



**Application for Exclusion of Network
Services by Oaky Creek Coal and Anglo
Coal (Capcoal Management)**

Draft Decision

December 2006

SUBMISSIONS

The Queensland Competition Authority considers public involvement to be an important element of its decision making processes. It therefore invites submissions from interested parties on its Draft Decision regarding the applications by Oaky Creek Coal and Anglo Coal-Capcoal Management for exclusion of their network services from the form of economic regulation required under clause 6.10.5 of the National Electricity Rules. The applications are available on the Authority's website or by telephoning the Authority on 07 3222 0555.

To facilitate the publication of submissions on the QCA's website, it is preferred if submissions are provided electronically by disk or email. Where this is not possible, written submissions are acceptable and should be sent to the address below. **Submissions, comments or inquiries regarding this paper should be directed to:**

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Submissions are due by no later than 26 January 2007.

Confidentiality

In the interests of transparency and to promote informed discussion, the Authority would prefer submissions to be made publicly available wherever this is reasonable. However, if a person making a submission does not want that submission to be public, that person should claim confidentiality in respect of the document (or any part of the document). Claims for confidentiality should be clearly noted on the front page of the submission and the relevant sections of the submission should be marked as confidential, so that the remainder of the document can be made publicly available. Again, it would also be appreciated if each version (that is, the complete version and another with confidential information removed) could be provided electronically (whether or not with a printed copy). Where it is unclear why a submission has been marked 'confidential', the status of the submission will be discussed with the person making the submission.

While the Authority will endeavour to identify and protect material claimed as confidential as well as exempt documents (within the meaning of the *Freedom of Information (FOI) Act 1989*), it cannot guarantee that submissions will not be made publicly available. As stated in s187 of the *Queensland Competition Authority Act 1997*, the Authority must take all reasonable steps to ensure the information is not disclosed without the person's consent, provided the Authority is satisfied that the person's belief is justified and that the disclosure of the information would not be in the public interest.

Public access to submissions

Subject to the above, submissions will normally be made available for public inspection at the Brisbane office of the Authority (see below), or on its website at www.qca.org.au.

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1. OVERVIEW

On 30 October 2006 and 3 November 2006 respectively, Oaky Creek Coal (OCC) and Anglo Coal-Capcoal Management (Capcoal) each applied to the Authority for exclusion of their network services from the form of economic regulation required under clause 6.10.5 of the National Electricity Rules. The exclusions, if granted, would allow the Authority to adopt a more light-handed approach to regulating the network services provided by OCC and Capcoal.

Following consideration of the exclusion applications by OCC and Capcoal and the requirements of the Authority's 2000 *Electricity Distribution: Determination of Prescribed Services*, the Authority has determined that the applications should be approved.

The Authority invites submissions from interested parties on this Draft Decision, to be submitted by no later than 26 January 2007.

2. INTRODUCTION

2.1 Background

The Queensland Competition Authority (the Authority) is the jurisdictional regulator responsible under the National Electricity Rules (the Rules) for the economic regulation of electricity distribution services in Queensland.

In September 2000, the Authority released its Prescribed Services Determination which identified those distribution services which were ‘prescribed distribution services’ and those which were ‘excluded distribution services’, as defined under the Rules.

Distribution services are defined under the Rules as:

‘The services provided by a distribution system which are associated with the conveyance of electricity through the distribution system. Distribution services include entry services, distribution use of system services and exit services which are provided by part of a distribution system.’

Prescribed distribution services are defined by the Rules as being:

‘Distribution services provided by distribution network assets or associated connection assets which are determined by the Jurisdictional Regulator under clause 6.10.4(a) as those which should be subject to economic regulation in accordance with the principles set out in clause 6.10.5.’

Excluded distribution services are defined by the Rules as being:

‘Distribution services which are subject to a more "light-handed" regulatory approach than that described in clause 6.10.5 with the result that the costs of and revenue for such services are excluded from the revenue cap or price cap which applies to prescribed distribution services.’

