

COMPETITION POLICY AND THE ENERGY INDUSTRY

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It seems to me that the scheduling of this conference is most timely, with the energy sector now undergoing dramatic reform – especially in the eastern States. We are witnessing the structural break-up of the old government-run monopolies and, in many states, privatisation. We are seeing the progressive removal of regulatory barriers to competition, new and more competitive access arrangements, interstate trade in gas and electricity, and open trading arrangements with vigorous competition and price discounting unimaginable a few years ago. Another development is the emergence of multi-utilities – retailers will soon be offering one-stop shop services in electricity, gas, water and telecommunications services. These reforms are also enhancing competition between electricity and gas – particularly as gas becomes a more pervasive stock fuel for electricity generation. The signs are clear that industry, consumers and governments will all be winners from this revolution.

The recent sale of the Dampier to Bunbury pipeline and the announcement of the likely sale of Western Power have refocussed the energy sector's attention squarely back towards the West. It was in this State that market reform – especially in the Pilbara region – started off as something of a trail blazer for the nation, only to fall behind as the pace of reform accelerated in the east. The question now is whether privatisation of the jewel in this state's energy crown – a stunning achievement in its own right – has set the stage for the wider reforms in energy sorely needed by industry.

There is no question that embracing reform will fuel the growth of an industry which is already crucial to this State's economy. Since 1980, energy consumption in WA has risen at about double the national average, and ABARE predicts that this trend will continue over the next decade. The greater part of this growth is forecast to be supplied by gas. As we speak, several major infrastructure projects are at the planning or implementation stage. Among them is a proposed second pipeline to duplicate the congested Dampier-Bunbury gas pipeline.

The impetus for growth comes from the State's energy-intensive industries such as alumina, chemicals, mineral sands, iron and steel. But keeping downward pressure on energy costs is vital to sustain the international competitiveness of these industries – especially in the face of recent currency depreciations in Asia.

In this context, recent price performance is less than encouraging. WA's vast reserves of gas result in well-head prices being low by the standards of other states. But this advantage is largely negated by high access charges. For example, tariffs (per km) on the Dampier-Bunbury pipeline are about double those charged for the former GTC pipeline in Victoria, and considerably above the PASA and EAPL tariffs.¹

In electricity, overall prices tend to be more than 10 per cent above those in the eastern states.² At the same time, Western Power's efficiency as an electricity

¹ Moran, p.6.

² Moran, p.4.

supplier lags behind the eastern states – especially in electricity generation. For example, WA required three times as many employees as NSW and twice as many as Victoria to produce each unit of electricity in 1994-95. The gap has probably widened with the sharp increases in productivity achieved in the eastern states since 1994-95 – coinciding with the shift to competing generators.³

As such, effective competition reform in the energy industry is vital if WA is to retain cost competitiveness against the eastern states. The introduction of open trading arrangements, the removal of legislative barriers to free trade and the development of effective third party access arrangements are essential ingredients for opening up markets, stimulating investment in new infrastructure and producing cheaper prices and better quality energy products for industrial, commercial and residential users.

We should bear in mind that the gains from reform in the energy sector are significant. The Industry Commission identified gas and electricity reform as likely to yield the biggest national payoff in the competition reform agenda. And academic studies indicate that the growth and employment benefits likely to accrue to WA are among the highest for any State.⁴

ROLE OF THE COUNCIL

Before looking at energy reform in more detail, I should give a brief overview of the Council and its role in the broader context of competition reform. The Council began operations in November 1995 following endorsement of the National Competition Policy package by COAG earlier that year.

The package contains a range of structural measures to enliven competition, including:

- > access to ‘nationally significant’ infrastructure services;
- > structural reform of government monopolies;
- > competitive neutrality reform;
- > closing gaps in the application of the Trade Practices Act;
- > reforming anti-competitive legislation and regulation; and
- > specific reforms in the electricity, gas, water, and road transport industries.

The Council plays four roles of direct significance to the energy sector, three of which relate to third party access:

- > firstly, the Council makes recommendations on applications under Part IIIA of the TPA to declare services provided by significant infrastructure facilities such as gas pipelines and electricity transmission grids. For example, the Council has recently handled a number of applications for declaration of services provided by rail networks in NSW, Queensland and WA. The Council also received an application from Futuris in September 1996 seeking access to the

³ Moran, p.3.

⁴ University of Tasmania Centre for Regional Economic Analysis., 1995 estimates.

