Energy Supply Association of Australia Limited

SUBMISSION TO
THE PRODUCTIVITY COMMISSION REVIEW OF NATIONAL COMPETITION POLICY ARRANGEMENTS

2 July 2004

INTRODUCTION

The Energy Supply Association of Australia (esaa) welcomes the opportunity to comment on the Productivity Commission's Review of the National Competition Policy (NCP) arrangements. esaa is the peak industry body representing the electricity and downstream gas industries in Australia, which includes more than 50 member businesses with over $110 billion in assets.

This submission focuses exclusively on the NCP arrangements and their impact on the stationary energy sector. Section 1 details some of the achievements of competition policy reform in the energy sector, while Section 2 examines the need for further reform if we are to realise the full potential benefits of NCP and attract the necessary future investment in energy infrastructure.

SECTION 1: REFORM ACHIEVEMENTS

OVERVIEW

In the early 1990's, Australian governments agreed to develop competitive energy markets to achieve more efficient, market based arrangements for the production, trade and consumption of electricity and gas. Specific objectives included: -

- Structural reform of publicly owned utilities;
- Creation of competitive stationary energy retail markets in the eastern States;
- A competitive wholesale market for electricity with a separate financial contract market; and
- Open access and economic regulation of gas and electricity networks.

This reform program has delivered considerable benefits to the economy. ABARE estimates suggest that the economy-wide benefits of reform, in electricity alone, had delivered around $A1.5 billion per year by 2000, with the potential to rise to around $A2.4 billion annually by 2010.

The benefits within the electricity sector have also included improved productivity (labour productivity and capacity utilisation) and internationally competitive electricity prices for customers. New generation and network capacity investments have taken place in response to market signals.

In the gas industry, the enabling of third party access to transmission and distribution pipelines has supported the early development of greater downstream competition. However, the relatively aggressive economic regulation experienced by the pre-existing pipelines has resulted in all new pipelines being built and operated in a manner that avoids economic regulation.

ELECTRICITY

PRICES

According to data collected by esaa, real average electricity retail prices for all Australian users have declined by 14% since the reform process began 10 years ago. Non-residential customers, i.e. commercial customers, have received the largest

reductions of about 20%. Residential prices have remained relatively stable over the same period despite the introduction of the GST. This occurred as a result of the removal of major cross subsidies from business customers to residential customers.

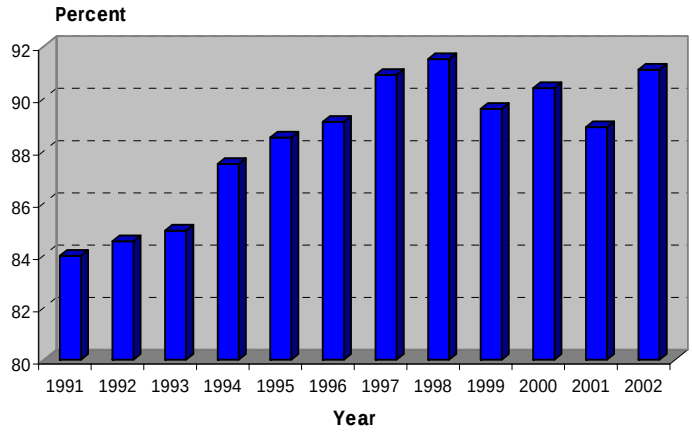
Reductions in the operating costs underlie most of these price reductions. As mentioned above, there has also been a realignment of prices across user groups.

Rural and regional Australia have also benefited from the reduction in real electricity prices. Over the period between 1996/7 and 2003/04 real tariff rates for farmers have declined in all jurisdictions within Australia.

GENERATOR AVAILABILITY

There have also been major reductions in the capital requirements for the industry as a result of competition reform. As shown below, generator availability has increased dramatically over the period of the reform program.

