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7 March 2007

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Dear Ms Ford

**Submission re: AGL and TRU – proposed asset swap**

The Energy Users Association of Australia (EUAA) appreciates the opportunity to provide a submission on the proposed acquisition of the Torrens Island powers station by AGL from TRUenergy and the reverse acquisition of AGL's Hallet power station by TRU.

The EUAA considers that, while the proposed swap of assets will have commercial benefits for both AGL and TRU, there is also likely to be a significant negative impact on competition in the South Australian electricity market. AGL is by far the dominant retailer and it will control over half of the mainstream generating capacity. With limited and, at times, unreliable interconnector capacity into the region AGL would be in a strong position to reduce liquidity in the financial hedge market and heavily influence the delivered price of electricity. TRU energy would seem to be left in a position where it will have less incentive to compete, even though the swap provides a better fit with its existing retail portfolio. Accordingly, the EUAA believes that the ACCC should reject

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the application on competition grounds in that it would result in a substantial lessening of competition in the SA market.

The submission comments on all the major issues raised by the ACCC and provides our assessment of these. This is directly relevant to our main conclusion.

The proposed merger of AGL and Origin compounds our concerns. If AGL's overtures are successful, it would leave the SA-Vic region (electricity and gas) extremely vulnerable to domination by the merged entity. The merged entity would be in a powerful position to dictate prices and retailer offerings.

We recognize that some sort of divestment to alleviate competition concerns could be required before the merger was allowed to proceed, the extent of domination and the vertically integrated structure of assets would seem to imply the need for a very substantial divestment of assets.

If you require further information please contact Robert Davenport on (03) 9898 3900 or at [bob.davenport@euaa.com.au](mailto:bob.davenport@euaa.com.au).

Yours sincerely



Roman Domanski  
**Executive Director**

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## **Submission to the Australian Competition and Consumer Commission**

### **AGL and TRU – Proposed Asset Swap**

### **Energy Users Association of Australia**

This submission provides a response to the ACCC's request for submissions by interested parties in relation to the proposed AGL and TRU – asset swap. The EUAA was assisted in preparation of this submission by Firecone Ventures P/L. The EUAA gratefully acknowledges the provision of funding by the Advocacy Panel to assist in preparation of this submission.

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The Energy Users Association of Australia (EUAA) is a non-profit organization focused entirely on energy issues on behalf of large business end users of gas and electricity. The EUAA currently has around 85 members and its position as the national association of larger energy users means that membership ranges across many sectors of the economy, including mining, manufacturing, construction, commercial, property and service sectors.

The EUAA considers that the proposed asset swap will lead to a substantial reduction in competition in the South Australian electricity market. AGL's position as the dominant retailer, coupled with its control of over half the generation capacity raises a strong concern that it will reduce liquidity in the financial market, reduce the availability of competitively priced hedges and leave AGL in a strong position to influence prices. Our concerns are addressed in detail below.

### **Specific Issues Raised by ACCC**

#### ***Issue 1. Whether there is a market for retailing electricity, gas and other forms of energy, or whether retailing electricity is in a market of its own.***

Electricity is an essential commodity in the Australian economy. Some electrical demands can be met through applications of other forms of energy, or avoided altogether. However, there are numerous applications for which electrical current is the only technically feasible form of energy. There is also a marked difference in the geographic coverage of electricity and of other forms of energy. The low price elasticity of demand for electricity and its non-storability also play an important part in reducing substitution possibilities. These factors mean that as such the electricity market is a market of its own.

#### ***Issue 2. Whether there are any factors distinct to South Australia that mean that South Australian electricity retailing should be considered a separate market***

What constitutes "the market" is the key issue for the ACCC and the EUAA considers that in the case of South Australia the characteristics of the load requirements and the generation capacity, the high risk for inter regional trading, the limited interconnector capacity and the very high level of dominance of one retailer clearly delineates the South Australian region as a separate market.