In its Prescribed Services Determination (Section 3), the Authority adopted an approach to classifying services whereby:

- initially, all services performed by each distribution network service provider (DNSP) that were associated with, or ancillary to, access to that DNSP’s network for the supply of electricity were declared as prescribed services and therefore subject to economic regulation by the Authority under clause 6.10.5 of the Rules; and
- DNSPs, or any other interested party, could apply on a case-by-case basis to have specific services treated as excluded services where it could be demonstrated that the market for such services was contestable, that is subject to potential – if not actual – competition. This would allow the Authority to adopt a more light-handed approach to regulation for these services than that required for prescribed services by the Rules.

2.2 Requests for Exclusion

Oaky Creek Coal (OCC) and Anglo Coal – Capcoal Management (Capcoal) each own and operate distribution network assets that support the mining activities that each company undertakes on its mining lease in central Queensland.

Previously, OCC and Capcoal sourced their power from the general market, using their own networks to distribute electricity which was delivered to their lease boundaries.

Independent parties have now established power stations at both mine sites – Envirogen at OCC’s site and Energy Developments at Capcoal’s site. These generators are connected to the networks operated by OCC and Capcoal. Both generators are powered by coal seam methane from the mines.

The generators have registered with the National Electricity Market Management Company (NEMMCO). While each mine uses its network to distribute electricity only to itself, and each network is wholly situated on the respective mining leases, OCC and Capcoal have registered their distribution networks with NEMMCO.

As OCC and Capcoal are now registered distribution network service providers (DNSPs), the distribution network services they provide are subject to economic regulation by the Authority.

In accordance with the Authority’s 2000 Prescribed Services Determination, all of the distribution network services provided by OCC and Capcoal are currently prescribed distribution services.

On 30 October 2006 and 3 November 2006 respectively, OCC and Capcoal each applied to the Authority for exclusion of their network services from the form of economic regulation required for prescribed services under clause 6.10.5 of the National Electricity Rules.

The applications are available on the Authority’s website. The applications are very similar. This is because OCC and Capcoal have very similar network arrangements and the exclusion applications were prepared by the same consultant. For these reasons, the Authority has chosen to consider the applications together.

Treatment of the network services provided by OCC and Capcoal as excluded distribution services would allow the Authority to apply a more light-handed approach to regulation than that required under the Rule for prescribed services.

3. PRESCRIBED SERVICES DETERMINATION REQUIREMENTS

3.1 Procedures for excluding network services

Section 6 of the Authority's Prescribed Services Determination details the process by which services may be declared as excluded services. Specifically, Section 6 states:

Where a DNSP or any other interested party wishes a specific service to be treated as an excluded service, they must make an application to the Authority. Each application will be assessed on a case by case basis and will need to provide detailed evidence justifying the service's treatment as an excluded service in line with the Authority's Contestability Test for Excluded Services (Appendix A). In particular, the application must:

- define the market; and
- demonstrate that the current level of competition or, alternatively, the lack of significant barriers to entry mean that the DNSP lacks substantial influence in the market.

The Authority will then investigate the application and make a determination as to the regulatory status of the service.

Appendix A to the Prescribed Services Determination is reproduced in Appendix A to this document.

4. QCA ASSESSMENT

4.1 Background

In accordance with its commitment in section 2 of the Prescribed Services Determination to consult with interested parties in relation to exclusion applications, the Authority is now issuing this Draft Decision on the applications by OCC and Capcoal.

4.2 Supporting Arguments by Oaky Creek Coal and Capcoal

In support of the argument that their services should be excluded, both OCC and Capcoal have claimed that:

- network services are limited to generator access for single embedded generators – Envirogen in relation to OCC’s network and Energy Developments in relation to Capcoal’s network;
- network assets are valued at less than \$20 million, a small fraction of the value of network assets managed by Ergon Energy;
- network services could also be provided by Ergon Energy or other private networks situated and operating on nearby mine sites;
- each of their customers independently chose the sites for their power stations and wanted to connect to the relevant network rather than Ergon Energy’s network or any of the other private mine networks in the area;
- treatment of their network services as excluded services is warranted because OCC and Capcoal have been granted exemptions from the requirements of Chapter 5 of the National Electricity Rules, on the basis of satisfying the *Guidelines for exemption from the requirement to register as a network service provider*.

