

**Submission to the Productivity Commission's Review of National Competition
Policy Reforms**

December 2004

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The Independent Competition and Regulatory Commission (the commission) provides the following comments and observations in relation to the Productivity Commission's Discussion Draft on National Competition Policy Reforms. The commission's comments relate to specific conclusions and recommendations that were made by the Productivity Commission.

Energy

Governments should complete all outstanding NCP electricity and gas reforms.

The commission supports the proposal that governments should agree to complete outstanding NCP electricity and gas reforms, noting that the key elements of these reforms now include the establishment of the Australian Energy Regulator (AER) and the Australian Energy Market Commission (AEMC). Having publicly committed the nation to a 'national regulator', governments must now see this task through to completion.

While it was expected that both the AER and the AEMC would be fully operational by December 2004, this will not now occur. There is uncertainty about a number of issues relating to the AER/AEMC including the precise role these bodies will perform. This has created wider uncertainty not only within the market place but also within regulatory agencies. This uncertainty may be affecting investment decisions of regulated firms and the administrative decisions of regulatory agencies.

The commission believes that the announcement of a revised timetable for the establishment of the AER and the AEMC as well as public clarification of the role of each would alleviate some of this uncertainty.

The commission also believes that creating an efficient national energy market requires, where possible, the harmonization of regulatory procedures between jurisdictions and also between the processes adopted for the regulation of both the electricity and gas markets. We note that already at a national level the Utility Regulators Forum regularly meets to discuss, compare and jointly study regulatory issues and practices and has adopted consistent approaches to implementing regulation where possible under state derogations and rules. In addition, the ACCC Energy Committee, which consists of the heads of the various jurisdictional regulatory agencies, also deals with issues relating to generation, transmission and the operation of the electricity market rule making body, NECA, with the goal of achieving consistent national outcomes. Thus, even at this time of transition to the national regulator, the existing regulatory bodies have been actively involved in implementing a 'national' approach to regulation.

The commission also notes that the present transitional period leading to the adoption of a national regulator will create a further period of uncertainty for service providers and consumers. Ultimately this will contribute to further 'losses' to the domestic economy. Given the nature of incentive regulation which extends beyond a single year, even once the new regulators are established, the process of setting price paths and reviewing the performance of regulated utilities will take upwards of a decade before providers will overcome their apprehension of possible change. If allowance is made for the process of reviewing and implementing reviews for the Gas and Electricity Codes, this period of transition, or 'state-of-flux', is likely to continue for more than a decade. A piecemeal approach to the roll out of a national system is only delaying the process and compounding the uncertainty that already exists. It also provides the opportunities for rent seeking behaviour by those who find that they can exploit the 'uncertainty' that exist at a national public policy level to their own advantage. As a strong advocate of national competition reform and source of official estimates of the 'benefits' that such reform has given the domestic economy, the Productivity Commission has a responsibility to raise a clear warning to all parties that this interregnum period should not be used to wind back the achievements made over the last ten years.

In summary, the commission notes that while there may remain obligations under the National Competition Policy agreements that are yet unmet, there has been significant progress made under the current state based regulatory arrangements. In some sense the majority of the potential gains in efficiency may have already been achieved especially with respect to achieving efficient pricing and sending consistent investment incentives to providers in the future. However, these are now in jeopardy from further delays in implementing reform at a national level. The Productivity Commission has a responsibility to ensure that these gains are not lost to the Australian economy.

In addition to its current work program, the Ministerial Council on Energy should give priority to:

- ***resolving whether generator market power in particular regions is still excessive and if there is a need for further disaggregation of government owned generation businesses;***

There is currently no significant electricity generation within the ACT with only a mini hydro-electricity facility at ActewAGL's Mt Stromlo water treatment plant and a methane gas generator at a landfill. Currently ActewAGL is also considering the development of wind generation projects, other mini hydro-electricity plants and a possible gas powered peaking plant.

In considering whether generator market power in particular regions is excessive there are several issues to consider. Benefits in regard to lower prices paid by consumers occur when the generator has limited, if any, market power. The possible result of reduced market power however, is the associated reduced incentive to invest in the generation market. As such, it is important that a balance between disaggregation and the incentive to invest is struck.

