

19 April 2005

Mr Richard Bolt  
Executive Director  
Energy and Security Division  
Victorian Department of Infrastructure  
GPO Box 2797Y  
MELBOURNE VIC 3001



Suite 1, Level 2,  
19-23 Prospect St  
BOX HILL Victoria 3128  
Telephone: (03) 9898 3900  
Fax: (03) 9898 7499  
Email: [euaa@euaa.com.au](mailto:euaa@euaa.com.au)  
Web page: [www.euaa.com.au](http://www.euaa.com.au)

Dear Richard

***EUAA submission to the Victorian Government Issues Paper: Cross-Ownership Rules for the Energy Sector***

The Energy Users Association of Australia (EUAA) appreciates the opportunity to provide a submission to the Victorian Government's Issues Paper on Cross-Ownership Rules for the Energy Sector.

As you may be aware the EUAA is a non-profit organisation focused entirely on energy issues on behalf of large business end users of electricity and/or gas. The EUAA currently has over 75 members. Membership ranges across a number of sectors, including mining, manufacturing, construction, commercial property and service sector. Many of the EUAA's members operate across States.

The submission has been assisted by funding provided by the National Electricity Consumer Advocacy Panel and technical input from Frontier Economics. This support is gratefully acknowledged. It should be noted, however, that the views expressed herein are solely those of the EUAA.

The EUAA applauds the Victorian Department of Infrastructure for producing the Issues Paper, which is a timely and well-considered treatment of the important issues at stake. The issues dealt with are important to the future of the energy sector and the benefits that end users derive from restructuring of the electricity industry over the past decade or so. The EUAA has formed the views in the attached submission on the basis of what is in the best interests of energy users. The EUAA is uniquely placed to provide the Victorian Government with such a view, given its involvement in both national and state energy policy issues and its position as the national association of large energy users.

If you have any questions about the submission or would like to discuss it further please do not hesitate to get in contact with me or EUAA's Director Policy and Regulation, Mr Con Hristodoulidis, on telephone number (03) 9898 3900.

Yours sincerely

A handwritten signature in black ink, appearing to read "Roman Domanski".

Roman Domanski  
**Executive Director**



**FINAL SUBMISSION**

**Cross-ownership rules for the energy sector:  
response to the Victorian Government  
Issues Paper**

**April 2005**

## TABLE OF CONTENTS

<b>Executive summary</b> .....	<b>1</b>
<b>1 Introduction</b> .....	<b>3</b>
1.1 Background .....	3
1.2 Brief history of reforms .....	3
1.3 Operation of cross-ownership rules .....	4
1.4 Approach of submission .....	5
<b>2 Competition in energy markets</b> .....	<b>7</b>
<b>3 Section 50 TPA</b> .....	<b>9</b>
3.1 Market definition and market power .....	9
3.2 Integration in energy markets .....	9
3.3 AGL case .....	13
3.4 EUAA comments .....	17
<b>4 Options</b> .....	<b>21</b>
4.1 Reliance on Victorian cross-ownership rules .....	21
4.2 NEM-wide cross-ownership restrictions .....	22
4.3 ACCC Energy merger guidelines or statements .....	23
4.4 Instituting a more stringent competition test for energy mergers .....	25
<b>5 Conclusions and recommendations</b> .....	<b>27</b>

## **Executive summary**

The Energy Users Association of Australia (EUAA) appreciates this opportunity to make a submission to the Victorian Government in response to the Issues Paper entitled “Cross-ownership Rules for the Energy Sector” (Issues Paper).

The EUAA seeks to promote legislative and regulatory arrangements that lead to the lowest sustainable energy prices for end-users based on competitive markets. We believe this is consistent with the new National Electricity Law single market objective, which is geared towards promoting efficiency for the long term interests of consumers.

The submission has been assisted by funding provided by the National Electricity Consumer Advocacy Panel and technical input from Frontier Economics. This support is gratefully acknowledged.

It should be noted, however, that the views expressed herein are solely those of the EUAA.

In short, we are concerned that the existing cross-ownership rules have not been allowed to apply to energy mergers, due to various exemptions that have been granted by the Victorian Government. The EUAA is not convinced that sole reliance on section 50 of the *Trade Practices Act* is sufficient to safeguard competition in energy markets and protect the long term interests of end-users. In our view, the Federal Court decision in the AGL case applied an excessively wide geographic market definition and an excessively relaxed view of market power in the NEM. The interpretation of section 50 of the TPA could potentially allow many more energy mergers to go through, enabling significant increases in wholesale prices. This could result both in inefficiency as well as higher prices and short to medium term wealth transfers from consumers of energy to producers.

Given the special features of electricity markets, such as the existence of monopoly network businesses, the high inelasticity of demand and supply and the transition stage of the industry, the EUAA recommends that other instruments be put in place to prevent further mergers that could harm competition.

Therefore, as a preliminary position, the EUAA makes the following conclusions and recommendations:

- Retaining the existing Victorian cross-ownership rules with exemptions for mergers that are either cleared by the ACCC or successfully challenged against the ACCC is inappropriate;
- Retaining the existing Victorian cross-ownership rules, without any exemptions, is a reasonable policy approach to adopt if there are no other more desirable approaches available;
- National cross-ownership rules, allowing for certain mergers to be exempted on the basis of market share and/or geographic location could be developed;
- Energy-specific ACCC merger guidelines or a separate ACCC statement on energy mergers, reflecting the special features of energy markets highlighted

by the UK Office of Fair Trading's guidelines will aid the transparency of mergers policy in Australia; and

- It would be worth exploring more fully the development of a more stringent competition test for energy mergers in Victoria (or the NEM) that operates in addition to the existing section 50 test.

The EUAA looks forward to discussing these proposals with the Government in the near future.

# 1 Introduction

## 1.1 BACKGROUND

The Energy Users Association of Australia (EUAA) appreciates the opportunity to make a submission to the Victorian Government in response to the Issues Paper entitled “Cross-ownership Rules for the Energy Sector” (Issues Paper).

The submission has been assisted by funding provided by the National Electricity Consumer Advocacy Panel and technical input from Frontier Economics. This support is gratefully acknowledged. It should be noted, however, that the views expressed herein are solely those of the EUAA.

The EUAA applauds the Victorian Department of Infrastructure (DOI) for producing the Issues Paper, which is a timely and well-considered treatment of the important issues at stake. The issues dealt with are important to the future of the energy sector and the benefits that end users derive from restructuring of the electricity industry over the past decade or so. In our view, there has been far too much ‘hidden’ consideration of these matters and the public release of the Issues Paper is a refreshing move towards greater transparency.

The EUAA is an industry association representing the views of over 75 members who include many of Australia’s and Victoria’s major energy users. We seek to promote legislative and regulatory arrangements that lead to the lowest sustainable energy prices for end-users based on competitive markets. We believe this is consistent with the new National Electricity Law (NEL) single market objective, which is geared towards promoting efficiency for the long-term interests of consumers of electricity. Clearly, this requires that energy suppliers do not make excess profits, and also that investment in energy infrastructure takes place in the manner and at the time that it is required. This means that markets should be allowed to reflect scarcity to signal the need for new capacity. However, at the same time, investment that occurs before it should due to strategic behaviour by suppliers or the neglect of alternatives such as demand-side management (DSM) is undesirable. The cross-ownership rules and merger provision of the *Trade Practices Act (TPA)* should be analysed in this context.