In closing their arguments, both OCC and Capcoal stated that:

... because OCC/Capcoal has:

- (i) entered into a Generator Connection Agreement with Envirogen/Energy Developments establishing the terms and conditions of the provision of distribution network services;
- (ii) contractually agreed a charge with Envirogen/EDL for the provision of distribution network services by OCC/Capcoal; and
- (iii) been granted an exemption from the requirements of Chapter 5 of the NER and the requirement to provide an access undertaking to the ACCC,

we believe that the interests of the distribution network service provider (i.e. OCC/Capcoal) and the distribution network user (i.e. Envirogen/EDL) are appropriately balanced. Therefore, we believe it to also be in the public interest that QCA’s regulatory approach to OCC/Capcoal should be light-handed and with minimum administrative burden on all parties, including QCA.

4.3 QCA Analysis

The Authority has considered the applications for exclusion from OCC and Capcoal in accordance with its Prescribed Services Determination. This requires that the relevant

market be defined and the degree of influence of the DNSP in that market be established in order to guide that consideration.

Market definition and influence

As the Envirogen and EDL generators are fuelled by coal seam methane sourced from the area of the mine, both OCC and Capcoal have defined the market in which they operate as being limited to electricity networks near to the Lilyvale substation in central Queensland which connect coal mines to the National Electricity Market.

This could be a reasonable market definition if, for example, the services being considered were ancillary to the distribution network, and hence could potentially be provided outside the mine lease area, rather than the actual distribution service which is not transportable and only able to be delivered within the mine lease.

Nevertheless, the Authority acknowledges the point made by OCC and Capcoal that the network services provided by OCC and Capcoal could potentially be sourced from Ergon Energy, or possibly another local small network operator, if the services provided by OCC or Capcoal did not meet the customer's requirements for any reason. In a normal market, this risk of by-pass would provide an ongoing limit to the possible price that could be charged to the customer by the distribution network operator.

However, the market for the services in question is probably more appropriately confined to the area of the mining lease, and OCC and Capcoal have control of this narrowly defined market. However, the distinguishing feature here is that the customer who could potentially be treated unfairly by exercise of this market power is the same entity as the DNSP who might seek to exercise that influence in the first place. In short, while the market may be narrowly defined and the DNSP may, in theory, have substantial influence in the market, there is no possibility, as things currently stand, for that market power to be used to any other party's detriment.

It therefore seems reasonable to conclude that neither OCC nor Capcoal have any real influence in the market and that both networks are eligible to be excluded from regulation under clause 6.10.5 of the National Electricity Rules.

This view is supported by the fact that the type of network service provided by OCC and Capcoal is listed as a likely excluded service in the National Electricity Rules (Chapter 6, Section 6 of Schedule 6.6). In particular this states that:

Services and activities that the *Jurisdictional Regulator* may define as *excluded distribution services* may include, but are not limited to, the following:

- (j) charges for *distribution services* and system augmentation required to receive *energy* from an *Embedded Generator*.

The Authority's conclusion is also supported by the decision of the National Electricity Code Administrator (now the responsibility of the Australian Energy Regulator) to grant both OCC and Capcoal exemptions from the requirement under Chapter 5 of the National Electricity Rules to provide an access undertaking to the ACCC.

5. DRAFT DECISION

The Authority's Draft Decision is to exclude the network services provided by OCC and Capcoal from the form of economic regulation required under clause 6.10.5 of the National Electricity Rules.

This then raises the question of how the Authority should regulate these network services.

Section 6.10.4 of the National Electricity Rules provides the Authority with the discretion to determine the form of regulation which is to be applied to excluded distribution services.

