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Energy market regulation in the new regulatory environment

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The establishment of the Australian Energy Regulator is an acknowledgment that while substantial benefits have arisen as result of energy market reforms, more needed to be done if Australia was to achieve a truly competitive market in gas and electricity.

In response to the 2002 Parer Review, the Ministerial Council on Energy agreed that significant benefits had arisen under the current ACCC-administered regulation including:

- Considerable integration of the wholesale electricity markets in Victoria, New South Wales, Queensland, the ACT and South Australia.
- Substantial investment in new electricity generation and gas production, and in particular in electricity and gas transmission interconnection between states in eastern and south eastern Australia.
- Vigorous electricity retail competition in the medium and large business sector and accelerating competition in the newly opened household and small business markets in NSW and Victoria.
- High levels of supply security, and improvements in network reliability.

However the ministers also agreed with the CoAG Review that substantial policy issues still had to be resolved if the full benefits of market reform were to be realised.

They therefore agreed to a second round of reforms to:

- Streamline and improve the quality of economic regulation across energy markets, to lower the cost and complexity of regulation facing investors.
- Improve the planning and development of electricity transmission networks to create a stable framework for efficient investment in new generation and transmission capacity.
- Further the introduction of retail competition, to increase the value of energy services to households and business.
- Further increase the penetration of natural gas, to lower energy costs and improve energy services, particularly in regional Australia, and reduce greenhouse emissions.

To put these proposals into practice, the Ministerial Council on Energy recommended that CoAG establish the Council as Australia's single energy market governance body and establish two new statutory commissions:

- The Australian Energy Market Commission (AEMC), with responsibility for rule-making and market development; and
- The Australian Energy Regulator (AER), with responsibility for market regulation and enforcement.

Australian Energy Regulator

The key principle behind the establishment of the Australian Energy Regulator was that the choice between gas and electricity should be determined by market disciplines and not 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.

A single consistent and independent regulator will reduce regulatory costs to business and barriers to entry and allow both gas and electricity to develop in a way that encourages competition within, and between the two, to the benefit of industry, consumers, and ultimately the nation.

The AER was initially given responsibility for electricity wholesale and transmission in the connected (NEM) jurisdictions, extended in 2005 to include gas transmission for all other than WA.

- ***Roles of AER and ACCC***

So how will this all work in practice?

There will be a single body of staff providing assistance to both the AER, and to the ACCC on energy matters.

This allows both to draw on the same substantial body of specialist skills and knowledge while avoiding costly, and potentially time-consuming, duplication.

The ACCC will continue to be responsible for approving mergers, access codes and undertakings, granting authorisations and for investigating and, where necessary, prosecuting possible contraventions of the Trade Practices Act.

However, the AER will now assume the ACCC's current electricity transmission revenue regulation functions, with gas transmission regulation functions to follow in the future. The AER will also assume NECA's current electricity regulatory functions, including monitoring the electricity spot market and ensuring compliance with the National Electricity Code. The AER will also be responsible for enforcement of the National Gas Code.

During 2006, the AER is scheduled to become responsible for the regulation of electricity distribution and retailing, other than retail pricing. Jurisdictions may also transfer responsibility for regulation of retail prices to the AER by agreement with the Commonwealth.

The Australian Energy Market Commission, AER and ACCC will be empowered to share information that they obtain with each other where that information is relevant.

Any information provided on a confidential basis to one regulatory body, including information provided on a “commercial-in-confidence” basis, may be provided to the other regulatory body and conditions may be imposed on the use of the information. The receiving body must protect that information from unauthorised use or disclosure.

However I should stress that despite these close links between the two, the AER will be responsible for making decisions on regulatory matters independently of the ACCC.

At all times when performing its electricity economic regulatory functions the AER will be required to act in a manner that is likely to contribute to the achievement of the national electricity market objective.

