



**UTLICON**

**5<sup>th</sup> Annual National Gas Conference**

*How Is The Current Regulatory Regime Contributing To  
Further Reform And Competition In Australia?*

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## **Introduction**

I wish to speak today about the state of utility regulation, focusing on three industries: gas, electricity and telecommunications. While I believe it is clear we have made significant advances in all three of these industries in the past six years, some question whether the reforms are achieving their objectives. As you will be aware, the Productivity Commission is inquiring into both the national access regime and the telecommunications-specific legislation in the *Trade Practices Act*. Today I will be making a number of observations about issues raised in these inquiries, and elsewhere.

The issues I will discuss can be grouped under five key questions:

- Why do we regulate utilities rather than let the market operate freely?
- Why do we have industry-specific regulation rather than “one size fits all”?
- Do the regulations allow regulated utilities to earn reasonable returns commensurate with the risks they face? Associated with this, do the regulations allow an appropriate level and pattern of infrastructure development to occur?
- Are the regulatory processes used appropriate? *And*
- What are the important issues of governance? In particular, I will spend some time discussing current impediments to the achievement of a national electricity market.

## **Why Do We Regulate?**

Prior to the 1990s many utilities were government owned monopolies exhibiting a high degree of vertical and horizontal integration. Economic regulation lacked transparency, was highly politicised and had insufficient regard for the promotion of competition. With commercialisation, corporatisation and perhaps especially privatisation it was clear that something much more sophisticated was required.

We now have in place regulatory frameworks which allow for independent regulatory decision making. Regulatory principles and precedents have been rapidly developed. Importantly regulation operates within the context of a strong pro-competition policy. It is clear that regulation and competition policies are starting to bite. They are drawing strong criticism from vested interests keen to maintain powerful incumbent positions. Rent seeking behaviour is

manifest in the large quantity of resources being channelled into trying to influence the outcomes of current inquiries by the Productivity Commission and Government decisions.

It is important that Governments and Regulators resist this rent seeking behaviour and clearly focus on the need to develop effective pro-competitive regulation and the public interest.

Regulation in the utilities sector is necessary to prevent the misuse of market power. In particular where utilities are vertically integrated there may be concerns that access on non-discriminatory terms and conditions to essential facility services will be denied by incumbent operators. In other cases there may be a simple concern that monopoly power will be mis-used by charging exploitative prices.

Regulation can open up an “essential facility” to third party access to promote competition in the contestable upstream and downstream markets. It can ensure the terms of access are reasonable and prices are efficient. Efficient prices allow for necessary new investment to be undertaken and for firms to obtain appropriate returns commensurate with the risks involved.

Many “essential facilities” exhibit natural monopoly characteristics, in that one firm can supply the whole market at a lower unit cost than two or more firms. Indeed, there seems to be a mindset emerging that regulation is not required where there is more than one firm in the market. A proposal to change the declaration test suggests that the wording of one of the criteria of the declaration test should be changed from “that it would be uneconomical for anyone to develop **another** facility” to “it would be uneconomical for anyone to develop a **second** facility.” The Commission does not believe that having two suppliers for a service necessarily makes the provision of that service competitive. Economic theory does not suggest that duopoly is much better than monopoly in terms of pricing and efficiency.

### **Why Do We Have Industry-Specific Regulation?**

Consider the case of telecommunications. In its Draft Report released in March, the Productivity Commission recommended a move away from industry-specific regulation such that Part XIC should be changed to become more like Part IIIA. However, the Commission believes that Part IIIA as currently expressed would not sufficiently address the issues facing the telecommunications industry. The Commission’s research has indicated that at least two services — including the unconditioned local loop service — currently declared under Part XIC would

not meet the proposed declaration criteria even though most would probably agree they should be.

There are three key factors unique to telecommunications that justify the existence of a separate regime under Part XIC. These include:

- The overwhelming dominance in the national market, and almost every segment of that market, of a single, vertically-integrated incumbent.
- The need for any individual connected to any network to be able to initiate contact with and receive contact from any individual connected to any other network — any-to-any connectivity.
- The speed of structural and technological change and service development in the market.

