Australian Competition & Consumer Commission

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Promoting Competition and Fair Trading

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The role of the ACCC in Australia's new regulatory regime

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The Australian Energy Regulator is perhaps the most exciting and revolutionary reform to energy regulation since the 1995 National Competition Policy agreement began the task of opening up Australia's state controlled gas and electricity monopolies.

As a result of National Competition Policy we have

- seen the removal of restrictions on interstate trade in gas and electricity
- the placing of the utilities on a commercial footing
- the separation of generation from transmission
- the opening up of third party access to transmission and distribution on fair and reasonable terms; and
- the establishment of retail contestability for gas and electricity.

The Australian Competition and Consumer Commission played a key role in this by overseeing aspects of the deregulation process where it was deemed that competition could only be achieved through government intervention.

Now, as competition in the gas and electricity markets matures, that regulation is also maturing to further improve efficient investment and competition to the benefit of business, consumers and the nation.

Australian Energy Regulator

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
- 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.

When fully operational it will comprise three Members who will be statutory appointments, including a full time Chair and two part time Members. One of the members will be a Commissioner of the ACCC, namely, me.

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.

This brings us to the second point – consistency in regulation.

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

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

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.

It's an example of the benefits that occur under the almost uniquely Australian system of having a single authority responsible for competition, consumer protection and regulation.

In a recent address to senior ACCC staff, leading US antitrust expert Professor William Shepherd noted that the United States divides the regulation of natural monopolies from antitrust policies to promote competition in "normal" markets.

He said this created entirely separate agencies who knew only about one side of the market, while Australia combined these into an efficient unit.

The AER is a very good example of this, and will ensure that at all times there is a consistent approach to all aspects of competition law such as mergers, enforcement and so on.

So how will this work in practice?

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

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

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

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

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

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

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

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

The transfer of distribution and retail regulation to the AER will require the development of a national framework. The Ministerial Council on Energy will shortly release for consultation an issues paper on distribution and retail regulation. Following consultation on the issues paper, a national distribution and retail regulatory framework will be developed, and considered by the Ministerial Council in 2005.

Recent developments in electricity regulation

I should just mention here two very recent developments in electricity regulation which we believe will further strengthen investment, and improve competition.

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

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

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

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

The Commission last week also issued its Draft Statement of Principles for the Regulation of Electricity Transmission Revenues (DRP).

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

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

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

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

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

Reliable and transparent service standards are crucial, which is why earlier this 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 NEM quantified, with quarterly reporting.

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

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

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

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

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

1. 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.

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

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

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

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

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

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

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

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

This decision was not taken lightly. But before discussing in detail the reasons for the ACCC lodging its appeal, it is worthwhile briefly recapping on some of the background to this matter.

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

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

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

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

EAPL declined to submit a revised access arrangement that complied with the ACCC's final decision. The ACCC, therefore, had to draft and approve its own access arrangement, which it did on 8 December last year.

EAPL then lodged an appeal with the Australian Competition Tribunal on 19 December.

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

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

The tribunal upheld the appeal. It decided that the value of the initial capital base should be set according to the depreciated optimised replacement cost (or DORC) methodology. DORC is normally the upper limit of a range of possible values for the initial capital base permitted under the Gas Code, although neither the ACCC nor the service provider proposed such an approach on this occasion.

The ACCC argued that a value less than DORC was appropriate for the MSP. In forming this view the ACCC took into account the loss of market share from gas shipped via the MSP to gas shipped via the Eastern Gas Pipeline and the fact that the expected life of the MSP had changed over the years.

Prior to the construction of the Eastern Gas Pipeline, the MSP supplied the entire Sydney and Canberra markets. Given that tariffs are derived by dividing costs by volumes, basing tariffs on EAPL's forecast (lower) volumes means that tariffs are higher than what they otherwise would have been if the Eastern Gas Pipeline had not been built.

The ACCC did not consider that a new source of gas into Sydney should signal higher tariffs. Such an outcome would not replicate a competitive market, one of the factors that the regulator is required to take into account under the Code when setting reference tariffs.

The Gas Code specifies 11 factors that the regulator must consider in establishing the value of the initial capital base for an existing gas pipeline. DORC is but one of these 11 factors.

With regard to these factors, the Tribunal noted that the first four specifically relate to valuation methodologies.

The Tribunal also noted that the remaining factors should only be used in extreme circumstances to set aside recognised valuation methodologies. Instead, according to the Tribunal, those remaining factors could assist the regulator in deciding between different methodologies or to adjust its preferred methodology in unusual circumstances.

