

Opening remarks

- Thank you for inviting me to speak to you today about progress in moving to national regulation in the energy sector.
- As you are aware, there has been massive transformation across the energy sector since the mid 1990s. Consider some of the developments we have seen over the past decade:
 - The sector has been substantially restructured: We have moved from vertically integrated, state owned energy businesses to disaggregated businesses with a mixture of ownership structures.
 - Victoria and South Australia have privatised their electricity supply industries and most of the gas supply sector is in private hands.
 - Competition has been introduced into the generation and retail sectors.
 - The national electricity market (NEM) is well established.
 - Interconnection between the states has been substantially expanded with projects such as QNI, SNOVIC augmentation, DirectLink, MurrayLink and BassLink.
 - Access regulation has been introduced for the transmission and distribution sectors along with a range of regulatory institutions.
 - Electricity demand has expanded from 170,000 GWH to 250,000 GWH per annum.
 - Gas consumption has expanded from 800 PJ to 1100 PJ per annum.
- Present indicators are that we are in for more transformation in the coming years. For example:
 - We are seeing a high level of merger activity across the sector.
 - Further privatisation - Queensland is in the process of selling its retail businesses.
 - Governments are about to introduce a new wave of legislative reform including a new National Gas Law (NGL) and amendments to the National Electricity Law (NEL).

- The National Electricity Market Management Company (NEMMCO) has forecast an increase in peak summer electricity demand across the NEM from 34,000 MW to 46,000 MW in the next decade.
- In this environment it is critical that users are highly involved so that your interests can be taken into account.

Introduction to speech

- In my talk today I would like to discuss some of the changes that are anticipated, the preparations that are in progress by the Australian Energy Regulator (AER) and our expectations of users in this process.
- First let me begin by introducing the AER and the reform process that led to its establishment.

Background to AER

- The AER was established in 2005 as a constituent part of the Australian Competition and Consumer Commission (ACCC). It operates as a separate legal entity to the ACCC.
- The AER is to assume responsibility for the economic regulation of the energy sector on a national basis with the exception of Western Australia where the Economic Regulation Authority will continue to perform the function of economic regulator. The AER will assume these responsibilities from State regulators on a staged basis over the next two years. Currently the AER regulates the wholesale electricity market and electricity transmission networks in the NEM.
- The AER is to assume its gas transmission, and gas and electricity distribution regulatory functions on 1 July 2007. In the interim, the ACCC continues to regulate gas transmission pipelines, assisted by the AER, and the state and territory regulators continue to regulate electricity and gas distribution systems.
- As the new national economic regulator for the sector with a new regulatory framework, the AER is seeking to take a forward looking approach to continue to improve the quality of regulation. To help us in achieving this outcome we will be seeking stronger engagement from users.

National reform agenda

- The reform process that led to the establishment of the AER commenced during the mid 1980s.
- The Hilmer Inquiry of 1993 was a catalyst for major energy reform in Australia. The Inquiry recommended extending the reach of competition law and policies to sectors of the economy that were not directly exposed to international competition such as energy.
- The first phase of energy market reform resulted in the creation of a NEM in the southern and eastern states, structural separation of generation, transmission and

distribution activities and retail contestability. This phase is now considered to have been relatively successful.

- Refinement and review of the first phase was structured around a new Ministerial Council on Energy (MCE) which was established by the Council of Australian Governments (COAG) on 8 June 2001. COAG also agreed to an independent review (the Parer review) of energy market directions in Australia. The Parer review observed that there were too many regulators and this had caused an overlap between the ACCC, state and territory regulators and National Electricity Code Administrator (NECA) in important areas. The panel recommended the creation of a national energy regulator.
- In response to the Parer review, the MCE announced in December 2003 a comprehensive set of policy decisions for its major energy market reform program. These policy decisions were given effect by COAG through the Australian Energy Market Agreement (AEMA) on 30 June 2004.
- For the second phase of energy reforms, the AEMA provided for three institutions to oversee the operation of Australia's energy market:
 - the Australian Energy Market Commission (AEMC), which was responsible for rule making and energy market development at a national level.
 - the AER, which was responsible for economic regulation and compliance with the codes of the electricity and natural gas industries at a national level.
 - the NEMMCO, which continued to be responsible for the day-to-day operation and administration of both the power system and electricity wholesale spot market in the NEM.
- The South Australian Parliament passed the new NEL on 14 April 2005 and new National Electricity Rules (NER) commenced on 1 July 2005.