Similarly there is an industry-specific code for the gas industry. The National Gas Code contains the regulatory regime for access to nationally significant gas transmission pipelines. Despite the efforts of a majority of states and territories, this regime is not uniform throughout Australia. For example, in 1998 the Queensland Government derogated a number of significant sections of the National Gas Code, preventing the Commission from setting tariffs on four Queensland pipelines. Further, the power to regulate access to gas distribution infrastructure lies with state jurisdictions.

Hence, in the gas sector the national access regime is not a truly national regime and there is potential for inconsistency in the terms, conditions and prices of access to gas pipelines in various Australian states. This is further complicated by the fact that there is a separate regulator for covered pipelines in Western Australia, OFFGAR, although recent decisions by this regulator have been broadly similar in approach to those of the Commission.

The Commission believes that the National Gas Code does have the ability to deliver consistent, efficient and low risk regulatory outcomes to the industry. However, to achieve this the Commission must be able to apply the provisions of the National Gas Code in a consistent manner throughout as many jurisdictions as possible. The Commission rejects the proposal made by members of the industry to the Productivity Commission inquiry into the National Access Regime that the National Gas Code be abandoned and pricing principles written into Part IIIA of the *Trade Practices Act*. The National Gas Code was developed in response to an industry

perception that Part IIIA was too uncertain and would deter investment. Little more than five years after the gas-specific National Gas Code was implemented, industry is complaining that it is too prescriptive. Later I will indicate that experience undermines this view.

### **Are Rates of Return Allowed Appropriate & What Has Been the Impact of Regulation on Investment?**

If you believe some industry participants and observers regulation is having a “chilling” effect on investment. Rates of return are supposedly set so low that planned infrastructure development is in jeopardy.

For example, Telstra has made repeated claims about the fragility of its own investment in areas subject to regulation, and how the supposedly low prices set by the Commission also discourage access seekers from establishing their own network facilities. However, this is completely at odds with the evidence about how much Telstra and its competitors are investing, including in the areas covered by regulation.

The Commission takes account of the risks associated with a project and uses a rate of return commensurate with those risks. The Commission recognises that greenfield projects are likely to be more risky than established infrastructure and uses a rate of return that reflects the higher risk. The Central West Pipeline in NSW is a case in point.

It also puts a lot of effort into observing what others do. For example, a recent study commissioned by the Commission and undertaken by National Economic Research Associates found that, in setting rates of return, Australian regulators are more generous than their US and UK counterparts.

It is also important to remember that, where incentive mechanisms are in place, a service provider has the opportunity to earn a rate of return in excess of the regulated rate of return.

Perhaps most importantly we monitor carefully what is happening with respect to infrastructure development in the industries we regulate.

In contrast to the innuendo, consider some of the hard facts about investment in telecommunications:

- Telstra currently invests over \$4 billion each year and this grew at an average annual rate of over 8 per cent from the mid-1990s to 1999-2000.
- Typically, well over half of Telstra's investment is in the fixed line network in switching, transmission and customer access.

The table below shows net cash used by Telstra in investing activities.

**Telstra's capital expenditures 1994-1995 to 1999- 2000 (millions of \$)**

	<i>1995</i>	<i>1996</i>	<i>1997</i>	<i>1998</i>	<i>1999</i>	<i>2000</i>
Switching	634	659	768	756	644	647
Transmission	335	486	579	584	624	693
Customer access	666	920	848	681	873	1285
Mobile Networks	526	342	330	340	621	628
Broadband network	60	282	459	97	34	30
International infrastructure	112	197	119	143	146	143
Other	905	1018	1145	1223	1424	1422
<b>Capital Expenditures</b>	<b>3238</b>	<b>3904</b>	<b>4248</b>	<b>3824</b>	<b>4366</b>	<b>4830</b>

- While the aggregate of Telstra's investment seems likely to fall in 2000-01, this is explained entirely by the completion of major programs in modernising the CAN and in CDMA.
- Outside of Telstra, current and proposed investment levels are high, especially in mobiles, fibre optics, xDSL and LMDS.
- Investments by other than Telstra include access networks and transmission links in regional Australia.