AlintaGas high-pressure gas distribution system. The applicant claimed that under Western Australia's access arrangements, it could only negotiate access to supply two of its six brick plants. The application was subsequently withdrawn following negotiations between Futuris and AlintaGas.

- > second, where a State Government wants to avoid the risk of declaration of services in its jurisdiction, it can apply to the Council for certification that an existing State access regime is 'effective' under the Competition Principles Agreement. Implementation of the National Access Code for gas pipelines will follow the certification route in the next few months.
- > third, the Council plays a number of ongoing roles under the National Gas Pipelines Access Regime. In particular, the Council will handle applications for coverage of a pipeline – and revocation of coverage – under the National Code. The Council understands the need for certainty as to the likely coverage of new infrastructure and will be available to advise investors on whether a proposed new pipeline would meet the coverage criteria. Alternatively, investors may seek coverage prior to construction of a new facility by adopting the Code's competitive tendering principles.
- > finally, the Council assesses State and Territory progress in implementing competition reforms agreed by COAG. The Council must deliver a report to the Federal Treasurer in June of 1997, 1999, and 2001, on progress by each State. This advice will form the basis of the Treasurer's decision to allocate three tranches of competition payments to each jurisdiction from these dates, of which about \$1.6 billion is earmarked for Western Australia.

Many of the general NCP reforms have direct relevance to the energy sector.

For example, under the Competition Principles Agreement, governments must apply *competitive neutrality principles* to government-owned energy businesses to ensure that they compete fairly with private sector businesses. The application of competitive neutrality requires – among other things – that significant government business enterprises be corporatised and/or adopt full cost pricing principles.

While the competition agreements do not require privatisation, the Council regards privatisation as an effective means of applying competitive neutrality. It can also bring wider benefits. For example, the operation of gas and electricity utilities is becoming an increasingly high risk business activity. Some of the recent price spikes in eastern spot markets give clear evidence of the increasing complexity in risk management in energy markets. There are strong arguments that private enterprise is better placed to manage such risk than governments.

It is also apparent that the private sector usually places a much higher valuation on energy assets than does a government owner – simply because the increasing complexity of this industry requires innovative and often highly technical skills in managing costs, trading operations and investment decisions. There are many local and overseas investors with a long track record in energy who believe they can manage these risks and reap the potential rewards more effectively than governments.

A critical imperative for privatisation in the eastern states is that competition is driving down prices, requiring utilities to become more efficient to earn acceptable margins. In fact, it was the shift to competing generators in Victoria and NSW which has exerted much of the downward pressure on prices.

Meanwhile, the industry in WA essentially remains a vertically integrated monopoly. While this may cushion Western Power's margins in the short term, it is doing nothing to promote efficient electricity prices in this State.

At the same time, privatisation should not be seen as the whole answer to reform. For example, little benefit would flow from a decision to convert a public monopoly into a private one. The incentives to cut costs would be missing. So too, the incentive to innovate and pass on efficiency gains to customers. Thus while privatisation can bring a range of rewards to the community, the necessary precondition is contestability in the market.

For these reasons, the Competition Principles Agreement also requires governments to review the structure of a public monopoly prior to the introduction of competition to the market or privatisation. Each review should consider a range of matters, including structural separation of the monopoly. Reviews of this kind should now be undertaken in relation to Western Power and AlintaGas. I return to this matter shortly.

Third, governments have agreed to review, and where appropriate, reform all legislative and regulatory barriers to competition by the year 2000. This commitment naturally covers any barriers affecting energy markets.

I would like to move on now to specific reforms being implemented in electricity and gas respectively.

ELECTRICITY REFORM

The reforms currently sweeping through electricity markets on the east coast stem from COAG initiatives in the early 1990s to develop a national electricity market. Western Australia is not part of this reform package due to the geographical reality that nobody is likely to string a transmission line across the Nullarbor in the foreseeable future.

However WA has indicated its support for the national market. And given the growing reality that Australia operates more and more as a single market in the global economy, developments on the east coast have important implications for economic development in the west.

The National Electricity Market reforms include:

- › competition between independent generators for the right to supply electricity;
- › customers free to choose suppliers, including generators, retailers and traders;
- › open access to the transmission and distribution grid;
- › no barriers to entry for new participants in generation or retail supply;

- > a wholesale market with open trading in which generators compete for the right to be despatched and customers bid for supply; and
- > removal of barriers to interstate and/or intrastate trade.

Reform is relatively advanced in NSW and Victoria, which are now harmonising their competitive wholesale markets. Each of these States has structurally separated the old vertically integrated monopolies into separate generation, transmission and distribution businesses – with competing generators and the phased introduction of competition between retailers. Wholesale trade between these States commenced in May 1997, with the full transition to the National Market arrangements scheduled for 29 March.

