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National Energy Regulation- The Way Forward

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## **Abstract**

The speech will cover the new national regulatory framework for the energy sector- electricity and gas transmission and distribution, and the implications for businesses that will be regulated by the AER. It also discusses the process for transition from state-based regulation to national regulation.

The provision of information will be important for the regulatory regime going forward. One initiative of the AER is to develop with the sector information templates, which amongst other things will seek to provide a better understanding of the business drivers for capital and operational expenditure of network service providers, as an input to assessing efficient expenditure levels for purposes of establishing prices.

## **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 a 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 of electricity networks between the states has been substantially expanded with projects such as QNI, SNOVIC augmentation, DirectLink, MurrayLink and BassLink.
  - Gas pipelines have also expanded significantly. Key population centres, such as Melbourne, Sydney, Adelaide and Perth are now each served by two or more pipelines.

- Access regulation has been introduced for the transmission and distribution sectors.
- Electricity lines within the NEM region: Transmission line lengths total 41,841 km and the distribution line length is approximately 691,608 km.
- Pipeline lengths: The length of transmission pipelines has increased from 7,600 km (1991) to over 21,000 km. Distribution pipelines has increased from 67,500 (1997) to over 76,000 km.
- Electricity demand has expanded from 170,000 GWH to 250,000 GWH per annum over the past decade.
- The changes to the gas production and gas pipeline industries reflect the growth in domestic demand for natural gas which has increased from 750 PJ in 1994/95 to 951 PJ in 2001/02 and is forecast to reach 1,747 PJ in 2019/20.
- This highlights the importance of ensuring efficient, competitive energy markets to ensure sufficient supply of competitively priced and reliable energy to meet Australia's growing needs. In this context efficient regulation of energy networks is a necessary component of meeting this objective.
- 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) to consolidate regulatory reforms.
  - 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.

## **Introduction**

- In my talk today I would like talk about the regulatory changes that are anticipated, and the preparations that are in progress by the Australian Energy Regulator (AER) to assume its new responsibilities.
- First let me begin by reflecting on the history that led to the AER's 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, decision-making entity to the ACCC.
- The AER will have full 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 key principle behind the establishment of the Australian Energy Regulator was that a national energy market needs regulation undertaken on a national basis. Despite the fact that gas and electricity has been traded across mainland borders for some time now, giving rise to a developing national market for both sectors, there are still energy regulators in every state and territory.
- The AER will assume responsibility for the regulation of electricity distribution networks from State regulators on a staged basis within the next year or so. Currently the AER regulates the wholesale electricity market and electricity transmission networks in the NEM.
- The AER is to assume its gas transmission and other gas regulatory functions on 1 July 2007. In the interim, the ACCC continues to regulate gas transmission pipelines, assisted by the AER. The AER will also assume responsibility for gas distribution from state regulators at around the same time.

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

### **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 the 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.
- The AEMA provided for three institutions to oversee the operation of Australia's energy market:
  - the Australian Energy Market Commission (AEMC), which is responsible for rule making and energy market development at a national level.

- the AER, which is 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 a new National Electricity Law (NEL) commenced on 1 July 2005, with the commencement of operation by the AER and AEMC.
  - The next phase of reforms, as required under the AEMA, is to move towards a fully national regime for energy regulation as I outlined earlier. In achieving this aim, a series of policy changes, which are being driven by the MCE, are currently in train.

### **Anticipated policy changes – including AEMC rules**

- 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 the long-term interests of consumers regarding specified service characteristics.
- The new NGL takes into account the MCE's response to the Productivity Commission Report and the Expert Panel (Beale Report). The MCE has recently released an exposure draft of the NGL. 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.
- New features of the gas regulatory framework pursuant to the NGL include: potential for a 15year coverage exemption for pipelines; exemption from price regulation for greenfield pipelines; a lighter handed approach to certain other pipeline services; and greater information seeking powers for the regulator.

### *Transition to the AER*

- 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 next Tasmanian distribution determination will be made by the jurisdictional regulator.

#### *The transmission regulatory framework*

One of the key development processes that has taken place recently which impacts on the AER's regulatory role is the making of new rules for electricity transmission by the AEMC. These Rules set out the framework for the economic regulation of electricity transmission revenues.

- The AEMC released its Final Transmission Revenue Rules on 15 November 2006. The Final Rules largely reflect the AER's Statement of Regulatory Principles (SRP), such as in adopting an ex-ante approach to the determination of capex and opex, and maintaining incentives on capex, opex and service standards to promote efficient behaviour by the business.
- The AER, and the ACCC before it, has a history dating back to 1998 of regulating transmission. The Statement of Regulatory Principles arose out of that experience. The key objectives of the AER in developing and administering the SRP incentive framework were to promote efficient investment in the planning and construction of essential transmission infrastructure, efficient ongoing operation of that infrastructure and an equitable allocation of efficiency gains between the network owners and network users.<sup>1</sup>
- Under the Final Rules transmission businesses will continue to be regulated under an incentive framework based on the established "building-block" approach for determining the revenue a network business is allowed to earn for the provision of monopoly services.
- Those amongst you with a regulatory background will be aware that at its core the building-block model is designed to provide the network owner with a return both on, and of, the capital that has been invested in providing monopoly services and an allowance for the efficient operation of the network.