A natural consequence of additional investment in generation capacity is that the wholesale price of electricity would fall. For investment to be attractive the potential investor must believe that it can earn a reasonable return on its investment. It is the existence of market power and the expectation of being able to earn a return on investment that comes from some degree of market power that drives investment. Private investors will not desire to invest in markets where they cannot expect a reasonable return on their investment. As such, it is important that a balance be found such that sufficient incentive to invest remains while not allowing excessive market power to be exercised to the detriment of consumers. The issue is also one of national competitiveness. The commission recognises that while electricity prices are an important cost component for production, if prices are artificially low, leading to under investment, then national competitiveness may suffer as a result of electricity shortages.

The process whereby the Ministerial Council reaches decisions on market power in particular regions is complex, and it is difficult to envisage how this would be achieved. However, a clear set of principles need to be established and applied to this decision making process and the Productivity Commission could contribute by making suggestions on what should be included in these principles.

- ***assessing whether processes for screening the competition implications of any reintegration in the electricity industry need strengthening;***

The issue of reintegration in the electricity industry is another issue currently addressed across jurisdictions by the ACCC Energy Committee, upon which the commission has a presence. The commission considers that benefits to consumers in the form of lower prices are more likely to occur if integration between the generation, transmission, distribution and retail segments of the market are minimal and businesses are as such unable to exert market power in the form of higher prices. However, the commission acknowledges that reintegration proposals need to be assessed on their merits.

The commission notes the decision by the ACCC in which it granted a transmission ring-fencing waiver for Energy Australia in December 2003 and that the ACCC is currently considering a similar application for waiver by SPI PowerNet. The commission considers that any assessment of integration in the electricity market should involve an investigation into the possible opportunities created for cost shifting between regulated and unregulated, as well as between regulated segments of the market.

In undertaking any investigation, it is important to acknowledge the possible efficiencies that may be gained by any vertical integration of the electricity industry. The commission acknowledges that the disaggregation experienced during the 1990's was an important initiative in creating a national market but that disaggregation may in the longer term constrain the national market. The commission believes that reintegration in non-adjacent sectors may be more beneficial than in adjacent sectors due to cost shifting and market power concerns. However, the commission acknowledges that there may also be benefits from adjacent sector aggregation.

The commission agrees with the Productivity Commission that more detailed analysis of these issues needs to be undertaken to assist policy makers and regulators dealing with these issues. The Productivity Commission could usefully contribute to this debate by going beyond simply stating the obvious need for a process to screen reintegration proposals and provide suggested principles that could be applied when assessing these applications.

- ***contributing to the development by CoAG of a more effective process for achieving a national approach to greenhouse gas abatement (see chapter 10);***

The ACT has recently passed legislation to establish a greenhouse gas abatement scheme. The scheme is modelled on, and integrated with, the NSW scheme. The ACT scheme is due to commence from 1 January 2005. The commission is the designated regulator of the scheme and will work closely with the NSW Independent Pricing and Regulatory Tribunal, who administers the NSW scheme.

The commission considers that there are greater potential benefits in a national approach to greenhouse gas abatement than in a fragmented State-by-State approach. A State-by-State approach potentially loses economies of scale of the pool of tradeable certificates/credits and may not be compatible with other states or with any future national scheme that may arise. The commission believes a national uniform scheme would be of greater benefit to industry and consumers and lead to a sustainable balance between economic growth and environmental concerns.

The commission notes that the current ACT (and NSW) scheme puts the onus on retailers and other users to meet the mandatory targets for reducing greenhouse gas emissions. The commission believes that if generators were to be made responsible for meeting the mandatory targets for reduced greenhouse gas emissions, this may act to increase overall greenhouse gas reductions due to the increased incentives for generators to invest in reduced greenhouse gas emitting technology.

- ***improving the efficiency of retail price and access regulation, with particular emphasis on achieving nationally consistent principles and ensuring there are appropriate incentives for investment;***

A detailed discussion in regard to the appropriate incentives required for investment can be found in the commission's response to the 'Oversight of regulated infrastructure providers' section below.

The commission acknowledges and supports the concept of 'nationally consistent principles' for retail price and access regulation. The commission notes the emphasis given by the Productivity Commission to ensuring appropriate incentives for investment. The focus of the recent debate has been upon 'appropriate incentives for investment' as they relate to service providers. However, from a holistic national perspective, the Productivity Commission must acknowledge and indeed highlight the need for

‘appropriate incentives for investment’ by **service consumers**, lest the debate becomes unbalanced.

The need for balance between the incentive given for investment in the service provider sector and in the service user sectors has been a feature of much of the Productivity Commission’s work over a number of years. But there is a perception that emerges from the current report, and is evident in the utility industry, that the focus should be solely upon providing an incentive for investment by that sector.

