National Energy Market Lawyers Forum
Sydney

ACCC and energy reform

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Ed Willett, Commissioner

Australia's energy sector directly contributes over $24 billion to our export wealth and many billions in indirect exports by underpinning the success of other key industries such as aluminium, steel, and paper.

Domestic demand for energy is now estimated at around $50 billion per annum, and is projected to increase by 50 per cent by 2020, with the industry itself estimating that investments of at least $37 billion will be required to meet the nation's energy needs over this period.

These are massive figures in anyone's language, and show how essential it is that we get the regulation right in Australia to ensure the energy sector continues to evolve from the rigid state-controlled markets that existed prior to the establishment of National Competition Policy to meet the growing domestic and international demands.

An important step in this regard is the establishment of a single, consistent and independent Australian Energy Regulator which will reduce regulatory costs to business and barriers to entry and ensure Australia can continue to meet its energy needs and continue to benefit from reliable and cheap energy.

However, opening up such a massive and tightly controlled markets as gas and electricity distribution and transmission was never going happen without some problems.

So I will be talking today about the successes that have occurred under National Competition Policy, but also the barriers that still remain to a truly competitive and efficient national energy market.

Recent developments in electricity regulation

Since 1999 the ACCC has progressively assumed responsibility for regulating transmission from state regulators.

Over the first five years of this regime around $4.6 billion will have been invested in transmission. This investment adds around 36% to the replacement costs of transmission assets. This is very high considering the long life of these assets.

These high levels of investment have come at a price though. Transmission nominal prices have increased in all states, rising by an average of 16%. The increase in prices has been a result of growing demand and the need to accommodate efficient investment to ensure a reliable supply of electricity to Australia.

Reliable and transparent service standards are crucial, which is why earlier this year we issued our draft decision on transmission service standards in the national electricity market.

Our approach would see the impact of transmission network constraints and outages in the NEM quantified, with quarterly reporting.

We believe these measures will provide increased transparency about a transmission network service provider's quality of service performance.

The measures are also a first step towards creating new incentives for transmission companies to take into account the impact of their decisions on the market.

The Commission also recently issued its *Draft Statement of Regulatory Principles for the Regulation of Electricity Transmission Revenues* (DRP).

Our aim here is to improve the climate for investment through greater certainty, improving incentives for efficiency, and providing greater transparency about transmission network performance.

Further, the ACCC is adopting an incentive form of regulation which aims to encourage efficiency while balancing the provision of adequate service quality to consumers.

The recent Somerville review of the Qld distribution network recommended that the Qld regulator, the Queensland Competition Authority, establish a capital expenditure regime similar to that which has been proposed by the ACCC.

The Somerville panel's report criticised the Qld distribution companies, Energex and Ergon, for under-investment, but noted that there were a number of factors underpinning the underspending. One factor noted by the panel was that QCA's current approach to capital expenditure is to set a firm investment cap, which means that distributors are not permitted to earn a return on capital expenditure that is above the amount submitted to the QCA. The Somerville panel said that this approach works well in times of low growth, but in times of high growth in demand, such as that which is currently occurring in Qld, this approach can cause the wrong outcome (distributors are restricted from spending more than forecast in times of high demand growth).

Therefore, the Somerville report proposed a similar approach to the ACCC's capital expenditure approach, which ensures that the regulatory framework is flexible to respond to changes in key investment drivers, such as unexpected demand growth, in order to achieve acceptable reliability outcomes.

In July the Commission also released its final decision on the review of the electricity regulatory test, the cost-benefit test used by transmission and distribution businesses to assess interconnectors and other network investments.

The amendments will promote further interconnection between states, which will in turn increase competition between generators.

The final decision outlines amendments to the regulatory test to ensure consistency between it and the National Electricity Code and provides greater guidance on what should be included as a cost and a benefit.

The decision outlines a workable methodology for the inclusion of competition benefits in the regulatory test although the inclusion of these benefits is only an optional add-on which transmission network service providers can choose to pursue if they wish.

In addition to the rising prices and the issues of service standards, the Commission is concerned by a recent rash of mergers in the electricity sector and moves to reaggregate the National Electricity Market.

In recent times the Commission has received several applications for informal clearance for proposed acquisitions that would bring many of the elements of the electricity supply chain back together and would re-aggregate the contestable generation and retail sectors. Such substantial re-aggregation in the NEM would be a reversal of the pro-competition structural reforms that have been achieved over the past decade.