The Tribunal's interpretation of the Gas Code contrasts with that of the WA Supreme Court in its decision on the Dampier to Bunbury gas pipeline. In particular, the WA Supreme Court did not suggest that the remaining factors were subordinate to the first four. Instead the Court noted that these were all factors to which the regulator must give fundamental weight in establishing the value of the initial capital base.

The Court stated the process was more than one of mere valuation. It stated the remaining factors brought into account a number of matters that are not directly related to value in the ordinary sense, but which, to quote the Court, 'by their very nature require the consideration of disparate issues which may well tend in different directions'.

In other words, it is not simply a case of applying a preferred valuation technique. Rather it is a case of taking a wide range of factors and applying them to the circumstances of a particular pipeline.

Another issue concerning the initial capital base for the MSP is the manner in which the DORC is derived from the ORC (the optimised replacement cost). The traditional method used by the ACCC, other regulators and industry is to use the straight line approach.

Under this approach DORC is simply the proportion of ORC derived from the ratio of the remaining useful life of the existing asset over the useful life of a new asset.

Once the ORC and remaining life have been determined, the calculation is straight forward and the resulting value relatively uncontentious.

The Tribunal rejected this approach, however, as a 'crude tool' in favour of a 'more sophisticated analysis'.

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

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

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

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

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

Given the relative infancy of operation of the regime, that is perhaps not surprising. The likelihood for appeals to arise is high, given the many industry stakeholders that serve to be affected by an access arrangement determination including those seeking access (i.e. shippers), producers, large end users/consumers, retailers and of course the owner/operator of the pipeline system itself.

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 MSP, the appeals have been upheld.

The Epic matter centred on the regulatory value of the Moomba to Adelaide pipeline, in particular the cost of steel pipe, and whether the Pelican Point expansion should be included in the capital base. Excluding this expansion meant that the regulated tariff was increased.

The value of GasNet's pipeline had been set in the initial access period. The appeal, however, resulted from the new owner's concern with aspects of the methodology used to set the cost of capital for the new regulatory period.

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

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

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

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

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

Gas Tribunal decisions

Effect on revenue

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

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

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

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

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

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

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

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

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

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

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

And ACIL Tasman found there was no clear evidence of the current regulatory practice having caused the delay of any particular pipeline investment, and there had in fact been a high level of investment over the period since the introduction of access regulation

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

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

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

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

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

There is no clearer current example of the damaging impact of allowing gas pipelines to exercise market power than what is happening in Western Australia at the moment. Bids for the purchase of the Dampier to Bunbury Gas Pipeline close on Friday. According to media reports, the sale process may fail because, firstly, the financial institutions that currently control the pipeline are insisting that their investment of $1.85 billion be repaid in full, and secondly, bidders are struggling to offer much more than the regulated asset value of $1.55 billion. The institutions have some leverage (reflecting the pipeline's market power) because they appear to be making a sale at their price a condition of the much needed expansion of the pipeline, which will cost around another half billion or so. One problem here is the lack of clarity in the Gas Code about whether expansions of a covered pipeline should be automatically regulated. The Productivity Commission has addressed this issue and recommended in the affirmative. If this recommendation was in place today then the current owners of the DPNG would be obliged to expand the pipeline if shippers were willing to pay the costs of that expansion, and the problem in Western Australia would be easily resolved.

But the real problem in Western Australia is that Epic Energy backed by the financial institutions paid around one billion dollars too much for the DPNG believing that, somehow, the clear implications of coverage of the pipeline under the Gas Code would not apply to them. A second pipeline to meet Western Australia’s needs could be built for around $1.2 billion. If it were not for the costs of a two year wait faced by energy consumers in the Perth region who desperately need more power, a second pipeline could be the best solution. Regardless, the financial institutions may have to face up to the fact that, had they been investing into a competitive market, funding the acquisition of an asset where the buyer paid around a billion dollars too much would quickly mean substantial losses for all involved. Coverage of a pipeline under the Gas Code should mean that investors face similar disciplines and incentives.

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

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

I also draw your attention to the release earlier this month 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.

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

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

Conclusion
Australia’s access to reliable and low cost energy resources have been a key factor in Australia’s economic success over the past decade.

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

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

The establishment of a single, consistent and independent Australian Energy Regulator will reduce regulatory costs to business and barriers to entry and ensure Australia can continue to meet its energy needs and continue to benefit from reliable and cheap energy.