Energy Users Group

Networks ’99 Conference

Making Gas and Electricity Regulation Work

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1. INTRODUCTION

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

In 1995 the Commonwealth, State and Territory Governments agreed to implement the National Competition Policy reforms. This package included the extension of Part IV of the *Trade Practices Act 1974* to unincorporated businesses and State and Territory Government business enterprises and the creation of Part IIIA of the Trade Practices Act which establishes a third party access regime to cover the services provided by significant infrastructure facilities such as gas pipelines.

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

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

The Part IIIA access regime provides for the declaration of the services provided by nationally significant infrastructure facilities and only applies to the services of facilities that would not be economically feasible to duplicate and where the access arrangements would be necessary to promote effective competition in upstream or

downstream markets. The regime establishes the Commission as the arbitrator of disputes over access to facilities which have been declared. As an alternative to declaration and arbitration, the regime creates mechanisms to facilitate the provision of access undertakings by service providers and the creation of State and Territory access regimes.

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

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

2. THE ROLE OF THE ACCC IN ELECTRICITY REGULATION

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

Regulatory responsibilities have been separated from commercial activity, enabling management of the new entities to focus on appropriate goals for the organisation. The Commission's role in the reform of the electricity industry is to enforce the anti-competitive conduct rules in Part IV of the TPA, and in administering Part IIIA of the TPA which deals with access to the services of essential facilities, such as transmission infrastructure.

A major development has been the move to establish interstate trading in electricity between the interconnected states (New South Wales, Victoria, South Australia and the Australian Capital Territory). The key characteristics of the national market which started in December 1998 are:

- freedom of choice for electricity buyers (transitional arrangements are being put in place to open the market progressively to smaller buyers of electricity);
- non-discriminatory access to the inter-connected transmission and distribution networks;
- no discriminatory legislative or regulatory barriers to entry for new participants in electricity generation or retail; and
- no barriers to intrastate trade in electricity.

These principles have been embodied in a comprehensive code (National Electricity Market Code) that was authorised by the Commission. The code embodies both new interstate trading arrangements such as a wholesale market pool with existing practices such as technical standards for generation and connection to the network. The access elements of the code form a separate access arrangement under Part IIIA and have been approved by the Commission.

Two new market institutions have been established - a Code Administrator (NECA) to monitor the operation of the market and a system operator (NEMMCO) to operate the market.

The Commission's role from the 1 July 1999 is to be progressively responsible for the regulation of transmission revenue in the National Electricity Market. The Commission will also be responsible for regulation of all transmission networks participating in the National Electricity Market from 1 January 2003.

3. THE ROLE OF THE ACCC IN GAS INDUSTRY REFORMS

In the case of the gas industry the Australian Heads of Government signed the Natural Gas Pipelines Access Agreement ('the access agreement') on 7 November 1997. The stated objective of the access agreement is to establish a uniform national framework for third party access to natural gas pipelines that facilitates the development and operation of a national market for natural gas by providing rights of access to pipelines on fair and reasonable terms. The Australian gas industry, historically, is one that is vertically separated into gas producers on the one hand and distribution and transmission pipelines on the other. It is the monopoly element transmission lines and distribution lines that are being regulated.

The National Third Party Access Code for Natural Gas Pipeline Systems (the Code) aims to provide access to the services provided by monopoly pipeline assets. On 7 November, the Australian Heads of Government agreed to implement the Code. Given that the code confers powers on Commonwealth bodies such as the Commission and the National Competition Council, Commonwealth legislation and complementary legislation in each State and Territory is required. The Commonwealth recently passed the Gas Pipelines Access (Commonwealth) Bill 1998, while the South Australian, Northern Territory and New South Wales legislation have already been proclaimed and other states are set to follow.

All jurisdictions have nominated the Commission as their transmission regulator, except Western Australian, which intends to establish a State-based regulator. All jurisdictions have nominated an independent State-based Regulator for distribution networks, except for the Northern Territory, which has nominated the Commission. The Commission is therefore involved in the economic regulation of some 15 major transmission pipelines and two distribution networks.

4. REGULATORY ISSUES AND THE COMMISSION'S APPROACH

Although there are a number of issues that have arisen in the application of regulatory regimes to access arrangements in utility industries, some issues stand out as being the most contentious. These include pricing arrangements, provision for new investment, dispute resolution, transparency and quality monitoring.

4.1. Pricing

In assessing prices the Commission needs to determine levels that are fair to both the utility owner and customers. In other words, prices need to be set at rates that restrict monopoly profit, yet still provide a reasonable return on investment.

The Commission favours an approach based on incentive regulation. The theoretical underpinning for incentive regulation is that with the ability to retain cost reductions as profits the service provider has a strong incentive to be more efficient in the provision of access services and to expand its market share and to contribute to market growth. To achieve the potential efficiency gains from competition in downstream markets it is important that the prices of access not reflect the exercise of market power by the service provider and that the structure of pricing among users and between different categories of service be based on the costs involved in providing each service. However if regulation adjusts prices simply to allow the service provider to recover costs and does not allow the provider to achieve a reasonable rate of return on investment the service provider will have little incentive to be efficient in the provision of such services; indeed there may be an incentive to reduce efficiency. Hence the need for incentive based regulatory mechanisms.

In the case of electricity the Commission is required as a condition of authorisation of the National Electricity Code to conduct a review of the regulatory arrangements in the Code applicable to the pricing of transmission and distribution networks and associated connection assets. This review is intended to examine, amongst other things, whether the transmission network-pricing model provides appropriate incentives for the supply of generation and for investment in generation, network and

demand side alternatives. The Code requires the Commission to develop a Statement of Regulatory Principles to provide additional detail on the approach that the Commission will adopt. The Commission issued its Draft Statement of Principles for the Regulation of Transmission Revenues last month.