On the surface, there is no cause for concern in these figures. In contrast to suggestions of a more "insidious" effect of regulation that has not yet shown up, the Commission believes that the robust competition and investment we now see is evidence that the Commission has done its job well and that confidence in our processes is high.

In the near future the Commission will be releasing a report on telecommunications investments. The report confirms that infrastructure development is occurring at a very healthy pace, driven by investments from both Telstra and its competitors. Investments cover fixed-line networks,

wireless and data, and extend from the CBDs to the regions. Competition is a clear driving force of investment in all key areas.

Turning now to the **gas industry**, the current situation there also belies the claim that regulation is deterring **investment** and that regulatory returns are too low. A Reuters report of early July noted investment proposals amounting to \$9 billion of transmission pipelines. There are proposals — at varying stages of maturity — to build second pipelines to Adelaide, Melbourne and Brisbane. There are already two pipelines, the Moomba-Sydney Pipeline and the Eastern Gas Pipeline, delivering gas to Sydney. These developments indicate a high level of confidence in the future of gas transmission pipelines. The push to increase electricity generating capacity in South-East Australia, using gas-fired power stations, is a further signal that demand for gas transmission infrastructure is on the rise.

Supporters of the view that the current regulatory framework is having a deleterious impact on investment have proposed several ways of dealing with this issue.

One concept is to allow a service provider to charge “market-based” tariffs instead of the more traditional approach of tariffs being based on efficient costs. The Commission is happy to consider such proposals recognising of course that so called “market-based” tariffs set by a monopolist may not necessarily be the same as efficient tariffs.

Another proposal is to allow a service provider an **access holiday**, during which time the service provider would not be regulated. This is suggested in the Productivity Commission’s drafts. It is important to note that, as suggested by the Productivity Commission, access holidays would apply to “marginal” new facilities only, not all new facilities.

In theory, the concept of access holidays for “marginal” new facilities might have some appeal. If you can identify in advance that a particular project is only marginal without regulation, then there seems little point in regulating the facility — the costs of regulation would not be offset by any benefits.

What would happen in practice, however, is another matter. In order to qualify for a holiday, owners of all new facilities may argue that their investment is only “marginal”. Apart from determining which projects qualify for an access holiday, other practical problems include



determining the duration of the holiday and the regulatory regime to apply once the holiday is over.

For example, how would you determine the value of the asset base? If during the holiday the facility has incurred a loss, the owner is likely to argue that the asset value should be inflated so that past losses can be recovered from future users.

On the other hand, if the facility has earned above normal returns during the holiday period and the regulator indicates that the asset base should be valued downwards so that users can share in the benefits of the high profits, the owner would claim “retrospective regulation”, “sovereign risk” and that “regulation is having a chilling effect on investment”.

The Commission considers that a better approach is, firstly, to ensure that the criteria that determine whether or not to regulate are sound and, secondly, once a service is regulated, to implement appropriate pricing structures and incentive mechanisms.

## **Governance Issues in Establishing the National Electricity Market**

I will now turn to electricity — a sector that has received a lot of media attention in recent months.

The real debate in electricity concerns the establishment of a national market and the performance of that market and its institutions.

You are all well aware of the issues that have been raised about the performance of the national electricity market (NEM) and its future direction. We have had the NEM on the agenda of CoAG, the recent NEM Ministers’ Forum discussing market performance and the announcement of an independent review for the NEM. This review will commence later in the year and will accompany reviews being undertaken by the NEM jurisdictions and the national code administrator. We might ask: “why all this activity now and not several years ago” and “will this renewed interest by governments lead to better outcomes”?

As a starting point, we need to recognise that the national electricity market is a significant policy and economic achievement that has already delivered real and substantial benefits. CoAG instituted the initial energy market reforms in the 1990s and a great deal of time and effort was invested in devising the market arrangements and the institutions to run the market. The introduction of the market institutions allowed a coordinated approach to the planning of network

interconnection and the implementation of the market encouraged more efficient use of capital and labour as well as the sharing of generation reserves between the states. These benefits are ongoing as the markets mature and become better at managing the risk inherent in trading in a competitive environment.