AGL has a very significant position in electricity retailing in South Australia. UBS estimates that in 2006, AGL supplied 540,000 out of 670,000 electricity customers in

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South Australia.<sup>1</sup> The next largest retailer, TRUenergy, is estimated to have 90,000 electricity customers in South Australia. The remaining 50,000 customers are split between Origin Energy and Energy Australia.<sup>2</sup>

AGL's dominant position in South Australia provides it with several sources of competitive advantage including incumbency, economies of scale and the portfolio benefits of a diversified customer base. All these advantages are specific to AGL's dominance in South Australia and provide it with an ability to compete above that in any other region of the NEM. AGL is the only party with a dominant position in the South Australian electricity retail market. AGL's dominance in South Australia is unique and goes beyond that in other regions of the NEM which, with the exception of Tasmania, have at least two major retail players.

In addition the characteristics of the South Australian electricity market result in interstate retailers and generators face a high risk profile (refer below). To this extent, the South Australian electricity retail market has certain characteristics over and above the constraints between other regions, reinforcing why it should be considered separately to other retail markets in the NEM.

### ***Issue 3. Whether there is a NEM-wide market for wholesaling electricity, regional markets or state-based markets?***

The NEM is a compulsory market (all grid-connected generators above a certain size are required to submit offers to supply) with six separate regional prices.

In the absence of binding inter-regional constraints, and ignoring the impact of intra-regional constraints, prices in NEM regions are likely to vary mainly due to the effect of transmission losses.

In a report to the ACCC, "Horizontal integration in generation in the NEM", October 2004, Frontier Economics concluded that Justice French's judgement in *Australian Gaslight Company v Australian Competition and Consumer Commission*, that there is one NEM-wide geographic market for the supply of electricity, relied on his judgment that:

- The incidence of interconnecting constraints between regions is low;
- There is evidence of generators trading against nodes other than their home nodes;
- The Settlements Residue Auction exists as a tool to manage inter-regional risk;

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<sup>1</sup> The Australian Gas Light Company, Scheme Booklet – Part 1, 2006. *Recommended Proposal between AGL and Alinta*, page 7.

<sup>2</sup> UBS 2006. *Australian Utilities Structure*.

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- Statistical analysis suggests that generators in different regions were being substituted with each other to meet demand in all regions.

While we do not accept Justice French's conclusion, we have examined each of the considerations to determine the extent to which they apply to the South Australian electricity market. Our findings are as follows:

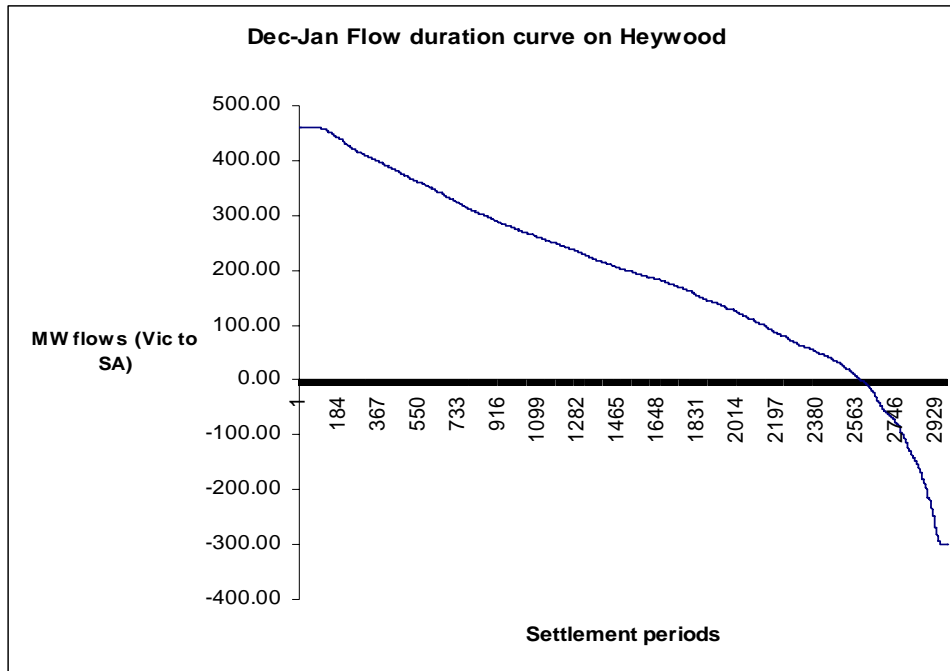
### **Consideration 1: Is the incidence of constraints between South Australia and the rest of the NEM low?**

