Australian Competition & Consumer Commission

The Australian Cogeneration & IPP Summit

"How the ACCC will ensure fair competition in the electricity and gas markets"

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1. Introduction

Today I wish to talk to you about the role of the ACCC in reforming the Australian gas and electricity sectors, and the challenges facing the Commission in creating a free trading energy market. Firstly, I would like to briefly describe the background to the Commission's responsibilities in the area of micro-economic reform.

In 1995 the Commonwealth, State and Territory Governments agreed to implement the National Competition Policy reforms. This package included the extension of Part IV of the *Trade Practices Act* to unincorporated businesses and State and Territory Government business enterprises and the creation of Part IIIA of the *Trade Practices Act* which establishes a third party access regime to cover the services provided by significant infrastructure facilities such as gas pipelines.

The introduction of Part IIIA has been designed to pursue two main objectives. The primary objective is an economic one. It aims to improve economic efficiency by introducing competitive forces into certain essential facilities which have been monopolised by one, or a very small number of owners in circumstances where access is required for persons to enable them to compete in upstream or downstream markets. To be successful this will generally require regulation or other incentives to guard against monopoly pricing, artificial constraints on capacity and anti-competitive behaviour.

The subsidiary objective is to establish light handed regulatory procedures. Such procedures should be flexible enough to accommodate individual circumstances, not generate unnecessarily high administrative and compliance costs but be binding on service providers and users.

To meet these objectives three separate administrative procedures were created in Part IIIA to establish access regimes. First, the Part IIIA access regime provides for the declaration of the services provided by nationally significant infrastructure facilities

and only applies to the services of facilities that would not be economically feasible to duplicate and where the access arrangements would be necessary to promote effective competition in upstream or downstream markets. The regime establishes the ACCC as the arbitrator of disputes over access to facilities which have been declared. As an alternative to declaration and arbitration, the regime creates mechanisms to facilitate the provision of access undertakings by service providers and the creation of State and Territory access regimes.

In simple terms, the declaration procedures for establishing an access regime will apply where the service is not already the subject of an effective State or Territory access regime or the subject of an access undertaking.

For a State or Territory access regime to be effective it must comply with the principles set out in the Competition Principles Agreement.

2. The Role of the ACCC in Electricity Regulation

The introduction of competition to the electricity industry is one of the keys to generating productivity improvements that will benefit all parts of the Australian economy. The structural reforms taking place involve the disaggregation of vertically integrated monopolies into separate transmission, generation and distribution businesses. In most States the generation sector is also being disaggregated into two or more competing units. Further competition is being introduced at the retail level, with large customers allowed a choice of retailer in some States/Territories and retile competition being enhanced by allowing new entrants to compete with existing retail bodies.

Regulatory responsibilities are being separated from commercial activity, enabling management of the new entities to focus on appropriate goals for the organisation. The Commission's role in the reform of the electricity industry is to enforce the anti-competitive conduct rules in Part IV of the TPA, and in administering Part IIIA of the

TPA which deals with access to the services of essential facilities, such as transmission infrastructure.

2.1 National Market

A major development has been the move to establish interstate trading in electricity between the interconnected states (New South Wales, Victoria, South Australia and the Australian Capital Territory). The key characteristics of the proposed national market are:

- freedom of choice for electricity buyers (transitional arrangements are being put in place to open the market progressively to smaller buyers of electricity);

- non-discriminatory access to the inter-connected transmission and distribution networks;

- no discriminatory legislative or regulatory barriers to entry for new participants in electricity generation or retail; and

- no barriers to interstate or intrastate trade in electricity.

These principles have been embodied in a comprehensive code (National Electricity Market Code) that was authorised by the Commission on 10 December 1997. The code embodies both new interstate trading arrangements such as a wholesale market pool with existing practices such as technical standards for generation and connection to the network. The access elements of the code form a separate access undertaking under Part IIIA. The Commission's final decision on the Access Code will be released by the end of this month.