Generator Availability Factor 1991 to 2002



Source – Electricity Australia 2003, **esaa Ltd**

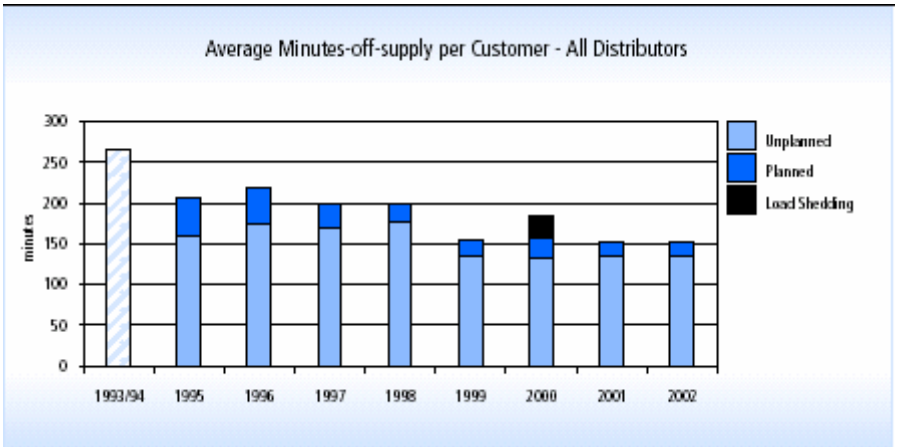
Following a concerted program of performance improvements, generator availability in New South Wales increased from around 80% in the 1980's to approximately 90% by the late 1990's. In Victoria, the improvement was more pronounced with availability rising to 93%.

These efficiency improvements demonstrate that competition pressures have resulted in better management of power plants. Billions of dollars of premature investment in new generation facilities that occurred in the period of state based monopoly generators has been avoided since the reform program was implemented, by exposing decisions of investors to market-based discipline. Indeed, power stations earmarked for closure have had their lives extended, while the price signals in the market have resulted in generation being built where it has been needed; in Queensland and South Australia for baseload and Victoria for peaking plant.

RELIABILITY OF SERVICE

While the massively increased reliability of generators has improved availability, so too has distribution reliability improved considerably in recent years. As an example, in Victoria, as illustrated below, there has been a continuing trend of improvement in the State's supply reliability. The average minutes-off-supply per customer in 1995 exceeded 200. The average minutes-off supply per customer for 2002 was 151 minutes, similar to that recorded for 2001 (152 minutes). Both the planned and unplanned minutes-off-supply remained stable at approximately 17 minutes and 135 minutes respectively. A similar improvement has been seen in most other jurisdictions.

Victorian Average minutes-off-supply per Customer – All Distributors



Source – Essential Services Commission of Victoria

Over the past four years, the average unplanned minutes-off-supply in Victoria remained considerably lower than the average for the period 1995-98[1]. Since 1999, the total State-wide unplanned minutes-off-supply remained relatively constant at around 135 minutes per year – a 21% improvement on the annual average of 170 minutes for 1995-98.

Planned minutes-off-supply per customer steadily decreased from 46 minutes in 1995 to 23 minutes in 1998, 22 minutes in 1999 and 17 minutes in 2001, remaining steady in 2002. Reductions in planned minutes-off-supply in previous years were due to increased live-line work and other initiatives to avoid interruptions to customers.

GAS

Prior to the application of competition reforms, the natural gas sector was characterised by single basin to single market pipelines. Carriage of gas on these pipelines was effected under bilateral contracts, often on a "take or pay" basis. Access to gas transportation, even if space capacity was available, was very difficult for third parties. Consequently monopoly retail, production and transportation arrangements characterised the sector.

[1] This excludes 28 unplanned minutes-off-supply due to load shedding in 2000, because these events were beyond the control of the distributors.

Competition reforms focused on enabling third parties to access pipeline capacity on fair and equitable terms. The resulting Natural Gas Pipeline Access Law and related Code undoubtedly supported the entry of new retailers and the initial establishment of competition downstream.

However, the existing pipelines were subjected to a restrictive economic regulatory approach that acted as a disincentive to investment, especially in the transmission sector. This is currently the subject of a separate Commission Inquiry.