### *Performance of the NEM*

Much of the recent criticism of the NEM has related to either the performance of the market or the direction the market is taking. In the case of the former, the high electricity prices of the last couple of summers have been seen as evidence that the market is not functioning well. Further, it is alleged that customers are being exploited by the exercise of market power. Finally, some commentators have suggested, rather spuriously, that electricity and competitive markets are not compatible and that there is something inappropriate about the private ownership of electricity assets.

A point is often made that markets are open to manipulation either by way of the exercise of market power or gaming of the rules of the market. Market power is predominantly a function of market structure. The Commission has been a strong advocate of the structural reform of the electricity sector. Having more players is better than having fewer players when there is no significant sacrifice of economies of scale. However, in the reform process, governments were the ultimate arbiters of the number of competing generators and retailers. Some governments moved to disaggregate power stations at the plant level while others combined power stations into competing portfolios.

While the design of the market, such as the compulsory power pool in use in Australia, can amplify market power at the margin, the real determiner has been the decisions taken about the number of competitors in the market. This remains unfinished business and the Commission encourages the NSW and Queensland Governments, in particular, to reconsider moving to a more competitive generation structure in their states. As for the design of the wholesale trading arrangements in Australia, it is expected that this will be an issue for the independent review of the NEM.

Current high prices are an intermediate outcome from a market slowly adapting to price signals which reflect the real value of energy at times of high demand. There have been responses to these price signals already. On the supply side, the market is responding with a number of

proposed generation developments in Victoria and South Australia, where generation is needed most. Enhanced interconnection — both regulated and unregulated — has also been proposed between NSW, Victoria and South Australia.

On demand side, retailers are actively looking at generation options and reducing demand at peak times. As full retail competition proceeds and interval meters become more common, customers will begin to see the relationship between peak use demand and price. This should encourage greater load switching and demand side response generally. So in the Commission's view, all this shows that clearly the market is working. Our task is not to stop it working but to improve the market's efficiency and ability to deliver reliable power at a competitive price.

In this context, it is now important to ensure that the benefits of the electricity industry reform process are passed through to customers, both large and small. Retail competition is being pursued so that all customers can choose their retailer. Where retail contestability involves interval metering, there will be potential for price signals to encourage demand side responsiveness thereby reducing the need for purely supply side responses.

### ***Performance of Governments***

The NEM and its institutions are increasingly becoming the object of political scrutiny. Energy was placed on the agenda of the recent CoAG meeting for the first time in many years. Further, we have seen the state governments re-enter the policy-making process at the NEM Ministerial Forum.

The inaugural Ministers Forum was held in Melbourne last month. The Ministers reaffirmed their commitment to ensuring stability in the market and the Code in order to have an efficient market, competitive power prices, and incentives for long-term investment in the electricity industry.

While the Commission endorses these goals, it is important that the institutional arrangements are set up to allow for their achievement. Having set up the NEM institutional arrangements, some of the jurisdictions now, I believe, feel that they have insufficient control over their creation. Clearly, the political consequences of things going wrong in the electricity market could be far reaching. It is entirely understandable that governments should want to decide the overall framework in which the market develops and have some assurance that it will perform well. However, the vital distinction needs to be made between overseeing the strategic direction

and being involved in the detail of the operation of the market and its institutions. While the Communique recognised this, the attachment to the Communique shows some disturbing signs that Governments want to involve themselves with detail issues, perhaps even picking the winners and losers of any future reform of the market.

While we would all agree that some degree of certainty is essential for investment, and this requires that the path for reform is well known and predictable, the fear is that the processes that have been put into place will not necessarily create certainty in the short-term, and may indeed create on-going uncertainty for the future.

For instance, going back to the CoAG meeting on 8 June, a number of processes were set in motion that will affect energy policy generally and the NEM in particular.

Out of the CoAG meeting we have:

- a new Ministerial Council on Energy;
- the NEM Ministerial Forum that I mentioned previously; and
- an independent review of energy market directions.

