



**Australian Energy Users Association
Annual Conference**

**“New Kid On The Block –
The Role of the AER”**

**13 October 2005
Steve Edwell, Chairman**

Thank you for the opportunity to address this 2005 Annual Conference of the Australian Energy Users Association.

I can recall that back in early 1997 following a speech at a very large conference to mark the commencement of the Queensland Electricity reform process, the very first question to me was posed by Roman Domanski. I'm not sure why I remember that. Perhaps it was one of Roman's difficult questions. Perhaps it was because there were so many in attendance and Roman, being at the rear of the room in the vast Conference Centre, was recognisable only by his voice. Whatever; much has transpired on energy reform since then. And it's good to see the EUAA still active and doing its thing for energy users.

I also noted with amusement that your conference program caption for this presentation is the “Australian Energy Regulator - “the new kid on the block.” As an avowed Eagles fan this conjures up the 1976 Eagles song about “a Johnny-come-lately, the new kid in town” with words like “great expectations, everybody's watching you..... so don't let them down”. We'll have to revisit the relevance of those lyrics in a few years.

In my presentation this morning I want to talk about the role and function of the AER as the “new kid in town,” our priorities and some possible implications and issues for the energy sector including gas and electricity users.

The AER considers that an effective engagement with users in the energy market will be a key to achieving quality regulatory outcomes. On a broader scale, the effective participation of users across the entire energy market is crucial to the development of a sustainably efficient national market. Frankly, there is a limit to what Governments and regulators can deliver in promoting efficient market outcomes. Well informed and empowered users engaging with a contestable supply side are the real prerequisites for market outcomes approaching optimality.

AER's Role and Functions

John Tamblyn no doubt talked yesterday about the new governance framework for the industry and the respective roles and functions of the various regulatory bodies. So, outside the AER's role, I don't propose to talk on this matter in detail. There is a slide in the handout which captures the various functions of the AER, ACCC and the AEMC.

I think that the new regulatory framework for the sector is a very good one with clear accountabilities, distinct separation between policy development and regulation, and a very transparent role for Governments in ongoing energy market development.

The key principle behind the establishment of the Australian Energy Regulator was that a national energy market needs a national energy regulator. Despite the fact that gas and electricity has been traded across borders for some time now, giving rise to a developing national market for both sectors, there are still a dozen or so state and territory energy regulators.

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

The AER's is to replace the various jurisdictional regulators and become a "one stop shop" regulator for the energy sector on a national basis.

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

Following COAG endorsement of the energy market reform process in 2003, amendments to the Australian Energy Market Agreement were made in 2004 to, amongst other things, recognise the AER's new role and set timelines for taking on its new responsibilities. These timelines reflect that the AER will assume its regulatory functions on a staged basis over approximately a two year period.

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 was to have passed 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, the AER is 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 from the new regulatory framework can 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.

Handover timing

I have to say, however, that I am concerned about the current ambiguity and potential for slippage of these timelines.

As I mentioned, under the 2004 Australian Energy Market Agreement the states agreed to transfer the regulation of gas and electricity distribution to the AER by 1 January 2007. The AER has been working with this timeframe in mind.

However, there are now indications that the states may delay handover or agree to a revised timeline for handover which is ambiguous and with potential for considerable slippage. Such a delay would be counter productive. Not only does it undermine the progress of energy reform, it creates a high degree of regulatory uncertainty. Absence of firm targets for the handover could also significantly compromise the AER's role in planning for and effecting a smooth transition to the new national regulation regime.

Industry and users are understandably keen to see how the AER proposes to go about the transition and what the new regulatory processes will be. Therefore, it is vital that a firm date be agreed and adhered to in order to allow work to proceed and for promised reforms to be delivered.

The AER is sensitive to issues of concern to the States in the transition. We are confident these matters can be managed. But we need a firm transition timeline to work towards.

It is important that the MCE address this matter at the forthcoming MCE Meeting in early November.