For a variety of reasons, the past decade has seen a significant expansion in Australia's gas industry. Australia's gas pipeline infrastructure is now over 90 thousand kilometres and links over 3.5 million customers. The industry has been expanding in response to market signals – rather than the economic regulatory regime. In the 5 years to June 2000, over 13 thousand kilometres of gas reticulation and transmission pipelines were laid. Even more recently the energy sectors have been accounting for around 20% of the engineering construction work undertaken in Australia.

A more comprehensive integrated gas transmission system has been developed for Australia with the construction of SEAGAS, EGP and the Bass Strait pipelines. This has provided a greater security of supply by better integrating different sources of supply and allowing the development of different options for suppliers to provide gas to customers. This development alone has changed the nature of the gas market from a bilaterally negotiated arrangement between fixed source suppliers and limited number of retailers. The integration of the transmission pipelines from different supply fields has led to competition between fields and thus retailers for supplying customers. However, all of these pipelines have been constructed and operated in a manner to avoid the economic regulation regime. This regime remains an area in need of significant revision to support the on-going development of the domestic gas industry.

SECTION 2: THE NEED FOR FURTHER REFORM

As section one has demonstrated, competition reforms in the energy sector have undoubtedly been valuable. The full realisation of the potential benefits from national competition policy, however, have been constrained by governments declining to complete the process. These are evidenced by: retail price controls in electricity and gas; lack of full retail contestability in some jurisdictions; ineffective national regulation and the lack of a clear policy direction when dealing with carbon emissions. It is important that these constraints are lifted if the required new investment is to be realised.

THE NEED FOR NEW INVESTMENT

It is essential that the energy reform process, having reached this juncture, does not lose momentum. In terms of new investment, the energy sector has significant hurdles ahead.

Growth in energy use remains substantial, with annual electricity consumption expected to rise by around 50% from the current 180 GWh over the next 20 years. This translates to at least 13,500 MW of new generation capacity being installed at a cost of some $14 billion to meet this additional demand.

Even greater investment is required in distribution network systems. This part of the supply chain has been averaging investment in excess of $1 billion a year over the past five years, and we estimate that it will need to spend around $16-$18 billion over a 10 year period from 2003. This is needed not only to meet new demand but also to replace ageing infrastructure and to cope with the increasing demand of a digital economy.

Transmission spending is also substantial. Electricity transmission spending has involved about $600 million across Australia recently. Allowing for a number of new projects, we estimate that the next decade will require around $5 billion of new investment.

If a large part of new generation is to be gas-fired, as ABARE projects, then esaa estimates that another $7 billion will need to be spent on gas delivery infrastructure over the next decade.

An estimated additional $3 billion to be spent on renewable plant under the MRET requirements results in almost $40 billion of new investment will be required in meeting our stationary energy supply requirements over the next 10 years. This excludes the cost of upstream oil or gas requirements.

To attract new investment, governments need to create an environment which is conducive and competitive. The current environment has resulted in significant legislative and regulatory uncertainty, which if not adequately addressed, has the potential to delay investment in these essential services. While governments, through the Ministerial Council on Energy process and the Federal Government's recently released White Paper on Energy have addressed some of our concerns, there are still a number of areas remaining which require urgent attention. These are detailed below.

REMOVAL OF RETAIL PRICE CONTROLS

For an industry to be sustainable on a long-term basis, it is essential that prices to end-users reflect the cost of supply, and the market is allowed to set its own pricing levels without undue government interference. This is critical for three major reasons;

1) to attract the necessary investment
2) to encourage efficient usage
3) to encourage effective competition

Ultimately, retail prices that are set at a level below the cost of supply (which should include an equitable level of profit commensurate with the risk) will have a dampening effect on investment. Whilst over the short-term investments may be made, over time investors will have little incentive to invest in new assets, raising the possibility of supply shortages.

Providing energy to consumers at less than the cost of supply also provides little incentive to use energy more efficiently. Although advertising and other initiatives that try to change consumer behaviour are important, the most effective means of influencing consumer behaviour is via prices.

