EnergyAustralia submission to the Productivity Commission on the Review of the National Access Regime

EnergyAustralia believes that the National Access Regime, embodied in Clause 6 of the Competition Principles Agreement and Part IIIA of the Trade Practices Act, is of fundamental importance to the success of competition in Australian markets. EnergyAustralia believes that in general the proposals made by the Productivity Commission ("the Commission") will improve the efficient operation of the regime. This submission outlines EnergyAustralia's comments on the specific proposals made in the Commission's Position Paper.

Proposal 5.1 (Tier 1)

EnergyAustralia supports the objects clause proposed by the Commission. EnergyAustralia believes that such a clause will help ensure that Part IIIA is appropriately targeted towards efficient investment and that there is sufficient consistency across the different operations of the national regime. Further, EnergyAustralia upholds the Commission's finding that Part IIIA should not be used to pursue distributional concerns, as these are more adequately covered by other policy instruments.

Proposal 5.3 (Tier 1)

EnergyAustralia welcomes the introduction of pricing principles into the framework of the national access regime. Comments regarding the specific principles proposed by the Commission are made below under Proposal 8.1.

Proposal 6.1 (Tier 1)

EnergyAustralia supports the Commission's proposed rewording of s44G(2)(a) to require that access would lead to "a substantial increase in competition" rather than to just the promotion of competition in a particular market (or markets). EnergyAustralia believe that declaration should only be made for services where a substantial benefit to the economy would result from the increase in competition.

EnergyAustralia does however have some concerns with regard to the proposed change of the word "another" to "second" in s44G(2)(b), so that criteria now reads "that it would be uneconomic for anyone to develop a second facility to provide the service". In proposing this change, the Commission seems to be of the belief that the existence of two facilities automatically ensures adequate, or at the very least the potential for adequate, competition. EnergyAustralia questions the effectiveness of this clause given the absence of any materiality thresholds to be applied to the facilities. EnergyAustralia believes that this could lead to situations whereby a second facility

may be viable however it may not possess the capacity necessary to provide an effective competitive discipline on the incumbent. It is therefore essential that the test have some regard to the level of competitive discipline that a second facility can provide. The existence of binding quantity constraints on the facility would mean that only that proportion of the incumbent's market share is at risk of changing supplier.

Proposal 6.2 (Tier 2)

EnergyAustralia generally agrees that there is a need to overhaul the current declaration criteria, however EnergyAustralia does not believe that all of the proposed criteria are suitable for this purpose. Generally the criteria are somewhat vague and open to different interpretations, which has been a significant flaw in the criteria used until now. Specifically, EnergyAustralia has concerns with criteria (a), (c) and (f), however as criteria (a) has been already been discussed above, the submission will now focus on (c) and (f).

Criteria (c) states that "competition in downstream markets is insufficient to prevent the provider of the service from exercising substantial market power". This test of countervailing power is fundamentally flawed and should not be included in the declaration criteria. Competition in the downstream markets is only relevant where there is a realistic threat of changing supplier, therefore the existence of 'sufficient' competition in the downstream market should not be a reason for the non-declaration of an upstream service.

Criteria (f) states that "access (or increased access) would not be contrary to the public interest". EnergyAustralia is concerned that there is no indication or guidance as to how these other considerations are to be measured, particularly given that this criteria is now more focused on non-efficiency considerations. This lack of certainty is of concern and adds a significant degree of regulatory risk to the process.

Proposal 6.3 (Tier 1)

EnergyAustralia agrees with the Commissions finding that information asymmetry is a major stumbling block to negotiation. Therefore it agrees, in principle, with the proposal that access providers be required to give sufficient information to access seekers to enable them to engage in effective negotiation. EnergyAustralia does however have a number of concerns with the application of such a requirement.

It is important to realise that information asymmetry does not always work in favour of the access provider. Access seekers are usually seeking to negotiate a price less than the fully distributed cost and their main bargaining tool in this process is to threaten to bypass the facility. In this situation the access provider, with no knowledge of the cost structures of the access seeker, has little idea whether the threats of bypass are real or not. This is the case with co-generators that have a second market for their waste heat. In this situation the access provider is exposed to the risk that the regulator may see the "discount" as inappropriate.

Due to the complexities surrounding the issue of information asymmetry, EnergyAustralia believes that there should not be a set of prescribed information disclosure requirements embodied in Part IIIA. Rather, it believes that Part IIIA should include general principles that would guide the requirements that would be included in the industry-specific regimes, which are a more appropriate instrument for detailed information requirements. These general principles could include a requirement to act in good faith and a two-way obligation on both parties to provide information that is necessary for effective negotiation.

