



***Energy regulation for the
21st century***
**Australian Energy and Utility
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Ed Willett, Commissioner**

Introduction

Thank you for inviting me here today.

The theme of today's discussion is – Energy regulation for the 21st century

It is a little over one year since the Australian Energy Regulator (the AER) was established. Much has happened in the past 12 months but much also remains to be done.

In addition to the establishment of the AER the Australian Energy Market Commission was also established.

Apart from these institutional arrangements, significant as they are, a number of important policy reviews have been prepared and considered by the Ministerial Council of Energy (MCE) including:

- the Expert Panel review of the regulatory framework for distribution and non-price retail with a view to establishing a consistent national framework, and
- the Productivity Commission's report on the National Gas Access Code.

In addition the Australian Energy Markets Commission (AEMC) has undertaken a review of Chapter 6 of the National Electricity Rules relating to the setting of maximum allowable revenue for transmission businesses and transmission pricing.

The AEMC is expected to shortly release its draft determination and draft Rules governing the regulation of electricity transmission revenue, with a view to issuing a final determination in the third quarter of 2006. The new rules will take effect in January 2007.

More recently the Council of Australian Governments (COAG) out of session has endorsed a number of amendments to the Australian Energy Market Agreement 2004 (AEMA).

The amendments build on progress that has been made to date in energy market reform and provide a foundation for future development and implementation of

energy reforms, and in particular the transfer of energy distribution and retail regulation to the national regime.

Update on the new regulatory environment

The AEMA clarifies the AER and AEMC's functions in light of the enactment of the revised National Electricity Law (NEL) and future enactment of the National Gas Law (NGL). The AEMA provides that the Australian energy market institutions comprise:

- The AEMC, which is responsible for rule-making and energy market development at a national level
- The AER has responsibility for economic regulation and compliance at a national level, including in respect of the National Electricity Law and, in the future, the new National Gas Law
- The National Electricity Market Management Company (NEMMCO) retains responsibility for the day-to-day operation and administration of both the power system and electricity wholesale spot market in the National Electricity Market (NEM) and other support activities.

Progress to date

The recent amendments to the AEMA provide for:

- Transfer of retail and distribution regulation (other than retail pricing) to a national framework in an agreed timeframe
- Agreement to implement new national rules for National Distribution and Retail functions by 1 January 2008
- A process for providing advice to jurisdictions on the effectiveness of competition in retail markets; and
- Arrangements for the certification of energy access regimes on a nationally consistent basis.

The MCE in its Communique of 19 May 2006 confirmed its commitments outlined in the amended AEMA to the delivery of the 2006 legislative package. Ministers endorsed the direction of a 2006 legislative package which includes the new National Gas Law and Rules and amendments to the National Electricity Law (NEL) and Rules.

Key components of the 2006 legislative package are:

- The transfer of economic regulation of distribution to the AER and AEMC from 1 January 2007

- The implementation of the MCE Response to the Productivity Commission Review of the Gas Access Regime released on 9 May 2006 including light-handed regulatory approaches, a common objects clause and incentives for greenfields pipelines
- the adoption of a limited merits review model for both gas and electricity
- The MCE's response to the report of its Expert Panel on Revenue and Network Pricing, adopting recommendations on pricing principles and a 'fit-for' purpose' decision making framework; and
- Amendments to the Australian Energy Market Commission Establishment Act 2004 to implement the MCE's November 2005 decision to establish a long-term consumer advocacy funding model for both gas and electricity advocacy.

Is energy market reform progressing as planned?

You may ask – is energy market reform is progressing as planned?

I think the answer lies somewhere in the middle of yes and no. An ambitious program was initiated involving the establishment of new institutions, the review of legislation, regulations and rules and the transfer of roles and functions from State and Territory bodies to the new institutions. Like all grand plans some slippage has occurred. For example, in just a few days the AER was to assume from the ACCC responsibility for gas transmission. Yet the legislative framework for this to occur is yet to be tabled in the South Australian parliament.

That said if the proliferation of activity that I have mentioned previously is anything to go by it is obvious that energy market reform is certainly moving forward. But as has been said many a time before 'Rome was not built in a day' and similarly energy market reform is unlikely to be achieved overnight.

While the task remains a work in progress the foundations for the future are in place and the detail will be settled this year.

The AER's increased role over the next few years

Transmission

The AEMC is shortly expected to release its draft determination and draft Rules governing the regulation of electricity transmission revenue, with a view to issuing a final determination in the third quarter of 2006.