Finally, below long-run cost pricing provides little incentive for new suppliers to enter the market. Not only are existing retailers being required to act in other than a commercial manner, but their competitors stand no chance of competing on fair and equitable terms.

Despite the three reasons outlined above, every jurisdiction in this country has taken action to place caps on retail prices for domestic customers, in some cases at levels below the cost of long-run supply. Whilst we fully understand the reluctance of governments to pass through significant energy price increases to consumers, this is extremely short-sighted and can have catastrophic consequences, as seen in California. Ultimately increases in the cost base must be passed through the chain to the end-user. To do otherwise creates the real risk to the same end-user of under investment and inadequate supply.

In addition to the above, some states have also established “balancing funds” (eg Electricity Tariff Equalisation Fund in NSW and the Benchmark Pricing Agreement in Queensland) to reduce the trading risk for their government owned businesses. These funds have reduced liquidity in the wholesale market (not only in their own jurisdiction), while at the same time making it more difficult for second-tier retailers to compete with the host retailers. The report of the CoAG Energy Market Review explored this issue in detail and concluded that they represent a significant distortion to the NEM. These balancing funds should be removed if we are to realise the full benefits of national competition policy.

Recent moves by Victoria towards a lighter-handed form of regulation of retail prices for residential and small business customers, including multiple-year price paths, are to be welcomed and encouraged. Although a price cap still remains, retailers have been given more flexibility in their pricing together with greater long-term certainty. The greater “head-room” provided has helped to stimulate more competition, as is evidenced by the new participants in the market and the higher customer churn rates.

Ultimately, all of these market interferences by governments have the impact of distorting the operations of the market and impeding true competition. Whilst almost all of these actions are taken by governments "to protect the consumer", it is our submission that they are also having a negative impact which may ultimately end up costing customers more. Creating an environment which reduces barriers to entry and allows all energy retailers to compete fairly, will ensure effective competition, timely new investment and provide customers with the lowest sustainable level of pricing.

NEED FOR FULL RETAIL COMPETITION ACROSS ALL JURISDICTIONS

The substantial benefits that have accrued to commercial and industrial customers have largely been denied to many small business and residential consumers in three states and the Northern Territory. Without the ability to choose their energy supplier, there are no competitive disciplines placed on retailers and the consumer misses out on potentially innovative and value adding energy products and services. Governments that have declined to allow choice of retailer have generally done so on the basis that this also requires the removal of regulated retail prices and a concern that often geographically remote consumers will be price disadvantaged. esaa accepts that some consumer groups may be disadvantaged by full retail competition, but maintains that, if government policy is to protect these groups, then this should be done via a transparent government arrangement rather than through hidden cross-subsidies built into the price of energy. An example of this was the network subsidy introduced to compensate Victorian regional electricity consumers for tariff increases at the time of full retail competition in Victoria.

Even where this is not feasible, full retail competition can still occur along with price certainty for smaller consumers, as evidenced by the States who have mandated maximum retail prices along with choice of supplier. While not ideal or efficient, this is preferable to a lack of competition, provided that the price caps are set at a level that provides sufficient headroom for effective competition, and does not advantage incumbent retailers over new market entrants.

EFFECTIVE NATIONAL REGULATION

Whilst esaa agrees that the reforms currently being addressed by the CoAG Ministerial Council on Energy are timely and required, we have concerns over whether this ultimately will improve the regulatory environment. Although significant changes are being made, we query whether these will create a more effective and sustainably competitive industry.

Streamlined code change process

Our first concern is that the new revised national electricity code change process is not an efficient "one-step" process. esaa understands that the core principle behind the proposed institutional change is the acceptance of the need for an effective, transparent and streamlined code change process, where the roles and responsibilities of the various regulatory agencies are clearly defined, and they are accountable for their actions. It is our view that for this to occur the code change process should promote the swift conclusion of matters, and without the potential for duplication or overlap between regulatory bodies. esaa has for some time argued that the simplest way of achieving this is to establish a "one-step" code change process, rather than the duplicative process which currently occurs.

