Energy Regulation and the Role of Regulators
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"What is the Regulatory Policy Agenda for 2001 and Beyond?"
by

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Introduction

I appreciate the opportunity to talk to you at a time when there is a renewed focus on Australian energy market reforms by both Australian governments and industry as a whole. The recent events in California have illustrated to policy makers that the risk of bad outcomes from not getting policy settings right is very real. This, at the same time as we are moving towards full retail contestability in energy markets, has caused concern for governments wanting to smooth the transition to competitive markets for their constituents. And remember that without full retail contestability we won't have anything like genuine markets much less genuine national markets in gas and electricity.

Governments and industry alike are calling for a review of the regulatory arrangements of the national gas and electricity markets. The Productivity Commission has recently released a position paper as part of its review of the Australian third party access regime for essential facilities – Part IIIA of the Trade Practices Act. Additional reviews have also been signalled. Both the Federal Treasurer and the Federal Minister for Science, Energy and Resources have indicated their support for a review of the operation of the National Gas Code. The Electricity Supply Association of Australia (ESAA) has requested an independent review of the National Electricity Market (NEM). The South Australian, Victorian and New South Wales Governments are initiating NEM reviews and ministerial forums to discuss the future development of the NEM. Finally the National Competition Council has also indicated that there may be some weaknesses in the institutional framework. Clearly a number of questions are being raised by Governments and industry as to the future path of reform of Australia's energy markets. Today, I will talk about how the Commission sees these developments.

Before I do so, I should set out the ACCC's objectives for energy markets in the year ahead. In brief, we would like to see:

- more vigorous competition in generation and retailing;
- removal of impediments to prudent interconnects between regions;
- network pricing that encourages efficient network use and signals the need for future investment; and
- regulatory powers to allow the ACCC to intervene where there are significant problems of market power.

The Current State of the Market

The electricity and gas market reforms instituted by CoAG in the 1990s have provided significant benefits to the industry, the Australian public and the economy as a whole. Benefits will continue to be delivered as the markets mature and become better at managing the risk inherent in these industries. In the case of electricity, the recent period of high electricity prices over the summer does not mean the reforms have been unsuccessful, as some critics argue. Rather, I believe they are an intermediate outcome from a market slowly adapting to price signals reflecting the real value of energy at times of high demand, a signal that would have been masked in a centrally planned system.

On the supply side it appears the market is responding, with a number of new proposed generation developments in the south-east regions. On the demand side, however, the market needs to be more responsive to high prices. For example, in the medium to long term interval metering will provide customers and retailers with information and price signals with which to effectively manage demand. There need to be mechanisms in place that provide incentives to retailers and contestable customers to come forward with interruptable supply contracts when prices are high. I believe that once both sides of the market are responding to price signals the benefits promised by the reforms will be realised.

In saying this, however, I recognise that improvements can be made to the governance of the market and that the National Electricity Code needs to continue to evolve. The issues that I consider of prime importance to be resolved are the institutional arrangements and the nature of government intervention.

Institutional Arrangements

The Commission is concerned that the current institutional arrangements in the electricity sector fail to provide strategic direction in implementing changes to the Code. This is highlighted by the processes for the current Code changes regarding network pricing. Let me briefly describe and contrast the current institutional arrangements in the gas and electricity sectors.

Gas institutional arrangements

Historically the Australian gas industry was characterised by monopolies at each stage of the vertical chain from production to transmission, distribution and retail. The CoAG commitment to "free and fair trade in natural gas" in 1994 led to the 1997 Natural Gas Access Agreement that each State and Territory would commit to the introduction of the Gas Code. This Code establishes a single set of principles to govern access by third parties to all transmission and distribution pipelines. The Code was developed in a joint process involving the Commonwealth, States and Territories and the industry.

The Code is given legal effect by State/Territory-based legislation. Each State/Territory applies to the National Competition Council (NCC) to have its regime "certified" such that it becomes an "effective" regime under Part IIIA of

the Trade Practices Act.

Under the Gas Pipelines Access Law, the ACCC is the relevant regulator for access to services provided by transmission pipelines in all States and Territories except Western Australia. Access to services provided by distribution networks is regulated by independent State/Territory-based regulators. The NCC recommends to the relevant minister which pipelines should be regulated under the Gas Code. This method separates decisions on the approval of the regime and the extent of its application from the regulators that operate under it.