## 1.2 BRIEF HISTORY OF REFORMS

Many of the energy firms now operating in the NEM jurisdictions began as parts of vertically-integrated State-owned monopolies. For instance, in the mid 1990s, the former State Electricity Commission of Victoria (SECV) was vertically separated into generation, transmission, distribution/retail and system operation firms. Later, generation and distribution/retail activities were split horizontally. All of these, bar the Victorian Power Exchange, the system operator, were eventually privatised. The former Gas and Fuel Corporation of Victoria was also split vertically and horizontally and later largely privatised.

In NSW, the Electricity Commission of New South Wales (later renamed Pacific Power) was split vertically and horizontally. However, the degree of horizontal disaggregation at the generation level did not go as far as in Victoria. Initially, only two generating companies were established – Macquarie Generation and Delta Electricity, with the Eraring power station later spun off from Pacific

Power to create Eraring Energy. Further, none of the generation, transmission or distribution/retail businesses have been privatised.

Both Victoria and NSW introduced full retail competition (FRC) in electricity and gas in 2002, allowing all customers to switch retailer.

In Queensland, vertical and horizontal separation took place in the mid to late 1990s and Queensland joined in the NEM at its commencement in December 1998. Currently, there is government, privately and a mixture of government/private owned generators operating, there are two government owned distributors/retailers and a single government owned transmission operator. However, privatisation has not occurred and retail competition does not extend to the household level.

South Australia split the Electricity Trust of South Australia in the late 1990s and effectively privatised (through long-term leases) all elements of the supply chain. FRC in electricity was introduced in 2003

The incumbent retailer in the ACT is Actew-AGL and FRC in electricity was introduced in the ACT in 2003.

Tasmania will join the NEM when the Basslink interconnector with the mainland is commissioned, which is now expected to be April 2006. In 1998, the vertically-integrated Hydro-Electric Commission was split into separate generation (Hydro Tasmania), transmission (Transend) and distribution/retail (Aurora Energy) business. FRC is due to commence in 2006, but given the recent Basslink delay, this too may be postponed.

All NEM States have established independent regulators, whose primary role in energy is to regulate distribution and retail prices. However, the Essential Services Commission in Victoria does not have the power to set retail prices. Rather, it is the State Government directly that has reserve powers to review and amend retailers' prices if it considers that adequate competition has not developed and that prices may be set at unreasonable levels. In Queensland, the Minister approves default retail tariffs while in NSW and South Australia, the jurisdictional regulator has this role.

The present review concerns cross-ownership rules for the energy sector in Victoria. These rules are contained in the *Electricity Industry Act 2000*. Clearly such rules would have no purpose in a State where all or most energy assets were Government-owned, as the Government would have direct control over mergers involving its businesses. The rationale of the rules stems from the extensive privatisation process and relatively disaggregated model of reform pursued in Victoria.

### **1.3 OPERATION OF CROSS-OWNERSHIP RULES**

As mentioned above, in Victoria ownership of the generation sector was separated into individual power stations and then privatised to maximise the initial number of competitors in the sector. This development was based on the objective of maximising horizontal competitive pressures. Thus, to maintain the competitive pressure the Victorian Government also decided to impose strict cross-ownership provisions.

However, the Issues Paper validly points out that the operation of the cross-ownership rules has been such that the impact of the rules in addition to the TPA has been very limited.

In their original form, the rules effectively prevented the owner of any Victorian-licensed generator, distributor or transmission business from acquiring a major stake (over 20%) in any other such business. However, the power to grant exemptions to the rules was introduced at the start of 2001. This power was first conferred on the Office of the Regulator-General and later transferred to the Australian Competition and Consumer Commission (ACCC). As the Issues Paper notes, the result of this change is that the cross-ownership rules do not apply to a merger if the ACCC decides that the merger would not breach the TPA.

However, for the recent AGL case in the Federal Court<sup>1</sup>, the cross-ownership rules were amended to allow AGL to complete its proposed transaction if it successfully challenged the ACCC in the courts, which it did. If an exemption from the rules were available in all cases where a prospective acquirer was minded to challenge the ACCC, the cross-ownership rules would have no independent operation to the TPA.

#### **1.4 APPROACH OF SUBMISSION**

The EUAA agrees with the Issues Paper's sentiment that, unless the cross-ownership rules have an impact that is independent from the TPA, they should be repealed. However, we note that the lack of independent operation to date has largely been a function of changes to the rules that the Victorian Government has itself introduced. While it appears that such changes may have been driven by a concern over future investment and supply reliability, there also appears to be little point in maintaining or modifying the cross-ownership rules or introducing other State-based controls, if the Government is not committed to ensuring that whatever rules are in operation actually apply to future mergers. Such rules should be set in a way that makes them effective in maintaining the desired degree of competition in the market and so as to provide a clear signal to market players or potential entrants. It would be poor public policy to change, amend or ignore the rules on a case-by-case basis.

Therefore, the EUAA believes that the analysis of the points raised in the Issues Paper must commence with an outline of the underlying rationale of rules that seek to limit mergers – which is to promote and maintain competition in the relevant market. Section 2 explores what this means in the context of an energy-only spot market for electricity.

The next step is to examine whether the current TPA merger provisions are adequate for addressing the competition impacts of energy mergers. This will involve an examination of the implications of *AGL*, as well as other relevant Court and Tribunal decisions (section 3). The analysis in this section will focus on geographic market definition and the meaning of market power in the TPA.

---

<sup>1</sup> *Australian Gas Light Company v Australian Competition and Consumer Commission (No 3)* [2003] ATPR 31-966; [2003] FCA 1525 (hereafter, *AGL*).

To the extent that the TPA may fall short of an ideal merger control provision in the electricity sector, we analyse a range of alternatives to relying solely on the TPA for energy mergers. These include:

- Reliance on the existing cross-ownership rules with or without ACCC power to grant exemptions;
- Instituting a more stringent competition test for energy mergers in Victoria;
- Developing national cross-ownership provisions; and
- Expansion of ACCC merger guidelines.

These alternatives are discussed in section 4.

Finally, section 5 draws together the conclusions and recommendations of this submission.

## 2 Competition in energy markets

In order to understand the purpose of merger regulation and to evaluate the various options outlined in later sections, it is first necessary to clarify what competition in energy markets means.

Generally speaking, competition is desirable because in most cases it promotes economic efficiency and sustainably low prices. Competition may also have other benefits such as promoting dynamism, productivity growth, economic mobility and opportunity, and so on. This submission will focus on the economic efficiency and pricing attributes of competition.

The economic efficiency properties of energy markets are not fundamentally different from other markets – the socially optimal level of output is where price equals the opportunity cost of production. In a perfectly competitive market, with all the assumptions that apply, we would expect to see prices at these levels. In an energy-only wholesale spot market such as the NEM, this first-best condition translates to price equalling the short-run incremental cost of production in the short term and the long-run incremental cost of supply in the long term.

Unfortunately, if demand is perfectly inelastic in such a market, high demand will occasionally lead to infinite (or VoLL) prices and load shedding. However, as renowned electricity economist Steve Stoft notes, this is an argument for reducing any barriers to DSM to flatten the demand curve and enable the market to clear – in other words, the presence of some demand response to high spot prices will limit or prevent the need for (or expectation of) occasional load shedding.<sup>2</sup> The NEM's record in reducing barriers to DSM has been extremely poor, which is why it can persuasively be argued that some degree of bidding above SRMC is necessary in order to promote investment and supply reliability. In the EUAA's view, this is far from optimal and very much an inferior option to enhancing DSM and promoting competitive bidding.

We note that end-users will be the ones who bear the costs of this inefficiency in the NEM. Our recent trial of a Demand Side Response (DSR) aggregation facility for the NEM (which received significant support from the Victorian Government), demonstrated that end users would respond to commercial opportunities for DSR and that this would be of major benefit to the NEM.<sup>3</sup>

In any case, idealised models are never perfectly replicated in the real world. Indeed, the NEM has a number of features that deviate from a textbook world – large fixed and sunk costs (especially in networks and generation), price controls, long-term contracts, a relatively small number of participants and so on.