A new regulatory framework

In a series of recent announcements, the MCE has signalled that further policy reform is on the way. Let me take you through some of the highlights.

- In a statement of scope released in July this year, the MCE announced that it would be introducing a new NGL and National Gas Rules, and amendments to the NEL and NER.
- The objectives of the NGL and NEL are to guide the AEMC and, together with rules, to guide the AER and promote efficient investment, operation and use of systems for long-term interests of consumers regarding specified service characteristics.

- The new NGL is currently being drafted and will take into account the MCE's response to the Productivity Commission Report and the Expert Panel (Beale Report).
- The MCE will release an exposure draft of the NGL shortly. The new laws are expected to come into force mid 2007.
- New laws will be required in each jurisdiction to apply the NGL and the *Australian Energy Market Act 2004* will be amended to ensure the AER, Australian Competition Tribunal, National Competition Council and Commonwealth Minister can take up their relevant functions under the NGL.

Transition to the AER

- In August this year, the MCE released a bulletin announcing that it would be amending the AEMA to change the dates for the transfer of functions to the national regime.
- Electricity transmission functions came across to the AER and AEMC on 1 July 2005. Gas transmission regulatory responsibilities for all jurisdictions except WA will pass from the ACCC to the AER from July 2007, after the new gas legislation is passed.
- The transfer of economic regulation of distribution from jurisdictional regulators to the AER and AEMC is scheduled for 1 July 2007. The AEMA also provides for the transfer of distribution and retail consumer protection functions to the AER and AEMC by 1 January 2008. It is expected that retail energy price controls will be retained by the relevant jurisdictions but can be transferred to the AER and AEMC at the discretion of each jurisdiction.
- In relation to the **gas** regime, all new regulatory determinations will be made by the AER following passage of the new NGL. Administration of existing decisions will also transition to the AER.
- In relation to **electricity**, MCE has confirmed that the upcoming distribution determinations in the ACT and NSW will be determined by the AER along with all other reviews starting after 1 January 2007. However, the existing Tasmanian distribution determination will be determined by the jurisdictional regulator.

The transmission regulatory framework proposed in Chapter 6A

- One of the key development processes underway at present is the writing of new rules for electricity transmission. The AEMC has been working on the new rules for around 15 months. The AER has been following this process closely and has made a number of submissions.
- The economic regulation of electricity transmission will be based on Transmission Revenue Rules (chapter 6A) which are due to commence in January 2007.
- The AEMC released its Draft Transmission Revenue Rules in July 2006. Key features of the Draft Rules include:

- a high level of prescription and reduced regulatory discretion, including prescribed parameters for determining the rate of return.
 - a fit-for-purpose decision making model which introduces a propose-respond process.
 - a ‘reasonable estimate test’ for the assessment of capital expenditure (capex) and operating expenditure (opex).
- The Draft Rules largely reflect the AER’s Statement of Regulatory Principles (SRP) in adopting an ex ante approach to the determination of capex and opex, maintaining incentives on capex, opex and service standards and prescribing a lock in roll-forward approach to asset valuation.
- The Draft Rules were made following lengthy consultation and detailed comments on the Proposed Rule that was released in February 2006. The AER considers that the Draft Rules is mostly an improvement on the Proposed Rules. In particular, the Draft Rules:
 - reinstate incentives on the depreciation component of capex.
 - increase the maximum service standards incentives from 1% to 5%.
 - remove some of the highly detailed deadlines imposed on the revenue determination process.
 - remove the provision for ex-post prudency reviews.
- However, the AER still has some concerns in relation to the AEMC’s Draft Transmission Revenue Rules. In particular, the AER is concerned that
 - The high level of prescription in the Rules will restrict the AER’s capacity to flexibly respond to the individual circumstances of each business.
 - The substantive restrictions on the AER’s ability to publish information on transmission network providers’ financial performance will undermine transparency in the electricity market.
 - The creation of a ‘reasonable estimates’ test for the approval of capex and operating and maintenance expenditure is inherently problematic.
- The AER has significant concerns in relation to the reasonable estimates test. The ‘reasonable estimate’ test in the context of a ‘fit-for-purpose’ model is inconsistent with the existing approaches used in gas or electricity. Whilst apparently seeking to increase regulatory certainty, the AEMC has instead created further uncertainty through creating a new concept of a ‘reasonable estimate’ which is likely to be tested in the courts with uncertain outcomes and delays.
- The AEMC is currently conducting consultation on how this should be interpreted.