There are three types of mergers that raise particular competition concerns in the National Energy Market:

1. ***Vertical mergers between transmission, distribution, generation and retail entities***

Vertical mergers may give the merged entity the ability and the economic incentive to restrict the level of competition in the contestable market by restricting its competitor's access to the essential facilities it controls. The entity could do this by raising prices, imposing terms for access that raise cost for their competitors, or through a more subtle reduction in the quality or timeliness of the essential service.

The Commission considered these issues in relation to the proposed acquisition of TXU Australia by SP Energy. The proposal raised significant competition concerns regarding the joint ownership of parts of the National Electricity Market transmission network with merchant activities in generation and retail.

However, following the offer of court-enforceable undertakings by SPE, the ACCC is satisfied that its concerns have been addressed and will not be intervening to block the acquisition.

2. ***Vertical mergers between generation and retail sectors***

The Commission is concerned that cross ownership between base-load generators and large incumbent retailers may reduce the ability of other retailers to secure competitively priced hedge contracts.

Such vertical integration also creates an incentive for other generators and retailers to merge, creating a market dominated by integrated generator-retailers. This would increase barriers to entry, leading to fewer new entrants and less intense competition in the retail market. However, the Commission recognises that this may be an issue primarily because of the current state of development of the NEM. There is nothing intrinsically wrong with vertical integration between generators and retailers in the long term (in fact, the Commission recognises many advantages), provided both generation and retail markets become and remain effectively competitive.

This is a significant challenge that the Commission faces in addressing the issues raised by electricity mergers and we are eager to develop solutions to prevent inappropriate concentration and re-aggregation in the electricity industry.

3. Horizontal mergers between generators

In general, our main concern is the ability of a large merged entity to manipulate spot prices and also to influence future contract prices.

NSW Government Trader Proposal

In terms of future merger activity in the electricity industry, the ACCC is aware that the NSW Government is consulting widely on a “trader proposal”, whereby the NSW government would allocate the trading rights to the physical activities of the generation and retail businesses (i.e. generator bidding and wholesale market purchases by retailers) to separate private sector entities. In exchange for the trading rights, private sector traders would pay the NSW Government a fixed fee, over the life of a contract of around five years.

As a starting point, the NSW Government has proposed that it would tender out three trader contracts to be linked to the capacity of the three existing generation companies (Macquarie Generation, Delta Electricity, and Eraring Energy).

A private sector trader would then determine how much capacity of each State-owned generator is traded in the NEM.

Retail trading arrangements would differ according to whether the customer was supplied under regulated or negotiated contracts arrangements. The State owned retailers would continue to provide retail services to *small* retail customers on regulated, standard form contracts. The Electricity Tariff Equalisation Fund (ETEF) would be retained for this group of small retail customers (currently the majority of small customers for now).

Responsibility for servicing and supplying customers on *negotiated retail contracts* (mostly large users at this stage) would transfer from the government owned retailer to a private *retail manager*. This would involve the appointment of four retail managers to manage the negotiated retail customer accounts of the NSW Government owned retailers, under a model called the *Agency Contract* (AC) model.

The trader proposal presents an opportunity for structural reform in New South Wales where ownership of generating capacity is concentrated among a few large companies (comprising more than 95 % of total generation capacity, all government owned). Structural reform can be achieved either by disaggregating the existing owners, or by ensuring that the trading contracts, particularly for generators, are allocated to new market entrants.

The trader proposal could also improve the competitiveness of the underlying market structure. In NSW the generation companies currently operate as ‘portfolio companies’, meaning that each company owns a number of generating units.

As Parer noted, this structure may strengthen the ability to exercise market power, particularly if the portfolio consists of a mix of baseload and peaking plant.

The NSW government has said that although it would tender out three trader contracts linked to the capacity of the three existing generation companies, the proposal is sufficiently flexible to allow for more than three contracts, such as for specific power stations.

The allocation of the trading contracts to more than three generation traders would further enhance the competitiveness of the market structure in NSW.

It is possible that some bidders for the trading contracts will seek to combine generation and retail activities. The ACCC recognises that in some cases, vertical integration can be advantageous, provided that there is effective competition at the horizontal level. For example, a vertically integrated generator-retailer may not raise significant competition concerns if there is effective competition in the separate retail and generation markets. Therefore, competition is likely to be enhanced in NSW if the trading contracts are allocated amongst individual, competing traders.

Parer specifically recommended that the NSW Government should further disaggregate its generation assets, and abolish the Electricity Tariff Equalisation Fund. This would enhance the success of the NSW government's proposal in achieving efficient, competitive market outcomes. However the NSW Government has decided to retain ETEF for the suppliers of small, regulated retail customers.

Overall, the trader arrangements should be welcomed: in many respects, they offer the opportunity to improve the effectiveness of, and competition in, electricity markets, including by diversifying participation in these markets.