Policy Review

The establishment of the new regulatory arrangements coincides with considerable ongoing policy review relating to the AER's regulatory role. In fact, the framework in which the AER will operate will be uncertain for some time yet pending completion of this work and development of the consequent rule changes and legislation. The major work being undertaken includes:

- The AEMC's review of Chapter 6 of the National Electricity Rules relating to the setting of maximum allowable revenue for transmission businesses and transmission pricing
- The MCE's review of the regulatory framework for distribution and non-price retail with a view to establishing a consistent national framework, and
- The MCE's response to the Productivity Commission's report on the National Gas Access Code.

The AER welcomes this work as a basis for promoting national consistency in the regulation of energy services. However, again, timely completion would greatly assist the smooth implementation of the new regulatory regime and the transition process.

AER's objectives

One of the important changes to the National Electricity Law (NEL) has been the inclusion of a single national objective which governs both policy development and regulation. The objective is to promote economic efficiency in the investment and use of electricity services for the long term interest of consumers. Importantly, the objective recognises the long life of electricity assets and the inherent interrelationship between price, quality and reliability of supply.

In terms of electricity our focus is to fulfil this NEM Objective as stated in the NEL as well as meet the various requirements of the National Electricity Rules. The AER wishes to promote and work within a regime that enables us to best undertake this role.

With respect to Gas, we will be looking to work to the Gas Code objectives once they are finalised as part of the Gas Access Code review.

Process of transition to the new regime

The AER was formally established on 1 July and I am pleased to report that we are well and truly up and running. We have announced our organisational structure, are advanced in developing internal processes, have already met with industry associations and a large number of the industry participants, and AER members are meeting regularly on a range of regulatory matters currently within our charter.

Distribution

The AER is also proposing a proactive approach to taking on distribution regulation and intends to engage with stakeholders to facilitate a successful transition. As I mentioned, the MCE has commenced a process to develop a national distribution regulatory framework and the AEMC is currently undertaking a review of transmission regulation. Clearly these reviews will significantly influence the regulatory process to be adopted by the AER. However, these reviews will take some time to complete.

In the meantime, therefore, the AER needs to form a view about how it will carry out its price/revenue reviews. In developing these views the AER has three main objectives:

1. The first is to minimise price shocks, provide regulatory stability and provide investment certainty. For instance, with regard to asset base valuations my preference is not to revisit the valuations established by state regulators.
2. The second is to maintain consistency in terms of the regulatory objectives, principles and arrangements for transmission and distribution regulation across gas and electricity.
3. The third is to streamline processes as much as possible. This may involve providing greater clarity about, and locking in up front, the regulatory methodology used by the regulator and greater clarity about information requirements.

The AER is currently undertaking a review and analysis of the current arrangements in gas and electricity distribution regulation. This review has included discussions with jurisdictional regulators, and will include initial informal discussions with regulated distribution companies over the next few months.

The AER has indeed started work towards developing its approach to distribution regulation. Our work program focuses on three aspects of how we regulate:

1. The first relates to the principles or methodology underlying the AER's regulatory approach. As a starting point we are reviewing the approaches adopted by the jurisdictional regulators as well as examining the applicability of the AER's Statement of

Regulatory Principles (which currently applies to the transmission sector) to distribution.

2. The second is defining and standardising our information requirements for pricing/revenue applications from distribution businesses. This tackles the vexed matter of information asymmetry between businesses and the regulator. The reality is, the better the information provided to the regulator, the better the regulatory decision and the more efficient and timely will be the regulatory process. Providing the information in the correct format also speeds up the revenue reset process and improves the timeliness of decisions.
3. The third is understanding investment cost drivers in setting opex and capex targets. At the moment most regulators (including the AER) apply an incentive regime and rely on incentives to reveal efficient costs. The AER wishes to move away from detailed assessment of projects towards a greater focus on underlying cost drivers.

Following this review the AER will develop an overall methodology for the regulation of gas and electricity distribution and will undergo consultation with industry and of course users. We will also be seeking to hold discussions with each regulated business to identify transition issues that will require clarity or resolution well in advance of revenue reviews. The intention is to release a discussion paper in the first quarter of next year on the form of distribution regulation.

Clearly this process will be influenced by the outputs from the MCE high level work programme, but at this stage we intend to be as proactive as possible whilst being consistent with the MCE's policy as it develops.