While you will see that most of the comments I have on institutional arrangements relate to the electricity arrangements, I consider the current move to full retail contestability raises significant challenges to both the gas and electricity institutional arrangements. In gas, as in electricity, I believe there is an urgent need for the States and Territories to come together to develop consistent implementation guidelines across jurisdictions. This is essential for the development of a national market, providing retailers and customers on different sides of a border with similar pricing, connection and metering arrangements. Unless, of course, States and Territories actually prefer energy markets to emulate the State railway systems of the 19th Century.

Electricity institutional arrangements

As indicated earlier, the NEM and its institutions are increasingly becoming the object of political scrutiny. In particular, the NEM participating jurisdictions have criticised the performance of the Markets' three governing bodies, NEMMCO, NECA and the ACCC, suggesting that governments need to be brought back into the policy-making process through a ministerial forum. I would like to comment on such criticisms and offer my own suggestions on where we can improve the arrangements. Before this, however, I think it is useful to recall the origins of the NEM governance arrangements.

The institutions of NEMMCO and NECA were created in May 1996 following commitments made by the Federal and State/Territorial Governments to National Competition Policy in April 1995. Setting out the rules for the National Electricity Market was the National Electricity Code, developed by the National Grid Management Council, a joint jurisdictional initiative established in July 1991.

NEMMCO was established to operate and administer the NEM. NECA, as the Code administrator, enforces, maintains and develops the Code.

While NEMMCO and NECA were created by the five NEM jurisdictions and the Commonwealth for the purposes of operating and administering the NEM and the Code, the ACCC was established by the Commonwealth Government in 1995 for the purposes of administering the *Trade Practices Act 1974* and the *Prices Surveillance Act 1983*.

The ACCC's formal involvement with the NEM began in November 1996 when NECA and NEMMCO submitted the National Electricity Code as an application

for authorisation under Part VII of the TPA. Then, in April 1997, NECA submitted an application to the Commission under Part IIIA of the Trade Practices Act to accept the NEM Access Code as an industry wide access undertaking for administering third party access to electricity and distribution networks.

For the assessment of the two applications, and in assessing any subsequent changes, the legislation sets out two separate tests. For an application for authorisation, the Commission must be satisfied that the public benefit arising from the arrangement outweighs any anti-competitive detriment that results from it. In accepting an industry access code as an effective undertaking, the Commission must have regard to a number of issues, including, for example, the legitimate business interests of the owners of the facilities, the interests of potential access seekers, and the public interest.

While the NEC and the NEM Access Codes are separated by law, in reality the NEM Access Code is a subset of the NEC. Therefore, because they are intertwined, the Commission in assessing applications for authorisation also examines how proposed Code changes impact on the NEM Access Code.

The Commission has one further role in relation to the regulation of the NEM. This is to regulate transmission networks' allowable revenue.

It has been the operation of these three institutions, NECA, NEMMCO and the ACCC, that has contributed greatly to the development of the NEM thus far. It would be a considerable exercise to appraise each institution's performance in relation to its functions and objectives set out in the Members Agreement, the Code and the Trade Practices Act. Rather, I will consider the performance of these institutions in an area that the Commission considers is critically important to the development of the NEM: the Code change process. It appears to be this process that is giving rise to much of the criticism of the institutional arrangements.

Code changes put forward by NECA to the Commission can vary in size and importance. While one may deal with an increase in the level of VoLL, another may be an extension of a derogation or clarification of pricing principles. It is clear that the more significant Code changes are likely to affect the public benefits and anti-competitive detriments consideration by the Commission more than the smaller changes do. The Commission, therefore, in accordance with NECA's objectives and the ACCC's obligations, considers that it can work more closely with NECA in the future to refine the number of Code changes forwarded to the Commission for authorisation. This would cut down the length of the Code change process for the less significant, clarificational changes, and reduce the regulatory burden for industry.

Better working arrangements between NECA and the ACCC will not, however, solve the more important issue of providing greater direction in the policy development of the NEM. I believe all three governing institutions contribute to the broad development of the NEM, with their respective roles and objectives set out in the Code, the Members Agreement and the Trade Practices Act. If parties,

especially the State/Territory jurisdictions, are unhappy with the development of the NEM then they must accept responsibility as the governments who established the framework for the NEM and the role of the NEM institutions. The fact that the State/Territory governments are accepting this responsibility by thinking anew about these issues is to be welcomed.