This means the AER has to look to the long term and promote greater investment, interconnection, efficiency and security of supply, and not just cheaper short term prices for end users.

The AER is therefore required, before setting revenue caps, to inform regulated transmission system operators of its considerations and allow them a reasonable opportunity to make submissions before any determination is made.

It must also provide a reasonable opportunity for the transmission system operator to recover the efficient costs in complying with various regulatory obligations.

And importantly, it must provide effective incentives to the operator to promote the efficient provision of regulated services, including the making of efficient investments.

- ***Closer co-operation***

A particularly important aspect of the new regime will be the arrangements between all three bodies which enable the AEMC, AER and ACCC to consult and co-operate on the code change and authorisation processes to avoid any duplication.

The AEMC will have specific obligations to consult in developing or considering any code changes and any person, including industry and end-users, may make comments on proposed code changes.

There is already an agreement in-principle to the development of a national approach to energy access under the Trade Practices Act, covering electricity and gas transmission and distribution.

- ***National Electricity Market objective***

An important feature of the new National Electricity Law is that it provides a single clear National Electricity Market objective.

This objective is to promote efficient investment in, and efficient use of, electricity services for the long term interests of consumers of electricity with respect to price, quality, reliability and security of supply of electricity, and the safety, reliability and security of the national electricity system.

Investment in and use of electricity services will be efficient when services are supplied in the long run at least cost, resources including infrastructure are used to deliver the greatest possible benefit and there is innovation and investment in response to changes in consumer needs and productive opportunities.

If the National Electricity Market is efficient in an economic sense the long term economic interests of consumers in respect of price, quality, reliability, safety and security of electricity services will be maximised.

Applying an objective of economic efficiency recognises that, in a general sense, the National Electricity Market should be competitive, that any person wishing to enter the market should be treated neither more nor less favourably than existing players, and that no one energy source should receive favourable treatment.

- ***Enforcement***

The Australian Energy Regulator will be responsible for bringing court proceedings in respect of breaches of the new National Electricity Law or the Rules, and issuing infringement notices.

The AER will have the power to apply directly to a magistrate for the issue of search warrants where it believes there are reasonable grounds there has been, or will be, a breach or even a possible breach of the National Electricity Law or the Rules.

Under the new regulatory regime the current graduated civil penalties scheme will be replaced by a maximum civil penalty of $100,000 and $10,000 for every day during which the breach continues (in the case of a body corporate) and of $20,000 and $2,000 for an individual.

In addition to these penalties the Court may direct the disconnection of a registered participant’s loads or suspend them from purchasing or supplying electricity through the wholesale exchange.

While only the AER can bring proceedings for a breach of the National Electricity Rules, there is a dispute resolution panel to resolve disputes under the Rules between registered participants or between a registered participant and the National Electricity Market Management Company.

Decisions of the panel can be appealed on questions of law, and enforced in a court.

I'm happy to report, that the AER is now very close to being fully operational, with the appointment in recent weeks of a Chairman and Chief Executive, and the passage of necessary federal and state legislation.

The importance of retail competition - developments underway.
Earlier, I explained that the National Electricity Market objective is to promote the efficient investment in, and use of, electricity services for the long term benefit of consumers. Efficient investment in infrastructure is vital, but it is equally important that prices in the NEM are established in such a way as to ensure that electricity consumers can contribute to the overall efficiency of the NEM. In short, consumers will only be able to contribute if they are able to receive and act on price signals.

This is an issue that has been recognised by governments and industry in recent years, and has been gaining more prominence recently with the Ministerial Council on Energy's response to some of the recommendations of the Parer Review.

Parer concluded that there were several impediments to effective participation in the NEM by consumers, not the least of which was the limited ability of most consumers to respond to price signals provided by the wholesale market. Parer noted that the ability of consumers to see the price of energy determined their response to changes in price. The report also concluded that because time-of-use meters were generally only used by larger industrial customers, residential customers, who represent around 40-50% of load in the NEM, were effectively excluded from accessing products that could encourage load reduction at peak times.