The release of these draft rules will provide direction to the market and allow the AER and regulated businesses to plan for and implement their work programs relating to transmission regulation. It is envisaged that the draft Rules will provide that the AER is to issue a number of guidelines, schemes and models.

The AER has already commenced a number of internal work streams to look at current guidelines relating to a range of matters with a view to issuing new or revised guidelines pursuant to whatever regime emanates from the review processes. Once it is clear what the new Rules will require of the AER in relation to guidelines, the AER will consult with industry as part of the process of developing guidelines required by the Rules.

Transfer of gas transmission functions from the ACCC to the AER

Gas transmission regulatory responsibilities for all jurisdictions except WA will also pass from the ACCC to the AER from January 2007, following passage of necessary legislation in the various States and Territories.

The new National Gas Law is now being drafted taking account of the MCE's response to the Productivity Commission report and the work of the Expert Panel.

Distribution

As mentioned, the MCE is committed to the transfer of economic regulation of distribution from jurisdictional regulators to the AER from 1 January 2007, with new national rules by 1 January 2008.

A key priority for the AER is to ensure a seamless roll-in of electricity distribution and gas regulated elements of the sector over the next two years. The AER is focussed on the task of transitioning the regulated electricity and gas distribution businesses to the national framework. The AER has already commenced this work to ensure our readiness for the role of distribution regulation. It intends to engage stakeholders to facilitate the successful transition to the national distribution regulatory framework envisioned by the MCE.

This is no small task considering there will be about 40 businesses involved under the national framework, and the AER has a substantial work plan to meet the challenge, having already committed significant resources.

To accomplish this task the AER is currently undertaking a three stage review of the current arrangements in electricity distribution regulation. This review involves discussions with jurisdictional regulators, distribution companies and user groups.

A key output of the review will be guidelines for the regulation of distribution businesses. The AER has begun a process of consultation and is committed to this process. Work on a price reset needs to commence about 2 years ahead of when the revenue reset occurs. In the context of the 2008/09 reviews of NSW and ACT electricity distributors work has commenced.

The eventual regulatory approach will be governed by the outputs of the MCE high level work programme on the framework for regulation of electricity

distribution. But at this stage we intend to be as prepared as possible without getting ahead of the game.

Given this need to be proactive, in March this year the AER released a scoping paper setting out the AER's proposed process and scope for the development of distribution regulatory guidelines for electricity and gas distribution. The AER's preliminary work plan is to conduct separate processes for the development of guidelines for:

1. Electricity distribution
2. Gas distribution and
3. Electricity transmission.

While there will be three separate sets of guidelines, the AER will aim to achieve the maximum consistency possible across these guidelines.

The AER's working assumption in developing electricity distribution guidelines is that the detailed elements of the building block approach outlined in the draft Chapter 6 Rules for transmission will be largely applicable to electricity distribution.

Although the final framework under which the AER will regulate is not yet in place, the AER needs to begin work in order to meet timelines for the next round of distribution resets. The scoping paper is an important step in this ongoing process as it investigates the desirability and possibility of achieving consistent regulatory guidelines for electricity transmission and distribution as well as for gas and electricity distribution.

In the past there have been a number of state and federal jurisdictional regulators which have operated under different arrangements and powers.

Distribution companies are also regulated under different broad frameworks with respect to the form of regulation and building block parameters as shown in these slides.

The transfer of these responsibilities to the AER provides an important opportunity to assess whether it is feasible or desirable to harmonise the regulatory regimes governing these different sectors.

The AER has sought comments on the proposed approach, the scope of the proposed distribution review, and the proposed process and timeframes for the development of distribution regulatory guidelines. Submissions to the scoping paper closed on 5 May 2006.

Retail

In relation to retail the MCE stated in its Communique of 19 May 2006 that there will be a legislative package and associated Rules in 2007 to complete the transfer to the AER and AEMC of distribution and retail consumer protection functions by 1 January 2008.

The MCE has agreed on a work program to develop recommendations on the national retail functions. The work program provides for the recommendations to be developed by a group of Commonwealth and State officials - the Retail Policy Working Group (RPWG) in consultation with stakeholders and with the assistance of expert legal advice. This stakeholder consultation will include consultation with existing energy regulator including the AER.

While the precise role of the AER in respect of non-price retail regulation is still to be determined by the MCE, the AER will continue to participate in the various consultation for a to facilitate the development of a national framework.

Greater consistency in non-price energy retail regulation should reduce regulatory compliance costs, for example by facilitating consistency in billing systems used by retailers across jurisdictions.