However, it is also possible, on particular scenarios, that implementation of the arrangements will increase competitive risks. The ACCC will take a strong interest in the implementation of the proposed NSW trader arrangements, and will oppose any arrangements that are likely to substantially lessen electricity market competition. Acquisitions by large existing generators and/or retailers and vertically integrated acquisitions are more likely to raise competition concerns. In particular, the trader arrangements in generation currently proposed, retaining the three portfolio generation interests, may limit the field of available potential acquirers.

Gas

The record in the gas industry under National Competition Policy reforms has been more positive.

The gas industry has ended the bad old days when local authorities took gas supplies from monopoly producers under long term contracts that left little room for an injection of competition from third parties.

Gas consumption has grown at an accelerating rate since the mid-1990s, averaging four per cent since 1995, while gas has increased as a proportion of Australia's energy mix from 12 per cent in 1980/81 to 20 percent in 2000. The augmentation of coal fired energy with natural gas is also, of course, a big plus for the environment.

The development of an effective access regime over the past decade also means niche players can now invest in gas exploration and development, confident they can access transmission and distribution systems on reasonable terms.

Now, with access to pipelines and other infrastructure available we are seeing a number of new developments in the Otway Basin, coal seam methane developments in New South Wales and Queensland and other new fields coming on stream, such as Yolla and Patricia/Baleen. It is also encouraging to see a number of new explorers have taken acreage in the Cooper Basin and major exploration programs foreshadowed or underway in the Gippsland Basin.

This is in turn increasing investment, diversity in ownership and reducing concentration of ownership in upstream gas production markets.

But here too, there have been recent developments which have caused some concern, namely, recent rulings on appeals under the Gas Code.

MSP appeal

On 4 August the ACCC lodged an application with the Federal Court for a review of the Australian Competition Tribunal's ruling on the Moomba to Sydney gas pipeline access arrangement.

Most of you will know that part of the Moomba to Sydney pipeline (or MSP) is what is known as a covered pipeline under the Gas Code. This means the service provider is required to submit an access arrangement to the ACCC for approval.

The access arrangement describes the terms and conditions of gas transportation services, including the price (known as the reference tariff). Allowing third party access to gas pipelines was one of the competition reforms introduced in the 1990s designed to promote competition in the gas industry.

In October last year the ACCC issued its final decision on the access arrangement submitted by pipeline owner EAPL to the ACCC for approval.

The ACCC did not approve the proposed access arrangement and specified several amendments that would have to be made.

EAPL declined to submit a revised access arrangement that complied with the ACCC's final decision. The ACCC, therefore, had to draft and approve its own access arrangement which prompted EAPL to lodge an appeal with the Australian Competition Tribunal.

While this was happening, the Minister for Industry Tourism and Resources decided that the Moomba to Marsden section of the pipeline would no longer be regulated.

This means that EAPL is free to set tariffs on that part of the pipeline without having to seek approval from the ACCC. This leaves only about 40 per cent of the pipeline (Marsden to Wilton and some laterals) which is still regulated.

The tribunal upheld the appeal on the primary issue of the initial capital base of the pipeline - using a valuation method that neither the ACCC nor the service provider had proposed. The Tribunal decided that the value of the initial capital base should be set according to the depreciated optimised replacement cost (or DORC) methodology. Its interpretation of the Gas Code in MSP decision, in the ACCC's view, also conflicted with that of the WA Supreme Court in its decision on the Dampier to Bunbury gas pipeline.

The Tribunal did not calculate a value for DORC, but referred the matter back to the ACCC. In its final decision the ACCC did consider this approach, but favoured more orthodox methodology.

The Tribunal seems to be suggesting that the ACCC did not adopt this new approach simply because it was, and I quote, 'too difficult'. The ACCC does not consider that this adequately portrays either its position or that of the expert advice it received on the approach.

This new approach requires estimates of long term cost differences between new and existing assets. Given the imprecise nature of the data, the ACCC did not consider that a value for DORC could be estimated with any degree of confidence.

The Tribunal made further comments on the interpretation of certain sections of the Gas Code in relation to setting the value of the initial capital base. I don't intend to go into detail here but by lodging its application for review, the ACCC is also seeking clarity on those issues.

The Tribunal's decision was the fourth occasion on which it has had to make a ruling under the Gas Code.

However, it's worth putting these appeals in perspective. The ACCC has approved 12 access arrangements. These arrangements embody a large number of discrete but often interrelated decisions. Most disagreements between the ACCC and the service provider are resolved during the ACCC's consideration of the access arrangements.