Transitional arrangements are already in place in New South Wales, Victoria and the Australian Capital Territory whereby a wholesale market pool has been established and these states have moved to a common merit order dispatch and common market rules. Queensland has also implemented arrangements to introduce a competitive wholesale market pool and will operate that market in parallel to the national market

at least until Queensland is physically connected to the transmission grid in New South Wales. November 15 is now the start date for the NEM.

The proposed national market design is:

- all electricity to be traded through a wholesale pool;
- generators in the interconnected states being dispatched by a single controller;
- open access for the transmission and distribution grid;
- wholesale customers being entitled to purchase their energy requirements either from the spot market or through contracts with suppliers or a combination of both;
- market settlement function handling spot and forward trading in the market;
- two new market institutions - a Code Administrator (NECA) to monitor the operation of the market and a system operator (NEMMCO) to operate the market.

2.2 Regulatory Issues

The national electricity market arrangement provides for the ACCC to determine revenue caps for transmission using a methodology based on CPI-X or some incentive based variant of CPI-X. The National Market Code provides guiding principles on the operation of the revenue cap that the ACCC must take into account, such as:

- an equitable allocation of efficiency gains between users and owners of the system;
- providing owners with a sustainable commercial revenue stream;
- prevention of monopoly rents;
- fostering efficient investment within the transmission sector and upstream and downstream of that sector.

2.3 Statement of Regulatory Intent

A major piece of work for the Commission at the moment is the development of a *Statement of regulatory Intent*. The statement is to set out the ACCC's approach to its regulatory role under the code, particularly where the code indicates a ACCC

discretion (for instance its approach to the setting of the X or the use of glide path). Issues include:

- asset valuation - what should be the appropriate methodology to assess asset values (note that the code places an upper limit on asset value by reference to deprival values but there would seem to be a bias in the code towards real cost asset valuations);
- what weight should be given to asset values in determining the appropriate cash flow of the business;
- determination of the X in the CPI minus X;
- use of CAPM models and determination of the WACC etc;
- sharing of efficiency benefits and to what extent a glide path should be used and in what circumstances;
- establishment of service standards in a way that can be measured and tied back to the revenue cap;
- value of benchmarking the performance of the regulated business with other businesses;
- information asymmetry - can that be addressed in some way to reduce the regulator's burden?

ACCC staff have developed an issues paper as the starting point for the development of the *Statement*. The *Issues Paper* was released to encourage industry comment and debate on the ACCC's role in setting revenue caps.

2.4 NECA Pricing Review

A key piece of work being undertaken is the review of the pricing principles in Chapter 6 of the National Electricity Code. This review resulted from ACCC pressure to test the adequacy of the current Code principles in respect of network pricing. The Commission argued that NECA's review of transmission pricing should consider the following issues:

- the appropriate balance between cost reflective network pricing and postage stamp allocation of costs for TUOS charges;
- the extent of any cross subsidies in the postage stamp component of the TUOS charges; and
- the incidence of TUOS charges with a view to promoting cost reflective and efficient usage, investment and location signals.

The ACCC and representatives from IPART, ORG, GPOC, Queensland Electricity Reform Unit and South Australian Treasury are on a steering group that oversights the review's progress. Any changes resulting from the review would be submitted to the Commission for approval.

2.5 Code Changes

The ACCC has an ongoing role in terms of assessing changes to the code and the access arrangements. On 11 August 1998, the Commission issued a draft determination proposing to grant authorisation to a number of proposed changes to the Code. The changes allow for an orderly commencement of the NEM on 15 November, and include further transitional arrangements, and amendments to clarify the interpretation and application of the Code. The draft determination sets out a number of conditions on authorisation, amending the proposed Code changes. The Commission held a pre-decision conference in relation to this matter on 27 August and will issue a final determination in due course. Further Code changes were lodged with the ACCC on 28 August. The Commission is currently considering these amendments.