While the Commission does not consider widespread changes to the design and operation of the NEM necessary, it does consider changes are needed to improve the broad development and policy direction governing the NEM. The Commission has learnt from its current assessment of the transmission network pricing Code changes that it is necessary to consider some Code changes more widely in terms of future market developments. The Commission is currently in the process of making a final determination on the authorisation of network pricing and Market Network Service Provider (MNSP) Code changes put forward by NECA. Amongst other things, these changes are aimed at improving locational and usage signals for the transmission network. The Commission in its draft determination considered the changes put forward would not constitute a public benefit in terms of greater usage and locational signalling and, therefore, proposed conditions of authorisation to ensure these signals are provided. These conditions of authorisation proposed by the Commission call for the development, by NECA, of a network pricing methodology which is based on eight guiding principles.

However, there is an important related process: NECA's Review of Integration of Energy Markets and Network Services, or RIEMNS. The proposed Code changes that are expected at the completion of the RIEMNS review will have a significant impact on the Commission's decision regarding the current network pricing and MNSP application. The proposed changes from RIEMNS are likely to include the creation of more regions and the improvement of inter-regional loss signals. These changes will result in an improvement in the short-run cost signals of transmission network usage in the energy market. There is a debate going on at the moment in the industry as to whether these changes will provide the appropriate usage and locational signalling for transmission use and investment. The question then arises whether there remains a need for further usage price signals through a separate transmission charge.

The Commission is therefore disappointed with the current situation where it is unable to fully consider the transmission network pricing issues in one complete application. I believe that similar situations can be prevented in the future by establishing closer ties between NECA, the ACCC and NEMMCO, where a long term plan for the development of the NEM could be implemented, improving the management of the Code change process. The ACCC is already pursuing talks with NECA for the purposes of obtaining a quick resolution to the network pricing issue. Such a move is necessary to improve not only the overall strategic direction of the NEM, but also the efficiency of implementing changes. However, as I will explain in a moment, better liaison between NECA, NEMMCO and the ACCC can only take us so far.

In contrast to the institutional arrangements in the electricity sector, it is worth noting that similar problems do not arise in the gas sector. In gas, the NCC

recommends which pipelines are to be covered under the National Gas Code, a Code jointly developed by the Commonwealth, States and Territories and the industry. With a clearer delineation of roles and fewer government ownership issues, a simpler and less contentious arrangement exists. However, it is worth noting that in electricity the ACCC's role of ultimate approval of the Code and changes to it reflected the wishes of a wide range of industry participants.

Appropriate Role of Governments

When discussing the current institutional arrangements, I indicated that there needs to be greater coordination between the three institutions with regard to the long term direction of the NEM. However, some jurisdictional governments have recently indicated that they plan to establish a ministerial council. I welcome a review by the State/Territory Governments of the overall objectives and institutional arrangements of the NEM. Indeed, the ACCC has been calling, literally for years, for a reassertion of policy leadership at the governmental level in the development of the NEM.

However, there are also dangers.

In the first place, it would be absurd to throw the rules governing the wholesale electricity market up in the air. The wholesale market is still bedding down but overall works pretty well.

Nothing would be worse for investment than a fundamental reappraisal of market rules when they have not been given the chance to operate for any length of time. Moreover, problems in the market – the lack of a comfortable margin between supply and demand in some regions – is manifestly the result, not of deficiencies in the market rules, but of impediments to interconnection and lack of demand-side response. These are just the issues where the involvement of governments may not lead to good outcomes.

So yes, the renaissance of government interest in the NEM is welcome, but with qualifications.

First, in dealing with immediate problems, governments are likely to make decisions that protect their constituents from negative short-term impacts but which compromise the ability of the market to deliver long-term benefits.

Secondly, it is hard to be confident that policy makers will make decisions in the overall interests of the market, of competition, and thus of end-users, given that some jurisdictions continue to have vested interests in the market as owners of generation and retail businesses. Consequently, I believe State/Territory jurisdictions should set the overall objectives of the NEM, but then leave the market development role to the current institutions.

These concerns about the ability of the policy makers to make decisions for the greater good of the market have been illustrated by two cases of intervention.