The South Australian electrical system is connected to the Victorian electrical system through the Heywood interconnector to the South and the Murraylink interconnector to the North. The maximum import capacity to South Australia, ignoring the interaction of the two interconnectors, is 460 MW Heywood and 220 MW at Murraylink, making 680 MW in total. In practice, the interaction of electrical flows on the two network elements means that the simultaneous maximum import capacity, ignoring transmission, losses is around 5% less than this. The maximum simultaneous export capacity is thus some 650 MW.

The demand side of the South Australian and Victorian electricity markets is similar. We analysed the demand, prices and interconnector flows in these two markets for summer months (December and January) and two winter months (June and July). During these periods demand was strongly correlated - 85% correlation in the summer months and 86% in the winter months. The price in the two markets was also strongly correlated - 66% in the summer months and 96% in the winter months.

An analysis of the flows on the interconnectors suggests that the interconnectors have low utilisation factors. The average import flows on the interconnectors as a quotient of South Australian maximum demand was just 16% on Heywood, 3% on Murraylink and 17% simultaneously. Export flows were considerably lower than this - typically just 2% on average, of SA demand. To illustrate the typical flows, the load duration curve on Heywood for the summer months is as shown in Figure 1.

Figure 1: December/January flow duration curve on Heywood interconnector



While the utilisation of the interconnectors was low on average, the value of the flows across the interconnector was extremely volatile. For example, the median value and standard deviation of imports to SA during summer months on Heywood was \$532/half hour and \$52,626/half hour respectively.

On Murraylink, the summer median and standard deviation was \$0/half hour and \$7,774/half hour respectively.

The simultaneous median and standard deviation on both interconnectors was \$4,538/half hour and \$53,222/half hour respectively. Typically winter flows were less volatile.

The picture that emerges clearly from these data is of interconnectors that have low value flows on average, but are volatile and when they do constrain, produce extremely high value flows.

With regard to the frequency of constraints, in its “Indicators of the market impact of transmission congestion: Report for 2005-06”, the ACCC concluded that:

*“flows in SA across the Heywood interconnector were constrained for 1400 hours or 16% of the time (compared to 1000 hours in 2004/5 and 1300 hours in 2003/4)”<sup>3</sup>.*

<sup>3</sup> AER, February 2007. *Impact of the market impact of transmission congestion: Report for 2005-06*

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The report also observes that network outages affected the availability of Murraylink for 336 hours and network outages in New South Wales affected flows in SA for a further 154 hours.<sup>4</sup>

The conclusion from these data is that the incidence and market impact of constraints between South Australia and the rest of the NEM are significant. This is crucial in defining the market that TIPS operates in. TIPS – like other generators in South Australia – is separated from the rest of the NEM by interconnectors that frequently constrain and at times, can result in extremely high price separation between SA and the rest of the NEM. Clearly, generators located outside of South Australia face substantially higher trading risks in serving South Australian demand, compared to generators located in South Australia. A crucial issue will be the implications for the liquidity of the hedge market if AGL acquires TIPS. AGL will be in a position to provide a physical hedge against a significant portion of its risk exposure which would mean the hedge market for other retailers would shrink significantly.