3. The Role of the ACCC in Gas Industry Reforms

On 7 November 1997, Australian Heads of Government signed the Natural Gas Pipelines Access Agreement ('the access agreement'). The stated objective of the access agreement is to establish a uniform national framework for third party access to natural gas pipelines that facilitates the development and operation of a national market for natural gas by providing rights of access to pipelines on fair and reasonable terms.

South Australia has submitted legislation to its Parliament to give effect to the Gas Code, with the Gas Pipelines Access Law annexed. All other jurisdictions (except Western Australia) agreed to introduce legislation applying the SA legislation before end June 1998. WA has agreed to introduce complementary legislation and has committed to amending it whenever the SA legislation is amended.

The *Gas Pipelines Access (Commonwealth) Bill* 1998 received Royal Assent on 30 July 1998. The South Australian Governor had issued a proclamation on 2 April 1998 that the *Gas Pipeline Access (South Australia) Act* 1997 would commence on the day on which the Commonwealth Act received Royal Assent. I understand that the NSW gas law came into effect on 14 August 1998. The remaining jurisdictions are at various stages of their own legislative process. The Commission therefore expects that the National Gas Code will come into effect in all jurisdictions by the end of 1998.

All jurisdictions have nominated the ACCC as their transmission regulator, except WA, which intends to establish a State-based regulator. All jurisdictions have nominated an independant State-based Regulator for distribution networks, except for the Northern Territory, which has nominated the ACCC. This creates a significant new workload for the Commission in the economic regulation of some 15 major transmission pipelines and two distribution networks throughout Australia.

3.1 Initial responsibilities of the Regulator

Within 90 days of the National Code coming into force, the Service Providers of each covered pipeline in that jurisdiction will be obliged to offer access arrangements to the Regulator for their respective systems. The Regulator has six months to consider the proposed access arrangements, during which time it must seek submissions, issue a draft determination, consult with interested parties on the draft, then issue a final determination.

This time period can be extended by the Regulator publishing a notice in the national press explaining why the extension is required and its length.

In deciding whether to approve or not approve an access arrangement, the Regulator must have regard to various criteria including the legitimate business interests of the service provider, the interests of users and prospective users and the public interest.

The Regulator must decide whether to require separate access arrangements for different parts of the pipeline system and must determine the appropriate level of information provision to users. The Regulator must inform each person known to the Regulator that has an interest in the proposed access arrangement. The Regulator must then publish a draft decision and allow interested parties sufficient time to make further submissions. The Regulator must then either approve the proposed access arrangement or not approve it.

3.2 Ongoing functions of the Regulator

At any time after an access arrangement has been approved, the Service Provider can apply for a review of the access arrangement and propose revisions to it. The Regulator must then consider such proposed revisions, following an identical public consultation process to the initial approval process. The Regulator also has a significant ongoing monitoring and enforcement role.

The Regulator will also play a major part in dispute resolution. Dispute resolution is limited to disputes over access to spare or developable capacity, where negotiations have broken down. The Regulator determines if there is a dispute or not. The Regulator can arbitrate and make determinations in relation to access to capacity. The Code sets out detailed principles the Arbitrator is to take into account in making any arbitration determination and also restrictions upon determinations.
The Regulator may appoint an agent to act for it as arbitrator.

3.3 MSOR

On 21 August 1998, the ACCC announced that it had conditionally authorised the Victorian Market and System Operations Rules (MSOR), subject to certain amendments being made.

The MSOR sets out procedures for the operation of Victorian wholesale spot

sales of gas. It catalogues the obligations and responsibilities of VENCorp and participants in relation to gas scheduling and technical standards such as metering, information disclosure requirements and so on.

The Commission believes that the MSOR will initiate and accelerate the benefits of competition reform in gas. This is because the total package of Victorian reforms, which include the access arrangements, have potential benefits in better use of infrastructure and capital than allowed for under the current arrangements.