As all parties – distributor and ultimate energy purchaser (OCC and Capcoal) and generator (Envirogen and Energy Developments) – have arrived at a commercial agreement which they each find satisfactory, there is no apparent reason why the Authority would wish to interfere in this agreement.

The Authority proposes to accept the network charges proposed by OCC and Capcoal, on the basis that these charges have been agreed by the parties involved and that the charges levied by the distributor on the customer are in these instances simply within company transfers rather than a price imposed by one entity on another.

However, as this decision is based on the particular circumstances outlined in this draft decision, it is proposed that that OCC and Capcoal be required to:

- notify the Authority in advance of any material changes to the network services provided, in terms of the price to be charged or the number of customers to be supplied; and
- submit to the Authority annually a letter co-signed by the network operator and generator that confirms each party's continued agreement with the arrangements.

This will ensure that the Authority is informed of any changes to the accepted arrangements and provide an opportunity for any party to withdraw from the agreement should circumstances change.

Should circumstances change, the Authority will revisit its decision on the eligibility for these services to be excluded and on the form of regulation to be applied.

The Authority requests submissions on this Draft Decision. Submissions must be received by no later than 26 January 2006.

APPENDIX A

Contestability Test for Excluded Services

Competition exists in a market where firms or sellers independently strive for the patronage of buyers in order to achieve their business objectives, such as profit or market share maximisation. Competition is an important process by which firms are forced to become efficient and offer greater choice of products and services at lower prices.

Economic regulation has no role to play where effective competition exists. Where a DNSP or a competitor of the DNSP can establish that effective competition exists in a market served by that DNSP, the Authority is prepared to exempt the services involved from economic regulation by determining the services to be 'excluded services'.

Role of substantial market power

Only where a DNSP dominates a market – in that it enjoys a position of economic strength such that it can behave to an appreciable extent independently of its competitors and customers – does economic regulation have a role to play.

If it so chooses, a firm with substantial market power is able to provide a lower level of service quality or choice, charge a higher price or undertake inefficient investment or operating expenditure, without necessarily suffering a decline in profit. In other words, the firm may be able to:

- charge prices which equate to a higher than expected rate of return on assets over the medium to longer term; or
- earn an excessive rate of return, based on efficient operation and investment; or
- allow service quality to decline to a level below that which might be expected in a competitive market; or
- impose onerous terms and conditions on customers.

If an incumbent firm (like a DNSP) possesses substantial market power, this does not mean that it is abusing – or will abuse – that market power. However, it does establish the grounds for economic regulation aimed at preventing cases of abuse from arising. Such services must continue to be 'prescribed services' for the purpose of the Authority's price regulation activities.

Define the market

A firm may be considered to have substantial market power if its behaviour is not subject to the disciplines competitive markets normally impose.

Determining whether a DNSP has a dominant position with respect to the services it provides – whether or not those services are associated with, or ancillary to, access to a DNSP's network – must be done by reference to a defined market.

A market for a service includes all services that are in close competition or rivalry with that service. The definition of a market needs to address the following dimensions:

- alternative services or substitutes which can be used instead of the incumbent's products or services;

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- the geographical region within which alternative sources of supply may be found; and
 - the period of time necessary for an effective competitor to enter the market.

Services comprising a market

The market comprises services which are substitutes for the service in question. The degree of substitution depends on:

- the extent to which services are direct substitutes. For example, two entities providing the same basic service, or indirect substitutes such as the supply of electricity versus supply of gas;
- the current prices for the alternate services; and
- the willingness of customers to change supplier and possibly incur switching costs in doing so.

Each of these factors will be important in determining which services are considered to be substitutes and are therefore potentially in competition with the service in question.

Geographical region

The geographic dimension of the market is defined by the feasibility of obtaining alternative services from elsewhere.

One major factor which affects the geographic dimension of the market is the cost of transportation associated with alternative sources of supply. For example, high density urban areas readily support a competitive market for contract distribution maintenance services. In direct contrast, the only provider in low density rural areas is likely to be the local DNSP as travel costs preclude out of area contractors offering a competitive service.