### **Consideration 2: Is there evidence of generators outside of South Australia trading against their own node to supply demand in South Australia**

**And**

### **Consideration 4: are generators in different regions being substituted with each other to meet demand in South Australia?**

Firstly, to clarify terminology, we understand that what Justice French had intended with the phrase “generators trading against their own node” is the circumstance where a generator located in one NEM region enters derivative contracts with customers/retailers located in another NEM region.

A generator could support this contract by buying contract cover within the same region as their customer. However, it is generally considered that there is a premium in contract markets. This would place them at a disadvantage against generators incumbent in the region concerned. A sustainable comparative advantage would therefore require that such a generator hedges the risk through production within its own region supported by hedges against inter-regional price separation.

Evidence from three sources supports the view that there is very limited trade of this kind to supply demand in South Australia.

First, evidence of consistent “trading against their node” is likely to show up in consistent physical power flows across the interconnectors. However, as described above, average flows on the interconnectors are low. For example, average flows on the interconnectors

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<sup>4</sup> Op Cit page 5.

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importing to South Australia were 260MW in the summer months and 280MW in the winter months on interconnectors with simultaneous import capacity of around 670MW. Flows over the interconnector supplied just 17% of South Australia's electricity in the summer months and 19% in the winter months.

In addition, the flows on the interconnectors are poorly correlated to demand in South Australia (-6% in summer months and -5% in winter months). This follows as a consequence of the high degree of demand and price correlation between South Australia and Victoria: significant flows (and constraints) on the interconnectors are more likely when demand/price is high in SA while low in Victoria, and vice versa. Since demand and price are highly correlated, interconnector flows between the regions are unlikely to be correlated to demand in SA or Vic.

A second factor suggesting limited "trading against nodes" is what market participants themselves say. A recent survey conducted by PricewaterhouseCoopers noted that:

*"the overwhelming majority of respondents ... viewed South Australia as having insufficient liquidity ... one respondent remarked that the risks of dealing in South Australia strongly incentivised operators in this region towards vertical integration or to form a generator-retailer alliance ... another respondent commented that although they do trade the South Australian market, they see the region as very risky and would think very carefully before entering a short position."*<sup>5</sup>

The same PwC report showed average volumes of South Australian contracts, whether brokered or traded through SFE, to be around 200,000 MWh per month – or the equivalent of just 8% of electricity sold in South Australia in a month.

The third factor indicating that trade of this kind is unlikely, is the difficulty in hedging the inter-regional price risk. This is considered below in our response to Consideration 3.

### **Consideration 3: Do inter-regional settlement residues provide an effective means of hedging inter-regional price risk to South Australia?**

We have analysed the inter-regional settlement residues on imports to South Australia and compared this to the proceeds paid at SRA auctions for the rights to these residues. The purpose of our analysis was to assess whether the market has been able to consistently price the settlement residues.

One way to measure this is to compare the actual residues to the amount paid at auction for the residues. If the market is able to price the residues consistently, then we would expect there to be some consistency in the ratio of the residues to the auction proceeds. If, in fact, this ratio is volatile then it suggests that participants have not been able to

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<sup>5</sup> PricewaterhouseCoopers, October 2006. *An Independent Survey of Contract Market Liquidity in the NEM: Commissioned by the NGF and ERAA.*

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reasonably forecast what the expected residues might be, and hence price them efficiently.

We should point out that we are not suggesting that the proceeds of the SRA auctions should be equivalent to the actual residues. The proceeds are a firm payment while the residues are an uncertain future income. There is no reason for expecting these to be equivalent. However, if the relationship between the proceeds and the actual residues is reasonably stable, this would at least suggest that market participants are able to price the risk associated with volatile inter-regional residues.

Our analysis of the residue and auction proceeds uses data available from NEMMCO's website. Over the period from the first quarter of 2001 to the second quarter of 2006, the minimum value of the actual residues divided by the auction proceeds was 9%, the maximum was 812%, the mean was 213%, median was 149% and standard deviation was 206%.