Nevertheless, the value of an idealised textbook example of an electricity market is that it provides a framework for analysis. Other things being equal, arrangements that move the market towards the theoretical ideal are likely to be

---

<sup>2</sup> Stoft, *op.cit.*, chapter 2-4.1, pp. 192-193.

<sup>3</sup> EUAA, "Trial of a demand-side response facility for the National Electricity Market: Independent Consultant's Report", April 2004 (<http://www.euaa.com.au/>).

worthwhile. The key is to ensure that the unintended costs of intervention do not outweigh the intended benefits.

## 3 Section 50 TPA

### 3.1 MARKET DEFINITION AND MARKET POWER

Section 50 of the TPA proscribes acquisitions of shares or assets that would have the effect, or the likely effect, of substantially lessening competition. Competition is a process that occurs within a market, so a key part of the analysis required under section 50 is to define the relevant market. According to the Trade Practices Tribunal in *Re QCMA*, “A market is the field of actual and potential transactions between buyers and sellers amongst whom there can be strong substitution, at least in the long run.”<sup>4</sup>

Further, whether a market is competitive depends on whether participants within that market have market power. In the High Court case of *Queensland Wire*, market power was defined as “the ability of a firm to raise prices above supply costs without rivals taking away customers in due time...”<sup>5</sup> The High Court also recognised the interdependence between the concepts of market and market power – the narrower one draws the boundary around the market, the more likely it is that one finds evidence of market power.<sup>6</sup>

### 3.2 INTEGRATION IN ENERGY MARKETS

This section describes the types of integration that has occurred in the NEM in recent years, so that the application of section 50 to the energy sector can be properly understood. Given the history of reform to disaggregate the industry both vertically and horizontally, there has been a range of opportunities for various kinds of reintegration. The transmission and distribution networks were separated from generation and retailing and made subject to price and access regulation by the ACCC and jurisdictional regulators. Meanwhile, the ‘merchant’ generation and retail activities were left to compete amongst themselves.

Against this background, integration in the NEM has taken the following forms:

○ *Vertical integration:*

- Between merchant businesses – for example, the recent CLP acquisition of the Singapore Power merchant energy business, which included retail and generation assets. AGL’s indirect part-acquisition of Loy Yang Power primarily involved the amalgamation of retail and generation assets, but AGL does also own a distribution network in Victoria;
- Between merchant and network businesses – Singapore Power’s 2004 acquisition of TXU assets (Singapore Power already owned the bulk of the Victorian transmission system), although the network/merchant aspect of this was reversed by the CLP transaction described above;

○ *Horizontal integration:*

---

<sup>4</sup> *Re Queensland Co-operative Milling Association Ltd and Defiance Holdings Ltd* (1976) 25 FLR 169, at p. 190.

<sup>5</sup> *Queensland Wire Industries Pty Ltd v Broken Hill Pty Co Ltd* (1989) 167 CLR 177, at p. 188.

<sup>6</sup> *Queensland Wire*, at p.187.

- At the generation level – for example, the International Power (who owns Hazelwood power station) acquisition of Edison Mission Energy's Loy Yang B; and
- At the retail and distribution level – for example, the merger between Country Energy, Advance Energy and Great Southern Energy in NSW.

We note that the above transactions have served to reduce the number of overall players in the NEM. A number of American-based investors have exited the industry after the privatisations of the 1990s, while Asian and Australian investors have increased their holdings. Given the trends towards greater integration overseas (particularly the UK and New Zealand), it is likely that unless regulators intervene, the level of concentration of ownership will continue to increase, with potentially negative implications for prices and end-users.

There are three types of mergers that raise competition concerns in the NEM, in particular:

- horizontal mergers between generators;
- vertical mergers between transmission, distribution, generation and retail entities; and
- vertical mergers between generation and retail sectors

### **Horizontal mergers – generation**

Generation-to-generation mergers can give rise to significant competition concerns. Strategic horizontal integration may lead to a generator exercising their market power by withholding capacity during peak times to push market prices higher than the LRMC level. ABARE stated that:<sup>7</sup>

“Already there is strong evidence that strategic behaviour is being exercised in the market, with electricity prices deviating significantly from competitive levels. It is estimated that, in the recent past, in certain months, up to half of the price paid for wholesale electricity in New South Wales, Victoria and South Australia may be attributable to strategic behaviour in the market.”

The framework for considering electricity generation mergers is the same as that used for assessing other mergers under s.50 of the TPA. However, there are a number of unique characteristics associated with the electricity industry that must be taken into consideration when assessing electricity mergers:

- electricity cannot be economically stored, therefore supply must continuously equal demand for system stability;
- demand is highly inelastic, especially in the short-term;

---

<sup>7</sup> Short C, Swan A, Graham B, Mackay-Smith W, “Electricity Reform – The Benefits and Costs to Australia”, ABARE Outlook 2001, p81.

- wholesale electricity is traded in the NEM pool, as well as in the forward contract ‘market’. Outcomes in these two trading arenas are closely aligned;
- electricity itself is homogenous, but is differentiated in the market place by the time of day/week/year and also the location that it is produced and consumed; and
- contract and pool prices, and the types of contracts traded, reflect this differentiation.

Accordingly, the capacity, location and type of generating plant held by the merging parties are critical to merger assessment.

In assessing mergers, the ACCC has historically used concentration measures, such as the Four Firm Concentration Ratio (CR4), to provide some guidance on the extent of market power. However, it has been argued that the usual safe haven thresholds for market concentration<sup>8</sup> may be too high for electricity generation because of the nature of the product.<sup>9</sup> For example, Stoft claims that demand inelasticity makes ‘market power at least ten times worse in power markets than in most other markets’.<sup>10</sup> The UK electricity regulator, Office of Gas and Electricity Markets, has also noted that some generators with not more than 5 per cent of installed capacity may have market power.<sup>11</sup>

While CR4 incorporates the likelihood of coordinated behaviour, it fails to take into consideration the:

- extreme inelasticity of demand in the electricity industry;
- style of competition in the market;

---

<sup>8</sup> For example, the current ACCC Merger Guidelines include the following CR4 provision: “*determine whether: – the largest four competitors will have (after the merger) a market share of 75 per cent or more and whether the merged firm will have a market share of 15 per cent, or – whether the merged firm will have a market share of 40 per cent or more*” (ACCC. “*Merger Guidelines*”, June 1999). If these market share thresholds are not breached, the ACCC will generally terminate its inquiry and the merger will be allowed to proceed. However, if the market share thresholds are breached, that does not in itself mean that the ACCC will conclude that the merger will substantially lessen competition. By way of comparison with the NEM as it is in 2005, the top four firms have a market share of 80.5% and two firms have a market share greater than 15% — if common Government ownership is assumed.

<sup>9</sup> See for example Borenstein, S.; Bushnell, J.; and C. Knittel (1999) “Market Power in Electricity Markets: Beyond Concentration Measures,” POWER Working Paper PWP-059, University of California Energy Institute.

<sup>10</sup> Stoft, S., 2002, *Power System Economics*, p.356.

<sup>11</sup> The Department of Justice (DOJ) uses HHI indices as a screening test. The DOJ guidelines state that a market is “unconcentrated” if its HHI is less than 1,000; “moderately concentrated” if its HHI lies between 1,000 and 1,800; and “highly concentrated” if its HHI is greater than 1,800. For purposes of reference, a monopoly has an HHI of 10,000; a market with ten identically sized firms an HHI of 1,000, while a market with five identically sized firms has an HHI of 2,000. A value of 1800 would be obtained with 5.6 identically sized firms. The DOJ merger guidelines further state that a market can be considered competitive if prices do not exceed their “perfectly competitive” level by more than 5%. The DOJ will generally let a merger pass if a market is shown to be “unconcentrated”, may let it pass without investigation if “moderately concentrated” and will always conduct a detail investigation if “highly concentrated”.