Competition between the 11 generators in Victoria and NSW has driven prices down significantly for contestable customers. While South Australia has not yet disaggregated its generation activities, competition is already emerging through cross-border trade with Victoria, and the State has just announced that it will privatise its generation, retail and distribution assets.

An interim wholesale market was introduced in Queensland following structural separation of the industry in July 1997. The introduction of contestability for the State's biggest customers is expected to commence shortly, with physical interconnection with NSW scheduled for around 2001.

By comparison, Western Power remains a vertically integrated monopoly, with customers having limited choice over supplier. True, about a third of electricity generated in the State comes from private generators, but much of this is either dedicated to specific users or is tied up by Western Power through contracting out arrangements.⁵ As noted earlier, electricity prices are relatively high in this State. With the full introduction of a national market in the east, the gap is likely to widen – with potentially damaging consequences for Western Australian industry.

In short, the question must be asked – does WA risk losing energy-dependent industrial projects to other States because of their lower electricity tariffs? The key to addressing price competitiveness, of course, is to introduce real competition between suppliers.

As you are aware, the Energy Board of Review recommended structural separation of Western Power back in 1992-93. Arguments have been raised that Western Power is a relatively small utility, that it faces significant take-or-pay (TOP) commitments and that the geography of this State gives rise to costly CSO commitments. While some of these claims may be valid, the funding of CSOs and TOP commitments through cross-subsidies supported by barriers to contestability does not strike me as the solution. Hidden cross-subsidies distort prices signals, leading to overconsumption by some users, and underconsumption by others. Where business is bearing the brunt of the cost, it can hinder the State's economic development.

There are better options for CSO funding, including direct funding through the Budget. At the same time, allowing more competitive arrangements in the market

⁵ Moran, p.10.

would stimulate demand for electricity and in the economy more generally, raising a bigger revenue cake to help fund CSOs.

Western Australia is developing its own State-based competitive market in electricity and has introduced third party access to the transmission and distribution network. But the contestability timetable for distribution is relatively slow, and is likely to limit access to all but a handful of the largest electricity consumers until at least 2000 when the 1 MW threshold is introduced.⁶ By contrast, NSW and Victoria this year open up the 160 MWh market – allowing thousands of small businesses to participate in the market. It seems to me that there may be serious risks to industry and the economy more generally in falling too far behind the national pace in this area.

The slow pace is also disappointing, given that gas market deregulation – and investment in co-generation plants – creates a potential competitor for electricity generation – but this requires access to the electricity grid so that plants can sell surplus power to third parties.

As I commented earlier, WA did not commit to implementing the National Electricity Market reforms. However, under clause 4 of the CPA, WA has committed to review the structure of a public monopoly prior to privatisation or the introduction of competition.

The WA government has recently indicated its intent to partly privatise Western Power in about the year 2000. Given that limited competition is already occurring in parts of the market, the timing for a comprehensive review of the corporation is now at hand. The Council regards this as an emerging assessment issue for Western Australia and will seek assurance that the review process is both independent and transparent. The Council regards the independence and transparency of the review process as critical to delivering outcomes which the community can have confidence in.

GAS REFORM

While Western Australia has tended to ‘drag the chain’ on electricity reform, progress has been better in gas. The State has been an active participant in the National Gas Reform process and was a signatory to the intergovernmental agreement to implement a National Access Code for gas pipelines in November 1997.

The gas reform agenda aims to promote free and fair trade in gas between and within the States. The key elements, agreed by all governments are:

- › implementation of a uniform national framework for third party access to the services of gas transmission and distribution pipelines;
- › removal of legislative and regulatory barriers to free and fair trade in gas between and within the States;
- › separation of publicly owned gas transmission and distribution facilities, and ring-fencing to separate privately owned transmission and distribution facilities.

⁶ from a single offtake point.

The imperative for gas reform is to ensure that infrastructure investment keeps pace with the burgeoning demand for gas. This problem, while chronic in some of the eastern states, is also apparent here, with the Dampier to Bunbury pipeline booked to capacity, and an urgent need for increased capacity to transport gas from the North West Shelf to the south-western corner of the State.