Time

The time dimension refers to the period of time necessary for an effective competitor to enter the market, and defines the time period over which substitution possibilities ought to be considered for the purpose of defining the market.

However, if a potential competitor requires significant new investment that may take some time to establish in order to enter a market, then it would not normally be included in the relevant market definition.

Identify the level of competition

Once the market has been defined, the principal factors that assist in determining if competition exists are the presence, or absence, of vigorous competition in the market together with barriers to entry for potential new entrants to the market.

Market share

A firm's market share indicates the relative size of the firm in the market in question in terms of the proportion of total output or sales or capacity it accounts for. Market shares form the basis of various measures of dominance or industry concentration (such as the Herfindahl-Hirschman Index).

High levels of market share may bestow market power on the dominant firm.

Therefore, a firm's market share provides an initial indicator of the competitive pressures in a market. Generally, a dominant firm is one that accounts for a significant share of a given market and has a significantly larger market share than its next largest rival. The Authority has adopted a market share of 40 per cent as the minimum level necessary to establish a prima facie case that a DNSP is in a position of dominance.

This is the threshold adopted in the ACCC's Merger Guidelines to define a situation of 'unilateral market power', which the ACCC describes as being similar to the concept of single firm dominance.¹ The unilateral exercise of market power requires that a dominant firm has sufficient control of the market, such that it can profitably 'give less and charge more' without being threatened by competing suppliers. For undifferentiated products, this normally requires that a firm controls a substantial proportion of the capacity in a market.

The ACCC considers its threshold to be at higher levels of concentration than those used in overseas jurisdictions. For example, while the US Department of Justice and Federal Trade Commission's 1992 Horizontal Merger Guidelines employed the Hirschman-Herfindahl Index (HHI), they imply a single firm market threshold of 35 per cent. The Canadian regulator adopts a similar threshold. However, a 40 per cent threshold is employed by the New Zealand Commerce Commission under a dominance test.² The Commission of the European Union has taken the view that a dominant position can generally be taken to exist when a firm has a market share of 40-45 per cent.³

In the Industry Commission's review of the ACCC's draft Merger Guidelines it was proposed that the ACCC look at the possibility of increasing the threshold market share for an individual merged firm from the present 40 per cent to 50 per cent.⁴

Therefore, the 40 per cent threshold chosen by the Authority has strong precedents.

The Authority's use of a quantitative threshold contrasts with the position it took in its earlier *Monopoly Criteria* paper where the Authority opted not to use a minimum threshold when assessing whether a government business activity qualified as a 'government monopoly business activity'.⁵ While the Authority did not feel the need to define a threshold for its own purposes, it is now responding to requests in submissions that some practical guidance be provided to parties wishing to apply for the exclusion of certain services. The Authority acknowledges that a threshold can provide useful guidance when the onus is on applicants (be they DNSPs or other parties) to demonstrate whether market dominance exists.

The Authority will use the threshold on the same basis as the ACCC. The ACCC uses the threshold as a guide to the market share below which a firm is unlikely to be declared to be in a dominant position, rather than a fixed threshold above which a firm is necessarily declared to be in a dominant position. As explained further below, where a DNSP's

¹ Australian Competition and Consumer Commission (ACCC), Merger Guidelines, AGPS, Canberra, June 1999, s. 5.95.

² ACCC, Merger Guidelines, AGPS, Canberra, June 1999, s. 5.95.

³ See Sally Van Siclen, "Background Note", Abuse of Dominance and Monopolisation, Competition Policy Roundtable No.8, OECD, 1996.

⁴ Industry Commission, Merger Regulation: A review of the draft merger guidelines administered by the Australian Competition and Consumer Commission, AGPS, Canberra, June 1996, pp. 36-37. See Sally.