In respect of retail price regulation, the AEMA contains a timeline and mechanisms for the AEMC to advise on and determine the effectiveness of competition in the jurisdictions and for the phase out of retail price regulation to be agreed upon. A move towards reforming price cap arrangements will need to recognise that the jurisdictions are at different stages, have widely different price protection arrangements and so will need to move forward from different bases.

Regulation can assist the promotion of competition to enhance the speed of transition to deregulation and the outcomes of deregulation through measures to ensure that the market is transparent and accessible. In particular, information as to choice should be easily available.

The AER will continue to monitor the state of the energy market to facilitate information as to changes in the market as the market continues to evolve and develop. As part of this framework the AER will release its first annual state of the market report later this year. I will comment on this shortly.

Overview of the benefits of the new framework

As noted in the previous section, future roles for the AER include:

- responsibility for electricity distribution regulation
- gas transmission and distribution regulation and
- non price retail regulatory functions as determined by the MCE.

added to its existing responsibilities in relation to:

- 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.

It is expected that having one single and independent national regulator will reduce regulatory costs and uncertainty to business, and allow the gas and electricity markets to develop, as much as possible, within a consistent regulatory framework. The key principle behind the establishment of the AER was that a national energy market needs a national energy regulator.

Understanding the challenges so far and how they have been met

The AER is committed to a streamlined regulatory process that reduces duplication and improves the timeliness of regulatory processes. In respect of current projects the AER has implemented a number of innovations to improve the regulatory process.

With respect to the revenue reset for Powerlink, the Queensland electricity transmission business the following initiatives have been undertaken:

- Pre-lodgement liaison with Powerlink to assess the major issues prior to Powerlink's application being received.
- Early and regular consultation at the commencement of the reset process. There was a public forum on 20 April, which gave Powerlink the opportunity to provide interested parties with an overview of its application, the opportunity to comment on the application and to ask questions of Powerlink. The advantage of this approach is that the AER will be able to take into account issues raised by interested parties when developing its draft decision.
- The development of information requirement templates. These templates cover historic/forecast capex and opex and have been developed for Powerlink to reduce delay and provide the AER and its consultants with greater focus. Previous revenue cap processes have suffered from an initial lack of relevant information and this has resulted in delays for consultants and the AER. The templates have focused on capital and operating expenditure as these were the areas where the information initially provided in previous revenue caps lacked sufficient detail to establish efficient cost targets. Depending on the final form of the Rules, it is intended that the Powerlink templates will be the basis for developing

- generic Information Guidelines. All TNSPs will be consulted during this process later in 2006.
- The reduction of timeframes and the earlier engagement of consultants. As part of the AER's commitment to timely decision making and streamlined regulatory processes, a final decision on Powerlink's revenue reset is planned by the end of 2006. This provides a 9 month time frame in which to make the revenue cap decision. Powerlink indicated early on in the process that it was prepared to work with the AER to achieve this timeframe. This co-operative approach has been supported by ongoing liaison between Powerlink and the AER, with potential issues identified by both parties well in advance. As a result, a number of matters raised by Powerlink were addressed prior to the lodgement of its application.
 - The AER intends to consult on both consultants' reports and draft decision at the same time. Conducting public consultation on both of these documents as part of a single step will save time and resources for both the AER and interested parties and assist the AER in achieving a 9 month timeframe for the reset.

Powerlink revenue reset

The AER has received Powerlink's revenue cap application and a copy of it has been placed on the AER's website. The revenue cap will cover a period of 5 years, that is, from 1 July 2007 to 30 June 2012. At the public forum we encouraged all interested parties to read Powerlink's application and make submissions on it. Submissions on the application closed on 13 June 2006.

The AER will consult widely with stakeholders and will seek submissions at other key stages of the process. Effective engagement between the AER and key stakeholders in the lead up to the application and during the reset process is critical to delivering a revenue cap decision that is clear, unambiguous, non-contentious and timely.

The AER has also encouraged 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 operating environment in which this revenue reset is taking place. We note the strong growth in demand that is occurring in Queensland, particularly in the south east of the state, and the need for investment in the network in order to maintain reliability levels.

Roma to Brisbane pipeline (RBP) access arrangement

Unlike revenue resets for electricity transmission businesses, responsibility for decisions under the Gas Code remains with the ACCC. The AER, however, is advising the Commission in its consideration of the access arrangement for the RBP.