The ACCC's recent action on the proposed AlintaGas-Epic Energy arrangements in relation to Kingstream is symptomatic of the type of problems which can emerge in a monopoly market coupled with capacity constraints. Clearly, a rational approach is needed to address the capacity constraints on the Dampier-Bunbury route, and the WA Government has informed the Council that it will seek expressions of interest in a second pipeline before the middle of 1998 through an open and competitive process. The construction of this second pipeline would promote competition between gas fields in WA – and cheaper gas prices in the south-west of the State.

The Council believes it is essential that there be no inappropriate regulatory or licensing barriers constraining the construction of a second pipeline should the market seek to do so.

Access to gas pipelines

A central plank in the national reform process has been the development of a national access regime for gas pipelines. This will allow businesses to negotiate access to transmission and distribution pipelines based on reference tariffs approved by an independent regulator – with a right to binding arbitration to resolve disputes.

This framework will promote competition between producers and retailers and fuel market development, creating the necessary conditions for investment. As I indicated a moment ago, construction of new infrastructure to link major producers with markets is the key to achieving truly competitive markets for gas.

The National Code was finalised late last year, and each jurisdiction has agreed to implementation by 30 June 1998. South Australia – the lead legislator – has already passed its legislation, which is expected to be proclaimed once the relevant Commonwealth legislation is passed – expected in March-April 1998. Each jurisdiction will apply to the Council in 1998 for certification of their access regimes established under the National Code.

The first access arrangement approved under this model was the AGL Undertaking for gas distribution services in NSW. This gives an indication of the type of benefits which can be expected under the national approach. The Undertaking – submitted under an interim regime based on the National Code – provides for access tariffs to fall by about 60 per cent in real terms, from \$2.26 per GJ in 1995 to \$1.05 per GJ in 2000.

As you are aware, Western Australia was one of the first states to initiate competitive arrangements in gas, with deregulation of the Pilbara market from 1995 resulting in swift and substantial price reductions for many of the State's biggest industrial customers. WA was also one of the first states to facilitate access to gas pipeline services, with access regimes for the Dampier-Bunbury, AlintaGas distribution

network and Goldfields pipeline established well ahead of the national reform process.

More recently, the \$2.4 billion privatisation of the Dampier-Bunbury pipeline is evidence of the government's ongoing commitment to reform. The Council notes that as a term of the sale, a transitional access regime will reduce access tariffs to \$1 per gigajoule by 2000, delivering significant benefits to gas users.

Having said that, the State's deregulation timetable in the south-west has been slower than in the north – and is generally slower than in the eastern states – with contestability at the 100 TJ threshold scheduled for 1 January 2000, and for all customers from 1 July 2002. In effect, about 97% of the south-west gas market will be contestable by the year 2000.

There are two kinds of issues for the Council in regard to gas reform in Western Australia:

- > certification of the State's access regime under the National Code; and
- > assessment of progress in gas reform for the purpose of the competition payments.

In regard to the first matter, each jurisdiction has agreed to implement the National Code by 30 June 1998 and to seek certification of its access package as an effective regime from the Council within 30 days of enactment of the relevant legislation. Certification is important in that it provides immunity from declaration under Part IIIA.

The Council will undertake public consultation in considering each jurisdiction's access package. While many certification issues were 'signed off' following a first round of public consultation in 1997, several State-specific issues remain to be tested later this year. I will now comment on the two central certification issues.

1 Regulatory issues

The National Code framework requires that access arrangements – including reference tariffs – be approved by an independent regulator. This is aimed at promoting commercial negotiation by providing all parties with a 'peg in the sand' which has been vetted by an objective party. However, the degree of discretion conferred on the regulator means that independence is essential for promoting effective access negotiations and efficient pricing.

The question of regulatory independence is particularly significant for Western Australia, which intends to have a State-based regulator for both transmission *and* distribution pipelines – but is yet to establish the relevant body.

In other jurisdictions, the ACCC will regulate transmission pipelines, while State-based regulators will regulate distribution pipelines only. The unique approach for Western Australia recognises that the State is not expected to be interconnected with another jurisdiction in the short to medium term. This position will be reviewed after five years – or earlier in the event of interconnection.

The World Bank believes the issue of regulatory independence for utility services is crucial. It argues that the core elements are:

- › an arms length relationship between the regulator and affected firms, consumers and other private interests;
- › an arms length relationship with political authorities; and
- › organisational autonomy, including earmarked funding which is sufficient to undertake regulatory processes.⁷

From a certification point of view, the Council applies similar tests of independence. The Council has previously considered the ACCC, the Independent Pricing and Regulatory Tribunal of NSW and Victoria's Office of Regulator General in this context and considered them to be appropriately independent.

