

Introduction

Thank you for the invitation to address this 16th Power and Electricity Congress in Sydney this morning.

I note that the Conference brochure labels this as an opportunity to discover what is being done to “re-invigorate” Australia’s energy sector. I’m not sure that the sector has ever suffered, at least in the last 10 years or so, from lack of vigor. Rather, I think that one of the strengths of the Australian industry, compared to overseas counterparts, is that we are always seeking ways to further improve the way it operates. There are some claims about reform fatigue; but I don’t hear anyone seriously engaged in the sector bemoaning the value and issues underpinning the Government bilateral reform initiatives.

We are certainly now experiencing a broad suite of reform and policy reviews aimed at taking the performance of the energy market to another level. And a major aspect of this is a move to national regulation; which is the subject of my talk here this morning.

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

AER’s Role and Functions

The key principle behind the establishment of the Australian Energy Regulator (AER) 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.

Of course the AER is not the only regulatory body. The new regulatory framework gives equally important roles to the Australian Energy Market Commission (AEMC) and the Australian Competition and Consumer Commission (ACCC). The AEMC is a new body with responsibility for market development, in particular electricity and gas market rule making. The ACCC will continue its role as competition regulator with responsibility for consumer protection and anti-competitive conduct as well as mergers and acquisitions under Part IV of the Trade practices Act.

The AER is in fact a constituent part of the ACCC but is also an independent legal entity in its own right. Apart from myself, the members of the AER are Ed Willett and Geoff Swier. The AER is will be funded by the Commonwealth Government.

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 the next few years.

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 will pass from the ACCC to the AER by January 2007, following the passage of necessary legislation in the various States and Territories.

Importantly, under the Australian Energy Market Agreement jurisdictions have also agreed to pass responsibility for regulation of energy distribution to the AER in January 2007. This means that by early 2007 the AER will have assumed responsibility for economic regulation of energy networks on a national basis. It is also envisaged that the AER will subsequently be given responsibility for certain aspects of non-price retail regulation but this is subject to further consideration by jurisdictions on a national framework.

I am pleased to say that following its formal establishment on 1 July the AER is 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.

The Task Ahead

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.

In 2004 terms, the total value of regulated assets at the commencement of respective businesses' current regulatory period is \$44 billion. Interestingly, total forecast capital expenditure for this period is around \$19.6 billion, over 40 percent of this opening asset base; which means that by the end of this regulatory cycle assets will have a regulatory value of around \$65

billion less, of course, depreciation. Opex of \$13.5 billion over this cycle has also been approved by regulators.

Nationally we are in a period of unprecedented energy demand growth, which coupled with aging network assets and high expectations regarding reliability, is posing peak load stress on the supply system. These capex and opex figures are certainly evidence of that.

One area we have been focusing on relates to the task of transitioning the 23 State regulated businesses to the national framework. Whilst this will happen over a number of years the work needs to start now given the long timeframes involved.

One key piece of information relates to the existing timing for price reviews which is depicted here in this next slide. The next distribution price resets are for the Victorian gas businesses and for Aurora, the Tasmanian electricity distributor. Because these reviews need to commence prior to 2007 when the AER assumes regulatory responsibility, they will be undertaken by the jurisdiction regulator. The AER's first reviews will be for NSW and ACT electricity.

This next graphic is fairly busy but gives a snapshot of the AER's workload based on existing reset timelines. You can see that, based on 2004 RAB values I referred to before, the assets under various stages of review will grow from \$11billion in 2006/07 to \$14billion by 2008/09 and to around \$26billion for 2009/10. An interesting representation of the building block approach, don't you think?

The reality is that work on a price reset needs to commence two years ahead of when new prices are released. The next graphic demonstrates this in the context of the 2008/09 reviews of NSW and ACT distribution. Work on these resets needs to commence by mid 2007 by which time a process for the review including the form of regulation needs to be established.

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 Ministerial Council on Energy'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 a further opportunity for this to occur.

I fully acknowledge that improvements can be made to enhance the quality of regulation. Regulation is imprecise; 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 or "up front" 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 see the traditional CPI – X building block approach implemented on this basis as a good model for moving forward.

However, other sectors of the industry appear to be advocating a material change of approach to the form of regulation. 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 will be participating in this debate and is open to discussions with market participants on operational issues associated with the regulatory framework. The AEMC review of transmission revenue regulation is to culminate in new rules by mid 2006.

One area of particular emphasis by the AER will be engagement with local industry. The AER proposes to be a very visible regulator at the various jurisdictional levels. I can assure

participants and stakeholders that they will have very open access to the AER on regulatory matters. In particular, we will be developing strong communications with the regulated businesses.

With respect to distribution, the AER needs to be ready to undertake handover of the distribution regulation role from jurisdiction regulators. 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 for distribution 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 three stage review and analysis of the current arrangements in gas and electricity distribution regulation. This review involves discussions with jurisdictional regulators and distribution companies.

A key output of this review will be a decision by the AER on the regulation process for distribution businesses. The intention is to firstly release a discussion paper following more clarity from the

policy makers on the form of regulation to apply to this sector of the industry. It is envisaged that the AER's final approach will be embodied in a document similar to the Compendium of Regulatory principles for TNSP's.

Importantly, our eventual 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 and not get ahead of it.

Generation Technical Standards

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

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 has been signalling that one area of focus will be generator compliance with technical performance standards.

The introduction of the generation technical standards regime in December 2004 has led to a requirement for compliance monitoring programmes to be established by each generator in the NEM.

Those programmes, which ensure compliance with performance standards, were required to be in place by mid 2005. The

investigation into the events of 14 March this year, highlighted the importance of these arrangements.

The AER, as a first step, is working with NEMMCO, Network Service Providers and generators to establish a common understanding prior to completing negotiation of those compliance monitoring programmes. These programmes should include an agreed method for each generating unit to confirm, and test, ongoing compliance with the applicable technical requirements of the National Electricity Rules.

The AER will be reviewing generator performance compliance programs as part of its compliance monitoring strategy in early 2006 to ensure the arrangements are effective.

In addition the AER's compliance monitoring programme will focus on:

- assessing the compliance with, and effectiveness of the additional reporting requirements placed on transmission network service providers in relation to planned network outages that will, or are likely to, have a material effect on interconnector transfer capabilities; and
- the extent to which network service providers have developed compliance programs in accordance with the Rules to ensure that its facilities operate reliably and in accordance with their performance requirements of schedule 5.1

This work will relate closely with the transmission service standards work through the Report on the Market Impact of Transmission which we propose to release early in 2006.

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 the challenge ahead and working with industry to deliver a national and consistent regulatory framework.