- extent of forward contracting and its impact on market power; and
- complication of interconnector constraints on market definition.

As a result, competition thresholds and rules derived from other industries may be misleading, as even small electricity generators can have substantial market power.

Aspects of the Federal Court's (the Court) decision in *Australian Gas Light Company v Australian Competition & Consumer Commission* (AGL case)<sup>12</sup> raise important competition and policy issues about the development and operation of the NEM. A significant result of the case is the defining of the market for electricity generation as being the whole of the NEM. This is broader than the state-based geographic market definition traditionally adopted by the ACCC. The Court did not find that markets for generation were state-based and thus appears to have given greater scope for generators to merge 'without gaining' market power. Section 3.3 will outline the reasoning behind the decision.

### **Vertical integration – generation, retail and transmission**

Generation-to-transmission and retail-to-transmission mergers can give rise to significant competition concerns.<sup>13</sup> When the owner of essential infrastructure also participates in a contestable market, it typically has the ability and the economic incentive to restrict the level of competition in the contestable market in ways that are difficult to police and prevent. It has the ability to harm competition by restricting access to the essential facility by raising the price, lowering the quality and quantity of service provided, or reducing the timeliness of the services it provides, relative to the services the integrated firm provides to its own affiliate. These problems are widely acknowledged.

For example, transmission is both a substitute and a complement for generation. An integrated transmission-generation company has the ability to restrict competition through its investment and maintenance decisions, its line rating decisions and through its negotiation and processing of connection agreements. Through its investment and maintenance decisions, the integrated entity can influence the capacity/reliability of those parts of its network that allow other generators to compete with its own affiliated generators. At the same time, it also has the capacity to influence the capacity/reliability of those parts of the network, which allow its own generators to compete.

An integrated entity has the incentive to restrict the level of competition when the natural monopoly is tightly regulated but the competitive activity is not. In this instance, the owner of the natural monopoly has strong incentive to provide the competitive activity itself, restrict competition in this activity, and thereby capture some of the monopoly rents that it would otherwise lose to regulation.

---

<sup>12</sup> *Australian Gas Light Company v Australian Competition and Consumer Commission* (No 3) [2003] FCA 1525

<sup>13</sup> Organisation of Economic Cooperation and Development, February 2002, *Policy brief: restructuring public utilities for competition*.

Although the NEM has a third party access regime that deals with some aspects of the above, it would not be possible for any regulatory regime to prevent all such anti-competitive conduct.

### **Vertical reintegration – generation and retail**

Re-integration can be used by retailers to mitigate the risks associated with generator market power by providing the retailer with a natural hedge against spot market volatility. However, ownership of a generator by a retailer may increase barriers to entry/expansion for stand-alone electricity retailers, through reduced scope for them to secure competitively priced hedging contracts. In the event that load closely matches output for the vertically integrated market participants, there is little surplus to be traded in contract markets. This is a concern in the NEM given its gross pool design that relies heavily on financial hedges to manage participants' risk and keep prices competitive.

The evidence from New Zealand suggests that stand-alone retailers could not obtain contracts from integrated players, as these firms kept contract cover to protect their own retail positions. Re-integration may also create pressures for other generators and retailers to merge, as happened in New Zealand and some other overseas markets.

## **3.3 AGL CASE**

The AGL case was the first (and remains the only) electricity merger to go before the Federal Court. For this reason, it is worthwhile examining in some detail in order to help assess whether section 50 of the TPA, by itself, is likely to provide the necessary level of protection of competitive outcomes in the NEM and energy markets generally.

In *AGL*, the court defined the market as encompassing both spot and contract trading in the entire NEM. Within that market, the court found that Loy Yang A did not have market power, particularly because the barriers to entry into generation were relatively low. This was a key reason for the court's conclusion that the proposed transaction would not substantially lessen competition.

The findings in *AGL* on geographic market definition and market power have also been controversial and, given that *AGL* is the most recent energy mergers case that has been litigated, it is worth exploring these issues further.

### **3.3.1 Geographic market definition**

On geographic market definition, French J found that transmission constraints between NEM regions were relatively infrequent and that participants often hedged with parties in other regions, taking advantage of settlement residue auctions to help manage inter-regional price risk. For these reasons, he concluded that the market was NEM-wide although, because of transient price separations, the individual NEM regions could be considered as temporally limited sub-markets. However, the law around section 50 relegates sub-markets to secondary importance when assessing the competitive impacts of mergers.

As mentioned above, French J's findings on geographic market are controversial and numerous experts appearing in that case argued that the relevant market was

narrower than the NEM. They argued it was necessary to consider the timing and financial impact of binding interconnector constraints rather than merely their frequency and duration, as enormous price differences could arise between regions when constraints bind, leading to substantial impacts on both retailer/customer liabilities and generator receipts. Further, although French J found that there was a single wholesale market comprising both spot and contract trade, the reality is that for most participants, inter-regional contract trading is very limited due to basis risk arising from inter-regional price differentials. The current inter-regional settlement residue rights are non-firm and so have limited usefulness in hedging basis risk in interconnector outage situations. For all of these reasons, the finding in *AGL* on geographic market definition remain highly controversial, open to dispute and may be inappropriate in many actual situations that arise in the NEM and give rise to market power.

The Parer Report, which examined the NEM in detail, also supported this view:

“A combination of a lack of access to firm financial instruments to manage inter-regional trading risk across interconnects and an inappropriately defined regional market structure has produced; inefficiently low levels of contracted inter-regional trade, with the potential to restrict the development of related financial markets; a consequent reduction in effective wholesale and retail competition throughout the NEM; and delayed development of an integrated NEM.”<sup>14</sup>

Nevertheless, the court’s current view that the existence of both substantial interconnection between NEM regions and average regional prices that generally move together combined with courts’ historical longrun view<sup>15</sup> on substitutability mean that, unless there is a future challenge to this view and the courts adopt a different interpretation of the NEM, it is unlikely that future courts will revise their NEM-wide market view. Interestingly, the ACCC has continued to employ a region or combined-region based approach to assessing electricity transactions.<sup>16</sup>

Therefore, if a narrower geographic market definition were considered appropriate, it would probably need to be implemented via legislation, either through changes to the TPA or through State-based rules.

### **3.3.2 Market power**

As noted above, courts have traditionally taken a long term view on market power as well as market definition. The Court accepted evidence in *AGL* that substantial new generation had occurred and would occur in the NEM in response to high prices, and that gas turbine generators could be commissioned in under 2 years. It is not clear if French J would have taken a different view on the issue of Loy Yang A’s market power if the lags to develop new generation

---

<sup>14</sup> Council of Australian Governments, Energy Market Review Final Report, “*Towards a Truly National and Efficient Energy Market*”, p.g. 130.

<sup>15</sup> J. French adopted a two year time horizon as a measure of sustained price increases to indicate market power. To many experts this would seem excessively long and likely to subject electricity consumers to an unacceptable period of high prices.

<sup>16</sup> See, for example, ACCC Media Release 143/04, *ACCC not to oppose Edison Mission acquisition*, 3 August 2004.

had been much longer than 2 years, as they inevitably are for base load (with most experts suggesting 3-5 year lead times for large base load plant).