Across the four Tribunal cases there were a total of 22 grounds for appeal. That is, when the Final Approval was issued the ACCC and the service provider had not reached an agreement on 22 aspects of the access arrangements.

The service provider abandoned 10 of these grounds before the Tribunal even considered the matter. On a further 3 the ACCC conceded the point. In 7 of the original 22 the Tribunal found in favour of the applicant, while in 2 cases the ACCC's decision was upheld.

Another way to assess the outcome of this process is to look at the impact of the revenue outcome of the Tribunal's decision benchmarked against the service provider's application and the ACCC Final Approval.

As you can see from this slide, even when the Tribunal has upheld the appeals the final revenue outcomes have fallen well short of the revenues originally claimed by the service provider.

Gas Tribunal decisions

Effect on revenue

	Service provider	ACCC	Tribunal
MAPS	$59m	$50m	$54m
GASNET	$95m	$77m	$79m
MSP	$86m	$68m	?

Note: for MAPS, ACCC rev of $50m is an estimate excluding the Pelican Point expansion ($54m with expansion)

Now, you would think that after all these rulings that regulators would have some clear guidance on how to apply the Gas Code.

The ACCC does not consider that this is the case, and we have therefore begun the legal challenge in order to bring certainty and clarity to the process.

Our concern is that the current approach rewards cherry picking, and encourages appeals where the applicants have nothing to lose and everything to gain by challenging specific aspects of our decisions, while leaving the rest of the decision untouched.

By seeking review of the Tribunal's decision the ACCC looking for some certainty and clarity on these issues.

For all the criticism we've heard from industry over the Gas Code, the facts show it has worked very well for consumers, industry and the nation.

Material prepared by consultants ACIL Tasman for the ACCC's submission to the Productivity Commission estimates the benefits of gas and electricity access regulation to the economy at $2.2 billion to $11 billion over a 15 year period, and the costs at just $185 million.

For consumers, ACIL Tasman estimates that without access regulation the price for transmission and distribution services could have been significantly higher.

Yet even with this price restraint gas transmission companies have done very well.

Businesses in ASX Utilities Index outperformed the S&P ASX 300 accumulation index over the past four years. Moreover, the market values of these businesses trade at a premium to the value of their regulatory asset bases.

And ACIL Tasman found there was no clear evidence of the current regulatory practice having caused the delay of any particular pipeline investment, and there had in fact been a high level of investment over the period since the introduction of access regulation. Neither Parer nor the Productivity Commission found any specific instances of chilled investment in gas pipelines, despite the persistent claims of gas transmission interests, although the Productivity Commission did suggest that the gas access regime is likely to be distorting investment in favour of less risky projects.

ACIL's modelling indicates that over the next 10 years only limited capital expenditure on greenfield transmission pipelines will be required as most of the major demand centres already have significant reserve pipeline capacity.

It identifies only one case where additional investment is required immediately – the expansion of the Dampier to Bunbury Natural Gas Pipeline which has been delayed due to Epic's unique circumstances.

Epic Energy backed by the financial institutions paid around one billion dollars too much for the DPNG believing that, somehow, the clear implications of coverage of the pipeline under the Gas Code would not apply to them. A second pipeline to meet Western Australia's needs could be built for around $1.2 billion. If it were not for the costs of a two year wait faced by energy consumers in the Perth region who desperately need more power, a second pipeline could be the best solution.

Regardless, the financial institutions may have to face up to the fact that, had they been investing into a competitive market, funding the acquisition of an asset where the buyer paid around a billion dollars too much would quickly mean substantial losses for all involved. Coverage of a pipeline under the Gas Code should mean that investors face similar disciplines and incentives.

The comprehensive ACIL Tasman analysis has been subject to some underwhelming and simplistic criticism recently. It is disappointing that purportedly serious commentators respond by mere assertion and rhetoric to such a serious and rigorous contribution to the debate. In particular, the assertion that the Productivity Commission 'demolished' the credibility of this work is simply wrong.

The essential point established by ACIL Tasman analysis is that abuse of monopoly power by gas pipelines, where that monopoly power exists, can have large detrimental long term implications for wealth creation and economic development. In the same work, ACIL Tasman made the same point about abuse of market power by electricity networks, which appears to be uncontested.

In the past, gas pipeliners and their consultants have consistently claimed that gas pipeline regulation could, at best, have only small beneficial effects on competition and efficiency because the differences in tariffs with and without regulation would be small. The ACIL Tasman work refutes those claims. In fact, the ACIL Tasman work underestimates the benefits of regulation because it does not take account of the pro-competitive effects of the regulation of non-price terms and conditions offered by pipelines with market power. The Hilmer report considered that the regulation of non-price terms and conditions was probably more important than the regulation of prices. However, the former are much more difficult to model.