The Victorian Government intervened in the electricity market in February last

year to soften the impact of what would have been a period of involuntary loadshedding. While mandatory restrictions did achieve their purpose, their implementation significantly distorted price signals not only in the Victorian region, but also in the other NEM regions. The effect of this price distortion has been to raise concerns that market participants in the future may be discouraged from hedging themselves against the occurrence of future sustained periods of high prices, for example through investment in peak generation and demand side management. The next summer should give us an indication of whether these concerns will be proven or not.

Another example of government intervention is in NSW where the NSW Treasury has established the Electricity Tariff Equalisation Fund (ETEF) to replace the NSW Vesting Contracts. The fund is a transitional arrangement to assist the gradual introduction of full retail contestability. The fund is designed to protect retailers supplying franchise customers from volatile pool prices. While the Commission supports the need to provide protection to retailers supplying customers with a regulated tariff, it is concerned that such a fund may have unintended effects such as potentially changing the incentives of NSW participants to trade in the contract market, although NSW has assured us that this is not the case.

The current debate and future Code changes with regard to RIEMNS further illustrate the conflict of interest governments may have as market policy makers. It has been expected that a likely outcome of the review will be that NECA applies for Code changes that increase the number of regions in the NEM. This move will be an attempt to further integrate energy market prices with network congestion costs, a move that will increase greatly the investment signals faced by all sectors of the market. However, some State/Territory governments remain opposed to the idea of increasing the number of regions. With such opposition the changes may not eventuate, preventing locational signals from reaching market participants.

Looking ahead, governments are nervous about the introduction of full retail contestability. It is natural that they should wish to protect consumers from price volatility. But there is a considerable danger that government fine-tuning of competition will result in barriers to entry, less competition, and fewer benefits for consumers. This will be particularly exacerbated by a lack of national perspective and a focus on parochial concerns.

As the Californian case demonstrated, if governments' involvement in development of the NEM actually stifles market development, partial deregulation is likely to be worst of all worlds. Thus the potential ramifications are great. For this reason I consider that the role of jurisdictions should be one of reviewing the outcomes of the NEM and determining its broader objectives and structure, rather than involvement in the ongoing development and operation of the market.

One National Body for Administration of Competition Law and Economic Regulation

Another issue that has been raised in the context of reviews is whether a National Energy Regulator, separate from the ACCC, should be created. The Commission believes that there are many benefits from having regulation undertaken by a general competition regulator as opposed to industry specific regulators.

The OECD has identified several areas in which competition agencies should convey certain advantages over sector specific regulators. In particular, competition agencies should be more:

- attuned to pursuing static and dynamic economic efficiency which are the principal reasons for introducing competition;
- convinced that competition truly will produce significant benefits, and motivated to demonstrate this in as many sectors as possible;
- familiar with what constitutes a competitive market and what threatens it;
- likely to rely on structural remedies which would probably prove to be a better instrument for developing competition than dependence on a set of behavioural principles; and
- willing to wind down both access and economic regulations as and when competition becomes sufficiently strong.

Based on the Australian experience to date, there is evidence to support the arguments put by the OECD. For example, in telecommunications a number of services were deemed declared in July 1997 and additional services were subsequently declared following public inquiries. However, as competition developed in the market, the focus of the Commission shifted from the regulation of services to the examination of the continuing need for regulation. Further, the Commission has since initiated two inquiries into the limitation, rather than the extension, of existing regulation. In gas, the Commission has supported revocation of coverage for a number of smaller gas pipelines that jurisdictions deemed to be covered in the Natural Gas Access Agreement.

Additionally there are administrative synergies that arise from combining economic regulatory and competition law functions. They occur largely because the same staff can be applied to a number of related matters, and combining several policy instruments in the same agency increases the chances that they will be used in tandem rather than sometimes at cross purposes.

The Papua New Guinea to Queensland Gas project provides an example of how the Commission has integrated its industry specific knowledge with its expertise in competition issues. The PNG producers have applied for authorisation of a joint marketing arrangement because they believe that the public benefits from this pricing arrangement outweigh any resultant anti-competitive behaviour. The approval of access principles for the pipeline is a separate but related aspect of the project. The joint consideration of the competition law issues combined with the economic regulatory role of assessing the access principles highlights the synergies arising from the combined roles of the Commission, and demonstrates the benefits of having a national competition regulator.

