

Introduction

It is a pleasure to be here this morning to talk at this Tasmania Power Conference 2005.

Since the Australian Energy Regulator (AER) was established in July this year, this is the first opportunity I have had to visit Tasmania to meet with the industry participants down here and to see some of the energy infrastructure which our CEO, Michelle Groves, and I will do over the next few days.

It is interesting, if coincidental, that Tasmania has joined the National Electricity Market (NEM) at a time when the energy market in Australia is moving towards national regulation.

Tasmania formally became a NEM member on 29 May 2005 and the AER and the Australian Energy Market Commission (the AEMC) were both established with powers and functions from 1 July.

Apart from NEM entry, Tasmania is embarking on the Basslink Project which, with 290km of undersea cable, will be the longest interconnect of its type in the world. Basslink will provide an export capability of 600MW to Victoria and import of up to 300MW into Tasmania. Basslink will further add to the competitiveness of the NEM by enabling electricity generation on the mainland and in Tasmania to compete in the wholesale market. The framework developed by the Government also endeavours to facilitate the development of wind generation resources.

I also note that the Tasmanian government proposes to phase in the introduction of retail contestability over a four year period from

around mid next year. To create additional competition in generation in the Tasmania market, the Government has also converted the Bell Bay power station to gas and plans to separate it from Hydro Tasmania also from around mid next year.

The Tasmanian Natural Gas Project is also part of the Tasmanian Government's energy reform program. Powerco is in the process of extending its distribution pipelines throughout the major population centres of Tasmania, and, I understand, that work is expected to be completed in 2007. Natural gas is already available to some domestic and industrial users in Hobart, Launceston and Longford, Westbury, Bell Bay, Wynyard and Devonport. Alinta, of course, operates the gas pipeline into Tasmania.

So the energy market in this State is certainly experiencing a period of considerable change.

Nationally, we are 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 and this presents some challenges to the regulatory framework.

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

As I said earlier, 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 (which will be so important given our challenging regulatory role), have already met with industry associations and many industry participants, and AER members are meeting regularly on a range of regulatory matters currently within our charter. In particular, we have commenced early work on the very challenging transition process from jurisdiction to national energy regulation.

AER's Role and Functions

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 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.

Importantly, under the Australian Energy Market Agreement jurisdictions also agreed to pass responsibility for regulation of energy distribution to the AER in January 2007 and subsequently non-price retail regulation subject to development of a national framework.

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.

Implications for Tasmania

The ACCC was, and now the AER is, responsible for economic regulation of transmission in Tasmania. This is consistent with the arrangements in place in other jurisdictions. The next revenue cap for Transend will begin 1 July 2009, which is at the same time as TransGrid's and Energy Australia's reset.

Currently, the Office of the Tasmanian Energy Regulator (OTTER) currently has a number of roles in the local electricity supply industry, including:

- responsibility for distribution network pricing and regulation of retail prices for noncontestable customers
- a role in the monitoring of Hydro Tasmania's compliance with the process for selling down the Inter Regional Residues that will be accrued by Basslink
- market monitoring to ensure that the design of the market in Tasmania and the operation of competition delivers benefits to the community.

The AER will ultimately assume from OTTER the responsibility for energy distribution network regulation in Tasmania. Aurora's distribution electricity networks will subsequently be covered by this new national arrangement.

Basslink, however, will operate as a market network service provider (MNSP) and, as such, will not have its revenues regulated by the AER. I understand that Hydro Tasmania (HT) has signed a services agreement with Basslink Pty Ltd (BPL) whereby HT will pay a facility fee and BPL will pay HT an amount of money equal to the value of the inter-regional residues accrued by the link. This facility fee would replace the variable revenue earned by BPL as a market services provider, mitigating the risk of uncertain revenue flows that is inherent for market interconnects.

With respect to gas, in October the Tasmanian Government applied to the National Competition Council (NCC) for a recommendation that the State's access regime for gas pipeline services is an effective access regime under s 44M of the Trade Practices Act 1974.