While the Commission welcomes the renewed interest of governments and believe there are worthwhile matters that we can revisit, it is difficult as yet to see how these all Councils, Forums and reviews fit together in a coordinated way. For example, the independent review will report to the Ministerial Council and will identify strategic issues and policies required, including regulatory approaches. The Ministerial Council will also look at opportunities for increasing interconnection and system security. The NEM Ministerial Forum likewise is looking at interconnection and a string of other issues including transmission pricing, rebidding, regional boundaries and demand side participation. Further CoAG itself has requested reviews of VoLL and bidding and rebidding rules.

If all of this can be pulled together, there is a real opportunity for progress in electricity markets. But we would emphasise again the distinction between market operations and its evolution, which should be the province of the NEM institutions, and the market framework, where governments have a legitimate strategic role.

Many of the matters listed above as being considered by the NEM Ministers' Forum look a lot like detailed issues of how the market operates. The danger is that in addressing these issues State governments may leave themselves a greater role in the ongoing development of the NEM. Past experiences of government involvement in markets highlight the dangers. First, in dealing with immediate problems, governments facing a short political cycle are likely to make decisions that protect their constituents from negative short-term impacts but which compromise the ability of the market to deliver long-term benefits. Moreover, it must be remembered that it is the long-term benefits of the reforms that contribute overall to the competitiveness of the Australian economy.

Second, it is hard to be confident that policy makers will make decisions in the overall interests of the market, of competition, and thus of end-users, given that some jurisdictions continue to have vested interests in the market as owners of generation and retail businesses. This is an ongoing tension that seems to be influencing how some governments view the electricity market and its evolution. If our market is to deliver all the benefits from the reforms, then this conflict needs to be resolved as soon as possible.

While the risks can be overstated, there may be significant consequences from the combination of partial deregulation and government intervention in the market. This is best illustrated by the recent experience in California. Although there are important differences between our market design and California's, there may be the possibility for the NEM to have the potential to imitate the Californian experience if governments do not clearly set a framework for the operation of the market and do not resolve their conflicting objectives. That framework must delineate the role of governments and limit it to the broader policy issues and leave the operation of the market to NECA and NEMMCO. Anything short of this will deter investors in the market.

However, let us look to the positive side. The NEM jurisdictions have been right to draw attention to the need for clearer energy market directions. In the CoAG Communique, all governments reaffirmed their existing commitments to currently agreed principles, reforms and timetables. Moreover, in the NEM Ministers' Communique Ministers recognised the importance of governments not straying into the role of market operation. In the light of their recommitment to reform, governments must now follow through with the further market development that is required to realise the objective of reform: a genuine national electricity market.

In addition, having accepted the implications of market objectives for the overall policy framework, they will, we hope, renew the mandate of NEM institutions to follow through those objectives into market development.

### ***Performance of Regulators***

As I have mentioned, the institutions of the NEM are under pressure. From recent public statements by State policy makers, it appears a major concern with the governance arrangements is the unclear division of accountabilities between the Commission, NECA and NEMMCO, leading to lack of strategic direction in the development of the NEM.

These concerns have become more pronounced over the last year or so as the Code change process has been placed under pressure by NEM governments. In such a climate, it is difficult for NEM institutions to resolve outstanding issues. Nor is the Commission able to give the guidance that we believe is needed given our limited role in the code change process, although we are happy to provide such leadership.

We need to consider the context of these expressions of concern. There has been ample opportunity to address concerns about governance given that a review into the role of NEM institutions was completed two years ago and its recommendations have yet to be considered. Further, as the NEM jurisdictions appoint the directors to NECA and NEMMCO they have direct lines of communication with the boards of these agencies. Consequently, it is a puzzle as to whether we are talking about the same issue. Does governance mean accountability or does it mean having control or the final say? What we need is to provide NEM institutions with the clear mandate to provide leadership and direction to the market.