Proposal 6.4 (Tier 2)

EnergyAustralia supports the proposed 30-day time limit for negotiation to take place before arbitration commences. Any attempts to streamline the process are welcomed and EnergyAustralia believes that this step is important in ensuring greater expediency in the process, which allows competition to be established at the earliest possible time.

Proposal 6.6 (Tier 1)

EnergyAustralia is of the firm opinion that, as much as is practicable, access terms and conditions should be the product of commercial negotiation. Therefore it supports the proposal that requires the ACCC explain its reasons for re-assessing matters that have already been agreed between parties in negotiation. EnergyAustralia believes this is an appropriate balance between allowing commercial negotiation to play its part while also remaining flexible enough to allow the ACCC to undertake any rebalancing that may need to take place as a result of its assessments.

Proposal 6.8 (Tier 1)

EnergyAustralia agrees with the Commission's proposal that the scope for the ACCC to require extensions of facilities should be removed and instead that the ACCC should be able to require that a service provider permit interconnection to its facility by an access seeker. EnergyAustralia is concerned though that this proposal leaves open the possibility that the facility owner could nullify the impact of interconnection by constraining off the new entrant. Therefore EnergyAustralia believes that this proposal should be amended to include a requirement that the interconnection create 'effective access', thereby ensuring that the access provider cannot hinder competition.

Proposal 7.1 (Tier 1)

EnergyAustralia believes that industry-specific regimes should be held closely in alignment with the generic framework of Part IIIA. For this reason, it supports the Commission's proposal that the Commonwealth Government be required to submit its industry access regimes for certification. The current inconsistencies create an inefficient and uncertain regulatory environment for industry. By encouraging greater convergence the Commission is taking the first

steps in ensuring that industry specific regimes are not used as a cover for more heavy-handed regulation.

A further benefit of greater convergence is that it removes the potential for different industry regimes to erode the existence of competitive neutrality between industries. The gas and electricity industries and their corresponding Codes are a case in point of the potential for differences in regimes to affect the relative competitiveness of firms within those industries and for barriers to entry to reduce the likelihood of firms entering the other industry.

Proposal 7.4 (Tier 2)

EnergyAustralia supports the Commission's proposal to embody modified certification provisions in Part IIIA. Further, it believes the Commission's proposed provisions are appropriate and will greatly assist consistency between access regimes and also ensure a rigorous certification process.

Proposal 8.1 (Tier 1)

EnergyAustralia welcomes the proposal to include a common set of pricing principles in Part IIIA. Further, the pricing principles put forward by the Commission are broadly appropriate and will go a long way to ensuring that the national access regime achieves its efficiency objective.
EnergyAustralia believes that prices should be set at a level that reflects the true costs of providing the service. For this reason EnergyAustralia particularly supports the third pricing principle, which states that access prices should "encourage multi-part tariffs and allow price discrimination when it aids efficiency". With the fourth pricing principle, which states that a vertically integrated access provider should not be allowed to set terms and conditions that discriminate in favour of its downstream operations, removing any potentially detrimental effects of this clause in terms of anti-competitive pricing, EnergyAustralia believes that there will be significant gains in access pricing efficiency as a result of the implementation of this principle.

Although EnergyAustralia notes that the Commission concluded in Finding 5.1 that "the national access regime should not be used to pursue distributional outcomes", EnergyAustralia believes that equity and social justice are valid concerns when setting prices. As a result, the pricing principles proposed by the Commission should include a principle stating that access prices should take into account equity considerations. EnergyAustralia suggests that the Commission consult IPART's report titled "Pricing Principles and Methodologies for Prescribed Electricity Distribution Services" released in March this year, for a guide as to how equity considerations could be included in the pricing principles. Specifically, the report stated that:

> "the PPM [Pricing Principles and Methodologies] aims to achieve prices for Prescribed Distribution Services that…
> - Promote equity, stability and consistency of outcomes by:
> - having regard to the impact of price changes on customers
> - being transparent
> - being based on published costs and methods."

Finding 8.1 and Proposal 8.2 (Tier 2)

EnergyAustralia agrees with the Commission's finding that there should be greater use of productivity-based approaches for setting price caps governing access to essential infrastructure services. EnergyAustralia believes that this would provide incentives to service providers that are currently absent under the building block approach. There are, however, a number of dangers that need to be recognised when pursuing a productivity-based approach.

There is no one method of productivity-based price regulation accepted in Australia. Productivity based approaches are highly information intensive and require detailed tailoring to the specific circumstances to which they are to be applied. For these reasons EnergyAustralia does not believe that there should be a requirement to implement such an approach until an efficient and workable benchmarking system has been developed between the regulators and industry.