Benefits are expected through:

- the promotion of economic efficiency from structural reform, and the introduction of wholesale competition via the development of spot sales;
- an increase in customers' choice after unbundling of gas supply from distribution and transmission;
- general benefits to the Victorian economy via improved network services; and
- even though the MSOR does not directly incorporate the retail sector, the 'market carriage' model will facilitate retail competition and pass through the benefits of reform and competition. It may also provide some conditions necessary for upstream competition.

The caveat to realising these benefits is that implementation of the MSOR, as currently drafted, may result in the public benefit being partially or fully offset by anti-competitive detriment. A number of problems, identified by interested parties and the ACCC, detract from the MSOR and reduce the likelihood that the full benefits of gas reform will be realised.

The concerns are:

- possible market distortions arising from design features of the MSOR - single zone daily pricing necessitating the need for ancillary and uplift payments, the price cap and the force majeure provisions;
- insufficient accountability and transparency in the present arrangements; &
- potential for anti-competitive behaviour arising from the information disclosure provisions of the MSOR, given a market with a limited number of players.

The ACCC made the authorisation conditional on certain amendments to the MSOR. Authorisation was granted until 1 January 2003. An application has been made to the Australian Competition Tribunal for a review of the Commission's Determination on the MSOR. The Tribunal is required, under the *Trade Practices Act*, to conduct a fresh hearing of the request for authorisation.

The Commission is concerned that the Victorian Office of the Treasurer has issued a press release (on 28 August 1998) indicating that the Victorian Government intends to exempt the MSOR from Part IV of the *Trade Practices Act*.

If such a course of action is taken, it may have significant implications for the Commission's performance of its regulatory roles under the Victorian MSOR and *Gas Industry Act* and for the Commission's assessment of the Access Arrangements.

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3.4 Victorian Access Arrangements

On 28 May 1998 the Commission released its draft decision in relation to the Victorian Gas Transmission Access Arrangements. The preliminary decision by the ACCC was to approve the Access Arrangements, subject to certain amendments being made. The decision has been subject to further public consultation including public forums, one specifically on the contentious issue of the appropriate weighted average cost of capital (WACC) to be applied in determining target revenues for the Service Provider. The Commission has received around 80 submissions since the release of the draft and will take such submissions into account in its final decision. The Commission is currently targeting a September release for the final decision on the Access Arrangements, subject to its consultation process and the completion and submission of the revised Access Arrangements from the Energy Projects Division.

3.5 Upstream Reform

The development of a truly competitive gas market on both the demand and supply sides is of vital concern to the Commission. The positive impact of reforms in the transmission and distribution sectors may be severely limited or may not eventuate if there is a lack of initiatives upstream.

Aggregation of production interests and coordinated marketing arrangements of gas production joint ventures in the main Australian gas basins are potential obstacles to the development of a competitive interconnected, multi-state Australian gas market. On a case-by-case basis there may well be sustainable public benefits in maintaining these arrangements pending further development of downstream markets, as long as upstream practices do not retard downstream development. That is why the Commission now builds in periodic review mechanisms or time limits in its authorisation determinations.

The significance of these concerns was identified by the Australian Competition Tribunal in its recent decision concerning the AGL Cooper Basin supply arrangements, where it stated that as against the benefits associated with the implementation of the National Competition Policy, there must be a balancing of "the forces that may limit the prospects for effective competition." The Tribunal recognised that common ownership of exploration leases, production facilities, the existence of economies of scale in the development of reserves and the construction of pipelines in gas fields may all raise barriers to entry and restrict the numbers of viable participating enterprises, with a resulting impact on gas consumers.

The Commission is aware that the achievement of a more competitive market structure in the upstream gas production sector will be a difficult task, particularly in basins where gas production and use is project-focused and associated with members of the joint venture contracting on common terms with customers for large, long-term quantities of gas. Given local market characteristics, Australia is unlikely to match the level of competitive activity in the USA and Canada in the near term. However, the prospective development of a secondary market trading in gas and pipeline capacity, the interconnection of pipelines and the development of gas swap opportunities and gas storage will encourage market entry and growth and an

environment sustaining greater competition between producers, if complemented by upstream reform initiatives in relation to acreage management, flexibility of delivery points, replacement of take-or-pay by more efficient two-part tariffs, and third-party access to gas gathering and processing facilities.