For the final word on this debate, I can’t go past this conclusion from the Allen Consulting Group on the impact of regulation on investment:

> *In summary, there is no evidence to suggest that Australia’s regulatory framework is deterring investment in regulated utilities. On the contrary, the regulated utilities sector has relatively strong investment fundamentals, whether compared to the Australian market or internationally.*

I also draw your attention to the final report of the Productivity Commission's review of the gas access regime.

The Productivity Commission is, as most of you in this audience are well aware, not the biggest fan of regulation so it is significant that its report recommends retention of a gas-specific regime, after finding the original arguments for the regime are still valid and are likely to remain so for some time.

The report observed that Australia has seen developing competition in upstream and downstream markets, lower gas transport charges, significant pipeline investment and efficiency gains for the broader economy under the existing regime.

Moreover, it found the gas market is maturing and the construction of new pipelines has assisted basin on basin competition.

By and large, the ACCC welcomes and supports the recommendations set out in the report, many of which we believe will streamline the functioning of the current regime resulting in lower administration and compliance costs.

Australian Energy Regulator

At the end of the day, whether industry or consumers choose gas or electricity should not be determined by differing regulations favouring one sector or the other. The goal of regulation should be to allow both to develop in a way that encourages competition within, and between the two, to the benefit of industry, end users, and the nation.

This is one of the key principles behind the agreement to establish a single, consistent and independent Australian Energy Regulator.

Different approaches to regulating utilities across industries distort investment decisions and create unnecessary costs and barriers for utilities operating in more than one industry.

Consistency in regulation across gas and electricity, and across the different jurisdictions, will reduce regulatory costs to business and reduce barriers to entry by interstate companies.

Another of the key principles behind the AER was that should be independent in its decision making, but through its close links to the ACCC able to take an approach consistent with competition law

The AER has been established under the *Trade Practices Act*, and will be a part of the ACCC but a separate legal entity. This means that the AER will make decisions on regulatory matters independently of the ACCC.

There will be a single body of staff providing assistance to both the AER, and to the ACCC on energy matters, creating a substantial body of specialist skills and knowledge. This will deliver the objective of a single national energy regulator and avoid duplication of processes by the ACCC and AER.

The ACCC will continue to perform its existing functions under the Trade Practices Act. These include:

- enforcement of Part IV (Restrictive Trade Practices, including mergers)
- authorisation of conduct under Part VII that may otherwise contravene the Trade Practices Act; and
- approval of access codes and acceptance of access undertakings.

Recent amendments to the Trade Practices Act facilitate a new streamlined process for amending the electricity and gas codes, allowing the ACCC to rely on consultations undertaken by the Australian Energy Markets Commission (AEMC) in making our rulings.

The amendments also streamline the authorisation process for the National Electricity Code, allowing the ACCC to rely on consultations that have been separately undertaken by the AEMC in a code change process.

The AER will assume the ACCC's current electricity transmission revenue regulation functions, and NECA's National Electricity Code compliance monitoring and enforcement functions.

The AER's regulatory functions initially include regulating electricity transmission revenues, and ensuring compliance with the National Electricity Code.

From July 2005, the AER will regulate gas transmission for all jurisdictions except Western Australia, with provision for WA to join the gas regulatory scheme by agreement.

During 2006, the AER will become responsible for the regulation of electricity distribution and retailing, other than retail pricing. Jurisdictions may transfer responsibility for regulation of retail prices to the AER.

Conclusion

It's fair to say that the opening up of the energy sector as a result of National Competition reforms have benefited the nation. The reform processes have worked well, especially in gas, but less so in electricity.

In gas, the reform process is almost complete with reform issues now focusing on refinement of the Gas Code and honing interpretations of the Code by regulators and review bodies. The benefits realised to date from gas reform have been substantial, with much more to come as competition and production in gas markets continues to grow.

The problems that have arisen in the electricity sector are evidence of the need for further reform – not less, and a strong case for why we must further develop the National Electricity Code and the National Energy Market, both from a policy and regulatory point of view.

The ACCC is playing its part: we have proposed reforms to almost all aspects of its regulatory functions. As recently recommended by the Productivity Commission (in its draft report for the National Competition Policy Review) governments should complete the NEM reforms.

In particular, the ACCC is concerned by trends toward reaggregation within the NEM which pose risks to competition and threaten to undo the benefits of the reform process and we will intervene against any arrangement that we believe is likely to substantially lessen competition.