Australian Competition and Consumer Commission

Promoting Competition and Fair Trading

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Recent and Emerging Trade Practices Issues in the Infrastructure Sector

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It's now been nearly a decade since all Australian governments committed to a comprehensive and ambitious reform agenda to improve our economic performance by opening up the nation's state controlled infrastructure to greater competition.

While there have been transition costs, sometimes falling unfairly on certain sectors of the economy, the evidence so far is that the benefits have been substantial.

There has been a surge of investment in vital national infrastructure such as gas pipelines, electricity transmission and generation, telecommunications and even rail.

Consumers have benefited by being offered greater choice, better services, and especially in areas like telecommunications, cheaper prices.

Formerly closed off areas of the economy such as state run electricity generation and transmission, gas pipelines, airports and rail links have become more dynamic, efficient and competitive businesses.

While it's impossible to predict precisely how much of our recent economic success is directly due to these reforms, the ACCC believes it is no coincidence that they have corresponded with the best economic run the nation has seen for forty years.

However, after a decade of NCP reform the ACCC believes it is now time to reinvigorate and refine the current competition framework.

While the reforms have exposed most sectors of the economy to the rigours of competition, competition in some industries is held back by legislation or the structure of the industry.

Telecommunications remains highly concentrated and competition uneven and regulations continue to restrict competition within the broadcasting sector. We are concerned by recent merger activity within the electricity industry and a recent series of rulings on the Gas Code.

Transport reforms have also lacked an integrated and national focus with inconsistent pricing of road and rail infrastructure and transport bottlenecks both requiring urgent attention.

So with that backdrop, I want to now turn to a few key areas of national infrastructure that have been impacted by National Competition Policy, look at the successes and the shortcomings and consider what action can be taken to ensure the reform process continues.

Telecommunications

The Commission's disappointment with the current state of competition within much of the telecommunications sector is fairly well known,

Competition in telecommunications has developed unevenly across different regions and at different levels. Outside of central business districts and some metropolitan areas, widespread competition remains elusive.

This is not to say that have not been benefits – far from it. Since 1997, new investment in the telecommunications sector by Telstra alone has totalled more than $19.7 billion.

Between 1997-98 and 2002-2003:

- the average price paid for local calls fell by 37.1 per cent
- the average price paid for long distance calls fell by around 31 per cent
- the average price paid for international calls fell by a staggering 61.7 per cent; and
- The average price paid for GSM mobile phone services fell by almost 24 per cent.

However, last year, for the first time since 1997, many of the indexes which the ACCC uses to measure changes in prices paid for telecommunications services began rising.

The reasons for this are clear – Telstra is one of the most vertically-integrated telecommunications companies in the world. It continues to be the major wholesale supplier across the full range of telecommunications services, from fixed-line and mobile voice services, through to Internet services and pay TV.

Telstra's market power across these services provides it with the ability and, most importantly, the incentive, to impede entry into new and emerging markets.

It is not now, and never will be the aim of the Australian Competition and Consumer Commission to try to stop Telstra from competing vigorously in emerging markets nor legitimately exploiting its economies of scale and scope. What we do want however is to see more effective competition between Telstra and other providers in a way that offers their customers better and more affordable services.

A very good example of this is in the area of broadband.

Telstra's ownership of both the copper access network that connects virtually every Australian home, and the largest HFC network in Australia provides it with effective control over the market for the delivery of broadband services.

Yet, despite being the retail broadband market leader, Telstra's share of this market has remained relatively low compared to the other services it offers.

Earlier this year, Telstra acted decisively to try to reverse this by slashing the price of its BigPond broadband service. Now, while it is entirely proper for Telstra to chase more customers by cutting prices, our very strong view is that Telstra's dominance over the infrastructure needed to deliver these services not be used improperly to dominate the retail broadband market and squeeze out its competitors.

That's is why we quickly issued a Competition Notice against Telstra, prompted by complaints from its wholesale customers that the price they were being charged at the wholesale level by Telstra meant it was uneconomic for them to compete with Telstra's retail price.

As the Commission still has reason to believe that Telstra's pricing is still likely to result in significant anti-competitive effects, we have decided to keep the notice in force.

Now, there is no denying the price cuts have had a positive effect on the take up of Broadband.

Our latest *Snapshot of Broadband Deployment*, found that as at March 2004 total broadband take-up stood at 829,300 services. This is an increase of 130,600 from December 2003 – the largest quarterly increase since the Commission began collecting these statistics in mid-2001.