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<sup>1</sup> Statement of Regulatory Principles, p15.

- Under this framework incentives are created by determining targets in advance for both capital and operational expenditure and allowing the regulated business to keep a portion of any efficiency gains made in beating those targets.
- As the rules are now in place, the AER will proceed to regulate transmission businesses in accordance with these rules.
- Before discussing the AER's forthcoming role in distribution it is appropriate to mention the recent release of the Energy Reform Implementation Group's Discussion Papers on electricity market structure, financial markets and particularly, transmission regulation.

*Energy Reform Implementation Group recommendations*

- You will have seen press reports that the Energy Reform Implementation Group, which was established by the Prime Minister in response to a decision of the Council of Australian Governments, released a series of discussion papers setting out their initial views on energy reform on 17 November 2006.
- There are some 80 recommendations, findings and areas identified for further comment and all in a very ambitious timeframe for further consideration. It remains to be seen whether the time allowed will enable a sufficiently fulsome consideration of all these issues.
- Whilst all of the issues raised are, to a greater or lesser extent, of interest to the AER I will focus today only on those that may be of particular interest to those of you interested in network development. These are ERIG's proposed options for changes to national transmission planning and changes to the regulatory test. Changes in these areas will have potentially major implications for us as the regulator in the approach taken to determining whether capital expenditure is warranted and efficient.
- The regulatory test is intended as an analytical tool to enable TNSPs to show that their investments in monopoly networks are efficient, having regard to all other possible transmission or generation options that may be feasible to meet customers energy needs; it is an attempt to ensure a level playing field between the competitive elements of the market (generation) and the transmission sector as a regulated monopoly.
- ERIG notes, however, that the relationship of this test with the economic regulatory framework is tenuous at best and its operation needs to be improved. There is no need for example for TNSPs to have satisfied the regulatory test before putting their capital expenditure plans to the AER for approval prior to each reset.
- ERIG proposes a number of changes and improvements to the regulatory test to make it more consistent with a national transmission planning framework (which they also recommend) and to rationalise or optimise the way it treats market and reliability benefits under the test.
- ERIG also considers the advantages of moving to a national basis for transmission planning and proposes three options for a central national planning function. This

would allow a move away from the current diverse approach whereby businesses are largely responsible for determining their own capital expenditure programs and the Inter-Regional Planning Committee (IRPC) co-ordinates the development of inter-connectors between the States. I note though, that in Victoria the transmission planning function is carried out by VENCORP whilst in South Australia the Electricity Supply Industry Planning Council also has planning role.

- ERIG's options can be broadly summarised as:
  1. a modified status quo (based on the existing Annual National Transmission Statement);
  2. a strategic national planner and co-ordinator; and
  3. a National Transmission Service procurer.
- Within these options ERIG proposes there also be modified institutional arrangements for the conduct of the national planning function. ERIG proposes three options for a central national planning function:
  1. the creation of a new entity;
  2. placement of the national planning function under the Australian Energy markets Commission; and
  3. placement of the national planning function within the National Electricity Market Management Company (NEMMCO).
- The AER supports improvements to both transmission planning and the regulatory test and we await with great interest the outcome of the ERIG process. Although we consider all the options to be viable alternatives they all involve tradeoffs on matters of scope, scale, co-ordination, effectiveness and efficiency that need to be carefully investigated and a measured judgement taken.

### **AER preparations**

- I would now like to turn to the AER's work in preparing for the transition of distribution functions.
- The framework for distribution regulation is now being developed by the MCE. We expect there will be significant consistency between the approach to the regulation of transmission and distribution networks as this will encourage optimal investment and operation of the two networks, in keeping with a move to national regulation for both
- As part of its preparations, the AER released a broad blue print of its approach to the transfer of distribution responsibilities. The statement, *Electricity distribution regulatory guidelines: Statement of Approach*, outlines the process for the development of guidelines regarding certain elements of regulation where the AER is to have certain policy discretion. 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.

- 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 2007. The AER expects to release two packages of guidelines, one early next year, and another in the latter part of next year. These will cover such areas as cost allocation; ring fencing; service standards; revenue modelling and incentive mechanisms.
- There are also other preparations under way. Staff are working with the jurisdictional regulators on transition matters, including issues that will arise from the AER's administration of existing distribution decisions. We are also increasing our resource base and now have around 75 people across a number of jurisdictions.
- 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 at a sufficiently early stage to ensure that we have considered the likely challenges in the handover of responsibilities.
- An issue which has a high priority at present is development of 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. It is particularly important given the workload the AER will have that information is provided as efficiently and in as timely way as possible.
  - The AER views cost reporting templates as a fundamental instrument of regulation as they provide an advance signal to businesses of the type of information required by the AER, are designed to allow better analysis and therefore improve the basis for the decisions we make that affect regulated businesses.
  - As a regulator, it is important to understand the drivers behind the capex and opex of regulated businesses. These drivers are essential in examining why costs may change from time to time and will play an important role in our information requests.

### **Concluding remarks**

- The AER will be very busy in the period leading to 1 July next year and in the ensuing period to January 2008 when we receive our additional responsibilities. .
- Effective and quality regulation is important for the energy sector going forward  
We are working closely with industry to achieve this outcome.
- Thank you.