
Regulatory issues

Electricity

Approval of guidelines for the negotiation of discounts

On 3 May 2002 the Commission approved the *Guidelines for the negotiation of discounted transmission charges*. The aim of the guidelines is to encourage transmission network service providers (TNSPs) to offer discounts to their customers when, and only when, there is a net economic benefit to the market. This should ensure that: customers do not leave the network, decide not to join the network or decide not to increase their demand for electricity when this would not be in the market's interest. The guidelines also ensure that other network users are not worse off as a result of the discount being offered than they would have been had the discount not been provided.

The Commission released a discussion paper containing draft guidelines for public comment on 10 October 2001. The submissions received were considered in developing the final guidelines. The Commission also took into account issues arising out of an assessment of an application for discount recovery received in accordance with clause 6.5.8(c)(1) of the National Electricity Code.

Specifically, the code permits a TNSP to recover the amount of a discount to a transmission customer's general and/or common service charges from other transmission customers, provided it is satisfied that it can demonstrate that the discount complies with the guidelines. If at subsequent revenue resets, the TNSP does not demonstrate to the satisfaction of the Commission that the discount satisfies the guidelines, the Commission may reduce the TNSP's revenue cap for the next regulatory control period.

Accordingly, the guidelines developed by the Commission have explicit objectives. First, a TNSP must ensure that the discount offered is no larger than that necessary to prevent the general and/or common service charges altering the beneficiary's behaviour. Further, the guidelines impose a responsibility on the TNSP to ensure that no other network users are worse off as a result of the

discount being offered. The Commission recognises that there may be costs incurred in negotiating a discount with transmission network customers, hence there is a safe-harbour provision that enables approval of 70 per cent of the amount of a discount, provided that a TNSP agrees to absorb the remaining 30 per cent. Finally, the Commission has included a guideline for the treatment of pre-existing discounts if the discount is provided in accordance with an agreement entered into before 10 October 2001.

Full retail competition—Mark II

On 10 December 2001 the Commission received applications for authorisation of amendments to the National Electricity Code to facilitate the introduction of full retail competition (FRC). The applications were submitted by the National Electricity Code Administrator (NECA), on behalf of the National Electricity Market Management Company (NEMMCO), under Part VII of the Trade Practices Act. The code changes relate to NEMMCO's powers to determine a 'declared' project and the market fees needed to cover the project's costs. The supplementary code changes also cover the processes for collection and transfer of data to facilitate full retail competition. And the amendments allow for the recovery of market fees relating to the introduction of FRC to be deferred until 1 July 2003.

On 8 May 2002 the Commission issued its determination with its analysis and views. This is available on the ACCC website at <<http://www.accc.gov.au>>.

The Commission considers that these code changes will facilitate the smooth transition to full retail contestability in the National Electricity Market (NEM) and lead to significant public benefit. Deferring the recovery of market fees to account for the development of systems required for FRC will mean that the costs will be more equitably allocated across customers in all states participating in the NEM that are likely to introduce FRC.

The supplementary code amendments facilitate the efficient collection and management of market data. The changes also allow automation in the area of discovery and transfer of customer and market data.

Without such automation, the potential transfer costs may block effective participation in a competitive retail market.

In addition, the clarification of NEMMCO's ability to declare a project and determine market fees for such a project will facilitate a smoother market development process in the future.

Review of technical standards: interim extension of existing derogations—National Electricity Code

On 15 February 2002 NECA applied to the Commission for authorisation of an interim extension of certain existing derogations to the National Electricity Code. This was to allow a managed transition by generators to the new arrangements proposed by NECA in its final report on the review of technical standards published on 7 December 2001.

The existing derogations allow the generators to meet different technical standards from those in the code. However, the derogations were to expire on 31 December 2002. NECA argued that it would take some considerable time to finalise and implement code changes arising out of its review.

On 5 June 2002 the Commission released its final determination granting authorisation to the proposed code changes, with the period of authorisation to expire on the earlier of 31 December 2004 or 12 months after the revised technical standards are gazetted.

This determination can be found on the ACCC website at <<http://www.accc.gov.au>>.

Principles for regulating transmission revenues—information requirements

On 27 May 1999 the Commission released its draft Statement of principles for the regulation of transmission revenues (regulatory principles). The draft regulatory principles outlined the Commission's initial views on the information disclosure requirements that it would impose on TNSPs. Draft information requirements guidelines were subsequently issued by the Commission on 9 May 2001 seeking comments from interested parties.