In terms of pricing the access arrangements that have attracted the most publicity have been those that applied to the Victorian gas market. In order to expedite its gas reform process the Victorian government introduced a transitional access code, which is identical in all material respects to the National Code. On 28 May 1998 the Commission released its draft decision in relation to the Victorian Gas Transmission Access Arrangements. The preliminary decision by the Commission was to approve the Access Arrangements, subject to certain amendments being made. The decision was subject to further public consultation including public forums on a number of issues, but the most contentious issue was the determination of the appropriate Weighted Average Cost of Capital to be applied in determining target revenues for the service provider. The Weighted Average Cost of Capital is essentially the rate of return allowed on the capital base. It is calculated as a weighted average of returns investors could otherwise achieve through industry specific debt and equity instruments. The Victorian Office of Regulator General and the Commission used a similar approach in determining the Weighted Average Cost of Capital for both transmission and distribution assets and calculated a real pre-tax figure of 7 per cent. Concerns were expressed within the industry about this figure with some parties arguing it was too high and others too low. In November 1998 the Commission released its final decision on the Victorian access arrangements and both the Office of Regulator General and the Commission have determined a real pre-tax Weighted Average Cost of Capital of 7.75 per cent, which is equivalent to a nominal after tax return on equity of at least 13.2 per cent. It should be stressed that this rate of return is one that is based on the specific characteristics of the gas industry and not necessarily applicable to other utility service providers.

The regulatory framework being put in place in the Victorian gas industry is incentive based that will allow owners to earn potentially higher returns than the regulatory rate of return if for instance:

- volumes of business are greater than forecasted;
- increases in efficiencies lead to a reduction in operating costs; or
- capital costs are reduced.

Any discussion of rates of return would be incomplete without a discussion of the manner in which assets are valued. Clearly the required revenue depends not only on the rate of return but also the value of the assets to which the rate of return applies. In the Victorian gas case the Commission supported the use of Depreciated Optimised Replacement Cost for the valuation of the initial capital base.[1] It is not an endorsement of the Depreciated Optimised Replacement Cost methodology generally and it should not be taken as a precedent.[2] Each case in the future will be judged on its merits.

4.2. New Investment

New investment can involve the expansion of capacity of an existing facility, the extension of an existing facility or the construction of an entirely new facility. Generally speaking the treatment of access to extensions would be consistent with the existing access regime in each case. The price of access would be set on a similar basis to the general pricing principles of access to existing facilities.

Any 'greenfield" projects are considered on their merits in accordance with associated risks. In some circumstances there is another option as in the Gas Code which may be used to determine reference tariffs for new investment. That mechanism is the competitive tendering process, which was used recently for the pipeline from PNG to Queensland. Under the tender process a regulated rate of return is *not* used to determine reference tariffs. Instead reference tariffs are determined competitively.

[1] DORC is the replacement cost of an 'optimised' system, less accumulated depreciation. An optimised system is the most efficient method of providing the services of the current asset.
[2] IPART in its evaluation of the New South Wales access regime advocated the use of depreciated optimised replacement costs. *Draft Report on Aspects of the NSW Rail Access regime*, February 1999.

4.3. Service Standards, Performance and Accountability

Product, technical and service quality are major concerns for both providers and users of any service. The adequacy of service provision can be determined and acted upon only if there are adequate mechanisms for measuring and reviewing service performance in access arrangements. The Commission considers transparency central to effective performance monitoring.

In the case of electricity the National Electricity Market Code provides that the Commission must take into account the establishment of service standards in a way that can be measured and tied back to the revenue cap; and the value of benchmarking the performance of the regulated business with other businesses.

Similar requirements have also been included in the gas code.

In most cases provision has been made to review access regulatory arrangements on a five yearly basis.

4.4. Dispute resolution

The Commission views effective dispute resolution as an essential component of the regulation of access arrangements. Such provisions should facilitate the fair, timely and efficient resolution of disputes. In general the Commission would expect dispute resolution provisions to take effect only after parties have made genuine attempts at negotiating terms and conditions of access.

In the case of declaration of a service the Commission may act as the arbitrator of disputes. In the case of certified regimes, access codes and access undertakings the dispute resolution body would be specified in the access arrangements. In these cases the dispute resolution body can be any appropriate person or body. It could for example be a private mediator or arbitrator, a State Government regulator such as the Independent Pricing & Regulatory Tribunal in NSW or the Office of the Regulator

General in Victoria – as in the case of gas distribution in those two states – or alternatively the Commission itself.

As an alternative to government bodies acting as arbitrators a dispute resolution body might be appointed. Dispute resolution committees have been formed in the various gas and electricity undertakings that are a part of the electricity and gas codes.

5. REGULATORY CONSISTENCY

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

5.1 The Energy Committee

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

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

5.2 The Regulators Forum

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

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

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

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

- the commercial interests of facility owners and access seekers;
- consequences for competition, economic efficiency and end users;
- asset valuation, cost of capital, depreciation and related costing issues;
- preventing monopoly pricing while encouraging the development of economically efficient rate structures;
- the appropriate application of price cap or rate base direct regulation methodologies versus more flexible negotiation/arbitration models;
- the tension between providing adequate regulatory certainty while retaining sufficient regulatory flexibility; and

- the expertise, analytical, modelling, information and procedural requirements to perform these regulatory functions in practice.

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

6. CONCLUSION

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