In developing productivity benchmarks it is important to ensure that prudence is exercised when making comparisons across firms. This is to ensure that the benchmarking system recognises the individual circumstances applicable to a particular firm. Also important is that appropriate measures are developed to ensure that they reflect the nature and drivers faced by firms and industries. This can only be achieved with the active involvement of industry and other interested parties. However in order for any measure to be useful it must fit into an appropriately designed regulatory framework that preserves the incentives and drivers captured by the benchmarking measures.

Due to the risks that poorly considered productivity-based approaches pose to important issues such as the ongoing maintenance of the infrastructure, EnergyAustralia does not believe that a productivity based approach should be implemented until it has been accepted by both industry and regulators. As such, EnergyAustralia proposes that the industry-specific regimes be given a certain period of time, say two years, to develop, in consultation with industry participants, an accepted system of external productivity benchmarks that will be used for setting price caps into the future. This approach is much more appropriate than that described in Proposal 8.2, which effectively forces regulators to rush in an imperfect and potentially harmful productivity-based system.

Asset Valuation Methodology

EnergyAustralia notes with some concern the Commission's discussion of the types of asset valuation methodologies available under the National Access Regime. EnergyAustralia is of the belief that any attempts to introduce depreciated actual cost (DAC) as a replacement for optimised depreciated replacement cost (ODRC or DORC) in the Australian regulatory framework must be approached with much caution. Our response to the specific questions raised by the Commission's Position Paper follow.

Firstly, EnergyAustralia questions whether there is a significant difference in the relative certainty of ODRC and DAC valuations. While the ODRC method is frequently criticised for its susceptibility to different judgements and interpretations, the DAC method is also open to inconsistent past accounting practices with respect to the capitalisation of assets, and different

purchasing practices between infrastructure owners.[1] Moreover, the comparability of the value of assets of differing generations is severely limited by the use of DAC. The lack of certainty that is currently evident in the ODRC approach is not due to an inherent flaw in the valuation methodology, but rather a lack of clear guidelines for its application. Hence rather than reject the whole approach for this reason, emphasis should be placed on developing these guidelines and in doing so 'firm up' the ODRC approach.

Secondly, EnergyAustralia does not believe that the DAC approach provides the appropriate incentives for investment to infrastructure owners, particularly in a sector such as electricity. Specific reasons for this belief are that:

- Competitive markets have generally been looked to as providing the basis of efficient pricing and resource allocation. It should be noted that in competitive markets prices are not strictly linked to the historic cost of assets employed. Rather, prices are determined by the interplay of competitive forces and the willingness to pay of customers. In the regulatory context the pricing outcomes can be approximated by the ODRC.

  This is because prices that are higher than efficient capital costs associated with the ODRC and efficient operating and maintenance costs would result in bypass becoming an efficient alternative to using the existing infrastructure. Therefore ODRC is a natural cap on the prices charged by monopoly infrastructure.

- Pricing is based on competitive outcomes, not input costs. This is consistent with the ODRC approach, which is the level at which a potential new entrant would decide to bypass the incumbent facility.

- In an infrastructure business with lumpy investments it is possible for DAC to result in fluctuating prices over time, with large price shocks and revenue shocks occurring due to the various vintages of assets. This clearly results in the wrong price signals being sent to customers.

- Inter-jurisdictional investment incentives are also skewed by the vintage of assets under the DAC approach. This is not the case under the current regulatory framework.

DAC is widely recognised as not providing the appropriate economic information for pricing and decision making. Hence the accounting profession has generally moved away from using a pure DAC to using a modified DAC framework that accounts for the changed value and costs of assets in use. Indeed there has been significant debate over whether the profession and standards should move further to utilise current cost accounting or other variants more broadly, as identified in the Statement of Accounting Principles 1 booklet published by the Australian Accounting Research Foundation.

[1] ACCC, Draft Statement of Principles for the Regulation of Transmission Revenues, May 1999.

Regulators are already using ODRC and investment decisions have been made on that basis. Therefore a change in policy without offsetting compensation to asset owners must be carefully considered as it is likely to alter the willingness to invest as regulatory risk will be seen to have increased. Moreover a change to the regulatory framework now, without compensation, amounts to the capture of private wealth.

Thirdly, while introducing prudence reviews or an 'optimised DAC' approach may limit the potential for 'gold plating' or 'cost padding', the added costs and uncertainty created by such an approach would erode the main arguments that have been put forward in favour of DAC, ie. simplicity and cost-effectiveness, due to the requirement for engineering consultants to model an optimised network. Therefore the introduction of prudence reviews, in our opinion, is not sufficient to warrant the adoption of the DAC approach.

Fast-tracking Arrangements

EnergyAustralia supports the proposal to fast-track the arrangements for second-round certifications and undertakings. Where there have been no significant changes that would warrant a whole re-assessment of the agreements, there is no valid reason why extending them cannot be much less complex and time consuming than the initial assessments. EnergyAustralia supports all endeavours to make this a reality.