On the basis of these results, if a market participant was seeking to hedge their inter-regional price risks in trading to South Australia by buying SRAs, the historical performance suggests that they should, on average, buy 2.13 SRA units for each MW traded across the boundary<sup>6</sup>. However, the probability distribution of possible outcomes is so wide that within one standard deviation from the mean (the 90<sup>th</sup> and 10<sup>th</sup> deciles) buying the average number of SRAs would mean that they could have under or over-insured by 97%.

These data demonstrate unambiguously that, while the market for inter-regional price hedges exist, the market is extraordinarily volatile and market participants have difficulty in pricing the inter-regional hedges efficiency. This inefficiency is a risk management cost that generators outside of Australia have to bear if they want to sell to customers in South Australia. TIPS like other generators located within South Australia does not face this risk.

**Summary**

We have applied the logic underling Justice French's judgement to determine whether the same conclusions would reasonably reached with AGL's proposed acquisition of TIPS.

Our analysis unambiguously demonstrates that the South Australian electricity market is not seamlessly integrated with other markets in the NEM. There are significant, volatile, inter-regional transmission constraints and market participants are not able to efficiently manage the resulting inter-regional price risks by acquiring SRA's.

By implication, TIPS will have a considerable competitive advantage relative to generators outside of South Australia in supplying South Australian electricity users. The ACCC's competition analysis thus needs to define South Australia, not the NEM as a whole, to be the relevant market in which TIPS competes.

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<sup>6</sup> Assuming the capacity of the interconnector was perfectly firm – which it is not.

**Issue 4: Whether the supply of wholesale electricity and the offering of financial derivative contracts form part of the same market or are in separate markets.**

Participation in the wholesale electricity market provides reasonable reassurance to retailers that they will be able to purchase electricity, and to generators that they can bid plant in, be dispatched and receive payment, in accordance with the spot market rules.

The wholesale market is a set of rules, which determine dispatch of the market and payments between participants. As pointed out by Justice French:

*“The words ‘purchase’ and ‘sell’ in the Code and the Act ...do not mean in any intelligible sense the retailer acquires ownership of electricity as one would own a piece of personal property’.”<sup>7</sup>*

Prices in the wholesale electricity market are very volatile. The derivatives contract market can be used to manage risk. Most participants use the derivatives market to reduce risk. It can and has also been used to increase risk, for example selling contract cover not supported by generation capacity. It is therefore best regarded as a market for risk, and a market that facilitates risk management.

The two markets are closely inter-related. Derivatives contracts are struck with reference to spot market prices. Spot market volatility influences demand for derivative contracts. The contracting position of generators influences their bidding behaviour and spot market outcomes.

The markets are also related at a geographic level. Where one region of the NEM has high average prices in the wholesale market, this is reflected in the contract market.

Although closely related, the two markets are separate:

- *The functions differ:* participation in the wholesale market provides reasonable certainty on the terms and conditions for operation of the wholesale market. The derivatives market is used to manage risk.
- *The products differ:* the wholesale market refers to an agreement, enforced by law and by the actions of market agencies. Commercial operations are managed through bids and offers to NEMMCO, within the market rules. The product in the contract market is a contract directly between two parties (usually a generator a retailer), which is not mediated by NEMMCO.

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<sup>7</sup> Op. cit. clause 382

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The difference in these markets is illustrated by the survey by PwC referred to above. This concluded that liquidity in the contract market was low, resulting in high bid-offer spreads. This is a description of a market for financial derivatives. It would not be applicable to the wholesale market, which is generally not considered to have 'liquidity' (although it may have market power) and which does not have bid offer spreads.