The commission awaits the outcomes of the Upstream Issues Working group, which is preparing a report on these matters for Government by the end of the year. The Commission is finalising its submission to the UIWG, which will call for the following reforms:

- exploration permits of generally smaller size and shorter duration, particularly in highly prospective areas;
- transparent consideration of retention lease applications; and
- the development of an industry code of access to upstream facilities, incorporating published information regarding capacity and pricing principles, and a binding dispute resolution process with an independent arbiter.

4. Regulatory Consistency

The Commission, in conjunction with several national and state bodies, has sought to refine its decision making in the areas of gas and electricity reforms via the formation of specialist consultation groups.

4.1 The Energy Committee

The ACCC has created an Energy Committee of the Commission to be responsible for its regulatory decision-making on gas and electricity matters. This initiative should also assist in achieving consistent regulatory outcomes. For the time being, the Energy Committee membership will be drawn from (as appropriate for particular decisions) the Chairperson and Deputy Chairperson of the ACCC and the State based regulators who are ex officio associate members of the Commission. The additional regulatory experience and expertise of the associate members should assist in achieving consistent approaches at all regulatory levels.

Among other things, the Energy Committee assists in the co-ordination of Commission decision-making with that of the state regulators. By giving State regulators input at the national level, the Energy Committee ensures that relevant regional considerations are reflected appropriately in Commission decision-making.

4.2 The Regulators Forum

The Commission has also established a forum of Australian public utility regulators which meets on a regular basis to facilitate effective co-operation and communication between regulators.

Federal, state and territory regulators are now facing new regulatory roles and responsibilities in newly competitive and commercially oriented public utility markets which have been subject to structural reform and, in some cases, privatisation. New regulatory policies, principles, methodologies and procedures are being developed in areas where there is limited or no past experience or established methodologies.

The regulators forum provides a mechanism for facilitating the development and adoption by regulators of consistent regulatory principles and methodologies, particularly in relation to interstate regulatory issues, for facilitating the exchange of information and experience and for sharing skills and resources during this important regulatory learning period.

Particularly in the area of access and access pricing, regulators face new challenges in developing appropriate regulatory principles, methodologies and procedures which address effectively issues such as:

- the commercial interests of facility owners and access seekers;
- consequences for competition, economic efficiency and end users;
- asset valuation, cost of capital, depreciation and related costing issues;

- preventing monopoly pricing while encouraging the development of economically efficient rate structures;
- the appropriate application of price cap or rate base direct regulation methodologies versus more flexible negotiation/arbitration models;
- the tension between providing adequate regulatory certainty while retaining sufficient regulatory flexibility; and
- the expertise, analytical, modelling, information and procedural requirements to perform these regulatory functions in practice.

The regulators forum should assist regulators to address these issues in a co-operative and consultative way, and in doing so, to identify and deal appropriately with any overlap of jurisdictional powers, and fostering a co-ordinated and consistent approach to regulation.

5. CONCLUSION

In summary, recent reform processes and accompanying changes to markets have resulted in a number of new regulatory roles for the Commission. These roles flow from decisions of the Council of Australian Governments, public business reform and privatisation. Structural reform, corporatisation and privatisation often raise complex competition issues which touch on matters that are either potential contraventions of the Act or concern the efficiency or effectiveness of competition in the delivery of goods and services. The Commission recognises that market reform, privatisation and deregulation can result in risks and costs for users of public utilities as well as efficiency, price and service quality gains. It will continue to follow progress in the reform agenda to identify the potential for adverse effects on competition and consumer interests and will work to promote the objectives of the Act in market reforms.