Under the Tasmanian regime, the Tasmanian government has provided Powerco (the gas distributor) with a non-renewable exclusive distribution franchise for the 23 foundation customers identified in stage 1.

In February 2005 the NCC issued its draft recommendation that the Tasmanian regime be certified as effective for a period of 15 years.

I understand that a decision by the Parliamentary Secretary to the Australian Government Treasurer on the NCC's final recommendation has not yet been released.

To be 'certified' as effective the regime must comply with clause 6 of the Competition Principles Agreement which contains guiding principles that ensure State and Territory regimes reflect the underlying policy objective of enhancing effective competition.

Once a regime is certified as an 'effective' access regime, third party access to the relevant transmission and distribution pipelines will be governed by the national gas access Code, and the pipelines will be protected from declaration under Part IIIA.

Currently there are no Tasmanian gas pipelines that are covered. In the event that a pipeline is covered under the Tasmanian Regime, then the relevant regulator for transmission pipelines is currently the Australian Competition and Consumer Commission (ACCC), and in the case of distribution pipelines it's the Government Prices Oversight Commission (GPOC). This role will ultimately pass to the AER.

Policy Review

The establishment of the new national 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.

AER's Approach to Regulation

There has been considerable debate recently about regulation of national infrastructure being too heavy handed. We now have a ten year history of regulation in the energy sector and it is perhaps timely that we give some reflection to the strengths and weaknesses of the current regulatory approach. The establishment of a new national regulator presents the opportunity for this to occur.

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.

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.

However, other sectors of the industry appear to be advocating a material change of approach. Clearly the AEMC and the Ministerial Council of Energy will be the ultimate decision makers on the regulatory framework for electricity transmission and gas pipelines respectively. In the meantime, the AER is open to discussions with energy participants on operational issues associated with the regulatory framework.

One area of emphasis will be engagement with local industry. The AER proposes to be a very visible regulator at the various jurisdictional level. I can assure participants and stakeholders in Tasmania that they will have very open access to the AER, which will be seeking to be fully informed on Tasmanian regulatory matters. In particular, we will be developing strong communications with the regulated businesses.

Transmission

Transend, the transmission network service provider (TNSP) in Tasmania, was originally regulated by the Office of the Tasmanian Energy Regulator under the Tasmanian Electricity Code (TEC). In 2001 as part of the transition to the NEM the Tasmanian and Commonwealth Governments agreed that the ACCC should be responsible for the economic regulation of Transend, when the OTTER decision expired on 31 December 2002. This was subsequently extended until 31 December 2003. This ACCC revenue cap decision was made under the TEC with the ACCC effectively acting as OTTER. The decision covers the period from 31 December 2003 to 30 June 2009.

Also in 2001 the ACCC authorised derogations to the NEC in relation to Tasmania. These derogations included provisions to deem, upon NEM-entry, the revenue cap made under the TEC to be a valid decision made under what is now the National Electricity Rules.

When Tasmania's NEM-entry occurred (29 May 2005) the ACCC was made the responsible regulator under the Rules. As I have mentioned previously, the AER will eventually assume this role. The next regulatory reset for Transend will be undertaken pursuant to the new Chapter 6 rules which will emanate from the AEMC review process.

Distribution

The next regulatory reset for Aurora Energy's electricity distribution assets is already underway by OTTER, on the basis that new prices need to be in place by the beginning of 2008. As the AER will not be assuming regulatory functions for distribution until January 2007, a decision will need to be made about how best to handle this reset: ie whether it is undertaken by OTTER or the

AER. Given that work will presumably need to commence prior to January 2007, my initial views are that OTTER is best placed to undertake the review, but we will need to discuss with Andrew and his team.

On a broader scale the AER needs to be ready to undertake the distribution regulation role. In this respect, 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.

In the meantime, 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.

Regarding Tasmania, we have already had a number of discussions with Andrew Reeves, from OTTER, and we are keen to further an effective relationship and coordination in the conduct

of our joint responsibilities. Indeed, from what I see, the regulatory experience in this state has been quite effective. There is a lot of local knowledge and experience within OTTER and we are keen to capture this.