Even if the wholesale markets and derivative markets are distinct, it remains possible either that they are close substitutes (and so should be considered together) or that they are an essential part of all electricity transactions, and so should be considered as an integral product. We consider both of these arguments are incorrect:

- *The products are not substitutes:* the derivatives market is used to hedge risks arising from the wholesale market. Participation in the wholesale market is not a substitute for the risk management provided by the derivatives market. Bidding behaviour in the wholesale market is a weak substitute for generators. Retail contracts, which may include load management during high price periods, are a weak substitute for retailers. Both are much less effective at managing risk than the contract market.
- *The products are separable:* Market participants differ in the level of hedging that they adopt, and their willingness to take spot exposure. Similarly, market participants differ in the level of inter-regional basis risk that they will accept and manage. Justice French pointed out that Southern Hydro trades against all nodes except the Snowy Region. However, other generators have indicated that they only enter contracts within their own region.

Justice French considered the basis risk arising from price separation between regions. He considered that the incidence of price separation was low with the incidence of constraint into Victoria at about 0.5%. He also considered that the materiality of price separation was low, and generally less than \$10. This supported his conclusion that there was a single NEM-wide market for the supply of electricity and associated derivative contracts.

This submission demonstrates that this conclusion is incorrect with respect to derivative contracts in South Australia, supported by generation in other regions. The incidence of constraint is high. Price differences are low on average but there is substantial volatility.

Our conclusion is therefore that the wholesale electricity and derivative markets are separate markets.

**Issue 5: The effects of the transaction, if any, of the increase in vertical integration between Torrens Island Power Station (TIPS) and AGL's position as the largest electricity retailer in South Australia.**

**And**

**Issue 7. The effects of the transaction, if any, on the ability of South Australian electricity retailers, particularly potential new entrants or smaller players trying to expand, to adequately manage their risk profile by entering into appropriate hedge contracts.**

**And**

**Issue 8. The effects of the transaction, if any, on the level of barriers to entry for South Australian electricity generation and retailing**

**And**

**Issue 9. Whether the level of hedge contracts facilitated using TIPS would be likely to increase, decrease or stay the same following the proposed transaction.**

The relevant issue here is whether AGL obtains any advantage from the acquisition of TIPS that it would not otherwise obtain by entering into contracts with TRU to acquire output from TIPS to serve its SA customers.

To start we reiterate the key conclusion from our response to issue 3, which is that TIPS has a significant competitive advantage in meeting SA demand compared to generators located on the other side of the Heywood and Murraylink interconnectors.

Within SA, the four 200 MW TIPS gas thermal units are positioned in the upper base/lower mid-merit point of the South Australian generation merit order. Other than cogeneration, other embedded generation and wind generators, these units would – on variable cost considerations – generally be dispatched after Babcock and Brown's Northern and Playford brown coal units (760 MWs) and International Power's 480 MW Pelican Point CCGT units.

At present TRU has a significantly smaller customer base in South Australia than generation capacity. It needs to compete with International Power and Babcock and Brown to sell capacity and energy to AGL, mainly, and other retailers in South Australia. Surplus uncontracted capacity could be exported, but the TIPS units are not competitive with Victoria's brown coal or NSW/QLD black coal units. This is reflected in the low level of exports from SA to other parts of the NEM.

AGL's acquisition of TIPS would therefore allow AGL to obtain control of the largest single generation complex in South Australia. This would substantially decrease the

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supply in the South Australia contract market for base load contracts. The remaining SA base load generators – Babcock and Brown Power and International Power would be the sole remnants – competing to sell to SA retailers dominated by AGL, and in the case of International Power, directly to customers through its retail business alliance with Energy Australia.

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The commercial logic to AGL of the swap of Hallett for TIPS is compelling:

- By integrating vertically and obtaining direct control over the bidding and operation of TIPS, it is able more efficiently to manage wholesale supply risks. AGL has stated “managing wholesale price risk and earnings volatility by matching upstream and retail exposures” to be a key part of its “value proposition of extracting value across the energy supply chain”.<sup>8</sup>
- By acquiring TIPS it is able to strengthen its monopsony over bulk purchases from Babcock and Brown Power and International Power in their sales to AGL in South Australia.
- By acquiring TIPS, AGL is able to substantially decrease the availability of hedges to potential new entrant retailers. The volatility of the South Australian market is such that the absence of such hedges will deter the entry of new retailers into the South Australian market, or expansion of existing retailers.