The access arrangement was submitted to the ACCC at the end of January and the plan is to have a draft decision released in August. This is a little later than originally planned but there have been delays in obtaining relevant information.

That said the process is working well. Most major users of the pipeline provided submissions on the proposed access arrangement. And, for the first time, a round table conference with users and the pipeline operator was held.

The AER understands that the Roma to Brisbane pipeline has some unique features. The pipeline is operating at close to capacity. Coal seam methane reserves are being developed in close proximity to the pipeline. In addition, gas fired power generation and industrial customers could seek access to additional gas supply.

This access arrangement will replace the derogated tariffs established by the Queensland Government.

Indicator of the market impact of transmission congestion – decision and report for 2003–04

I also want to touch on an important new piece of work undertaken by the AER. I am referring to the – Indicators of the market impact of transmission congestion and accompanying Report for 2003–04.

The impact of transmission network congestion on electricity prices has been a key issue since the commencement of the National Electricity Market.

With the assistance of NEMMCO the AER has developed a number of indicators to measure this impact. The indicators show total congestion costs in the NEM of \$36 million in 2003-04. Given the turnover in the electricity market for the same period was \$6 billion this would indicate that the cost of congestion is relatively low.

This is the first time that indicators of the market impact of transmission congestion have been developed in Australia or in any other country.

We are still treating this data cautiously as we only have results for a single year. Going forward, this data will help industry, policy makers and the AER

understand the economic costs of transmission congestion and to identify measure to reduce those costs.

Compliance and enforcement

The AER's approach to wholesale market enforcement is, in the first instance, about comprehensive observation of and reporting on the market. The AER believes a regime that emphasises a culture of corporate compliance is reasonable given the track record of the industry with respect to compliance management to date.

The AER will continue to work with the industry to promote rule compliance. For the regime to work effectively, however, it needs to be complimented by detailed monitoring of participant conduct and effective enforcement arrangements.

The AER has been given considerable powers to enforce the law, regulations and rules and will not hesitate to respond quickly and firmly if a compliance matter arises. We have recently raised with the AEMC the inadequacy of the current penalty regime for generator technical compliance. It is important that the rules ensure that the potential significance to the market of non-compliance is reflected in the penalty regime and that generators face incentives to ensure their plant is operated in compliance with the standards. We consider that the penalty regime for technical standards should be more in line with the regime for the re-bidding rules, i.e. up to a \$1million and \$50,000 for each day of non-compliance.

The AER will work with industry when significant compliance matters are identified. This has recently been the case with respect to the lack of generator technical performance standards and associated compliance programmes that were required to be in place by mid 2005. 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 recent years made clear the importance of generator performance standards to the maintenance of power system security.

The AER is working with NEMMCO, the AEMC and industry to ensure the necessary steps to resolve this compliance matters are expeditiously implemented. The AER has made clear a cut off date of June 2007, to finalise these arrangement, is critical. At that point, ensuring effective compliance monitoring programmes are maintained, and appropriate enforcement arrangements are in place will be our focus.

Market monitoring

The spot market for electricity, with an annual market turnover of \$7 billion, continues to deliver significant benefits as the trend towards truly national arrangement continues.

Annual spot prices in Queensland and South Australia, which were high at market start, have fallen and now aligned more closely with other regions. Despite record demands and a significant number of high priced events during the recent summer, the 2005-06 average spot prices on the mainland range between \$32/MWh in Queensland, \$36/MWh in Victoria and \$44/MWh in New South Wales and South Australia. Spot prices in Tasmania have been reducing since it joined the NEM in May last year. In its first quarter the average spot price was \$100/MWh which reduced to \$63 and then \$33. The average for the year is \$61.

Since the market commenced in 1998, spot market prices and the forward prices in the contract markets have tended to converge.

Around five thousand MW of capacity has come into the market since 1998, with a further 9500MW of new investment proposed, the majority [5600MW of the proposed capacity] being gas fired. In addition the potential for a further 5000MW of geothermal generation is on the drawing board.

The AER is continuing to enhance its market reporting arrangements to ensure that the information and analysis provided continues to improve and is consistent with our monitoring functions and objectives. We are continually developing our reporting methods to be user-friendly and accessible.

We will 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 is the platform to publish a broader set of metrics and indices that monitor the many seasonal factors that influence market outcomes.