The AER has already started thinking about 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 issues paper on 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 specific transition issues that will require clarity or resolution well in advance of revenue reviews. The intention is to release the issues paper around the second quarter of next year on the form of distribution regulation.

Our thinking on this matter needs to take account of the outcomes of the recent MCE meeting regarding distribution handover, on which we still need to be briefed. Specifically, our proposed approach will be significantly influenced by the eventual outputs from the MCE high level work programme on the framework for regulation of energy distribution, but at this stage we intend to be as proactive as possible whilst, along the way, being consistent with the MCE's policy as it develops.

Tasmania's NEM Entry

Tasmania entered the National Electricity Market (NEM) on 29 May 2005. Upon NEM entry, NEMMCO, in conjunction with Transend, have operated the power system. Transend is responsible for network reliability; NEMMCO is responsible for system security and wholesale market reliability. Hydro Tasmania competes in the wholesale energy and ancillary services markets for profit.

As part of its market monitoring function, the AER produces a weekly market report. Market outcomes to date show that the introduction of the NEM dispatch process has given rise to wholesale market price signals in Tasmania, which at times has produced extreme prices for both energy and ancillary services. Since its NEM entry the Tasmanian spot price has averaged \$93/MWh compared to prices across the mainland, which were between \$22/MWh in Queensland and \$34/MWh in South Australia, for the same period.

This situation is not unlike South Australia's NEM entry, where the volume weighted average price in its first full year was \$69/MWh. Since that time, with the installation of new peaking and intermediate capacity average prices in South Australia have fallen to \$39/MWh for the last financial year.

The price signals that would not have been previously seen in Tasmania include:

- HT offers its capacity to the market at certain prices. The NEM dispatch engine (NEMDE) dispatches the generation, for both energy and ancillary services, in the ascending order of these offers, subject to constraints.

- Should the reliability of the network be in doubt, Transend would have to either augment its network or seek network support arrangements. Transend's choice between these two options reflects an economic decision.

- If system security or wholesale market reliability is in doubt then NEMMCO would direct participant(s) to ensure the security is maintained. In this situation there is a market mechanism to compensate a directed participant who provides services to maintain system security.

Some of the factors contributing to high average prices in Tasmania include low long-term water storage levels; trade-offs between energy and ancillary services; and limited availability of some frequency control ancillary services.

An underlying feature of the Tasmanian market is that, whilst there is ample capacity, Tasmania is energy limited being captive to water storage levels. Unfortunately, the State has been in a seven year drought, with water storage at a low level. Basslink should help to alleviate this problem by providing a more diversified fuel source for power generation.

I have observed that, more recently, the situation has improved somewhat; with long term storage up to 40% and prices over the last few months falling to the \$65-\$70 range. Teething problems from installation of new (SCADA) monitoring and control systems operated by Transend as part NEM entry are also being resolved.

I note that in response to the water shortages and as insurance against further delays with Basslink and outages at Bell Bay Power Station, the Tasmanian Government has purchased 120 MW of additional generation capacity in the form of three gas fired turbines to be installed at Bell Bay.

The latest Statement of Opportunities was published by NEMMCO last month. While the SOO did not indicate any shortfalls on a capacity basis, the energy constrained nature of the region indicates that, in the short term, the projected energy demand for Tasmania, has already outstripped the long-term average energy capability of Hydro Tasmania's hydroelectric assets. NEMMCO is working with Hydro Tasmania to better model the energy condition in Tasmania as part of the long-term forecasting process, for the future.

I remain hopeful that with the completion of Basslink around April, the separation of Bell Bay from Hydro Tasmania, scheduled for July next year, and an easing of the drought conditions, prices in Tasmania will, over time, align more closely with the those observed across the rest of the national market.

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 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 in Queensland and South Australia 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 Tasmania has much to gain from its engagement in and the further development of the national energy market. I welcome Tasmania being a strong supporter of national regulation and we look forward to a very constructive relationship with both the Tasmanian Government, your local regulator OTTER and industry in the transition to the new framework.
