Queensland Power Conference 2005

"Regulating transmission and Distribution Assets"

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Steve Edwell, Chairman

Introduction

It is a pleasure to have the opportunity to talk at this 9th Annual Queensland Power Conference.

I can recall presenting to this Conference back in 1997 at the commencement of the Queensland electricity reform. The next few years delivered significant structural change to the Queensland industry, the establishment of the National Electricity Market (NEM) and the interconnection between the New South Wales and Queensland grids (QNI).

I am here on this occasion as a regulator and not as someone necessarily directly involved in industry policy. Like all things in life this has pros and cons. I've learnt that regulators don't figure high in the popularity stakes. Fortunately, the AER is currently in a honeymoon period. Long honeymoons are a good thing.

Since 1997 and after a subsequent period of consolidation (some would suggest market development inertia), I think we are again in a period of considerable industry change; albeit for Queensland more market related than structural. A new governance framework for the NEM is bedding down, major policy reviews of both gas and electricity market issues are underway; Powerlink and Transgrid are jointly investigating an expansion to the QNI; the Queensland Government has announced the introduction of full retail competition (FRC) from July 2007 and, of course, we now have a national regulator for the energy sector in the form of the Australian Energy Regulator (AER).

We are also in a period of unprecedented energy demand growth, which coupled with aging network assets, is posing, in particular, peak load stress on the system supply.

The essential take from these dynamics is that the national energy market is becoming more and more national, consistent of course with the initial policy intent of all jurisdictions. For Queensland this, in my view, is a very good thing indeed. Queensland energy businesses are well placed to compete in the NEM. In particular, the State has abundant low cost fuel and efficient, strategically located generation to be a competitive source of energy supply. The State is already a net exporter of electricity.

In this context, I think the Government's recent announcement on FRC for electricity and gas is very timely. The AER is very supportive of FRC in Queensland and believes it will be important in increasing the level of competition in the NEM.

I note the Government's assessment that the electricity savings for Queensland households could be up to $150 per annum. Additionally, the Government has committed to maintaining the Uniform Tariff, to ensure that no consumer is worse off after the introduction of FRC. This important initiative will enable small users in this State share in the benefits of the competitive market.

Indeed, I think that Queensland has much to gain from the development of the national market and that the State should be an aggressive supporter of the ongoing market development initiatives.

In my talk this morning I will be focussing on the AER and its regulatory role.

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 number of the industry participants, and AER members are meeting regularly on a range of regulatory matters currently within our charter.

AER's Role and Functions

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 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 early next year, following the passage of necessary legislation in the various States and Territories.

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

The actual transition of these various responsibilities 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.

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 Approach to Regulation

There has been considerable debate recently about the association between regulation and infrastructure investment in the energy sector. 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 the 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 precisely 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 distribution networks 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 and we are keen to engage with industry on this issue. 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.

Overall, the AER Members believe that we need to conduct pristine process, be pragmatic in exercising discretion, be fully engaged with the industry, and strongly informed on local issues, and, above all, be fiercely independent. We propose to open an AER office in Queensland in the future.

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;
- providing more up-front certainty 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.

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." It is important for those promoting this argument to provide more definition to what they mean as light handed.

What it means for Queensland

In taking on responsibility for regulation of Queensland businesses the AER is cognisant of recent events.

Somerville Review

The Somerville Review of the Queensland distribution network criticised Energex and Ergon for under-investment but also noted that the firm investment cap in place at the time did not work well with high demand and inaccuracy in demand forecasts. The Review has led to the Queensland Government and the Queensland Competition Authority (QCA) making and proposing major amendments to the regulation of distribution networks.

Notably, the Review recommended that the QCA provide flexibility in the capital expenditure target to allow the service provider to respond to key investment drivers. The AER is supportive of a flexible approach.

The Review also calls for greater investment certainty and regard to cost drivers. The AER believes its approach in the SRP provides significant investment certainty by locking in the asset base. In relation to cost drivers, the AER recognises the importance of understanding investment cost drivers in setting opex and capex targets. The AER wishes to move away from detailed assessment of projects towards a greater focus on underlying cost drivers and is therefore looking at whether there is a case to supplement individual project assessment with more detailed engineering cost modelling.