It is important to note that the principle of independence must be applied to all regulatory bodies – including appeals bodies and dispute resolution bodies. Where the regulator and arbitrator are one and the same body – as is the case under the National Code framework – mechanisms must also be established to provide for reasonable independence between the two functions.

2 Transitional arrangements and derogations

The Council accepts that transitional or 'phase-in' arrangements can provide a 'breathing space' for parties to adjust to the realities of competitive market conditions. Such arrangements might include

- › timetables to phase in the availability of access for different classes of customer; and/or
- › arrangements to phase out cross-subsidies embedded in access tariffs.

The Council will seek to accommodate transitional arrangements where appropriate. That said, the Council will *not* recommend certification of access regimes which unnecessarily restrict access through the guise of transitional arrangements. For example, the Council cannot recommend certification in respect of services which are the subject of a total 'derogation' (exemption) from an access regime.

WA has proposed a number of derogations from the National Code. These include:

- › a 'transitional access regime' to be applied to the *Dampier to Bunbury* pipeline until 1 January 2000, after which the National Code would apply. As I noted earlier, the transitional regime provides for access tariffs to be phased down to \$1 per gigajoule by 2000;
- › existing access regimes for the *AlintaGas distribution* system and *Goldfields* pipeline to remain in place until 1 January 2000. Concerns have been raised in

⁷ World Bank, Note No 127, page 1.

some quarters that access tariffs on the latter pipeline may be up to seven times higher than comparable charges for other pipelines around the country.⁸

The Council would not be in a position to consider certification of these pipelines under the National Code until they are subject to the National Code obligations. In theory, the Council would therefore have to consider a declaration application in regard to any of these pipelines while they remain outside the National Code.

Any delay in applying the National Code also raises assessment issues. The Council regards on-time implementation of the National Code as a central assessment issue for all jurisdictions. At the same time, given that WA developed its own access framework ahead of the national process, the Council is aware that there may be some valid transitional issues in folding across to the national framework.

In considering these issues, the Council would need to be convinced of the policy merit in any delay in implementation. For example, in regard to the Dampier-Bunbury pipeline, the Council would regard the reduction in tariffs to \$1 per gigajoule by 1 January 2000 as critical in demonstrating the State's commitment to reform.

Other gas reform issues

While access is central to the gas reform agenda, it is part of a broader package. I will comment now on two other key elements, each of which raises assessment issues for the Council.

First, governments have agreed to the structural separation of publicly owned gas transmission and distribution facilities.

Privatisation of the Dampier-Bunbury pipeline addresses this commitment. However, an independent review of AlintaGas – under the clause 4 principles – is overdue. In addition, the National Code requires further steps. In particular, the Code sets out ring fencing arrangements between gas distribution and retailing activities. These ring fencing principles are fundamental to vigorous competition in gas marketing, which is necessary to enliven competition in gas markets more generally. Western Australia proposes to derogate from these principles until as late as 1 July 2002. Once again, this raises important assessment issues for the Council.

Second, the national reform process requires that governments remove any legislative and regulatory barriers to free and fair trade in gas by 1 July 1996. The Council regards this as an ongoing commitment and would be extremely concerned if regulatory barriers were used to unnecessarily delay a proposal to develop new gas infrastructure – such as a second pipeline along the western seaboard.

CONCLUSION

The energy sector is currently undergoing dramatic change. Western Australia – one of the first states to initiate reform – has dropped behind somewhat in the last couple of years.

⁸ Financial Review, 24 July 1997.

In electricity, where reform has virtually ground to a halt, prices are slipping ‘out of kilter’ with the eastern states, with disturbing implications for the State’s energy competitiveness.

And while gas reform may have had its origins in the west, the State’s pipelines are in many cases subject to uncompetitive tariffs.

There are positive signs, however. Gas deregulation in the Pilbara gives an indication of what competition reform in the energy sector can achieve. And recent announcements on privatisation are cause for optimism.

But effective competition in the south-west corner of the State requires more – it requires fundamental structural reform, expanding gas transmission capacity and the application of more competitive access arrangements under the National Code.

There is much work to do on energy reform in the west, and this raises a number of issues for the Council to consider in its second tranche assessments – as I have indicated during this discussion. It is important to keep track of the underlying aims here. Urgent reform is vital for this State to maintain its cost competitiveness against the eastern states and in the aftermath of the Asian crisis.

Western Australia is already a year or two behind the eastern states in implementing many key reforms. While this may not seem like much on the broader canvas, perceptions are formed and investment decisions made – or shelved – in considerably less time than this.

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