On 5 June 2002 the Commission released its final information requirements guidelines. The Commission's objective in issuing these guidelines is to reinforce the effectiveness of the regulatory

processes by limiting the ability of the TNSPs to extend their monopoly powers from the network business to the contestable parts of the industry. In particular, the Commission is seeking to ensure that regulated activities do not cross-subsidise contestable activities.

TNSPs are required to separate out prescribed and non-prescribed services when performing their regulatory accounting. TNSPs are also needed to reasonably allocate costs shared between prescribed services and any other activities.

Information provided by the regulated TNSP will form the basis of the Commission's revenue cap decisions. The Commission will also use its information gathering powers to annually monitor the TNSP's compliance with its revenue cap.

This decision is available on the ACCC website at <<http://www.accc.gov.au>>.

Airports regulatory regime

On 13 May 2002 the Government announced its response to the Productivity Commission's *Report on airport price regulation*.¹ The PC reported to the Government in January after conducting an inquiry into airport price regulation throughout 2001.

The Government decided to implement price monitoring of aeronautical services and aeronautical-related services at Sydney, Brisbane,

¹ In recent years a number of major airports have been subject to price regulation under the PS Act. The regulation has generally taken the form of a price cap on aeronautical services such as provision of runway and terminal facilities by the airports. Aeronautical-related services, such as check-in counters and car parking, were subject to price monitoring. In addition, the regulatory regime included service quality monitoring and financial reporting requirements administered by the Commission. These arrangements were applicable for the five-year period starting from when Melbourne, Brisbane and Perth airports were leased in July 1997. The PC inquiry reviewed these regulatory arrangements and made recommendations for what approach should be implemented from July 2002.

Before the inquiry was completed in October 2001 the price cap arrangements were revoked at eight airports, Adelaide, Alice Springs, Canberra, Coolangatta, Darwin, Hobart, Launceston and Townsville. In June 2002, the Government revoked the remaining declarations for Sydney, Melbourne, Brisbane and Perth airports.

Melbourne, Perth, Adelaide, Canberra and Darwin airports. The monitoring will be conducted under s. 27A of the *Prices Surveillance Act 1983*.

A price cap will apply for regional aeronautical services at Sydney Airport, with average charges only allowed to increase in line with inflation.

Service quality monitoring is to continue at the seven airports subject to price monitoring. The Government considers that service quality monitoring is a useful adjunct to price monitoring as it helps ensure that airport operators do not reduce costs in ways that reduce the standards of service below that expected by airport stakeholders. The Government also decided that financial reporting under Part 7 of the *Airports Act 1996* be retained, subject to some review of the details.

Specific provisions for access—currently available under s. 192 of the *Airports Act*—will be discontinued, with the general access provisions of Part IIIA of the *Trade Practices Act* providing possible recourse for access seekers.

A review will be conducted before June 2007 to assess whether price needs to be regulated. The Government also reserved the right to bring forward a review if it appears that there have been unjustifiable price increases in the intervening period. The Government set out some review criteria against which it would assess the need for stricter prices oversight, and indicated that it will only consider stricter controls if the review indicates that airport operators have breached these principles.

The Commission is presently developing guidelines for its information requirements under the new price monitoring regime and will consult with other stakeholders.

During the term of the monitoring regime, the Commission will report annually on the prices, costs and profits for the aeronautical and aeronautical-related services listed under the monitoring direction for the seven declared airports. In addition, it will continue to report on service quality and publish financial information under the regulatory reporting framework.



Reforming Australia's energy markets: Commission submission to the Energy Market Review

Last year the Council of Australian Governments (COAG) initiated an independent review of Australia's energy markets (the Energy Market Review). The terms of reference are wide ranging, covering both the gas and electricity sectors. The Commission prepared a submission for the review. It is available at <<http://www.energymarketreview.org>> and summarises the main points.

Energy reform process stalling

During the 1990's COAG agreed to fundamental reforms to gas and electricity markets. The reforms introduced by COAG aimed for market driven outcomes as far as possible, with free and fair trade in energy. To achieve this COAG introduced measures directed at making energy markets operate more effectively. At the same time COAG recognised that not all markets can be competitive, so it established access regimes covering electricity transmission and distribution networks and some gas pipelines.

Historically Australia's energy markets have been geographically fragmented. COAG aimed to establish a national market in which companies can compete across state boundaries. When it set out its objectives COAG addressed the gas and electricity markets separately. It is now possible to envisage an integrated energy market in which gas competes with electricity and the importance of gas in electricity generation is recognised.²

The reforms introduced over the past decade have gone a long way to achieving the objectives set out by COAG. State and territory governments, in conjunction with the Commonwealth, structurally separated government owned gas and electricity utilities, established the National Electricity Market (NEM) and established new institutions to manage and regulate energy markets. They also established access regimes covering electricity transmission and distribution services and gas pipelines.