⁵ The Queensland Competition Authority, Criteria for the Declaration of Government Monopoly Business Activities, 1997.

market share exceeds the threshold, the Authority will require detailed consideration of the barriers to entry relevant to the market before declaring the DNSP to be in a dominant position and the service provided as a 'prescribed service'. It should also be noted that a market share below 40 per cent does not preclude the DNSP from being declared to be in a dominant position but rather indicates a market share below which an interested party would need to present prima facie evidence of a lack of contestability in the market before the Authority would undertake a detailed investigation.

Barriers to entry

Even if a DNSP's market share is high, the exercise of market power is only possible if there are factors such as barriers to entry. If the entry of new competition would rapidly and effectively constrain a price increase, then a dominant firm cannot exercise market power even in a concentrated market.

Timely and sufficient entry can obviate concern about the ability of a dominant firm to raise prices above reasonable levels or earn a return that would be excessive were it not operating inefficiently, by assuring that increased supply from independent sources will defeat efforts to exercise market power. If entry is quick (and the costs of entry are recoverable if the entry does not succeed), the exercise of market power is unlikely even if there is only one current supplier.

Actual competition may therefore not be important in determining the existence of a 'contestable' market. A fully contestable market is one in which:

- there are no barriers to entry or exit;
- all firms, both incumbent and potential entrants, have access to equivalent production
- technology;
- there is perfect information on prices, available to all consumers and firms; and
- entrants can enter and exit before incumbents can adjust prices.

A contestable market may have any number of firms (including only one or a few) and the dominant incumbent will maintain prices close to the competitive level because of the threat posed by potential entrants.⁶

Establishing whether a market is contestable is therefore of considerable importance. An analysis of the applicable barriers to entry is essential in this regard. Barriers to entry are factors which prevent or deter the entry of new firms into an industry even when incumbent firms are earning excess profits.

The Authority's focus will be on structural barriers to entry arising from basic industry characteristics such as technology, costs, demand and government erected statutory or regulated barriers. A barrier to entry can be any factor which discourages new entry into a market, so that incumbents are not faced with the threat of competition. Barriers to entry can include:

⁶ If incumbents raise prices, entry will occur (no barriers to entry), and the entrants will be able to produce as efficiently as incumbents (access to technology). Moreover, if price declines as a result of the entry, the entrant will be able to exit the industry quickly and costlessly (no barriers to exit).

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- sunk costs, such as those costs incurred in entering a market that cannot be recovered if entry fails.⁷ In assessing the significance of sunk costs, it is not just the amount that is important, but also the length of time before these costs can be expected to be recovered. Examples of sunk costs include infrastructure construction, staff training and advertising and promotional costs associated with establishing a recognised presence in the market;
 - legal or regulatory barriers, such as licensing requirements or legislated monopolies. An example of a potential regulatory barrier would be the requirement to obtain a retailing licence in order to sell or trade in electricity in Queensland;
 - access to scarce resources (including know-how and intellectual property);
 - information advantages. For example, where the market structure is such that an incumbent entity immediately becomes aware of any existing customer changing supplier thereby enabling the entity to target that customer;
 - the nature of relationships in the market. For example, the existence of long term contracts in an industry can represent a major barrier to entry for a potential entrant due to these contracts effectively rendering a proportion of the market non-contestable;
 - brand loyalty and customer inertia. While a degree of buyer loyalty exists for any product, in certain instances the need to gain market acceptance of a new entity can significantly delay successful entry and therefore constitute a barrier to entry. Inertia can arise for many reasons, including fear and uncertainty of change, lock-ins (where the customer will remain dependent on the incumbent for some of its services), lack of information regarding choices and high changeover costs; and
 - insufficient demand. That is, where the minimum efficient scale of an enterprise in the industry is large relative to current demand, the number of efficient firms in a market will be small. In such instances, the presence of an incumbent may preclude entry by prospective efficient entrants because the market simply may not be big enough to support them. This is likely to be the case where there are economies of scale or scope associated with production technology.

⁷ Sunk costs are an important barrier to entry in infrastructure industries. Since such costs must be incurred by entrants, but have already been borne by incumbents, a barrier to entry is created.