Distribution regulation

Queensland's next distribution price review for Energex and Ergon will need to commence before 2009. The AER will be mindful of Queensland's circumstances and history in undertaking its role. In particular, the strong growth in electricity demand that has occurred in Queensland and the need for significant investment in the distribution network to maintain reliability levels will be major factors in any regulatory decisions. The AER will endeavour to consider specific mechanisms used in Queensland's existing distribution pricing decision and any special arrangements established by the QCA.

Regulatory test and investment outcomes

The AER is committed to improving investment outcomes in Queensland – both in terms of the level of investment spending, but also efficiency in the choice and delivery of investment projects.

The ACCC's regulatory test (which has been inherited by the AER) has drawn strong interest in Queensland with views expressed that it acts as an impediment to investment in the interstate transmission links by not fully recognising broader benefits that inter-connectors can deliver by facilitating wholesale market competition.

It is relevant, however, that notwithstanding issues with the test the 2001-07 Powerlink revenue cap decision allowed all of Powerlink's requested $1.04 billion in capital expenditure. In addition, the ACCC also approved pricing to cover the Queensland- NSW Interconnector (QNI) even though the provisions in the National Electricity Code were problematic. This facilitated QNI's timely development.

Subsequently, the framework for transmission development and assessment has changed significantly, and moved from the customer benefits-based test to the current revised regulatory test. Promulgated in August 2004, the revised regulatory test aims to provide further clarity surrounding its operation and explicitly recognises competition benefits. I am personally interested in the performance of the competition benefits arm of the test as an ongoing tool for assessing interconnect augmentations.

I think the overall focus is to remove any bias against efficient interconnection between the states. Interestingly, only last week it was reported that the results of a pre-feasibility study undertaken by Powerlink and TransGrid indicate that a QNI upgrade of 150 to 200 MW with a capital cost of $120 million is likely to generate sufficient benefits to satisfy the revised AER regulatory test, based on a target commissioning date of late 2009. The AER will observe the development of this proposal with interest.

Process of Transition to the New Regime

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.

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.

The AER is sensitive to matters of concern to the states in transferring responsibilities to a national regulator. We are very confident these matters can be managed. Both the AER and industry needs a firm transition timeline to work towards.

Powerlink Revenue Reset 2007-2012

A new revenue cap for Powerlink will need to be made before the current regulatory control period ends on 30 June 2007. The AER expects to receive a revenue cap application from Powerlink on 1 April 2006. A decision is required to be made by 1 May 2007 so that Powerlink is able to publish its transmission charges. The revenue cap will cover a period of five years, that is, from 1 July 2007 to 30 June 2012.

The AER and Powerlink have agreed to discuss a number of issues in the lead up to the revenue reset. Members are particularly interested in resolving issues relating to process and approach well ahead of the review commencement. Several meetings have already been held and others are planned in the coming months. The AER intends to consult widely with stakeholders and will seek submissions at key stages of the process. We also intend to encourage Powerlink to engage with stakeholders early in the process so that they are aware of Powerlink's investment plans and the impact of these plans on transmission charges and reliability.

The AER is aware of the strong growth in electricity demand that has occurred in Queensland, particularly in the south east of the state, and the need for significant investment in the transmission network in order to maintain reliability levels.

Indeed, it has been estimated by the ABARE that investment requirements across the industry as a whole total around $30 billion for the period to 2020.

In making its revenue cap decision the AER aims to provide Powerlink with an efficient level of capital and operating allowances to maintain the reliability of its network over the upcoming regulatory period.

<u>Distribution</u>

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.

Market Monitoring and Compliance

As I mentioned, the AER also has the role of monitoring compliance and enforcing the Electricity Market rules.

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 the policy intent is for the AER not to 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

In conclusion, the AER is looking forward to assuming its full powers and functions and working with industry to deliver a national and consistent regulatory framework.

I believe that Queensland has much to gain from the further development of the national energy market. I welcome Queensland being a strong supporter of national regulation and an early transition to the new national regulatory framework.

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