There is also the additional matter that very little of the new generation built in the NEM has been built by new entrants and that no new base load generation (of the type provided by Loy Yang) has been built without some form of State Government help. Table 1 sets out new generation commissioned since NEM start. Note that the only baseload generation (coal-fired or CCGT) developed has either been in Queensland and NSW (both States where the bulk of generation is owned by Government-owned businesses) or Government-sponsored (Pelican Point in South Australia).

The following quotation from the judgment shows the importance of timeframe in deciding the issue of market power:

“I am prepared to accept that there are periods of high demand where a generator may opportunistically bid to increase the spot price. I do not accept that such inter-temporal market power reflects more than an intermittent phenomenon nor does it reflect a longrun phenomenon having regard to the possibilities of new entry through additional generation capacity and the upgrade of interconnection between regions. It does not amount to an ongoing ability to price without constraint from competition.”<sup>17</sup>

Hence, according to French J, Loy Yang A’s ability to game the spot market for certain periods in early 2001 did not reflect market power. According to the judgement, this behaviour was too intermittent and could too easily be defeated by a supply response to be concerned about. What is not clear from the judgment is whether a greater and more consistent ability to raise prices would be considered evidence of market power, even if barriers to entry remained low – the passage above distinguishes between a “more than intermittent” phenomenon and a “longrun” phenomenon as apparently separate concepts (and states that Loy Yang A’s behaviour reflected neither). It is possible that an ability to raise prices consistently for several months or years in advance of new entry would be considered market power, as it might be “more than intermittent” but less than “longrun”. However, this is only one interpretation of the above passage.

In any case, the decision in *AGL* highlights the difference between the commonly-used Lerner measure of market power<sup>18</sup> (price less marginal cost as a proportion of marginal cost) and the more relaxed definition of market power for the purposes of a section 50 analysis of NEM behaviour.

---

<sup>17</sup> *AGL*, at para 493.

<sup>18</sup> In the context of electricity markets, it has been said that “The fundamental measure of the exercise of market power is the price-cost margin, which measures the degree to which prices exceed marginal costs...” - see Borenstein, S. J. Bushnell and C.R. Knittel (1999) “Market power in electricity markets: Beyond concentration measures”, *The Energy Journal*, Vol. 20. 4, pp. 65-88, at p.67. Under the *Trade Practices Act*, Mason CJ and Wilson J said in *Queensland Wire Industries Pty Ltd v Broken Hill Pty Co Ltd* (1989) 167 CLR 177 at p.189, “Market power can be defined as the ability of a firm to raise prices above supply cost without rivals taking away customers in due time...”

**Table 1 New generation commissioned since NEM start**

<b>Name</b>	<b>State</b>	<b>Technology</b>	<b>Type</b>	<b>Capacity</b>	<b>Ownership</b>	<b>Commissioning Date</b>
Roma	Qld	Gas GT	Peak	76	Origin Energy	1999
Bulwer Island	Qld	Gas CCGT	Mid/peak	32	Origin Energy	2000
Ladbroke Grove	SA	Gas GT	Peak	80	Origin Energy	2000
Pelican Point	SA	Gas CCGT	Baseload/ mid	480	International Power	2000-2001
Callide C	Qld	Coal	Baseload	900	InterGen/ CS Energy	2001
Mica Creek A expansion	Qld	Gas CCGT	Mid/peak	309	CS Energy	2001
Redbank	NSW	Coal	Baseload	150	National Power	2001
Bairnsdale	Vic	Gas GT	Peak	92	Alinta	2001
Millmerran	Qld	Coal	Baseload	852	OzGen (InterGen)/ others	2002
Tarong North	Qld	Coal	Baseload	450	Tarong Energy	2002
Swanbank E	Qld	Gas GT (CSM)	Mid/peak	360	CS Energy	2002
Somerton	Vic	Gas GT	Peak	160	AGL	2002
Valley Power	Vic	Gas GT	Peak	300	International Power/ others	2002
Quarantine	SA	Gas GT	Peak	100	Origin Energy	2002
Hallett	SA	Gas GT	Peak	220	AGL	2002

## **3.4 EUAA COMMENTS**

### **3.4.1 Market definition**

We understand that the DOI is particularly interested in stakeholders' views on the appropriate geographic market. This depends crucially on where the relevant activities are assumed to occur. If we are concerned about mergers and behaviour within Victoria, it is necessary to consider the incidence of interconnector constraints from other regions to Victoria. On the other hand, if we were concerned about activities in, say, South Australia, the incidence of constraints into South Australia would be more relevant.

Focusing on Victoria, our analysis shows that for calendar 2004, constraints from South Australia to Victoria occurred for less than 0.05% of the time. This suggests that from the perspective of examining Victorian generators' behaviour, South Australia could reasonably be considered as part of the relevant geographic market.

Constraints from the Snowy region into Victoria occurred for less than 0.5% of the time in the second half of calendar 2004 and for 0.25% of the time in the first half of 2004. However, in the second half of 2003, constraints from Snowy occurred for 5.5% of the time. This suggests that Snowy may potentially be considered part of the market, subject to the Snowy to Victoria interconnector remaining relatively unconstrained. The commissioning of Basslink should help in this respect, by reducing the need for Victorian demand to be met by flows from Snowy/NSW or South Australia.<sup>19</sup>

Constraints from NSW into Snowy have been virtually non-existent over the past several years. This means that if Snowy were considered part of the relevant market, NSW should also be included.

Constraints from Queensland into NSW have been material in recent times (3-7% of the time). This raises strong doubts about whether Queensland should be considered part of the market.

Figure 1 sets out the proportion of time interconnectors were constrained for each six-month period from the first half of 2000 to the second half of 2004.

In defining the market it is not only useful to look at the number of time constraints occurred but also the exact timing and financial consequences of those constraints.

In a competitive market you would expect constraints to occur when supply cannot meet demand. However, as noted, there is strong evidence that strategic behaviour is being exercised in the market, with electricity prices deviating significantly from competitive levels. A generator may exercise their market power by withholding capacity during peak times to push market prices higher.

---

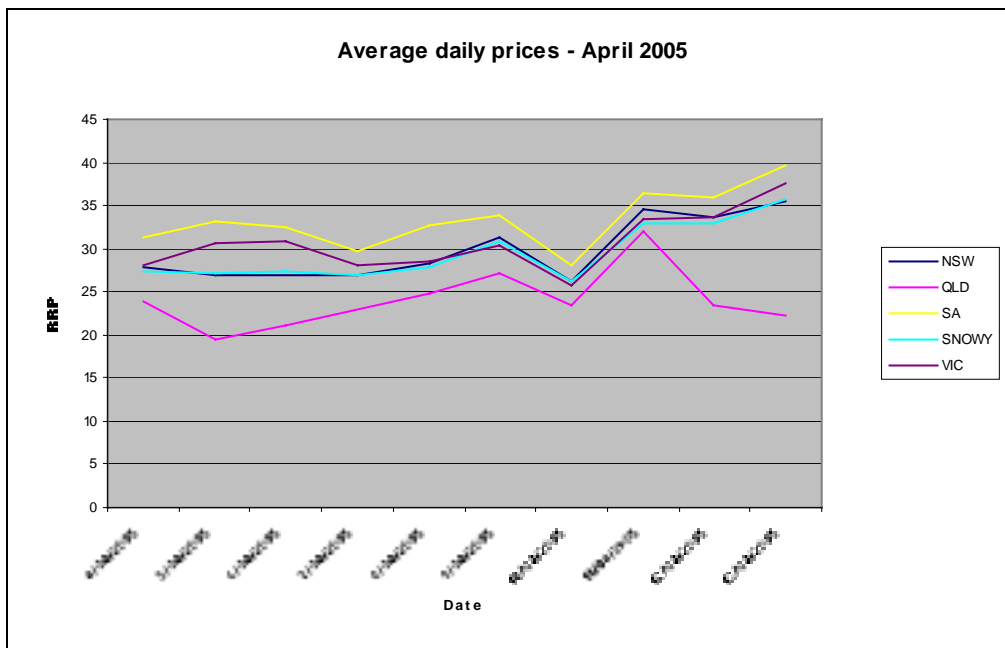
<sup>19</sup> The commissioning of Basslink appeared important to the ACCC's recent approval of the CLP acquisition of Singapore Power's merchant energy business (ACCC Media Release 77/05, *ACCC not to intervene in China Light and Power's proposed energy acquisition*, 30 March 2005).