The benefits are showing with a trend to more efficient electricity and gas pricing, improved service standards and substantial new investment in all parts of the energy market.

² Already 20 per cent of gas is used to generate electricity.

Nevertheless there is still some way to go before the goals set by COAG in the 1990s are achieved. Thus:

- in the electricity industry further structural reforms are needed to realise the full competitive potential of the NEM
- the NEM also remains somewhat fragmented because of inadequate transmission interconnection
- customer choice of supplier is still not available to many energy customers and information to drive demand side responses remains inadequate.

More fundamentally the existing arrangements do not provide an effective mechanism to develop and implement these reforms and address other issues as they arise. Agreement by the states is required before this can happen and leadership is needed to drive the reforms to achieve COAG's original objectives. In practice little progress is being made on either front. The reform process is stalling.

Reforms to the wholesale electricity market

The Commission's submission proposes various reforms to help achieve the competitive potential of the NEM.

The experience in Australia and overseas suggests that generators may have some market power even if there are several competing companies. Two consultancy reports commissioned by the Commission last year identify 'price spikes' attributable to generator market power.³ In the UK OFGEM considered market power issues in detail and reached similar conclusions.⁴ Modelling work carried out by ABARE suggests that large generation companies can dominate particular segments of the market in some states.⁵ The occasional price spike seems inevitable and is not necessarily inconsistent with efficient outcomes. The challenge for policy makers and regulators is to prevent frequent price spikes and extended periods of high prices that are not driven by supply and demand considerations.

³ One report (*Review of Generators Bidding and Rebidding Practices in the NEM*) was by Robert Booth of Bardak Ventures and the other (*Review of Generators' Bidding and Rebidding*) by Hugh Banister of Intelligent Energy Systems.

⁴ Office of Gas and Electricity Markets (OFGEM), *Pool prices in July—statutory consultation on proposed licence amendments*, December 1999.

⁵ Australian Bureau of Agricultural and Resource Economics, consultancy report carried out for the Commission in 1997.

The Commission believes that further reform is needed to address market power in the wholesale market by promoting competition and providing better investment signals. The proposals are directed to making the electricity market operate more effectively through:

- new entry and/or further structural reforms
- completion of the move to full retail contestability and the roll out of interval based meters
- further investment in transmission between the states (and supporting intra-state transmission).

The first and third of these reform proposals is designed to increase competition between generators, both within states by increasing the number of competing generators, and between states through increased interconnection.

The second reform proposal (complete the move to full retail contestability and encourage the roll-out of interval based meters) is directed at COAG's objective of giving energy consumers choice of supplier and making electricity markets work more effectively. Choice of supplier and interval metering are pre-requisites to allowing demand-side participation (so users can respond to peak prices and other price signals).

The third proposal reflects the Commission's view that interconnection investment outcomes could be improved. Interconnection investments have been relatively slow to materialise and the NEM remains loosely connected. The limited interconnection between states often leads to network constraints which segment the market. When states are isolated there is less competition between generation. Limited interconnection also increases the risks of power failures and increases reserve capacity needs.

The Commission favours giving greater emphasis to the market in determining future transmission investment. In the longer term there may be scope to rely more heavily on market-driven investment outcomes undertaken by Market Network Service Providers (MNSPs). This would involve a strong commitment to the move to nodal pricing and the provision of firm transmission rights.

However, if governments are not willing to commit to market based solutions for electricity transmission then it is desirable to bring both an independent and national perspective to network planning. This will help to ensure that regulated investment is planned on a market-wide basis and does not crowd out alternative investment options. To this end this submission proposes establishing a new national body

(under the umbrella of NEMMCO) to plan transmission investment requirements for the NEM as a whole. The approach is modelled on the planning arrangements undertaken by VENCorp in Victoria.

Developing a national gas market

An Australia-wide and integrated gas network is the shared vision of producers, regulators, and government and will enable inter-basin competition to become widespread. Notwithstanding the ongoing expansion of pipeline infrastructure and other changes that have occurred, the present oligopolistic gas transmission network is unlikely to change without a corresponding increase in gas demand to drive further pipeline investment. An expanding gas market will require access to, and effective price signals from, the non-contestable transmission and distribution markets to produce efficient economic outcomes in downstream markets.