There is a balance that needs to be achieved, and reform of the existing regulatory rules and legislation will assist in working towards this balance. By the nature of its role, the Productivity Commission cannot be expected to deal in detail with every aspect of this search for balance – this is an issue that is in fact the responsibility of the policy makers and in part the responsibility of the regulators and policy implementers. But the Productivity Commission has a responsibility to ensure that arguments in favour of ‘economic efficiency’ are not exclusively for the benefit of one sector, or at the expense of another, or at a net expense to the economy as a whole. There needs to be an appropriate balance which may in part involve trade-offs between sectors. The Productivity Commission must clearly enunciate these issues and highlight the need for a wider understanding of the concept of the phrase ‘appropriate incentive for investment’. There is a real danger that the use of terms such as this will be used by rent seekers to benefit their own interests at the expense of the wider economy.

Water

All governments should complete outstanding NCP water requirements and give high priority to resolving the current uncertainty about the future of the National Water Initiative by recommitting to its reforms.

The commission agrees that the reforms of the National Water Initiative need to be progressed, but the commission does not share the Productivity Commission’s view that reforms are stalled. Indeed, the recent formation of the National Water Commission within the Department of Prime Minister and Cabinet is evidence of commitment on behalf of the Federal government to this reform process and there have also been some important initiatives at the individual state and territory level. The commission notes that within the ACT there has been progress on water trading, more efficient pricing, costing of externalities and an increase in the effort on demand management. Many of these reforms are also under progress in other jurisdictions especially following the recent drought conditions experienced in the eastern states. The Utilities Regulators Forum includes water policy issues as a standing item on the agenda. In addition, a number of jurisdictional regulators voluntarily meet on a quarterly basis to discuss water initiatives with a view to harmonising arrangements between states.

These initiatives need to be encouraged and further built upon. There is much to be achieved and the Productivity Commission can provide support for these initiatives.

In addition, the CoAG water reform process should give close attention to:

- ***developing ways to achieve more effective management of environmental externalities;***

The treatment of externalities is not only a constitutional requirement but also a requirement of administrative law in relation to regulatory legislation. In particular, regulators must take account of not only the environmental but also the social impacts of any regulatory decisions. The commission believes that the most effective method of dealing with environmental externalities is for those externalities to be quantified and included within the price of water for all users. This not only includes measuring environmental externalities but also including measures of the scarcity value of water when pricing water. The ACT government imposed a Water Abstraction Charge (WAC) in 1999 that included components in its determination for environmental externalities and the scarcity value of water. The WAC is applied to all water sold within the ACT and is currently set at 20 cents per kilolitre. The commission provided advice to the ACT Government in October 2003 on the methodology for determining and the level of the WAC. In this advice the commission determined that of the 20 cents per kilolitre charge that 5.1 cents per kilolitre should apply as environmental costs and 4.4 cents per kilolitre should apply as the scarcity value. These figures are, of course, specific to the ACT, but do provide an indication of costs that could be recovered elsewhere. States abilities to efficiently cost externalities is limited by constitutional constraints on State and Territory taxing powers. The commission believes that if it were recognised that environmental externalities do not stop at state borders, a consistent national approach to efficiently cost environmental externalities could be adopted. The adoption of a nationally consistent approach to costing environmental externalities would also relieve any lingering doubts as to the ability of the states to implement a water abstraction charge which potentially has 'tax' characteristics.

- ***exploring new opportunities for cost-effective water recycling;***

The commission agrees that cost-effective water recycling should be encouraged. The ACT Government released its water strategy entitled, Think Water Act Water (TAWW), in April 2004. The goal set in TAWW was to raise the level of effluent reuse to 20 per cent by 2013. The commission also agrees that water-recycling programs should be economically viable while acknowledging that it is difficult to put a value on the social and economic benefits. The commission has identified the pricing of recycled water as an important factor for consideration when making choices between the use of recycled water and potable water. The ACT already fully treats its wastewater which is then released into the Murrumbidgee River and is reused by town and rural communities further down the Murrumbidgee/Murray river system. To the extent that water is 'reused' within the ACT, it may decrease the available water for reuse further down the valley from the ACT. Thus, appropriate pricing and decision making principles need to be in place to avoid decisions on water reuse that may be economically and environmentally inefficient. For example, within urban areas such as Canberra, the price of recycled water must be set below the price of potable water but cannot be set too low or otherwise net water usage (the difference between the amount of water abstracted and the amount of

water returned to the system downstream) could actually increase. The ACT is particularly mindful of this potential problem because of its high (40%) recovery of water for future reuse downstream of Canberra.