We believe that the proposed code change structure and process, as outlined in the recently tabled legislation, is likely to be a duplicative, inefficient process, with many of the same faults as the current process. The proposed new process has not precluded a 'two-step' decision making process as the ACCC remains able to commence its own, separate investigation into those Code changes that the AEMC has referred to it for authorisation and is consequently not an improvement on the current approach. This is likely to lead to lengthy approval processes, leading to added uncertainty and regulatory risk.

Need for economic merit review

esaa has significant concerns regarding rights of review and avenues of appeal for decisions of the new AEMC and AER. The new legislation states that, whilst ACCC decisions will be subject to both merit review by the Australian Competition Tribunal and judicial review on questions of law, decisions of the AEMC will only be subject to judicial review on questions of law. Further, revenue determination decisions made by the AER under the Electricity Code will not be subject to merit review, whilst the existing provision under the Gas Code for merit review of certain decisions will remain for the time being.

Clearly, there are a number of inconsistencies in the above proposals. The view of esaa is that all decisions of the ACCC, AEMC and the AER should be subject to judicial review on questions of law as well as merit review by the Australian Competition Tribunal. This does not appear to be in doubt.

We believe that accountability, consistent with independence and an appropriate balancing of interests, is achieved by the imposition of a clear and understandable legal framework, with oversight and supervision provided by a suitably qualified body. It is imperative that stakeholders are not denied the protection of the judicial system in an environment where the regulators have broad powers. We do not promote an environment of US style rate making where legal processes dominate, but recognition needs to be given to the fact that, with so much at stake in regulatory decision-making, resort to legal protection is a basic entitlement.

esaa also strongly believes that an appropriate appeal forum should be available to review the regulator's decision on merits, rather than simply exercise a supervisory jurisdiction. Regulatory decisions, especially in the determination of price paths, revenue caps and allowed rates of return involve subjective judgements that can critically alter outcomes for the affected businesses. For example, the price re-set process for regulated businesses is lengthy and intricate in which errors of calculation can be easily made and where the technical and economic application of the Codes can be open to reasonable debate. As such, esaa recommends that the Australian Competition Tribunal be used as an appropriate forum for appeal of decisions by the AEMC and AER, in the same manner as it is used for reviewing decisions of the ACCC. This is also consistent with practice in the United Kingdom, where the Competition Commission reviews decisions of the UK energy regulators on merit.

Need for national regulatory requirements

Under the new regulatory environment, regulation of the NEM needs to be national in nature, not only in name. This means a national approach to all regulatory requirements, including retail licensing and other compliance matters. The current state-based approach adds significant amounts to the cost of supply, as retailers struggle with developing different systems to meet the various state requirements.

Having a different set of license conditions and requirements in different States also acts as a barrier to entry, and may prevent retailers from growing their business and gaining the economies of scale necessary to reduce costs.

Although members of the MCE have indicated their agreement in principle of moving down this path, no formal timetable for the implementation of these important reforms is in place.

Urgent attention is also needed to resolve the problematic access and economic regulatory arrangements for gas pipelines. Many submissions to the current Productivity Commission review of the operation of the Gas Access Regime have described the very real problems that the current framework has delivered. Regulation of access and price should only be applied where competition is not in place. Clearly, with the advent of the Eastern Gas Pipeline and the SEA Gas pipeline, basin-on-basin and pipeline-on-pipeline competition exists for south and eastern Australia. This is a positive outcome that should be supported and further enhanced.

Further development of the natural gas network will be dependent on pipeline proponents being able to progress projects without the constraints of intrusive regulation. In circumstances where two parties are prepared to commit to long-term commercial arrangements for the transportation of gas in a new pipeline, then the proponent has every right to expect freedom to contract without the threat of later regulatory intrusion. Reducing investment risk is vital to achieving a well-developed natural gas network and hence market. Circumstances where regulators or third parties can intervene in otherwise private commercial relationships after commitment to construction has been achieved or surplus capacity is available in a privately owned pipeline is a hindrance to achieving long term gas market objectives, when viewed against the background of a “linked” transmission system in south-eastern Australia.