In other words, on this basis, the acquisition of TIPS could allow AGL to reduce the competitiveness of the contract market, thereby strengthening its position relative to existing suppliers, and helping it to raise the barriers to entry to prospective new retailers or expansion by existing retailers.

From TRU’s perspective, swapping Hallett and TIPS will bring its South Australian retail portfolio closer into line with its South Australian generation capacity. Presumably the commercial terms of the proposed transaction will also have allowed TRU to share in the value that AGL will gain from the ownership of TIPS.

It is obvious from this analysis that the gains to TRU and AGL are commercially justifiable but could come at the expense of South Australian electricity consumers, as a result of the reduced competitiveness of the wholesale and retail market.

### **Issue 6. The effects of the transaction, if any, on TRU’s ability and incentive to compete vigorously as a retailer of electricity in South Australia**

Swapping TIPS for Hallett will allow TRU to retreat from its significantly long generation position in South Australia. The ACCC’s letter suggests that, as part of the transaction, AGL will provide derivatives to TRU against the South Australian node in quantities that are material but substantially less than the capacity of TIPS.

Without knowing the terms of this contract, we presume that the effect of the hedges, combined with TRU’s ownership of Hallett, will bring TRU’s South Australian generation portfolio much closer in line with its retail position. This is commercially justifiable. However, at the same time through this, TRU could also have a much weaker incentive to vigorously compete to acquire new customers in South Australia.

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<sup>8</sup> The Australian Gas Light Company, *Scheme Booklet – Part 2*, Page 27.

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If after the proposed transaction, TRU sought to expand its retail operations, it will need to attract customers away from other retailers dominated by AGL. The corollary of a transaction that strengthens AGL's retail market position in South Australia is that it relatively weakens TRU's retail position. Should TRU wish to compete vigorously with AGL in South Australia after the sale of TIPS, it is likely to have to sacrifice value to fund such expansion. It seems reasonable to conclude that this is unlikely to be in TRU's best interest.

## **Conclusion**

The EUAA firmly believes that the proposed asset swap could well further increase the dominance of AGL in the South Australian electricity market. AGL is already by far the dominant retailer and is able to exert monopsony power. The acquisition of acquiring over half of the main stream generating capacity will further strengthen its market power.

The commercial logic to AGL of the swap of Hallett for TIPS is compelling:

- By integrating vertically and obtaining direct control over the bidding and operation of TIPS, it is able more efficiently to manage wholesale supply risks. AGL has stated “managing wholesale price risk and earnings volatility by matching upstream and retail exposures” to be a key part of its “value proposition of extracting value across the energy supply chain”.<sup>9</sup>
- By acquiring TIPS it is able to strengthen its monopsony over bulk purchases from Babcock and Brown Power and International Power in their sales to AGL in South Australia.
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In other words the acquisition of TIPS allows AGL to reduce the competitiveness of the contract market, thereby strengthening its position relative to existing suppliers, and helping it to raise the barriers to entry to prospective new retailers or expansion by existing retailers.

The proposed deal would seem to be in TRU's genuine commercial interests and provides a better match with its retail book. Unfortunately, it could also provide a brake on its ability and incentive to compete in the SA retail market.

The characteristics of the South Australian region already ensure that there is a lack of effective competition. As detailed above, however, this proposed asset swap goes

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<sup>9</sup> The Australian Gas Light Company, *Scheme Booklet – Part 2*, Page 27.

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beyond just reducing liquidity in the region but will increase the ability of AGL to exert market power to increase costs to end users.

Finally we note that the proposed swap arrangement contains a significant element pertaining to contract rights in respect of gas. No doubt that these elements have been rolled into the final contract price. With the lack of the provision of detail on these contracts we are not in a position to make any meaningful comment however we flag that there are possible scenarios that could lead to adverse to adverse effects for other case end users and we urge the ACCC to carefully consider this element.