- ***ensuring that monitoring arrangements post-NCP provide a discipline on all governments to progress agreed water reforms.***

The commission agrees that it is important that appropriate monitoring arrangements be in place to ensure that there is consistent and uniform progress on water reforms. However this may be hard to enforce if all jurisdictions have not signed up. Within the Murray-Darling Basin there are four states and the ACT that need to cooperate in order to develop a coordinated and cohesive system. The Murray-Darling Basin Council and Commission (MDBC) provides the vehicle whereby a 'total valley/basin' approach can be adopted to water management. But even in the context of the MDBC, with all its resources and formal processes, this is often difficult to achieve. For example, without uniform definitions for trading in water, allocation efficiency gains cannot be realised. It is in this area that future progress needs to be made concerning a national set of principles and rules. Eliminating inefficient usage of water is impossible without clear and strong price signals. The commission would also be concerned if the national approach did not attempt to minimise adjustment costs. Ultimately the National Water Commission would appear to be the natural repository for these functions. However, the Productivity Commission should not underestimate the practical difficulties to be faced.

Passenger transport

CoAG should commission an independent national review of the passenger transport sector to assess the impacts of recent reforms and determine what is now required to deliver further performance improvements in both urban and regional areas.

The commission considers that a national review of passenger transport that would include reviews of public transport and taxis is welcome but the commission would be concerned that a one-size-fits-all solution may not be appropriate. Passenger transport fits into the broader subject of urban planning and the commission notes that that changing demographics, urban infill, availability of 'cheaper' cars and greater flexibility in general lifestyle practices have a significant effect on passenger transport markets and the type of public transport required in Australia.

Currently, the commission regulates taxi and bus fares in the ACT as well as some of the conditions of these services (there is no suburban rail transport within the ACT). In its recent reviews of taxi and bus fares, the commission has identified areas where it believes that further efficiencies can be achieved in the provision of these services in a changing market paradigm. In 2002 the commission was issued a reference to investigate and provide advice to the Government on a range of issues relating to the reform of the taxi and hire car industry. Many of the terms of reference arose from recommendations contained in the National Competition Policy review of the taxi and hire car industry. The commission recommended that the taxi and hire cars industries be deregulated and

that the regulation of maximum fares be lifted within three years. The ACT Government has to date not acted on these recommendations. However, the continuing pressure of changes in the market will ultimately force further reforms in public transport policy in the ACT.

Consumer protection policy

The Australian Government in consultation with the States and Territories should establish a national review into consumer protection policy and administration in Australia. The review should focus particularly on: the effectiveness of existing measures in protecting consumers in the more competitive market environment; mechanisms for coordinating policy development and application across jurisdictions and for avoiding regulatory duplication; the scope for self-regulatory and co-regulatory approaches; and ways to resolve any tensions between the administrative and advocacy roles of consumer affairs bodies.

The commission considers that any review into consumer protection policy and administration in Australia should focus on attempting to coordinate policy between jurisdictions and where applicable between similar market segments.

Jurisdictional regulators have, for some time, been working towards achieving greater consistency in the regulation of electricity supply and distribution, including consumer protection policy. Likewise, the MCE is attempting to remove unnecessary duplication in regulatory procedures and has, in fact, proposed the development of a single consumer protection code that applies in respect of electricity and gas retail and distribution in each jurisdiction. The commission supports the development and adoption of such a single consumer protection code. It should also be noted that the MCE is responsible for the introduction of the AER and the AEMC, which aim to develop nationally consistent regulatory principles for the energy market.

The commission would also support the other areas of the review suggested by the Productivity Commission including an investigation into the effectiveness of existing measures to protect consumers in the more competitive market environment, the scope for self-regulatory and co-regulatory approaches and ways to resolve any tensions between the administrative and advocacy roles of consumer affairs bodies.

The competitive neutrality regime

The competitive neutrality regime should be retained beyond the life of the current NCP.

Under the *Independent Competition and Regulatory Commission Act 1997*, one of the functions of the commission is to investigate and report on competitive neutrality complaints. The commission considers this an important function of the commission as it allows an avenue for those who believe they have been adversely impacted by the public ownership of a business to initiate a review independent of government.

The commission agrees that the principles underlying the competitive neutrality regime remain appropriate and that the regime should be retained. In particular the commission supports the retention of the complaints handling mechanisms established under the competitive neutrality regime, and the role that the relevant agencies have to play in monitoring ongoing compliance with the principles of competitive neutrality. However, the commission also believes that there is an opportunity for the Productivity Commission to clarify the circumstances under which a competitive neutrality complaint may be lodged or the process whereby a competitive complaint is made.