So cheaper prices will drive growth in the number of broadband customers, but if those price cuts drive competitors out of the market, this may not be in the best long term interest of the broadband sector.

The stifling of competition, especially at the entry or lower speed level of the market, has the potential to shut out long term competition at an important stage of broadband growth in Australia. Equally, such anti-competitive actions could impede the development of new efficient technologies and their ability to provide broadband services, such as wireless networks.

One way to overcome this is to promote and protect the development of new technologies on existing and refurbished networks, such as new access networks based on wireless technologies.

Networks of this type generally involve infrastructure investment on a smaller scale than the fixed networks. Importantly, these networks are not reliant on Telstra's copper and cable networks in order to gain access to customers. If new networks gain sufficient traction, they can provide a real competitive challenge to existing networks.

Another promising area of development is the move towards the provision of new services using new IP-based technologies on existing networks.

The provision of voice over IP services on existing networks provides one example of where Telstra's dominance over the provision of basic voice services is likely to be increasingly challenged over time. Ultimately, the provision of voice, text and data services over new next generation networks could afford even greater opportunities for the development of more broadly based competition.

The extent to which this ultimately occurs remains to be seen. However the Commission will be particularly vigilant in examining any conduct that impedes efficient network deployment by these new operators.

New entrants need a reasonable opportunity to build new access networks, or to use existing networks to provide new services and technologies. This should be able to occur without the added burden of having to combat anti-competitive behaviour.

Transport

The Commission's approach to transport has been to treat the entire sector as an integrated chain, and not look at it as discrete elements such as road, rail and air, for example.

In a perfect world each of these sectors would compete for the business of transporting passengers and freight on an entirely equal footing and customers would choose the one which offered them the best price and service.

The problem of course is that the history of the various transport sectors in Australia, much of which has been heavily regulated by state or federal government until recently, has meant they have all developed along vastly differing paths.

Reforms to make rail more efficient have, for example, had to overcome enormous hurdles – most notoriously in the decision of the three eastern states to choose different rail gauges. This acted as a huge barrier to interstate travel and competition and, as they developed, gave road and air freight a huge competitive advantage. In short, it was anything but efficient.

Some work has begun over the past decade to overcome these hurdles, most notably through the creation of a single gauge railway linking all the mainland capitals, and of course, most recently, the completion of the Alice-Darwin railway.

But the key development as far as the Commission is concerned was the establishment by State and Federal Governments of rail access regimes under the National Competition Policy reforms.

The aim of these regimes was to encourage use of rail infrastructure by making it easier for third parties to access the rail network. The right of these third parties to negotiate access to rail infrastructure is a legal right under the provisions of the Trade Practices Act, and it is therefore the role of the ACCC to see that right of access is not abused by either party.

Again, the results to date have been quite pleasing and include such achievements as:

- The establishment of the National Rail Corporation Limited to manage all interstate rail freight,
- The separation of rail ownership from above rail businesses of some government entities; and
- Improved and uniform safety, technical and operating standards.

Evidence suggests that there are now more providers of rail services than prior to the opening up of the rail networks in the mid 1990s and the increasing competition in the sector has produced some significant efficiency improvements.

These include an increase in train lengths of approximately 5-6 per cent on the east-west corridor, a 30 per cent increase in the gross mass carried per train and a 20 per cent fall in the average real freight access rate.

That's the good news – but there is still more to be done.

A number of access regimes currently exist across the interstate and various intrastate networks. These regimes are administered by different bodies under different principles. Obviously, the establishment of a uniform and national rail access framework would go a long way towards promoting better use of, and competition in, the rail sector.

Of more concern is the lack of integration in planning reforms across the entire transport sector.

Currently, heavy vehicle and train operators are charged for access to infrastructure under different pricing structures. Train operators pay for access to rail infrastructure under various state and interstate access regimes that do not appear to generate sufficient cost recovery for long term financial viability.

Heavy vehicle road charges are currently designed to only recover new road construction and maintenance costs.

To the extent that access to infrastructure for different modes of transport is priced differently, one mode of transport may be unduly favoured over the other. As well as leading to a potential misallocation of resources, this may create congestion problems on the lower cost transport mode. Increasing the consistency between the two pricing regimes should foster competitive neutrality between modes of transport and improve the efficiency of Australia's logistics network.

An additional concern is that the transport sector as a whole is becoming increasingly vertically integrated. This of course enables businesses that own bottleneck facilities to restrict access or charge prices that favour their operations to the detriment of competitors that rely on those facilities.

Reforms that create greater consistency, or remove bottlenecks, within and between transport sectors may further improve the competitiveness of Australia's transport and logistics industry.