The in-principle case for addressing market power in these segments of the gas industry remains a priority today as it was at the outset of the reform process in 1995. Regulation seeks to do this by limiting the potential for asset owners to exert market power arising from these bottleneck facilities.

It is expected that the gas market will eventually expand and develop to a level at which an interconnected gas pipeline network allows vigorous inter-basin competition. If this were adequately demonstrated, there would be a case for reducing the level of regulation of these assets. In practice, Australia's low population density and long distances between gas basins and major cities means that the current oligopolistic conditions for gas transmission are likely to continue for some time.

Regulation and new investment

It is generally accepted that there is significant market power in gas and electricity distribution services and some transmission services. From an economic efficiency perspective market power in distribution and transmission services should be addressed through effective price and access regulation.

In the absence of regulation, higher energy prices flowing from denial of access or high access prices will affect business input costs and the ability of businesses to compete in Australia and overseas. Over time, high prices are also likely to significantly affect downstream investment, particularly in the energy intensive manufacturing and resource processing sectors.

High gas prices also affect electricity prices. Electricity is increasingly generated using gas. While energy prices themselves are not overly high in Australia, the objective of the reforms is to ensure that energy markets can deliver efficiently priced gas and electricity that is reliably supplied.

The case for regulation has been recognised in the gas and electricity codes. It is also widely recognised overseas. Most OECD countries have comprehensive regulatory arrangements in the gas and electricity sectors. The one example of a more 'light handed' approach is in New Zealand. However, the New Zealand Government is moving to re-regulate electricity transmission and distribution after disappointing outcomes in recent years. Also regulation benefits need to be weighed against regulation costs. Thus regulation should be targeted only at those services with significant market power.

Australian governments have adopted incentive-based regulation in the form of CPI-X price or revenue caps. The approach does not cap returns on equity. Instead prices are based on expected usage and costs. If a business is able to outperform its forecasts or reduce operating and maintenance costs, it can exceed the benchmark return anticipated by the regulator. The evidence to date suggests that the regulatory provisions have helped to deliver efficient prices and improved service outcomes.⁶ The evidence also suggests that the current regulatory provisions and their application provide a solid base for future investment in electricity and gas transmission regulation, in part because the Commission's regulatory decisions provide earnings opportunities comparable to those elsewhere on the Australian share market.⁷ Recent investment outcomes and proposals include the following:

- more than \$800 million in gas transmission developments is under construction or committed⁸

⁶ Price, quality and investment outcomes over the past few years are discussed in chapter 8 of the Commission's submission.

⁷ The returns on equity provided in the Commission's decisions range from 11.8 per cent to 15.4 per cent. This compares with an average return on equity from investing in the Australian share market over the past ten years of 11.7 per cent and an average return on Australian superannuation funds over the last three years of 6.6 per cent. The Commission's decisions also compare favourably to regulatory decisions in the United States, the United Kingdom and Canada which have provided post-tax nominal returns to equity of between 9 per cent and 12 per cent.

- a further \$5.4 billion in gas transmission investment is proposed⁸
- \$2.5 billion in new intra-state electricity transmission investments is underway or planned (the new investment will increase the transmission asset base in the NEM by 40–50 per cent over a period of around five years).

Nevertheless the Commission understands the risks associated with some investments and has worked with industry to understand and address the potential impact of regulation on new investment. The Commission recently released guidelines to help industry develop access arrangements that accommodate the risks associated with greenfield gas developments.

Governance

Responsibility for managing and regulating gas and electricity markets is shared between several state and federal agencies. The nature of the governance arrangements partly reflects the constitutional split in responsibilities and partly the states' historical involvement in energy markets.

Over the past few years the arrangements have proved workable in delivering reforms in both sectors. The governance arrangements are, however, a compromise and are less than ideal particularly in the NEM. No single agency has responsibility for the NEM. This means that none of the agencies is well placed to provide strategic direction for the NEM and energy markets as a whole. Further concerns, though less significant, are that market participants have to deal with multiple regulators and the electricity code change process is complex and sometimes slow.

This submission considers three options for addressing shortcomings in the governance arrangements covering the NEM.

The first option is to establish a national regulator. It could potentially take on the roles of the state regulators, NECA and some of those of the Commission.

There are various advantages and disadvantages with this approach. Among the advantages are that it may reduce some of the costs of dealing with regulators and is likely to see a high level of consistency in regulatory decision making in energy. But state

regulators as well as the Commission would have a continued involvement in regulating other sectors—so creating a new energy regulator could increase the total number of regulators. Furthermore, while establishing a national regulator may increase consistency in decision making in energy it seems likely that it would reduce consistency in regulating access across the various utility sectors.