**Figure 1 NEM constraints 2000-2004<sup>20</sup>**

		Proportion of time constraints occur across the NEM							
		V-SA into SA	V-SA into VIC	V-SN into SNOWY	V-SN into VIC	SN-N into NSW	SN-N into SNOWY	QNI into QLD	QNI into NSW
2000	Jan-Jun	29.5%	0.0%	3.2%	0.5%	0.00%	0.06%	0.0%	0.0%
	Jul-Dec	21.1%	0.1%	6.0%	1.9%	0.00%	0.10%	0.0%	0.0%
2001	Jan-Jun	14.4%	0.4%	11.2%	0.8%	0.00%	0.05%	5.3%	6.0%
	Jul-Dec	4.6%	1.1%	7.1%	0.6%	0.00%	0.02%	2.1%	5.7%
2002	Jan-Jun	7.9%	0.7%	4.2%	0.5%	0.11%	0.00%	3.7%	3.3%
	Jul-Dec	10.6%	2.2%	17.4%	0.5%	0.01%	0.00%	3.9%	3.8%
2003	Jan-Jun	27.7%	0.1%	11.3%	1.0%	0.12%	0.00%	2.1%	4.6%
	Jul-Dec	9.2%	0.1%	2.5%	5.6%	0.01%	0.27%	0.2%	7.3%
2004	Jan-Jun	21.9%	0.0%	24.1%	0.2%	0.06%	0.04%	0.2%	5.1%
	Jul-Dec	11.7%	0.0%	12.2%	0.5%	0.74%	0.08%	0.6%	3.1%

In relation to the financial consequences of constraints, you would expect that if there were limited constraints between jurisdictions then the pool price (given losses) would be close to the same value. For example, for VIC and SA, you would expect that the pool prices would be close to the same value, differing only about 10% to account for losses. Figure 2 reflects this presumption outlining the average daily prices between the 4 to the 13 of April 2005.

**Figure 2 – Average daily prices (April 2005)<sup>21</sup>**



<sup>20</sup> NEMMCO website: [www.nemmco.com.au](http://www.nemmco.com.au).

<sup>21</sup> Ibid.

It is clear that there is a minimum price difference between the VIC/SA markets. This strongly suggests that there is a VIC/SA market but less likely a VIC/SA/NSW market and certainly not a VIC/SA/NSW/QLD market.

The EUAA's preliminary view is that a conservative geographic market definition should include Victoria and South Australia. This would recognise the importance of preventing mergers within these regions that would lead to higher prices for consumers in the short to medium term. A more relaxed definition, based on the current level of constraints, could include Snowy and NSW at the present time. However, this is dependent on expected new capacity (eg the Laverton North gas turbine) and interconnection (Basslink) coming on stream when indicated. Such investment would, by helping to satisfy peak mainland demands, make it likely that the Snowy-Victoria and NSW-Snowy interconnectors would remain relatively unconstrained. On this basis, we consider a NEM-excluding-Queensland market to reflect market realities while a NEM-wide market appears to exaggerate the degree of competitive pressure experienced by Victorian generators. It is less clear whether Victoria-NSW should be considered a single market.

At the same time, it is clear from *AGL* that the key issue in assessing mergers is the meaning of market power. Even if the relevant geographic wholesale market for electricity were region-based, if barriers to entry were considered low and the ability to cause price spikes at will were not considered indicative of market power, it is not clear that the outcome of future merger cases would be any different than if the geographic market remained NEM-wide.

That said, a smaller market could mean that the minimum efficient scale (MES) of generation investment was larger as a proportion of overall capacity. This would deter new entry if it meant that new MES generation investment – being large relative to demand – caused post-entry prices to fall. However, taking Victoria and South Australia as the smallest defensible geographic market, such 'lumpiness' problems are unlikely to be significant.<sup>22</sup>

### **3.4.2 Market power**

In our view, the real question is whether the court's view of market power in *AGL* is appropriate for mergers in energy markets. On this, there is a real risk that the decision in *AGL* could allow almost any horizontal generation merger in the NEM to go ahead. Depending on the interpretation of the passage on market power quoted above, the reasoning in *AGL* could allow several generators in each NEM region to merge into one. As long as sufficient new generation or interconnection could theoretically be commissioned in something less than the "longrun", high prices for months or years on end could be regarded as nothing more than transitory market power.

The EUAA submits that prolonged high wholesale energy prices as a result of a merger or mergers would be harmful for several reasons.

---

<sup>22</sup> Power economist Steve Stoft argues that inefficiency typically caused by the lumpiness of generators is negligible and observed that "The problems of power markets do not arise from fixed costs but from the difficulty in achieving competitive prices in the face of demand-side flaws." (Stoft, S., *Power System Economics: Designing Markets for Electricity* (2002) Wiley-IEEE Press, chapter 2-2.3, pp.130-132.

First, the inelasticity of demand for energy (particularly electricity) combined with poor or infeasible storability, mean that high wholesale prices are likely to lead to large transfers of wealth from electricity consumers to producers, notwithstanding the often stated policy intent of energy market reform being to benefit end users. Therefore, the distributional impacts of high prices (while they exist) are likely to be detrimental and significant.

Second, energy is a major input into the production of many other goods and services. Therefore, a rise in wholesale prices may increase the prices of other products and lead to greater allocative inefficiency in production and consumption than would occur if the price rise occurred in the production of other (non-intermediate) goods or services.

Third, to the extent that high prices brought on by transitory market power led to new energy generation or supply in advance of when it would otherwise occur, this would constitute dynamic inefficiency. It would imply that resources were invested earlier than would have occurred in a more competitive market. The degree of earlier investment would represent a deadweight loss of welfare to society as a whole. Furthermore, if more entry was met with more mergers, the process could be repeated and further inefficiency could result.

Therefore, given the uncertainty over the precise meaning of market power in *AGL*, there may be some benefit in implementing State-based or national rules that prevent energy mergers that would be likely to lead to high prices for substantial (but less than “longrun”) periods of time. On the assumption that changes to the TPA are beyond the scope of this review, the remainder of this submission considers a number of options for supplementing section 50 with other merger rules. It must be remembered that to be net beneficial, options for limiting future mergers must offer likely benefits that exceed likely costs. The options selected are discussed in section 4 below.

### **3.4.3 Adequacy of section 50 in light of *AGL***

In light of the shortcomings of the *AGL* judgement to market definition and market power under section 50 of the TPA, the EUAA is concerned that relying solely on section 50 to prevent mergers could have a negative impact on efficiency putting end-user welfare at substantial risks. *AGL* could be interpreted to allow many more vertical and horizontal mergers to go ahead, facilitating higher wholesale prices and leading to inefficient investment and wealth transfers from energy consumers to producers.

