier retailers has been significant.

NSW and the ACT lag behind SA and Victoria in terms of customer transfers relative to population size. In NSW up to the end of July – 425,000 customers had transferred (gross switching figures) despite a customer base of approximately 2.7 million. The ACT to date has reported an extremely small number of retailer transfers and, of course, Queensland is yet to introduce full retail competition.

In the final analysis I think everyone needs to recognize that a national market really means establishing the same retail conditions across all jurisdictions comprising that market and to achieve this as soon as possible. However, a move towards reforming price caps should perhaps recognize that the jurisdictions are at different stages, have widely different price protection arrangements and so will need to move forward from different bases but with the one goal of price deregulation in sight.

In closing I want to raise four issues that I think are important in moving towards effective competition.

The first is the need as a transitional measure for interim or standing contract prices to be cost reflective. The need to resolve important longer term cost issues arises as a consequence of increased consumer use of technologies such as air-conditioning and the resulting cross-subsidisation between consumer classes. Ensuring that the regulated price is cost reflective will assist the degree of competition that can occur in the market by giving 2nd tier retailers more room to compete.

Secondly, customer awareness is important. The indicators as to customer awareness of FRC and receipt of offers are encouraging in South Australia and Victoria. Survey evidence commissioned by state regulators and reported in February 2004 in Victoria and September 2004 in South Australia show that customer awareness of retail competition in these jurisdictions is between 80 and 90 %. Based on these surveys, over a third of customers in Victoria and 44% of customers in South Australia were reported as having received offers since FRC. Information collected from retailers reveals that energy companies are offering new, innovative products in response to perceptions of customers' desired products (i.e. dual fuel; green energy).

Another issue is reducing transaction costs for both customers and retailers. For consumers the complexity of price/service offerings from various retailers

and the added complexity of “dual-fuel” offerings can be disheartening and creates the perception, even for more informed customers, that switching involves too much effort.

Joshua Gans from the University of Melbourne has coined the phrase “road to confusopoly” to describe the switching research process.

As fellow AER Member Geoff Swier remarked in addressing a recent ACCC Regulators Conference, the level of excitement from the average “sticky customer” is well summed up by the recent advertisement by TruEnergy that they were excited about their new name “even if you’re not.”

Policy makers and, indeed, retailers, need to consider ways of simplifying this maze of information to reduce the transaction costs to consumers and thereby increase the potential for higher levels of effective competition.

Government mandated energy comparator schemes such as those accessible on the ESC and ESCOSA websites, and the provision of a toll-free phone based comparator service in SA, are ways in which consumers can ascertain their best energy option. Such schemes need to benefit from regulation which ensures clear, accurate and comparable data can be provided through these forums such that the costs (time and money) to customers will be minimised. SA has recently introduced a requirement that these services be advertised on the front page of bills to customers.

Lack of consumer engagement increases the cost of new entry. Two consequences are the high cost of building brand awareness and the importance of door to door selling as an effective marketing technique.

Professor Catherine Waddams Price addressed the 2005 ACCC Regulatory Conference on outcomes in the United Kingdom post FRC and the removal of price caps. She estimated the cost to recruit new customers in the United Kingdom to be 55-60 pounds. Similarly, in Australia, the costs associated with traditional methods of recruitment such as doorknocking and ‘cold-calling’ would be comparatively high when compared to other consumer goods and services given the relatively low margins for retailers of electricity on a customer by customer basis. Professor Waddams Price’s analysis of the experiences in the United Kingdom was that ‘traditional incumbents’ in the United Kingdom have been able to maintain 47% - 85% market shares whilst pricing eight percent above their lowest priced competitors.

These findings seem to indicate that if transaction costs are decreased then this could enhance the gains from switching for both producers and consumers.

My final point relates to customer hardship. This will be an issue for Governments in moving away from price controls. Industry should have in place effective mechanisms to manage situations of genuine customer hardship. I recognise this is more complex than first appears but retailers perhaps need to initiate suitable industry wide arrangements.

My strong view is that, where there is effective competition, consumers only stand to benefit from relaxation of price controls. The approach to higher cost to serve customers, in areas not serviced by the grid or in isolated regions may perhaps need some ongoing regulation. Industry needs to be proactively working with Governments in developing national customer protection mechanisms and in attempts to reduce transaction costs and to promote effective competition in those areas of the market where it is deficient. Given that jurisdictions are at different stages in market development and given that most of the existing retailers have an incumbency in their home market the challenge is for the sector as well as Governments.

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