Interconnection is a case in point. The lack of development of regulated interconnectors, and hence the limiting of inter-regional trade in the NEM, has led to criticisms of the regulatory arrangements. For example, the National Competition Council's report titled "NCP — Third Tranche Assessment Framework" stated that delays in resolving the SNI project have been excessive and mean that the NEM objective of no discriminatory legislative or regulatory barriers to interstate and/or intrastate trade is not being met<sup>1</sup>.

So far there has not been a regulated interconnector approved under the regulatory test. The Queensland New South Wales (QNI) interconnector proceeded under a derogation from the Code

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<sup>1</sup> NCC, Third Tranche Assessment Framework, 5 February 2001, p. 6.9, [www.ncc.com.au](http://www.ncc.com.au)

approved by the Commission. TransGrid's SNI proposal is therefore the only interconnector to be considered under the Code arrangements.

Concerns regarding the nature of the regulatory process for new regulated augmentations have been addressed in the set of Code changes brought to the Commission titled "Network and Distributed Resources". These Code changes amend the process for determining whether to regulate an interconnector. One of the changes is to remove the market operator, NEMMCO's, responsibility for applying the regulatory test. Instead the proponent TNSP would be responsible for applying the regulatory test, but its determination would be subject to a two-stage dispute resolution process, including the Commission having a final right of review.

In addition to these Network and Distributed Resources Code changes, NEMMCO has established an Interconnector Working Group to investigate and report on the processes for assessment of proposals to establish new interconnectors or augment existing interconnectors<sup>2</sup>. The working group is required to include the proposed Code changes regarding Network and Distributed Resources when undertaking the review of the processes.

While the arrangements for the approval of regulated interconnectors are the subject of discussion and Code changes are currently before the Commission, we consider that the questions surrounding the development of regulated interconnectors need to be considered in the context of the direction of the market. Are we moving towards a zonal/nodal pricing market, where congestion rents signal the need for new investment, or are investment decisions to be left with networks and regulators under some form of centrally planned common carriage regime where investment is undertaken to ensure no network congestion?

The Commission is of the view that for the investment decisions to be driven by the market, the market must empower users of network services to contribute to and benefit from network investment. However, this is not a view shared by some governments who would prefer that networks remain outside the market, even though their behaviour is critical to the success of the performance of the market.

The Commission does not believe the current NEM institutions are in a position to answer such questions in the light of the government debate about NEM governance. That is in part why we welcome the renewed policy interest State governments have taken through the Ministerial

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<sup>2</sup> Interconnector Working Group, Issues for Consultation, 23 April 2001, p. 1.

Policy Forum and would encourage them to consider how we can maintain the momentum of our electricity reforms, reforms that are well recognised around the world. We need to encourage timely and efficient investment in the electricity market, promote competitive outcomes and efficient prices, and ensure that those who pay for and benefit from such investment decisions are given an interest in the outcome.

As the Commission sees it, the choice is starker than some seem to realise. Unless we move to market-based prices signalling the need for new network investment, we will be left with a set of separate regional (ie State) electricity markets. Although they will be interconnected, this will not be a truly national network.

If we don't move all the way to a zonal/nodal pricing market, the next-best alternative would be a centrally planned national network. However, we wouldn't have that either. We'd have the great Australian railway story: separate State networks each going its own way. In fact, that's what we do have. Does that do justice to our potential?

## **Concluding Comments**

Today I have covered a lot of ground, but want to leave you with three main messages.

First, while we recognise the importance of moving forward with the reform process, the achievements of the national competition policy process in increasing competition, improving market signals and promoting efficient investment in gas, telecommunications and electricity have been impressive, and it is good to reflect on just how far we have come.

Second, we are concerned that the multitude of reviews, inquiries and proposed legislative and code changes in regulated industries is being carried out with differing objectives and in some cases only relates to a small section of the industry. In this environment we caution against hasty reactions to problems that are already in the process of being solved. For example, there are already a number of significant investment proposals to address gas and electricity supply shortages in South Australia.

Third, the National Electricity Market needs to be able to continue properly as an integrated national market. We welcome the interest of the various jurisdictions in reassessing the rules and ensuring the right framework is put in place. However, we consider that the appropriate role for government is to provide broad strategic oversight, not to interfere in market operation.



