INFORMATION

New rules for networks

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

The AEMC has decided to change 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.

Position paper released

The AEMC has released its final position on new rules to regulate electricity network prices. The new rules 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 new National Electricity Rules (NER) mean the AER is able to adapt its approaches to the nature of the business it is regulating.

They clarify the AER's powers to undertake benchmarking, including requiring the regulator to publish annual reports on the relative efficiencies of electricity network businesses. The new rules aim to promote greater confidence in regulatory outcomes.

This new rules will include changes to rate of return provisions in the National Gas Rules (NGR) which are applied by the AER in the eastern states. In Western Australia these gas rules are applied by the Economic Regulation Authority.

New rules overview

The AEMC has decided to change the 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 their rate of return on capital and the size of their regulatory asset base. The AEMC has made significant changes to these areas, as well as others:

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

- The new rate of return framework 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 new common framework 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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New rules will be in place on 29 November 2012.

The new rules act on the need to promote efficiency in a changing environment.

New rules overview (continued)

2. Capital expenditure incentives (under National Electricity Rules)

- New regulatory tools such as capital expenditure sharing schemes and efficiency reviews, are introduced so the regulator can incentivise network service providers to invest capital efficiently.
- The regulator is able to apply the tools it considers are appropriate for each network business, in order to meet the important objective efficient capital expenditure should form part of the regulated asset base.
- The regulator is able to review the efficiency of past capital expenditure when assessing expenditure proposals from network businesses and setting future expenditure allowances.

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

- The new rules improve clarity and remove ambiguities regarding the powers of the AER to interrogate, review and amend capital expenditure and operating expenditure proposals submitted by network service providers.
- 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 is lengthened by four months to expand opportunities for stakeholder involvement particularly by community representatives.

Implementation

The AEMC's final position will be confirmed when the AEMC publishes its final determination and final rules on 29 November 2012. In these documents the arrangements required to transition network businesses to the new rules will also be set out.

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

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 rules were developed the environment has become more dynamic. There are a range of reasons for this, including peak demand increasing relative to average demand requiring additional infrastructure; increased reliability requirements; and changed costs associated with more volatile capital markets post-GFC.

The new rules will promote efficiency in this changing environment while providing regulation that is adaptive to changing circumstances.

Network regulation in Australia is economic regulation – which means the regulator is responsible for regulating revenues and prices for network businesses.

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 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 funding 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 allowances 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 efficient risk allocation and investment in future generation and transmission.
- The Reliability Standards Review is looking at the merits of moving to national framework for setting distribution reliability standards.

We are providing advice to governments on all these areas.

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15 November 2012