- The AER has submitted its concerns that the regulatory framework outlined in the Draft Revenue Rules may alter the current balance of interests in favour of the regulated businesses.
- There is a risk that the proposed arrangements in the AEMC's Draft Revenue Rules will lead to increases in electricity prices, without any guarantee of increased investment or improved service standards.
- The AEMC's Final Rules are due to be released later this week.

The adoption of Chapter 6A for distribution

- The jurisdictions are developing a framework for access regulation of distribution. It is critical to get the distribution regulatory framework right.
- **The impact of distribution charges on wholesale electricity prices is four times greater than that of transmission charges.** This means that the implications of a reasonable estimate test are magnified in the context of distribution.

AER preparations

- I would now like to turn to the AER's work in preparing for the transition of distribution functions.
- A milestone in the AER's preparations has been reached with the recent release of the AER's *Electricity distribution regulatory guidelines: Statement of Approach*. This statement outlines the process for consultation on the development of guidelines for electricity distribution services. The AER wants to make its preparations for the transition as transparent as possible, and this Statement is aimed at providing guidance to interested parties in the energy industry. The Statement is on the AER's website and I encourage you to have a look at it if you have not already.
- Given that the legislative framework for energy regulation is still being developed, the AER will consult on its guidelines for electricity distribution through a staged process over the latter part of 2006 and 2007. The AER expects to release two packages of guidelines, one late this year or early next year, and another in the first half of next year. These will cover the regulatory functions required of the AER in its electricity distribution regulation, and any guidelines that the electricity distribution rules require.
- The AER believes that there is sufficient consensus among stakeholders on the fundamental elements of the likely regulatory regime to begin work on the guidelines. The AER has been particularly guided by the AEMC's recent draft rule determination for electricity transmission, and the MCE's latest announcements regarding the 2006 and 2007 legislative packages for energy network regulation.
- The AER is mindful of the concerns expressed by stakeholders regarding the possible pre-empting of policy outcomes, and will ensure that its guidelines comply with the relevant legislation as it is developed and implemented.

- We are also mindful of our responsibility to provide clear guidance as to how the AER intends to carry out its regulatory functions for the New South Wales and ACT electricity distribution resets. This is why we believe that we need to move forward with the guidelines work at this time. We want interested parties to have sufficient time next year to comment on the draft guidelines that we release.
- The timetable of guidelines may change as the legislative environment becomes clearer but we believe that the work we are doing now will facilitate a smooth transition of regulatory functions.
- Given that the MCE has set a time frame for the AER to take up responsibility for administering existing decisions, AER staff are already undertaking work preparing for this role. Staff have met with their counterparts in jurisdictional regulators to discuss a number of issues that will arise from existing distribution decisions.
- The AER expects that the details of the transition of these responsibilities will be spelt out in the rules for electricity distribution. However, we are working with our colleagues in the jurisdictional regulators to ensure that we have considered all likely challenges in the handover of responsibilities.
- Issues that have a high priority at present include:
 - Cost reporting templates – these are being designed to ensure that the AER and other parties have the information they need up-front to form sound judgements on the proposals that are received from the distribution companies.
 - Cost allocation guidelines – we need to be confident that the costs reported by each business relate only to regulated services. We want to develop an approach that provides confidence and transparency but which is not too onerous.
 - Revenue modelling – the objective is to develop a generic model that can be applied to all businesses. This will support a consistent and transparent approach for each business.
 - Connection and capital contributions – these can be an important issue for users. We want to develop an approach that appropriately balances the interests of all parties.
 - Incentive mechanisms – these mechanisms are critical elements of the regime. If they operate well they have the potential to make life easier for everyone. We will be reviewing these carefully.