- ***Stevedoring***

The major reform in the stevedoring industry since the introduction of the NCP has come about through the reforms implemented by the Commonwealth Government in 1996/97.

Since then, the industry has seen some impressive productivity improvements, with crane rates increasing from 18.7 uplifts per hour in 1998 to a world standard of 27.5 in June last year. This has produced big benefits for port users in the form of faster turnaround times and significant falls in real prices.

There have also been big gains for the nation and the stevedoring companies. The ACCC's *Stevedoring Monitoring Report No. 5* indicated that port volumes increased by 16 per cent during 2002-03. The stevedores' profits grew during 2002-03 with average rates of return on assets increasing from 19.3 per cent in 2001–02 to 25.6 per.

The industry is still in a state of transition, and it is too early to determine whether further reform is required.

Margins in the industry have improved significantly, but it is unclear whether these are excessive in relation to the costs associated with the industry.

The evidence on barriers to entry is also mixed. The fact that Australia has no single port acting as a primary destination, requiring new entrants to offer stevedoring services at many ports, can act as a barrier. Exclusive long term lease arrangements between stevedores and ports, which typically last 20 years, also can act to prevent new entrants into the market.

- ***Aviation***

In June 1999, the Commonwealth Government, following a report by the Productivity Commission into international air services, announced a range of measures aimed at liberalising air travel between Australia and the rest of the world.

These measures included:

- Reciprocal "open skies" agreements with like minded countries where this was in the national interest
- Unrestricted entry for foreign carriers to all international airports except Sydney, Melbourne, Brisbane and Perth;
- Allowing foreigners, (including foreign airlines which can individually acquire up to 25 per cent) to acquire up to 49 per cent of the equity of an Australian international airline and up to 100 per cent of the equity in an Australian domestic airline, unless that was contrary to the national interest; and
- Unrestricted access to all international airports for dedicated freighters.

The aim of these measures was to ensure airlines could meet demand for international air travel on routes to and from Australia. Again, the results have been promising.

The first clear benefit appears to be the entry of Virgin Blue, initially a 100 per cent foreign owned carrier, into the Australian domestic aviation market.

The second appears to be expanded frequencies and capacity on international routes to and from Australia.

A third benefit is the declining trend of airline prices on both domestic and international routes, especially for the price sensitive passengers.

The Bureau of Tourism Research's *Avline* publication showed that real best discount airfares (cheapest advertised) for domestic travel in April 2004 were 31 per cent lower than in September 1999.

The ACCC has a prices surveillance role for the provision of en route navigation, terminal navigation and terminal fire-fighting services provided by Air Services Australia. Given the natural monopoly characteristics of the services provided by Air Services Australia, it is our strong belief that prices surveillance must be sustained in the medium term to prevent and deter uncompetitive pricing of these services.

Energy

Historically, the gas and electricity industries were state-based and publicly owned. Within the electricity industry, there was little interconnection between states. In the gas industry, supply to demand centres was typically met by a single basin through state owned pipeline infrastructure. In both cases the infrastructure for transporting and retailing electricity or gas was vertically integrated.

During the 1990s, Federal, State and Territory governments agreed through the Council of Australian Governments to reforms for both industries to improve their competitiveness and develop their respective national markets.

These included:

- Placing utilities on a commercial footing through corporatisation
- Vertically separating generation, transmission, distribution and retail businesses and 'ring-fencing' these businesses from other activities
- Allowing for customer choice of supplier through full retail contestability
- Encouraging third party access to transmission and distribution infrastructure on fair and reasonable terms
- Removing restrictions upon interstate trade and, in the case of electricity, establishing the National Energy Market (NEM)

- ***Gas***

In the gas sector, the agreement saw a major restructure of the industry, with monopolies such as pipelines being separated from more competitive segments of the gas industry, such as production and retailing.

In addition to structural reforms, governments agreed to remove barriers to interstate trade in gas and governments and industry developed a national framework creating a right of access by gas producers and retailers to Australia's major monopoly gas pipelines.

The record so far has been impressive.

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.

Gas users have also benefited with ACIL Tasman estimating that without access regulation the price for transmission and distribution services could have been 25 per cent higher.

- ***Electricity***

The record in the electricity sector is more mixed.

During the 1970's and 1980's the electricity industry was publicly owned and vertically integrated. State based markets meant that each state was self sufficient in terms of generation, however, it was widely accepted that there existed significant over investment in generation plant in NSW and Victoria. In particular, Victoria was building expensive new power stations even though in NSW excess power could be made available if stronger interconnection was constructed.