Similarly, Parer observed that even in jurisdictions that have implemented full retail competition the existence of price controls on such a significant proportion of load in the NEM restricts the ability of retailers to offer products that will provide financial incentives to reduce consumption when wholesale prices are high. The potential for retail price caps to stifle investment in electricity supply in the long run was also highlighted.

Among other recommendations to improve consumer involvement in the NEM, Parer recommended the removal of retail price caps, the introduction of full retail contestability in all jurisdictions, and the roll out of interval meters for residential customers.

The ACCC recognises the opportunities presented by interval meters in creating more innovative and responsive retail markets. To encourage their effective participation in the NEM, it is important that consumers are able to respond as electricity prices vary throughout the day. Whether this is market driven, or facilitated by a regulatory rollout of interval meters like the process which is due to commence in Victoria next year, it is imperative that regulatory frameworks give retailers the opportunities to develop innovative tariff solutions so that consumers have incentives to reduce and shift load.

This encourages innovative retailers to seek to gain a competitive edge by developing offerings that reward consumers who reduce their consumption in peak periods, thus creating a much more efficient electricity market.

But although sophisticated metering is a key factor in facilitating user participation, establishing a regulatory framework that promotes efficient supply is crucial for ensuring that consumers receive the benefits of a competitive retail market in the long run.

Much has been said of the California experience in this context. Typically, regulators and governments impose price caps where there is not effective competition in retail markets. On the one hand, they face the challenge of setting price caps at a level that cover efficient costs and allow adequate margins, and hence provide an incentive for future investment in electricity supply. On the other hand, retail price caps should not be set so low that investment in generation is stifled, and second tier retailers cannot make attractive offers to consumers because they can't undercut the price controls.

Given the significant demand growth and forecast shortages of supply that have been projected for the NEM over the next decade or so, it is a good time for governments to assess the need for retail price caps. I understand that the Ministerial Council on Energy has determined that the AEMC should be responsible for developing a framework for more efficient retail price regulation and a periodic assessment of the need for price caps in jurisdictions where full retail contestability has been implemented. While it is encouraging that the Council has put this issue on the reform agenda, I would suggest that, for the reasons I have discussed here, it is important for this work to commence as soon as possible.

In the meantime, aligning price caps with the underlying costs goes some way toward providing the correct signals for new entry and investment and a level playing field for retailers. I note that in its most recent determination on Regulated Retail Tariffs, IPART reported that since 1992, average retail prices for residential customers in NSW were, in many cases, lower than the full cost of supply.

One final point I would add is that, from a competition perspective, the ACCC believes that moves to promote new entry in retail and generation markets are welcome, particularly in the current climate of increasing aggregation of generators, and vertical integration between generators and retailers.

Although merger proposals involving vertical integration have the potential to create competition issues, effective competition in the separate functional areas of retail and generation can mitigate any such concerns. This is a view that the ACCC has emphasised in several recent submissions, including the Productivity Commission's review of National Competition Policy, and the Victorian Government's review of energy cross-ownership rules. These considerations were also highlighted earlier this year in the ACCC's assessment of China Light & Power's acquisition of SPI's contestable assets in Victoria.

Energy Market Investment – the record under ACCC regulation
The imminent establishment of the Australian Energy Regulator comes at a time when there is increasing debate about Australia's infrastructure and the role played by regulators like the ACCC.

Some of the more exaggerated commentators have suggested Australia is on the verge of a collapse in infrastructure due to the failure of the Australian Competition and Consumer Commission to allow them to earn a reasonable income out of their monopoly pipelines and transmission lines, leading to an investment drought.

The facts, of course, are very different.

Since responsibility for transmission regulation in the National Electricity Market began being progressively transferred to the ACCC in 1999, our decisions have accommodated over $4.5 billion in transmission investment.