|

User involvement

- A fundamental objective of the new legislation is to regulate in the long-term interests of energy consumers.
- For consumers, the main impact of the AER's work is often what it will mean for prices. Service standards are also important for consumers. Consumers should be able to expect a reasonable level of service from their energy supply.
- Organisations such as the Energy Users Association of Australia (EUAA) play a vital role in voicing the interests of energy users to the AER. The EUAA's membership covers users in many sectors of the economy, including mining, manufacturing, construction, commercial, property and service sectors. As such, the AER is interested in the wide-ranging demand-side perspective that the EUAA brings to energy issues.
- The AER recognises the importance of pro-active consumer consultation. We have commenced discussions with some groups and we will be seeking to expand our activities in this area. Some recent examples have been meeting with the Integral Energy Customer Consultative Committee and the Rural Energy Consumers Forum in Ballarat.
- During this period of transition, the AER has been, is currently, and will continue to consult with interested stakeholders to ensure we get things right.
- At the moment, a major work stream being undertaken by the AER is the development of guidelines to inform parties of the approach the AER will take to electricity distribution regulation. In developing these guidelines, the AER is consulting with industry, the jurisdictional regulators and is presently about to embark on a round of consumer consultations. I encourage the EUAA to participate strongly in this process.
- As part of this consultation process the AER looks forward to meeting the EUAA in November at the NEM Network Consumer Roundtable and again in December at the Essential Services Commission's Customer Consultative Committee. We are also open to consulting with EUAA members individually.
- The AER and EUAA share a vision for energy that is competitively priced, reliable and effectively regulated. Through collaboration, I believe we can go a long way in achieving these aims.
- Outcomes in our regulatory processes depend on the active involvement of both the service providers and users.
- Clearly, the service providers have a strong incentive to be highly engaged in the process, so as to achieve the best financial outcome for their businesses. Users, on the other hand, tend to be more dispersed and less able to be actively engaged in the process due to financial constraints. This creates difficulties for the regulator. We are charged with developing regulatory decisions that promote efficiency. However, this can only be achieved where we are fully informed about the facts surrounding each decision.

- As the EUAA would be aware, the National Electricity Consumers Advocacy Panel was established by the MCE in 2003. The panel grants funds for advocacy projects to the representatives of business and domestic electricity customers affected by the operation of the NEM.
- The panel is funded by fees charged by NEMMCO on some market participants, and is independent of government and market participants. Appointments to the panel are made by the AEMC, which appoints four members and a chairman. Advocacy groups submit applications for funding and decisions are made at panel meetings held approximately every two months, or as required for urgent applications.
- I understand that the EUAA has received advocacy panel funding for a number of projects and I would encourage you to continue to take full advantage of the panel so you can become further involved in the AER's decision-making processes.
- Going forward, I would like to highlight three areas where strong user involvement would be most valuable:
 - First, in the policy development process. Over the next few months the MCE will be issuing a range of policy documents and exposure drafts of legislation. It is important for your views to be heard clearly.
 - Second, in the preparation of the AER guidelines. We will be issuing a large number of guideline documents over the coming year covering all areas of the energy sector. We encourage you to take a strong interest in these documents.
 - Third, in regulatory decision processes. We are facing around 40 regulatory reset decisions over a five year period. While this is a heavy commitment, it is vital for good decision making that you make substantive input into these processes.
- We look positively on the prospect of being more engaged with the EUAA, and other user groups, going forward.

Concluding remarks

- The AER wants a cooperative relationship with all interested parties in the energy industry as a means of ensuring quality regulatory outcomes. We understand that there will always be some asymmetry of interests, but given a new regulatory framework and a fresh AER approach we are looking at better regulatory processes.
- During this transition period the AER has been careful not to let its processes get ahead of the MCE's policy development.
- As the reform program progresses, the AER will also clearly indicate its view on key issues and consult before it implements any changes to its regulatory approach. As the AER becomes more established we will consult and issue new guidelines on a range of issues such as the transition to the AER's role in distribution regulation.
- Thank you.