Retail

The MCE is undertaking a high level review of those non price aspects of retailing that are subject to regulation. The aim is to develop a consistent national framework for retail regulation including determining what areas should be subject to regulation on an ongoing basis and which of these aspects should be regulated by the AER or otherwise be retained by the states. The intention of the jurisdictions is that handover of non price regulation to the AER will not occur until the new framework is in place.

I understand that industry is involved in this review process.

I guess the message here is that the precise role of the AER in respect of non price retail regulation is still unclear pending outcome of the MCE review.

Through the Utility Regulators' Forum, the AER, however, is participating in complementary work by jurisdictional energy regulators which will facilitate consistency in energy retail regulation as well as national reporting

requirements for retailing. This work has focussed on developing best practice arrangements in areas such as consumer protection requirements, marketing, compliance and auditing.

The AER may use this work in the future as a basis for consultation on retail regulatory requirements once the broader framework is settled.

Ultimately the development of a competitive national market for energy should involve phasing out retail price caps, particularly where effective competition can be proven. However, this requires an agreed understanding of what 'effective competition' entails. Any process to remove retail price caps would need to take into account the different situations of the jurisdictions and probably be phased in accordingly.

At this stage, it is not envisaged that the AER will have a role regarding retail pricing; although a jurisdiction could refer certain functions at a later time.

MCE review of distribution and AEMC's review of Chapter 6 of the NER

I want to return to the MCE review of distribution and the AEMC's review of Chapter 6 of the Market rules in respect of transmission regulation. These processes are of vital interest to the AER. They should be of great interest to users as well, given that these reviews will establish the framework for regulating electricity network and gas pipeline service providers for the foreseeable future.

There has been considerable debate recently about regulation in the energy sector being too heavy handed. We now have a ten year history of regulation in the sector and it is perhaps timely that we give some reflection to the strengths and weaknesses of current regulatory approach.

I fully acknowledge that improvements can be made to enhance the quality of regulation. Regulation is an art not a science. Regulators need to be conscious that they can't replicate competitive outcomes; so there's no point in trying to finesse to achieve economic optimality. Regulation is also there to support the market and to facilitate timely investment in energy infrastructure.

On the other hand, the reality is that electricity networks and gas pipelines are natural monopolies and that a comprehensive regulatory framework is warranted. The central issue going forward is what form should that regulation take and to what extent is a shift away from the status quo approach justified.

The AER will certainly be looking at ways to make regulation more efficient. Initiatives we are pursuing include clearly defining and locking in the regulatory process and parameters well ahead so that the NSP and stakeholders have certainty regarding the framework well before lodgement of the revenue application; developing standard information templates; and adopting wherever possible a less intrusive approach.

In this respect, the framework already adopted by the AER for transmission revenue regulation (as outlined in the AER's Compendium of Electricity Transmission Regulatory Guidelines) includes a number of initiatives:

- locking in asset values and not subjecting assets once in the RAB to revaluation or optimisation;
- defining up front and standardizing the parameters of the WACC;
- adopting an ex ante approach to approval of capital expenditure;
- enhancing the incentive arrangements for NSPs to reduce costs by providing certainty regarding cost sharing; and
- committing to set timelines for consultation and decisions.

I perceive fairly strong support for this framework from a number of transmission and distribution businesses. These businesses advise that they consider this regime is a good model and should be the basis for amendments to the National Electricity Rules with only incremental changes.

However, other sectors of the industry appear to be advocating a material change of approach. The ESAA for instance is seeking "light handed regulation, at low cost, (that) delivers high quality regulatory decisions, and includes merit and judicial review."

To me this appears to mean we want the best possible batting pitch, no new ball, the right to bat first and individual right of appeal against dismissal to all three umpires.

So what do people mean by "light handed"; particularly for network and distribution assets that, under current technology, are clearly natural monopolies? In particular, how would a light handed approach equip the regulator to achieve the objects of the national electricity law to which I have previously referred?

To what extent is it appropriate to fundamentally move away from the traditional CPI-X building block approach; and, if so to what model?

