INFORMATION

Economic regulation of networks

Economic regulation of network service providers and the price and revenue regulation of gas services

Draft determination and draft rules

The AEMC draft determination and draft rules on network regulation better equip the Australian Energy Regulator (AER) to develop methods and processes to achieve efficient outcomes in setting revenues and prices for consumers in a number of areas. They include how the rate of return on capital is set.

The AEMC proposes changes to the National Electricity Rules (NER) and National Gas Rules (NGR) to improve the strength and capacity of the regulator to determine network price increases so consumers don't pay any more than necessary for the reliable supply of electricity and gas.

The proposal provides flexibility in the National Electricity Rules (NER) for the AER to adapt its approaches to the nature of the business it is regulating.

It clarifies the AER's powers to undertake benchmarking, including requiring the regulator to publish annual reports on the relative efficiencies of electricity network businesses. The proposed rule promotes greater confidence in the decisions of the regulator and the regulatory process.

The draft determination also includes changes to the rate of return provisions in the National Gas Rules (NGR) which are applied by the AER in the eastern states. In Western Australia the gas rules are applied by the Economic Regulation Authority.

Our proposals

The AEMC draft determination proposes to change rules governing:

- Rate of return (electricity and gas)
- Capital expenditure incentives (electricity)
- Capital expenditure and operating expenditure allowances (electricity); and
- Regulatory process (electricity).

The most significant factors that determine the revenues earned and prices charged by network businesses are the size of their asset base and the rate of return on capital. The draft rule determination released today proposes significant changes to these areas, as well as others:

1. <u>Rate of return (under National Electricity Rules and National Gas Rules)</u>

- The AEMC is proposing a new rate of return framework that is common to electricity distribution, electricity transmission and gas. It requires the regulator to make the best possible estimate of the rate of return at the time a regulatory determination is made. It requires the regulator to take into account market circumstances, estimation methods, financial models and other relevant information.
- The regulator is required to undertake an open and consultative process at least every three years to develop its approach to setting the rate of return.
- The proposed common framework also enables the regulator to take a range of different approaches to estimate the return on debt component, potentially allowing for reduced risk for debt financing for network businesses.

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Final rules will be in place by November 2012.

The AEMC's draft determination acts on the need to promote efficiency in a changing environment.

Our proposals (continued)

2. Capital expenditure incentives (under National Electricity Rules)

- The draft determination provides for new tools under the NER, such as capital expenditure sharing schemes and efficiency reviews, so the regulator can incentivise network service providers to invest capital efficiently.
- The regulator can apply the tools as it considers appropriate to each network business, having regard to an overall objective. That objective is that only capital expenditure that is efficient should form part of the regulated asset base.
- The benefits of reviewing the efficiency of past capital expenditure include contributing to the regulator's analysis when assessing expenditure proposals and setting future expenditure allowances.

3. Capital expenditure and operating expenditure allowances (under National Electricity Rules)

- The draft determination improves clarity and removes ambiguities regarding the powers of the AER to interrogate, review and amend capital expenditure and operating expenditure proposals submitted by network service providers.
- Under the proposed changes, the AER is also required to publish annual benchmarking reports, setting out the relative efficiencies of network businesses.

4. Regulatory process (under the National Electricity Rules)

- The regulatory determination process would be lengthened by six months and other changes are proposed to enhance stakeholder involvement particularly by community representatives.

Implementation

Arrangements will be required to transition network businesses to the new rules. The AEMC's implementation proposal will be published by mid-September 2012 for public consultation.

Rule change requests and timing

This draft determination responds to rule change requests received from the AER and a group of large energy users (Energy Users Rule Change Committee EURCC) to change the electricity and gas rules in relation to the economic regulation of network service providers.

Timing and next steps

These rule change requests were lodged by the AER and EURCC in September and October 2011 following the close of the first regulatory period for each network business.

The areas of reform identified in the draft determination have been evaluated in a directions paper and discussed at forums across Australia. The AEMC has looked at the available evidence and considered approaches taken by other regulators in relevant jurisdictions in Australia and overseas including NSW, WA, UK and NZ,

Stakeholder comments are now being sought of the package of amendments in the draft determination.

Submissions close on 4 October 2012.

The final determination and rule will be made in November 2012. Final rules will be in place by November 2012.

Changing context for the rules - electricity

The National Electricity Rules govern the operation of the National Electricity Market (NEM). The National Gas Rules govern access to natural gas pipeline services and elements of broader natural gas markets. The AEMC makes and amends both sets of rules. The rules are applied by the AER to set the maximum revenues that may be earned and prices charged by electricity and gas network businesses to deliver energy to customers. In Western Australia the NGR are applied by the Energy Regulation Authority of Western Australia.

The five-year regulatory cycle was established to help ensure a stable investment environment. The current rules for electricity distribution were developed by the then

Network regulation in Australia is economic regulation – which means the AER is focussed on regulating revenues and prices for network service providers.

Ministerial Council on Energy (now Standing Council on Energy and Resources) and commenced in January 2008. The current rules for electricity transmission were developed by the AEMC in 2006.

At the time these rules were developed, major concerns were investment certainty and meeting reliability. The external environment, including financial markets, had been stable for a relatively prolonged period.

Since the current rules were developed the environment has become more dynamic. There are a range of reasons for this. They include growth in peak demand relative to average demand requiring additional infrastructure; increased reliability requirements; and changed costs associated with post-GFC capital markets. The AEMC's draft determination acts on the need to promote efficiency in this changing environment while providing regulation that is adaptive to changing circumstances.

Network regulation and electricity price rises

In recent years, rising transmission and distribution network costs have been the single biggest contributor of electricity price increases in the eastern and southern states of Australia. Collectively, transmission and distribution network costs are a bigger contributor to overall electricity prices increases than wholesale and retail costs.

There is no one single cause for the electricity price increases consumers are facing.

Increased network costs have been driven by a number of factors including:

- investment to meet growing peak demand;
- investment to meet reliability standards and requirements;
- investment to replace ageing infrastructure; and
- costs associated with attracting capital for investment.

The rules enable the regulator to set maximum revenues and prices that networks may earn and charge. This package of amendments improves the strength and capacity of the regulator to carry out its functions in approving future spending by network businesses.

Other factors also relevant to the outcomes experienced by consumers are:

- the application of the rules by the regulator; and
- the management of businesses by their shareholders and managers.

Continuing reform agenda – electricity

The AEMC's work program is enhancing the rules to allow businesses and the regulator to deliver reliable electricity supply for consumers in the most cost efficient way. This requires an electricity market that can adapt to changing circumstances and deliver efficient investment and innovation.

Our other work also focuses on driving efficient electricity market outcomes:

- The Power of choice review is creating a framework to allow innovation and customer choice to drive the most efficient use and delivery of energy services. It is looking at ways for consumers to have more control over the way they access electricity and the prices they pay.
- The Transmission frameworks review addresses the need to create a flexible framework to deliver cost efficient investment in future generation and transmission.
- The NSW reliability standards review is looking at the costs and benefits of different levels of reliability outcomes for consumers in NSW.

We are providing advice to governments on all these areas over the coming weeks and months.

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