Additionally, the enforcement of compliance with the GST and the assessment of deceptive or misleading advertising in the energy sectors require an intimate

knowledge of these areas. Again, there are significant benefits in having the combined expertise of the staff in both the gas and electricity units and the compliance unit within one national competition regulator.

Incentives for Future Investment

Despite the substantial investment in new infrastructure in the energy sectors, concerns are raised as to whether the relevant codes can adequately address the specific needs of a greenfield pipeline or new electricity transmission assets. There have been calls recently for a regulatory holiday for these new investments. I'll come back to that in a moment.

Addressing greenfield risk in the gas sector is a major challenge facing the Commission, and one to which we are giving careful consideration. Compared to established infrastructure, greenfield projects typically have an uncertain volume profile and a variety of specific risks. A number of options exists to deal with these risks.

The Commission is conscious of the need to balance the interests of customers and investors, the need to provide incentives for long term efficient investment and the desirability of setting prices which track efficient costs as closely as possible.

The Commission has demonstrated its flexibility in relation to the Code in the Access Arrangement for the Central West greenfield pipeline. In addition to a return on equity at the high end of the feasible range, this decision provided for losses to be carried forward for future recovery. The access arrangement review period was extended to ten years to allow any upside from volumes above those forecast to be retained by the Service Provider. A number of features in this decision are a definitive signal to industry that the Commission recognises the risks associated with greenfields investment can be different to existing infrastructure.

The Commission is willing to provide as much regulatory certainty as possible to any new or proposed investment. We are currently in discussion with Duke in relation to their proposed greenfield pipeline into Tasmania. In this situation Duke has a high capital investment with a pipeline extending from Longford into the gas frontier of a State that relies heavily on hydro-electric power. There are many risks involved in this project. Again, the Commission is happy to discuss the regulatory environment prior to construction of any new investment.

Regulatory Holidays

Regulatory holidays are advocated by a number of industry participants as a method of overcoming greenfields risks. As the term suggests, they would provide the investor with a grace period without the usual regulation in order to earn an unregulated rate of return without any regulatory risk during that period. The recent Productivity Commission Position Paper on the National Access Regime seeks suggestions on the practicality of these access holidays. The Commission is yet to form a considered view as to whether this idea has merit or

if it only has superficial attraction. Clearly there are many issues that need to be addressed in relation to this proposal.

- What effect would regulatory holidays have on efficiency? Would investors gain too much market power, or would they not have sufficient power to extract monopoly rents during the development stage of gaining market share?
- When should the regulatory holiday start or cease? Should it be for a fixed period of time or should there be a point in time where the investor is deemed able to utilise market power?
- What constitutes a greenfield investment? Should it be determined by a set of criteria and then, upon approval, be granted the regulatory holiday? And who assesses these criteria?
- Further it has become apparent to industry that the benefits of a regulatory holiday only arise in the future when the company has the ability to utilise its market power and earn potentially high profits. So when is the appropriate time to grant such a holiday?

The Commission does not want this process to be seen as one of picking winners. By this we mean that it is one thing to grant a regulatory holiday for all entrepreneurial pipelines, but it is quite another for governments to pick and choose which projects are granted this status.

Conclusion

The coming year is going to be a critical time for national energy markets as questions arise on their operation and governance arrangements and a number of reviews are undertaken. So far, deregulation has delivered considerable benefits to users, industry and the economy; benefits that will only increase as the reform process proceeds. While I believe that it is premature to make wholesale changes to the market arrangements, I do support an independent inquiry into the electricity market so that we can learn from our experiences gained so far.

In the electricity market I identified what I consider to be the key problems with the current institutional arrangements. The institutions of NECA, NEMMCO and the ACCC have contributed strongly to the development of the NEM. Nevertheless, the arrangements can be improved to provide a more streamlined Code change process - one that provides more direction in terms of development of the NEM. While governments remain shareholders of electricity business, their ability to make decisions regarding the best interest of the market, and thus the long-term interests of consumers, is compromised.

Most importantly, a revitalised government interest in energy markets needs to be channelled into genuinely strategic, national matters and not degenerate into parochial protection of local interests.

There is much debate that still needs to be had if we are to achieve good market governance and a well-working market with responsiveness in both supply and demand; and avoid the temptation of ad hoc government interventions resulting in half-baked deregulation.