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.

Just as crucial are reliable and transparent service standards, which is why earlier this month 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 National Electricity Market 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.

Australian Energy Regulator

Perhaps the most exciting development in energy regulation though has come about as a result of the establishment of the Australian Energy Regulator or AER.

The principles behind the Australian Energy Regulator were that it should be:

- independent in its decision making, but through its close links to the ACCC able to take an approach consistent with competition law; and
- achieve national consistency in regulating electricity and gas transmission and distribution.

In line with that first point, 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.

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.

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 Western Australia 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.

So we have some very impressive results from opening up the state run gas and electricity utilities to competition and now, with the maturing of that process, the

creation of a single, independent regulatory to achieve national consistency in regulating electricity and gas transmission and distribution.

But at the same time, there have been a number of recent developments in the energy sector that the Commission is concerned have the potential to put a halt to these gains – namely, mergers within the electricity industry and some recent conflicting interpretations of Gas Code provisions

Gas Code rulings

As you may be aware, the ACCC has decided to appeal the Australian Competition Tribunal's decision, handed down on 8 July, on the Moomba to Sydney Pipeline Access Arrangement.

In that decision the Tribunal rejected both the valuation methodology applied by the ACCC and that proposed by the pipeline owner, East Australian Pipeline Limited and instead adopted the depreciated optimised replacement cost (DORC) methodology based upon the net present value of cost as the preferred approach for valuing the MSP.

It is the view of the ACCC that this decision has created some doubt about how the code should apply and as a consequence, we have lodged an application with the Federal Court seeking judicial review of the Tribunal's decision.

The ACCC application is confined to the Tribunal's application of the law, consideration of evidence and reasonableness of its propositions relating to the methodology to be applied when establishing the initial capital base of the pipeline pursuant to the National Gas Code.

While our appeal application specifically applies to the MSP ruling, this was just the latest in a series of cases going back to 2001 which we believe have left important questions unanswered about the Gas Code Access arrangements.

Since 2001 there have been four appeals to the Tribunal over Gas Code Access Arrangement decisions by the ACCC. Given the relative infancy of operation of the regime, that is perhaps not surprising.

In the first of these, lodged in 2001, the Commission's decision to include a trigger mechanism in the access arrangement for the Duke-owned Queensland Gas Pipeline was upheld.

In the remaining three appeals, by Epic, GasNet and the Moomba to Sydney pipeline, the appeals have been upheld.

However, it's worth putting these appeals in perspective. The ACCC has approved 12 access arrangements. These arrangements embody hundreds of minor decisions. Most of these issues were resolved during the ACCC's consideration of the access arrangements.

Out of these 12 arrangements and hundreds of rulings, there have been just four challenges involving 22 grounds for appeal.

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)

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.

The result of cherry picking has been the creation of a level of inconsistency in Gas Code interpretation which ultimately leads to a higher level of regulatory uncertainty that can only be detrimental to the future management of the access regime, for service providers and users alike.

Gas transmission companies have more to lose than anyone in such an uncertain environment. Under the current regime, gas transmission companies have been very successful businesses. An example I can point to is the performance of the ASX Utilities Index. Businesses in this 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. This

suggests that regulated returns are higher than necessary to maintain regulated asset values.

It's also worth noting at this point the release, just this week, of 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.

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.

Electricity Mergers

Our other area of concern is the recent rash of mergers in the electricity sector which would bring many of the elements of the electricity supply chain back together and reverse the pro-competition structural reforms of the past decade.

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

1. Horizontal mergers between generators

The Commission has considered applications for mergers of large baseload generators in Victoria. In general, our main concern is the ability of a large merged entity to manipulate spot prices and also to influence future contract prices.

2. 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 has recently 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.

3. 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.

CONCLUSION

In a recent address to ACCC senior staff, leading US antitrust expert Professor William Shepherd gave this stark warning about the dangers of giving in to those who push for the winding back of regulation.

> *"Don't deregulate unless you simply have to. And if you must do it, be very cautious and have no illusions. You may well get stuck with an entrenched near-monopolist. Deregulation often lets the monopoly become a permanent high-dominance firm, with about 80%, and free of public constraints."*

He also warned we should have no illusions that antitrust can do very much to enforce a shift to effective competition once an industry is deregulated.

In natural monopoly sectors of the economy, regulation that limits market power needs to provide service providers with revenues that cover efficient costs. In sectors where competition is weak, regulation has an important role in creating and developing markets.