## 4 Options

### 4.1 RELIANCE ON VICTORIAN CROSS-OWNERSHIP RULES

As stated above, the EUAA agrees with the sentiment expressed in the Issues Paper that there is little point in maintaining cross-ownership rules that have no independent operation from the TPA. Therefore, if the Government continually exempted prospective acquirers from the rules if they could successfully challenge the ACCC on section 50 grounds, the rules would have no function other than to impose lobbying costs on prospective acquirers. This would create uncertainty and inefficiency, resulting in poor public policy outcomes. The discussion below is based on the Government not continuing such exemptions. Of course, this overlooks the question of how the Government could credibly undertake not to change the rules in the future, given that it has already done so in the past (in the context of *AGL*).

In our view, the Issues Paper correctly observes that it would be undesirable for the application of the cross-ownership rules to turn on the ACCC's pre-merger notification process, due to its informality and lack of transparency. Given that the ACCC's pre-merger process is based on its interpretation of the law, parties should continue to have the right to challenge the ACCC's interpretation of section 50 in the same way as they have the right to challenge any executive body's interpretation of the relevant law.

The question is then whether maintaining the cross-ownership rules without any power for the ACCC to grant exemptions would be appropriate. Such arrangements would have prevented most of the recent transactions in the NEM: the *AGL-Loy Yang* transaction, the Singapore Power acquisition of *TXU*, the International Power acquisition of Edison Mission Energy's interest in *Loy Yang B* and *China Light and Power's* recent acquisition of the *SP* merchant energy business. These transactions have increased the concentration of ownership of electricity assets in Victoria such that it may be appropriate for rules to prevent further energy mergers, especially those where businesses predominantly compete at the same functional level.

On the other hand, there are several drawbacks with the current cross-ownership rules.

First, the rules are exclusively focussed on market concentration. They ignore much of the theoretical and legal debate that has occurred over the last 50 years on the importance of barriers to entry and contestability of markets. As *Mason CJ* and *Wilson J* said in *Queensland Wire*

“A large market share may well be evidence of market power... but the ease with which competitors would be able to enter the market must also be considered. It is only when for some reason it is not rational or possible for new entrants to participate in the market that a firm can have market power... There must be barriers to entry. As professor F M Scherer has written, “significant barriers to entry are the *sine qua non* of monopoly or oligopoly, for... sellers have little or no enduring power over price when entry barriers are non-existent.”<sup>23</sup>

---

<sup>23</sup> At 189-190.

Therefore, reliance on quantitative cross-ownership rules alone could risk blocking transactions that may either have no negative impact on competition or could even enhance competition or efficiency.

Another problem with such rules is the creation of barriers to exit for investors in energy assets, especially those assets that involve high fixed costs. If prospective investors believe that it will be difficult for them to sell assets and exit the industry because of tough competition or cross-ownership rules, they may be less inclined to enter. In effect, the rules would increase the risk that their investment, once made, would be irreversible (ie “sunk”). This could harm competition in the long run.

Finally, such rules could partly insulate owners of existing assets from competition in the market for corporate control. Inefficient incumbents would know that a rival incumbent would not be able to make a hostile takeover bid for the inefficient firm’s assets. This could reduce the impetus on the inefficient incumbent’s managers to improve efficiency. For example, Origin Energy, being an Australian-listed company, would ordinarily be at risk of takeover if it made poor use of its assets. However, with strict cross-ownership rules in place, its management will know they will be safe from takeover by both AGL and CLP. That said, firms like Origin would still face the discipline of its shareholders for poor returns, so it is not clear how great is the risk of inefficiency from this source.

In any case, we may have got to the stage where any further ownership concentration of generation (or retail) assets is undesirable, such that some negative impact on future investment or efficiency may be a price worth paying for preventing further consolidation. Certainly, where transmission or distribution network businesses are concerned, there is a strong public policy argument for preventing *any* further aggregation of network and merchant (retail and generation) activities. For this reason, the EUAA believes that the retention of the Victorian cross-ownership rules, without any exemptions, is a reasonable policy approach to adopt if there are no other more desirable approaches available.

## **4.2 NEM-WIDE CROSS-OWNERSHIP RESTRICTIONS**

The Issues Paper raises the possibility of national cross-ownership laws instead of the current Victoria-only rules on the basis that energy markets are becoming more national in character. The Issues Paper notes that Victoria-only cross-ownership rules could lead to the following types of errors:

- They could implicitly over-state the market power of entities licensed in Victoria by blocking mergers between such parties even where competition was not harmed due to competition from inter-State players; and
- They could ignore the anti-competitive impact of mergers involving non-Victorian licensed participants.

The Issues Paper does not itself provide an outline for how national cross-ownership rules could operate, but restricts itself to asking whether Victoria-specific rules are appropriate in light of the problems outlined in the bullets above.

Considering the prospect of national or NEM-wide cross-ownership rules, the most obvious type of rules would block energy mergers between any parties licensed in any NEM jurisdiction. This would overcome the second problem by recognising that mergers between parties in different regions could harm competition. The Victorian cross-ownership rules do not achieve this as the rules ignore the anti-competitive impact of mergers involving non-Victorian licensed participants.

It is not clear how such rules would overcome the first problem – that they could prevent mergers that did not harm competition. In fact, if the rules prevented *any* NEM energy mergers from going ahead, they would not only effectively freeze the ownership of electricity and gas assets in NEM jurisdictions, but also be likely to block more benign or desirable mergers than the existing Victoria-only cross-ownership restrictions. This could create barriers to exit and entry for new entrants, as well as barriers to investment for existing licence-holders.

To limit such unintended consequences, it would be necessary to develop more sophisticated cross-ownership rules for NEM-wide application than are currently in place in Victoria. It may be possible to create exemptions for certain mergers, based on factors such as:

- Market shares
- Geographic location

If such rules could be developed and agreement reached amongst all jurisdictions, the EUAA would support reviewing the development of national cross-ownership rules.

However, the EUAA notes that NEM-wide cross ownership rules are likely to have limited impact in New South Wales and Queensland (and Tasmania when it joins the NEM) as electricity assets in these States remain largely in Government hands and are already highly concentrated, as are retail assets. Their impact in South Australia is also likely to be limited given the concentrated nature of generation and retail in that State.

### **4.3 ACCC ENERGY MERGER GUIDELINES OR STATEMENTS**

The Issues Paper notes many of the problems associated with quantitative cross-ownership rules in the context of energy mergers, such as ignoring barriers to entry. At the same time, it recognises that special features of electricity markets may warrant additional merger controls. These special features include (leaving aside the regulated network elements), the non-storability of and highly inelastic demand for electricity.

The Issues Paper suggests that there may be a case for energy-specific merger guidelines. We note that the Office of Fair Trading and Ofgem in the UK have developed guidelines for how they will enforce Articles 81 and 82 of the EC Treaty and Chapters 1 and 2 of the *Competition Act* 1998 in the energy sector.<sup>24</sup>

---

<sup>24</sup> Office of Fair Trading, *Application in the energy sector, understanding competition law*, January 2005, pp. 10-11.

These guidelines provide advice and information on the factors that Ofgem will take into account in exercising its powers, including special features of energy markets such as:

- The existence of monopoly networks in electricity and gas;
- The importance of separation of network and merchant businesses in the transition from monopoly to competition;
- Existing market power in areas such as connections, retailing and metering;
- The existence of price controls for transmission and distribution activities;
- The low elasticity of demand and supply for both electricity and gas, particularly in the short term and in particular locations;
- Complexity of various rules, codes and agreements; and
- Economic linkages between spot and contract markets and between electricity and gas markets.