In theory a national regulator should be able to provide market leadership and direction to energy markets, but this does not seem likely given the current role of governments. Current institutions are either not allowed to exercise leadership, or when they do, governments move to reclaim such a role for themselves.

The second option is to increase cooperation between regulators and streamline activities between the national bodies. Consistency between regulators is currently being actively pursued through the Utilities Regulators Forum and the Energy Committee of the Commission.¹⁰ This approach could be strengthened by changing the Electricity Code change process and its administration to ensure that only a single process is undertaken in seeking input from key stakeholders such as government, industry and users.

A third option is to consolidate the regulatory activities of the national bodies involved in regulating the electricity sector: NECA, NEMMCO and the Commission.

NEMMCO is the electricity pool operator and it would make little sense to have its functions moved. However, there are potential advantages in consolidating the functions undertaken by NECA and the Commission. It is claimed that there is duplication of consultation processes for code changes. Rationalising them could save time. Two things need to be considered though. First, such a change does not in itself address the role of key stakeholders such as governments. Second, depending on how such consolidation is undertaken, the outcome could be greater rather than less regulatory fragmentation as the Commission would continue to undertake a range of functions under

⁸ Source: Delta Electricity & Access Economics *Investment Monitor* no. 46, June 2001, p. 20.

⁹ *ibid*

¹⁰ The Regulators' Forum comprises economic regulators from the Commonwealth and each of the states and territories. The Energy Committee (which is part of the Commission) comprises representatives from the Commission and state energy regulators acting in their capacity as ex-officio members of the Commission. It reviews electricity and gas regulatory matters before the Commission.

the Trade Practices Act including assessment of merger proposals (s. 50), authorisation of Code changes (Part VII), assessment of access codes and undertakings (ss. 44ZZA and 44ZZAA), enforcement of Part VI provisions including misuse of market power (s. 46) and enforcement of consumer protection provisions (Part V).

Depending on how they are implemented, these options could result in some administrative savings. However, the key issue to be addressed remains a commitment by key stakeholders in particular jurisdictions to complete the implementation of the NEM and allow the mechanisms needed by a properly functioning market to develop. These include allowing price signals to reflect market conditions (including in transmission), the development of secondary markets to enable proper risk management tools to be used, and an industry structure that allows adequate competition to emerge both upstream and downstream.

Productivity Commission report on harbour towage

The position paper of the public inquiry, Economic regulation of harbour towage and related services, was released by the Productivity Commission on 6 June 2002.

Printed copies of the report can be obtained from Michelle Cross, phone (03) 9653 2115, and it is also available at <<http://www.pc.gov.au/inquiry/harbourtowage/positionpaper/index.html>>

Australia Post proposes price increases

On April 30 2002 Australia Post provided the Commission with a draft notification identifying proposed price changes to some notified services, including the price of the basic postage stamp, pre-sorted mail, greeting cards and large letters, effective 13 January 2003. Australia Post also proposed to introduce a new bulk mail category, 'Clean Mail', priced at a discount to the basic postage rate.

Under the *Australian Postal Corporation Act 1989*, some postal services are 'reserved' or are exclusive to Australia Post such as delivering letters within Australia and issuing postage stamps. Services 'reserved' to Australia Post are declared under the *Prices Surveillance Act 1983* and the Commission is responsible for assessing any proposed price changes to these services.

Australia Post argues that the price increases are needed because of diminishing volume growth, diminishing productivity gains, the need to fund its community service obligations (CSO) and to generate commercial rates of return.

The Commission is currently considering Australia Post's proposal. An issues paper seeking comments was released on 10 May 2002. Submissions have been received from various organisations including representative bodies such as the Major Mail Users Association and businesses from the printing, direct marketing and mail aggregation industries.

Many of the submissions opposed the price increases. Concerns expressed in the submissions include:

- predictions made by Australia Post on volume decline
- Australia Post's suggestions that there is reduced scope for productivity gains
- Australia Post's estimates of the impact on users of the removal of the AdPost service and the proposed price changes.

The Commission has chaired various public forums in the course of its assessment. These were held in cities throughout Australia between 17 June and 28 June 2002 and provided an opportunity for consumers and small businesses, in particular, to comment on the price proposals. In addition, the Commission held a technical issues forum in Melbourne on 11 July 2002.

The Commission intends to release a draft decision shortly. Further comments will then be sought from interested parties before a final decision is released.