For example, the commission notes that, since assuming responsibility for investigation of competitive neutrality complaints in 2000, it has received only a small number of complaints in the ACT. The commission believes that this may in part be due to the fact that any investigation conducted by the commission must be funded by the complainant. The commission believes that this may act as a deterrent to making a complaint and that the Productivity Commission may have a role in addressing this issue.

The commission is also aware of circumstances under which a government may use its power to grant exclusive operating licence, or provide subsidised funding, as a mechanism of encouraging public infrastructure development by the private sector. The granting of an exclusive licence, or provision of subsidised funding, may have an impact on other private sector providers but be outside the principles of competitive neutrality. The Productivity Commission may wish to consider the circumstances where there may be an opportunity for a formal review of a government action that has all the characteristics of a competitive neutrality issue.

Oversight of regulated infrastructure providers

Governments and regulatory agencies should continue to explore opportunities to improve the efficacy of price setting and access arrangements for regulated infrastructure providers. Particular emphasis should be given to improving incentives for providers to undertake investment to maintain existing facilities and expand networks, including through the implementation of clear and nationally consistent principles to guide regulators. Specific approaches outlined in recent Productivity Commission reports into the National Access Regime and the Gas Access Code provide a basis for improvements in this area.

The commission believes that there should be a move towards trying to align both the principles and processes involved in conducting reviews of access arrangements and price determinations for the electricity and gas markets. These principles and processes are to a large extent determined by national codes such as the Gas Code. While the Productivity Commission has made some useful comments on aspects of the Gas Code in its recent reviews, there is concern amongst market participants, such as regulators who have to work within the legal framework set by the code, that the Productivity Commission has missed an opportunity to address some fundamental issues such as the inconsistencies with the operation of the Code. For example, when there are diametrically

opposing views from the Australian Competition Tribunal and the Supreme Court on interpretations of the same part of the Code, there is clearly a significant problem that the regulators, the regulated and the various consumer groups have in applying the Code. Problems such as these are not unique to the Gas Code. The commission also notes the current trend of users resorting to the courts, who are seen as being more sympathetic to consumer interests, than the Australian Competition Tribunal. If this tendency were to continue, the commission believes this fragmentation of views could increase which would in turn lead to further uncertainties for both regulators, the regulated and users.

While general ‘objective’ statements of the type proposed by the Productivity Commission in its report on the Gas Code will be helpful in setting the framework for pricing decisions, they fail to address the underlying problems of inconsistencies within the Gas and Electricity Codes and differing interpretations being given to these codes by appeals bodies. The Productivity Commission should at least take the opportunity to comment on this anomaly in its current report in order to highlight the fundamental practical problems that both the regulators and regulated face.

In regard to improving incentives for service providers to maintain existing facilities and expand networks, the commission believes that it is debatable whether there has actually been a moratorium on new investment, as some have claimed. The commission considers that in regard to investment in maintaining existing facilities, as long as there is a commitment by the relevant regulator that all prudent expenditure will be included in the regulatory asset base and that it will be granted a fair return, there is adequate incentive for the business to conduct necessary maintenance activities.

In regard to investment aimed at expanding networks, the commission believes that if a business can be guaranteed fair returns over time prior to investment taking place, then sufficient incentive exists to undertake necessary network expansion. The ACCC has given clear guidance on major new investments where assurances regarding longer term recovery of investment is required.

The commission has sympathy with the Productivity Commission’s view that a productivity based pricing approach may be less intrusive and easier to administer than the current cost based approach. However, the commission believes that the sole reliance on a productivity based approach may be overly simplistic. For example, there will still be a need for some investigation into the service providers costs. Also, as is being demonstrated by current attempts by regulators to use the productivity indicators model, an extensive, intrusive and costly process to assemble the necessary datasets to apply such an approach is still required. The commission also believes that there needs to be further study on what the effects of reliance on benchmarking alone will have on important variables other than consumer price such as service quality and reliability. The commission takes the view that benchmarking may not in its self be sufficient as a regulatory tool, but may be used in tandem with some form of cost of service approach.

Natural resource management

CoAG should immediately take a greater role in addressing fragmentation and uncertainty in relation to greenhouse gas abatement policies. It should also initiate a review to identify other areas of natural resource management — beyond its current and foreshadowed responsibilities — where the pay-offs from nationally coordinated reform are likely to be high.

See comments above.

Independent Competition and Regulatory Commission
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