The need for an efficient, effective and robust regulatory framework is essential to attract the necessary infrastructure investment and create the competitive environment our economy requires. Investors in the stationary energy sector need to be confident that their investments will not be caught up in an inefficient regulatory environment where lengthy processes dominate and urgent action is delayed – something which we have experienced in the electricity sector in particular. Similarly, investors require assurance that regulators are accountable for their actions and that they have in place legislated rights of appeal against both the process followed and the economic merits of a decision. Regulators should not operate in an environment where, due to the absence of adequate policy direction, they become both developers and implementers of policy. Clearer guidelines and directions from policy makers will reduce the significant amounts of discretion currently allowed to regulators, thereby decreasing the level of risk to investors. Regulation must also be restricted to circumstances where there is clearly limited or no opportunity for competition or where significant and on-going market power is being exercised.

GREENHOUSE GASES

One of the biggest sovereign risk issues facing the energy sector is future Government policy and measures on greenhouse gases. Base load power stations cost at least a billion dollars each and have a lifespan of 35-50 years, while transmission systems for both electricity and gas have lives of around 50 years. Companies making these long lived investments have to understand their policy environment beyond the next few years.

At present there is no common Government policy position on dealing with carbon emissions, creating significant uncertainty for potential investors. Industry believes that greater certainty can be achieved by the Federal Government setting a single greenhouse gas emission target for 2050 that applies to the whole economy.

In setting the target, the Federal Government must ensure that Australia remains a competitive economy, providing much more certainty for investors while concurrently addressing the supply challenge and greenhouse objectives.

The target should be set in the context of an all encompassing international target to ensure that distortions to the international location of industries are not built into the system with consequent ineffectiveness of world abatement and reduced world economic production. Australian government negotiators should make this a fundamental criterion of any future international agreement.

Against a long term greenhouse gas abatement target, companies and individuals must be able to choose from the widest possible set of options, technologies and techniques to achieve the necessary reductions. The industry is strongly of the view that this should be through a mechanism that minimises the impact on the economy and the energy market. All potential mechanisms should be carefully modelled to ensure that their economy-wide impacts can be assessed and managed before any implementation decisions are made.

Technology developments will be an important contributor to achieving greenhouse gas abatement. esaa supports the moves by the Federal Government to coordinate and continue funding research efforts to reduce greenhouse gas emissions from the stationary energy sector. It is also vital that Australia is an active participant in developing global approaches to abate emissions to maximise access to the widest range of abatement measures and techniques.

The policy solution to greenhouse must encompass competition policy principles. The current range of existing and proposed State government greenhouse gas policy initiatives constrain a national approach and the consequent operation of an efficient national market in energy supply. Administratively required measures such as the NSW and Queensland schemes will not allow the market to work effectively in finding the least cost solutions.

Apart from having the widest possible range of measures for the industry and the economy to meet the long term obligations that are reached, any scheme must also be integrated to ensure that the least cost means of effectively achieving this are available. The various state based schemes will not allow the lowest cost means of achieving reductions but are an active barrier to achieving an integrated competitive market for electricity and gas in the different states.

esaa notes that the Issues Paper makes reference to the potential application of market based measures to address social and other objectives, including environmental goals. Specific mention is made of greenhouse gas emissions. As a normally strong advocate that effective and openly competitive market based arrangements deliver superior outcomes, esaa cautions that market based measures for greenhouse gas abatement, such as emissions trading, may not lead to the benefits that many people expect.

In esaa's view, care is required in pursuing market-based arrangements for carbon emission purposes, and their impacts should be carefully analysed before any decisions are made. Financial instruments alone will not necessarily lead to carbon abatement of significance in the electricity generation sector, yet can very easily erode the price benefits that were so eagerly pursued and delivered under the original National Competition Policy arrangements.

As noted above, in our opinion comprehensive greenhouse gas abatement policies are central to delivering the level of investor confidence necessary to meet the demand growth for energy and carbon emission abatement objectives. No single measure, instrument or technology will on its own deliver the necessary results and this applies as equally to market based financial instruments as it does to specific technologies.