Surely price monitoring is not appropriate for natural monopoly assets. I believe there is merit in the proposal that for certain gas pipelines an alternative form of regulation to that which currently applies may be appropriate. However, there is a question that if price monitoring is to be the basis of a lighter handed approach, how does this reconcile with pipeline assets that have passed the third party access coverage test, because they have significant monopoly power?

Productivity based regulation (such as total factor productivity or data envelopment analysis) do have appeal over time. However, such approaches need comprehensive benchmark development and ongoing reporting which, I would suggest, could be just as if not more intrusive than the existing regime.

I think it's incumbent on industry associations to define precisely what they mean by "light handed." They have this opportunity as part of the AEMC and MCE reviews.

It is also important that user associations such as the EUAA engage in this debate.

At the end of the day the AER will undertake its regulatory functions pursuant to whatever regime emanates from the review processes. But we do have a vested interest in the policy debate delivering a model that enables us to achieve the objects in the legislation.

Need greater user engagement

Consultation involving as many market participants as possible contributes to well-considered and balanced decisions. Given this, the AER would like to see greater engagement by user groups and consumer advocates in consultation processes.

The AER is currently some thought as to what arrangements might be best for to achieve effective user consultation both generally and also on particular revenue resets.

In the meantime, as I have said, the AER encourages consumer advocates and user groups to participate in the AEMC's review of Chapter 6 and the MCE's review of distribution regulation. These reviews are highly important to the continuing reform of the electricity sector and would benefit from a wide range of perspectives.

The AER recognises that the complexity of the issues is an obstacle to receiving strong user submissions. The AER is working to address this problem by making our work more user-friendly. An example of this is our annual market monitoring report which will provide an assessment of the state of the market. That report will, in a user friendly way, present a high level review of the market covering all aspects of the energy market arrangements in Australia monitored by the AER. The report will be targeted at a broad audience, including those not directly involved in the operation of the market and will highlight issues the AER believes present impediments to the full realisation of the market objectives.

However, energy regulation does unavoidably have an underlying complexity. We remain open to ideas about how users' views could be better incorporated into the regulatory process.

AER's approach to market monitoring and compliance

Compliance

The AER's approach to enforcement is, in the first instance, about comprehensive observation of and reporting on the market. I believe a light handed regime, that emphasises a voluntary compliance approach is reasonable given the track record of the industry with respect to compliance management to date. I would like to see the culture of corporate compliance continue. For this regime to work effectively, however, it needs to be complimented by detailed monitoring of participant conduct and effective enforcement arrangements.

Having said that, the AER has been given considerable powers to enforce the law, regulations and rules and will not hesitate to respond quickly and firmly if a compliance matter arises.

The AER would like to emphasise that one area of focus will be generator compliance with technical performance standards. These compliance programmes are aimed to protect the system from a cascading effect of generator failure following disturbances on the system. The power system events of January and March this year and the subsequent orders of the National Electricity Tribunal make clear the importance of generator performance standards to the maintenance of power system security.

The AER will be targeting the compliance programmes that should have been determined by generators in consultation with the network operators and NEMMCO.

Market monitoring

The AER is currently enhancing the market reporting arrangements previously developed by NECA to ensure that the information and analysis provided in such reports continues to improve, consistent with our monitoring functions and objectives. We are working towards making our reports more user-friendly and accessible.

We propose to continue to publish weekly reports on compliance and operational issues as they arise in the wholesale market. The weekly market analysis reports are also the mechanism for reporting on pricing events above \$5,000/MWh and significant variations between actual and forecast prices. The AER website will also continue to be used as a platform to publish a broader set of metrics and indices that monitor the many seasonal factors that influence market outcomes.

An annual report on the market will provide an assessment of the state of the market. This report will, in a user friendly way, present a 'bird's eye' review of the market, analysing what is working, what isn't and will cover all aspects of the energy market arrangements in Australia monitored by the AER.

Conclusion

I have very much appreciated the opportunity to address this conference. The AER has an important role in regulating a sector that is experiencing unprecedented growth, with investment requirements predicted by the ABARE to be around \$30billion over the period to 2020.

We are committed to achieving best practice regulation and delivering quality regulatory outcomes consistent with the market objectives. We look forward to ongoing engagement with users in the development of our role as national regulator, in particular during the transition process.
