11 June 2004

NCP Inquiry
Productivity Commission
PO Box 80
Belconnen ACT 2616

**Submission to Review of National Competition Policy Arrangements**

Thank you for the opportunity to respond to the Terms of Reference provided to the Productivity Commission (the Commission) in relation to the Review of National Competition Policy (NCP). The Review is timely in the context of the more specific reforms currently underway in the energy sector.

As the Issues Paper identifies, key elements of the original NCP reform package included, among other things:

- introducing third party access arrangements for infrastructure services to promote competition in related markets; and

- specific initiatives to establish independent authorities to set, administer or oversee prices for services remaining under monopoly control.

ENERGEX has a number of comments in relation to these two particular points, for the consideration of the Commission.

<u>Third party access to promote competition in related markets</u>

ENERGEX is of the view that the process of opening up monopoly infrastructure has, for the most part, been a successful element of NCP. For example, there is a good level of competition in the National Electricity Market, and multiple retailers now compete for customers on many gas and electricity networks across Australia. The extent to which competition has driven savings and improved service for consumers, as opposed to other factors (such as technology and managerial change), is difficult to quantify. However, what is clear is that the energy sector has become more efficient over time, and that consumers have benefited from this improvement.

Having said this, a number of issues associated with “related markets” also warrant attention. The NCP ideal was to introduce access in monopoly markets in order to promote competition in other markets, such as generation and retail energy markets. However, the reality has been that while the introduction of network access has promoted competition, a range of other intrusions into related markets have, to a large extent, acted to inhibit competition. The current Ministerial Council on Energy reform program, for example, is considering increasing the level of regulation in the generation market. Such changes in the National Electricity Market have the potential to impose

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much larger costs than the commensurate benefits they might bring. This highlights the dangers inherent in trying to fine-tune an otherwise competitive market. In addition, restrictions in upstream gas markets have had a negative impact on the ability of the downstream gas industry to compete effectively.

The lesson from both the NCP reforms of the past and the current energy reform program is that competitive markets should be allowed to flourish as free from regulatory intervention as possible. While this will inevitably mean some glitches will occur, these are generally short-term in nature and best resolved through market processes. Any intrusion to correct perceived market failures should be confined to circumstances where a clear case can be put that the failure is structural, and where analysis indicates that there are net benefits in imposing a regulatory solution over a market-based one.

Prices oversight for monopoly services by independent authorities

The second area worthy of some comment is that of price or revenue control of those services deemed to have monopoly characteristics that could not be opened up to competition.

ENERGEX believes the original intention of the NCP process was for a light-handed approach to the oversight of monopoly pricing. The original 1993 Hilmer report “National Competition Policy – Report by the Independent Committee of Inquiry” noted that:

> *The Committee supports formalising a prices monitoring power as a less intrusive form of overseeing pricing behaviour … The Committee was not persuaded of a need to include a price control power. Regulated prices increase the risk of deterring efficient business activity. … In these circumstances, the Committee favours reliance on less intrusive powers … “ [p. 276-7]*

The then Industry Commission, in its November 1995 report “Implementing the National Competition Policy: Access and Prices Regulation”, also noted that:

> *Under the new competition policy agreements, prices surveillance processes will be streamlined, less obstructive prices monitoring will be formally introduced, and prices oversight (encompassing both surveillance and monitoring) will be extended to State and Territory GBEs. [p. xiii]*
>
> *There is a case for … reducing the extent of price controls in favour of prices oversight (see section 4.2). Price control measures may involve greater costs than prices oversight in terms of reduced incentives for investment and productivity improvement. They may also encourage greater intervention in the management of firms and be used as an alternative to promoting competition. [p. xiii]*

However, in practice, regulation of monopoly prices has proved to be much more intrusive and interventionist than was first envisaged. The prices oversight model was effectively abandoned in favour of a cost-of-service, building block approach that involved a highly detailed level of scrutiny and justification of infrastructure costs. The objective of removing monopoly rents dominated the regulatory process, while other objectives, such as facilitating investment and meeting customer needs, were given little consideration.

Following disillusionment with this, and other, aspects of monopoly price regulation, the Productivity Commission investigated both the National Access Regime and the Gas Access Regime. It concluded in its September 2001 Review of the National Access Regime:

> *The present national access regime is deficient in a number of respects … most importantly, the national access regime does not do enough to guard against the possibility that investment in essential infrastructure will be deterred. So called 'regulatory risk' under the regime is greater than it need be … there is a significant risk that arbitrated determinations under the regime could go beyond appropriating genuine monopoly rent. Furthermore, the fact that coverage and other determinations are generally made after a facility is in place gives rise to the possibility of regulatory 'moral hazard'. [p. xxi]*

And further, in the December 2003 Draft Report on the Review of the Gas Access Regime, the Commission found:

> *The original approach for access regulation (as reflected in the Competition Principles Agreement and subsequent enactment of part IIIA of the Trade Practices Act) was to promote competition in upstream and downstream markets. This was to be achieved by establishing a right for third party access to the services of essential facilities (such as gas transmission and distribution networks) and preventing the misuse of terms and conditions of access (including price). … Although the gas access regime appears to be based on a negotiate-arbitrate framework, in practice it has become price regulation of the services available to third party access seekers from covered pipelines. … The outcome has been that third party access is essentially based on the regulator approved cost related reference tariff. … There is a high degree of risk that the price set by the regulator is no more efficient than that which would have prevailed in the absence of price regulation, particular given the other deficiencies in the regulation discussed below. There is a significant prospect that the regulation of prices is leading to a distortion in investment … and delaying the development of new pipelines. [p. xxv-xxvi]*

ENERGEX endorses these findings and believes the current deficiencies in monopoly price regulation indicate a deviation from the original intentions of NCP. ENERGEX believes that the findings are reinforced by a range of recent court decisions and determinations by the Australian Competition Tribunal, which have been referenced in Allgas' submissions to the Review of the Gas Access Regime. Also pertinent is the recent House of Commons review of blackouts in the UK, which found the root cause to be the intrusive form of regulation applied by the regulator, a form identical to that applied here.

To this end, ENERGEX strongly supports the model put forward by the Productivity Commission in its Draft Report on the Review of the Gas Access Regime, which involves a return to the concept of price monitoring as a genuinely light-handed approach to the oversight of monopoly prices, and a less stringent coverage test in determining whether infrastructure should indeed be regulated at all. ENERGEX urges the Commission to consider endorsing the wider application of such an approach across all regulated infrastructure industries.

ENERGEX trusts these high level comments will be of interest to the Commission in the preparation of what will undoubtedly be a wide-ranging report of interest to all sectors of the Australian community.

Yours sincerely

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