State of the market report

With the growing complexity of energy markets there is a need for reliable and comprehensive data to inform participants. At present, energy market data is published by various bodies, including State regulators, the AER, NEMMCO, state-based market management bodies, ABARE, the Energy Supply Association of Australia, private monitoring bodies and others. With each focussing on particular areas of interest, it can be difficult to gauge a "big picture" sense of what is going in energy markets overall. The available information is at time

piecemeal, and some significant gaps are evident. This can cause difficulties for market participants and can affect the quality of policy debate on energy market issues.

The AER itself has significant data needs. Our market monitoring, compliance and enforcement responsibilities under the National Electricity Rules require reliable data on the wholesale market. We also need good data on network markets to undertake our regulatory work. With the AER's responsibilities likely to extend into distribution and retail – both in electricity and gas – the need for reliable data will become even more crucial over time.

As noted earlier, the AER already publishes weekly and quarterly reports on activity in the NEM. From 2006 we will supplement this with a new annual report on the state of the energy market. The report will bring together information available to us through our regulatory activities and from other public sources to present a big picture perspective on energy market activity in Australia. This type of report, also used by the US Federal Energy Regulatory Commission, will target a wide audience, including government, industry and the broader community. The style will be as user friendly as possible.

The 2006 report will focus on areas for which the AER currently has responsibility – the NEM and electricity transmission networks – but will also cover electricity distribution, retail and gas. The coverage of distribution and retail will expand in future years as regulatory responsibilities in those areas transfer to the AER. Similarly, reporting on gas markets will expand over time.

The AER regards this new annual report as an evolving project. The first report will seek information from the market on possible improvements, including areas where better information may be needed. Over time, we hope the report will become a valuable resource – both for market participants and policy makers.

Future challenges

Merits review

In outlining the steps that have been taken to implement the national energy market arrangements I referred to the MCE's recent announcement on merits review.

MCE has confirmed that there will be limited merits review for economic regulatory decisions in the gas and electricity access regimes.

Let me make it very clear the AER considers that all administrative decisions should be subject to review.

Our view is that limited merits review provides the right incentive to ensure that all relevant information is presented to the AER for consideration as part of the regulatory decision making process.

The MCE's decision outlines the grounds for review as follows:

- (a) that the decision-maker made an error of fact and that fact was material to the decision
- (b) that the exercise of the decision-maker's discretion was incorrect having regard to all the circumstances
- (c) that the decision-maker's decision was unreasonable having regard to all the circumstances.

These grounds require the AER to correctly apply the law. This is a duty the AER accepts and will strive to meet.

Last year the ACCC appealed one aspect of the Tribunal's decision to set aside aspects of the Moomba to Sydney pipeline access arrangement to the Federal Court. The ACCC took this action because it thought that the Tribunal had made an error in its application of the law. In addition, we felt that the appeal could help clarify the scope and reasonableness of a regulator's decision.

The Federal Court found that the ACCC did not make an error of law in establishing the regulatory value of the pipeline. The Court's reasons are not yet public. When the reasons are released I am hopeful that the Court's consideration of this matter will provide important guidance on the exercise of regulatory discretion.

General comments

The regulatory approach adopted first by the ACCC and now the AER has resulted in a number of positive outcomes. We have seen unprecedented levels of network investment demonstrating that the regulatory framework is providing investment certainty to the market.

Network reliability has improved and productivity in the sector has improved markedly, especially where assets have been privatised.

While changes to the Rules are needed in a number of respects to align them with current accepted regulatory practice, departures from current practice are warranted to the extent that they address identified problems and move further towards best practice regulation. However, it is important that the flexibility of the current regulatory framework is maintained to allow the AER the capacity to respond to the individual circumstances of each business.

Conclusion

As we move more into the 21st century what do we expect to happen?

The role of the AER is set to expand over the next 2 years. 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.

The AER has well and truly commenced planning for its increased role and functions and is keen to get on with it.

The new regulatory framework also gives equally important roles to the AEMC and the ACCC. While the AEMC will have responsibility for market development, the ACCC will continue its role as competition regulator.

The role of the courts will also expand with the introduction of limited merits review for all electricity and gas decisions. Now this could be seen (especially by a regulator) as a negative. However, it does provide an opportunity for further certainty in regulation. No doubt entities will test the AER’s decisions in the Courts and the AER is more than happy for its decision to be tested. As the outcomes of the Courts decisions should provide clarity for all parties and hence enhance regulatory decision making.

There is also scope for the role of governments to decline. While they will continue to be responsible for energy policy matters, the regulatory institutions that have been established should be allowed to carry out the day-to-day running of the energy markets and energy regulation.

The stage has been set.....