Importantly, the guidelines only relate to the following prohibitions:

- Agreements that have the object or effect of preventing, restricting or distorting competition; and
- Conduct amounting to abuse of a dominant position in a market.<sup>25</sup>

With respect to mergers, Ofgem investigates proposed energy mergers and advises the OFT whether they would be likely to give rise to competition concerns. The OFT then decides whether the transaction should be referred to the Competition Commission, who decides whether a merger should be permitted. Whilst we note that similar industry-specific guidelines to those referred to above do not apply to the Competition Commission's consideration of energy mergers<sup>26</sup>, this is not to say that such factors as those listed above could not be adapted for mergers.

In coming to a view on this option, it is important to understand the role of the existing merger guidelines. The guidelines do not replace section 50. Rather, they inform the public of the ACCC's approach to merger clearances. If a proposed merger would not breach the guidelines, the ACCC will be unlikely to take a further interest in it. On the other hand, if a proposed merger would breach the guidelines, the ACCC may want to investigate further. However, parties would at all times be free to challenge the ACCC's position in court according to the law on section 50. The commercial reality is that many merger proponents would seek to avoid litigation, which confers a special authority (and responsibility) on the ACCC, but ultimately the merger guidelines are not law and do not bind any party (including the ACCC).

In this context, we note that the ACCC has taken a strong interest in all the energy mergers that have occurred since NEM commencement and this is probably at least partly due to the inadequacy of the existing merger guidelines to identify mergers in energy (please refer to section 3.2) that raise competition

---

<sup>25</sup> Office of Fair Trading, *op. cit.*

<sup>26</sup> Competition Commission, *General Advice and Information*, June 2003.

concerns, for all the reasons mentioned in the OFT guidelines. This suggests that for the sake of improving the applicability and transparency of the existing ACCC merger guidelines, it would be appropriate for the ACCC to either:

- Expand the existing merger guidelines to explicitly refer to the special features of energy markets that warrant greater attention in applying section 50 of the TPA; and/or
- Make a separate statement on energy mergers that highlighted the special features of energy markets and explained why a more detailed examination of mergers involving energy assets was necessary.

#### **4.4 INSTITUTING A MORE STRINGENT COMPETITION TEST FOR ENERGY MERGERS**

As discussed above, part of the problem with quantitative cross-ownership controls is that they are inflexible and not based on a proper consideration of the issues relevant to the individual case, such as the factors set out in section 50. This inflexibility creates a temptation or practical necessity for Governments to introduce exemptions or otherwise relax the rules.

Therefore, one option may be to abolish quantitative limits altogether (at least in relation to merchant energy businesses) and introduce a more stringent competition test than the current TPA section 50 for energy mergers. This could be included in the new National Electricity Law or National Electricity Rules.

One approach could be a test that proscribed mergers that “*significantly* lessened competition” rather than only those that were likely to “*substantially* lessen competition”. Such a test would provide the relevant regulator (say the Australian Energy Regulator) with an independent and transparent criterion for blocking energy mergers that was stricter than the current TPA section 50 test. The deliberate use of different language would provide a clear signal to those interpreting the rule that it was intended to prevent mergers that section 50 would allow.

Other things being equal, a more stringent competition test could shift the criteria for energy mergers away from some possible interpretations of the *AGL* statements on market power. A court could find that, say, a merger between Loy Yang A, Yallourn and Hazelwood power stations would not substantially lessen competition based on *AGL*, but would significantly lessen competition. Obviously, whether such an outcome resulted would depend on how the relevant bodies interpreted the test.

If this approach was considered too vague, a variation would be to define a “significant lessening of competition” more precisely by reference to the magnitude and duration of expected price impacts. For example, a significant lessening of competition could arise if a proposed merger would be likely to lead to an increase in a region’s wholesale electricity prices of at least 5% for at least 2 of the next 5 years compared to the counterfactual of no merger. Clearly, such a criterion would place a much stronger emphasis on electricity pool modelling than has been the practice to date and this would require greater transparency and robustness of the various model methodologies in the marketplace. Over-reliance on such work can be problematic at the best of times. However, the

advantage of this option is greater certainty for participants and policy-makers than a supplementary test based on different language from section 50.

There would be a number of drawbacks from a supplementary competition test for energy mergers, whether or not it was extensively defined.

First, while a new test might address some of the uncertainties resulting from *AGL*, it would also create uncertainty by departing from long-standing law (the TPA section 50 framework and precedent history). There is no doubt that despite remaining controversial and open to challenge, *AGL* at least imparted a degree of certainty for participants and policy-makers on the types of electricity mergers that would offend the TPA section 50.

Second, as well as creating some uncertainty, we would envisage a new test, sitting within the NEL or Rules (ie outside the TPA) would operate in addition to the existing TPA section 50 process. Therefore, it may imply some duplication of competition analysis by the ACCC and AER, as well as duplication of participant effort in complying with regulatory processes. If this occurred, it could impose a significant cost on the market. On the other hand, if an additional test were developed, the ACCC and AER, being closely related, may decide to implement protocols between themselves that could relieve these problems as part of their proposed Memorandum of Understanding. For example, the ACCC could agree to give automatic clearance to a merger that was not opposed by the AER. Of course, such protocols would not bind aggrieved participants who wanted to challenge a transaction under the TPA.

Third, a new test incorporated in relevant State legislation such as the new NEL would presumably be enforced by the AER. This would raise issues of AER governance such as the ability of participants to appeal the AER's decisions. At this stage, we understand that decisions of the AER would only be subject to judicial review (rather than a review on the merits of the case).

Finally, while a more strict competition test would be able to take into account factors such as barriers to entry and the special features of energy markets discussed above, it would still tend to increase barriers to exit (and entry) by creating greater difficulties for investors wishing to sell assets. Other things being equal, this could harm competition in the long run, although this would not be a major concern if the existing level of concentration were considered to be the highest allowable level of energy market aggregation.

While there are obviously a host of issues that would require consultation and resolution, the EUAA still believes it would be worth exploring further the scope for a more stringent competition test to operate in addition to TPA section 50.

## **5 Conclusions and recommendations**

This submission has recognised that there is a key difference between the ‘purist’ Lerner approach to energy market competition and reasonable policy towards energy mergers in the real world. The EUAA recognises that designing rules to impose idealised behaviour on energy market participants is unrealistic and inappropriate. However, the EUAA is concerned that the current state of mergers law – in particular, the views expressed on the meaning of market power in *AGL* – leaves open the possibility that a great deal of energy asset ownership aggregation could occur within the law. While the implications of such activity may be limited in the very long term, we are concerned that end-users of energy and consumers of final goods and services could suffer for a number of months or years in the interim. Further, the allocative and dynamic inefficiency created by high prices would impose permanent costs on the economy.

At the same time, the EUAA seeks to avoid regulatory options that could have adverse unintended consequences greater than the likely benefits. Any measures that would prevent energy mergers need to be analysed thoroughly to ensure their negative impacts are minimised. This would require extensive stakeholder consultation and robust qualitative and quantitative analysis.

Therefore, as a preliminary position, the EUAA makes the following conclusions and recommendations:

- Retaining the existing Victorian cross-ownership rules with exemptions for mergers that are either cleared by the ACCC or successfully challenged against the ACCC is inappropriate;
- Retaining the existing Victorian cross-ownership rules with exemptions for mergers that are either cleared by the ACCC or successfully challenged against the ACCC is inappropriate
- National cross-ownership rules, allowing for certain mergers to be exempted on the basis of market share and/or geographic location could be developed;
- Energy-specific ACCC merger guidelines or a separate ACCC statement on energy mergers, reflecting the special features of energy markets highlighted by the UK Office of Fair Trading’s guidelines will aid the transparency of mergers policy in Australia; and
- It would be worth exploring more fully the development of a more stringent competition test for energy mergers in Victoria (or the NEM) that operates in addition to the existing section 50 test.

The EUAA looks forward to discussing these proposals with the Government in the near future.