Just two months ago the ACCC paved the way for $1.4 billion in new investment in electricity transmission alone in NSW and the ACT over the next five years with its final revenue cap decisions for TransGrid and EnergyAustralia.

Together with the ACCC's previous decisions, investment in NSW and ACT transmission networks will amount to around $2.6 billion, which more than doubles the value of transmission assets (in replacement cost terms) in just ten years.

The ACCC's decisions also allow TransGrid and EnergyAustralia to seek up to $800 million to fund additional investments if the need arises.

The record in gas has been even more impressive. According to the pipeline industry association's own figures, 14,000 km new transmission pipelines have been laid in Australia since 1997. This amounts to a doubling in the length of transmission pipelines in Australia to 28,000 km in just seven years.

Capital expenditure on new pipelines has increased substantially. Capital expenditure on new transmission pipelines stepped up to new levels around the time of the reform package in the mid 1990s. Data is not available for the most recent years, but based on the industry's statements about the construction of new pipelines since 1997 we would expect the trend in the graph to have continued if not accelerated.

MSP
One major concern we do have in the gas industry is uncertainty caused by recent rulings and appeals.

The most notable of course was the Australian Competition Tribunal's review of the ACCC's decision on the proposed access arrangement for the Moomba to Sydney Pipeline. The ACCC has therefore lodged an application with the

Federal Court for a review of the Australian Competition Tribunal's, primarily to get some clarity on key aspects of the Gas Code.

The Tribunal's decision in the MSP matter was the fourth occasion on which it has had to make a ruling under the Gas Code as a result of a disagreement between the ACCC and pipeline operators.

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 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.

However, it's worth putting these appeals in perspective. Of the 13 access arrangements that had the potential to be appealed to the Tribunal, just four ended up there. Across the four Tribunal cases there were a total of 22 issues raised by parties in their applications for review.

The service provider abandoned 10 of these 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.

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. We have therefore begun the legal challenge in order to bring certainty and clarity to the process and hope to have the matter heard by the full bench of the Federal Court later this year.

One of the Commission's concerns 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.

ACCC regulation – good for investors

Notwithstanding our concerns about electricity mergers and uncertainty in Gas Code rulings, there is no doubt ACCC regulation of the energy sector has been good for the industry and good for investors.

Since 1996, the Utilities Accumulation Index has generated a compound annual return of 17.4%, well in excess of the compound annual return of the ASX200 Accumulation Index of 11.1%. While the Utilities Accumulation Index is concentrated, the Commission considers this relevant evidence that healthy returns in regulated industries are available.

Ratings agencies have been just as positive about the prospects of regulated companies over the next three to five years. Moody's noted "the supportive regulatory frameworks and stable operating and financial profiles" while

Standard and Poor's noted the "supportive and transparent regulatory regimes". Similarly, Fitch Ratings stated "the current regulatory regime appears relatively supportive for transmission entities".

The Allen Consulting Group (ACG) has also prepared a report that reviews the adequacy of the returns of regulated Australian utilities. ACG concluded that 'the Australian regulatory framework is providing adequate scope for companies to earn appropriate returns in the energy infrastructure industry'.

For the final word on the performance of ACCC regulation I can't go past the latest definitive survey of the world's leading competition agencies, carried out by the Global Competition Review and released just last week.

The report, which covers 36 agencies in 29 countries put the ACCC near the top of the table on 4 stars out of a possible 5, just behind the US, UK and EU, and equal with Germany and the Netherlands.

I'm particularly pleased that in spite of what you may hear to the contrary, the agency found that the ACCC, and I quote, "is said to understand competition in energy markets particularly well. Several sources identified this as an area in which it 'leads the international field'."

I have no doubt that this finding will be reinforced in coming months by the work of the AER, and by the measures now underway to strengthen retail competition and promote a more efficient Australian energy market for the befit of investors, consumers and the entire economy.

Thank you