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Mergers and Acquisitions in the Energy Sector

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It's now been nearly a decade since all Australian governments committed to a comprehensive and ambitious reform agenda to improve our economic performance – National Competition Policy.

These reforms led to the opening up of Australia's previously rigidly state controlled infrastructure including electricity and gas with the ACCC given the job of ensuring fair access by new entrants while providing reasonable returns which would stimulate investment and competition.

We believe the results of these reforms has been pretty impressive, with over $4 billion invested in new electricity assets, and a doubling of gas pipelines in Australia during that period.

However, the ACCC is concerned by a number of recent developments, including increasing uncertainty in the gas code and recent merger activity within the electricity industry.

Electricity Mergers

There has been much discussion recently about the implications of the many merger proposals that have arisen in the electricity industry over the past two or so years.

Some of these proposals suggest that the market could be moving back toward the integrated structures that existed prior to the competition policy reforms of the 1990s. Those reforms introduced disaggregation and vertical separation of the former monopoly electricity supply businesses, and resulted in substantial benefits to energy suppliers and users. From the ACCC's perspective, it is important to ensure that those gains are not reversed by substantial re-aggregation in the NEM.

- ***Areas for further reform***

Most discussion lately has focused on whether there are areas of the NEM where competition is lacking, or perhaps more relevantly, where current acquisition trends risk NEM markets becoming less competitive, and whether policy changes are therefore necessary to address those deficiencies and ensure ongoing benefits to the NEM. Hence, it is appropriate to distinguish the areas of the market and its regulatory framework that are effective from those that can practicably be improved in the interests of efficient markets.

The ACCC considers that the Trade Practices Act can adequately deal with most possible merger scenarios. However in energy markets that are still maturing, there are issues that can be especially complex.

- ***Generation/retail mergers***

Recent merger activity within the electricity industry indicates a move towards vertically integrated generator–retailers. This is fundamentally different to the electricity market structure that emerged as a result of the initial energy market reforms.

Reintegration can be used by retailers to mitigate the risks associated with generator market power by providing a natural hedge against spot market volatility, but at the same time, this can reduce contract market liquidity.

Reduced liquidity would increase barriers to new retail entry and undermine the capacity of non-integrated players to compete effectively. New Zealand provides an example of the potential risks. There NGC, which was 66% owned by AGL, exited the electricity retail market the year after it acquired TransAlta, New Zealand's largest electricity retailer. It exited the market because it could not get access to competitive contracts, forcing it to buy contracts at high prices. There has not been any significant new entry since then and there are no significant independent (non-integrated) retailers. In generation–retail merger cases, it would be prudent to consider whether independent firms could remain viable in the emerging circumstances.

In the Commission's view, illiquid contract markets are also likely to raise risks for independent generators. Thus any undermining of contract markets is likely to increase barriers to entry to both independent retail and generation operations.

We argued in the AGL case that allowing that acquisition to go ahead could open the door for a cascade of vertical mergers – each one on its own perhaps having a good argument for why it should go ahead, but the net effect gradually bringing about a more concentrated market structure.

Our fears in this area have been strengthened in recent months with the merger between China Light and Power and TXU and the EnergyAustralia and International Power joint venture.

Notwithstanding these concerns, it is clear that the competitive impact of vertical integration of generation and retail will, to a large extent, depend on whether there is sufficient competition in the respective generation and retail sectors. Where there is effective competition in the generation and retail sectors, vertical mergers of this type are less likely to raise serious competition concerns. Therefore, continued enforcement of Section 50 of the Act in terms of horizontal mergers of generation and retail is fundamental in protecting competition in this area.

- ***Vertical mergers between transmission and generation entities***

The ACCC believes that in principle, natural monopoly elements should be kept separate from contestable sectors. In the past year there have been proposals for mergers of networks with contestable elements of the industry. The 2004 merger of SPI and TXU, which concerned all four elements of the electricity supply chain, is one case in point, although the ACCC's concerns in this matter were addressed by court-enforceable undertakings.

Even more recently, there have reports in the press that the New South Wales government has mooted the possible merger of Energy Australia and Delta Electricity. While this proposal primarily involves the merger of generation and retail interests, it is complicated by the fact that Energy Australia owns a substantial distribution network, and some transmission assets. But more on this later.

The ACCC regards the structural separation of the operation and control of the transmission from merchant activities as an important competition issue in the NEM.

It is the ACCC's view that there is a strong incentive for an integrated firm holding a monopoly in the provision of a network service in the electricity industry to discriminate in favour of the vertically integrated firm's own operations and against non-integrated competitors in upstream and downstream markets.

The decision in the AGL matter adds weight to the ACCC's concerns. In the AGL matter, the court indicated that the substantial lessening of competition test could not rest upon speculation or theory.

There are obvious concerns if this creates a precedent for the assessment of transmission–generation mergers. The anti-competitive impacts of such a merger result from the potential for market manipulation, which must be based to some degree on speculation because these sorts of mergers were not contemplated in the development of the NEM.

The ACCC has communicated these concerns in submissions to the respective reviews conducted by the Productivity Commission and the Victorian Government. I am pleased to see that the Productivity Commission has recognised the dangers of this type of re-integration. In its final report, the Productivity Commission recommended that an independent national review be initiated by the Commonwealth Government, looking at the competition implications of cross-ownership of transmission and generation assets in the industry.

- ***Horizontal mergers between generators***

As you would no doubt be aware, the ACCC has also considered applications for mergers of large baseload generators in Victoria. In general, our main concern is the ability of a large merged entity to manipulate spot prices and also to influence future contract prices.

The electricity generation sector is becoming increasingly concentrated. Generation market power manifests in very unique ways, and raises some important issues which should be considered in the context of how policy measures could promote more competitive market structures.

There has been considerable re-aggregation of generation interests in the NEM. For example, in Victoria, there are currently three baseload generation companies including China Light and Power (Yallourn), International Power (Hazelwood and Loy Yang B) and the AGL consortium (Loy Yang A). Further, in NSW, Delta, Macquarie Generation and Eraring hold approximately 95 percent of the generation capacity in NSW through generation portfolios.

The Parer Review found deficiencies with the current market structure in generation, noting that a number of reforms could be pursued to improve the operation of the NEM. Parer's recommendation arose from the finding that the market structures in the generation sector enables some generators to exercise market power, leading to price outcomes that were higher than would otherwise be the case. Parer recommended further disaggregation of generation portfolios in NSW and more generally made the comment that further divestment was required to reduce concentration of ownership and control in the NEM. The Productivity Commission's latest recommendation largely echoes those views.

The Federal Court's decision in the AGL matter raises the potential risk of further re-aggregation of generation interests in the NEM. A significant result of that case is the defining of the market for generation as being the whole of the NEM. The Court did not agree that markets for generation were state-based and thus gave greater scope for generators to merge 'without gaining' market power.

Much of the Court's decision was based on the premise that the interconnectors between regions are rarely constrained and therefore power is able to flow freely between regions to defeat price rises. While the number of hours that interconnectors constrain each year is relatively small, in the periods that they do constrain, the "rare" exercise of market power by generators can have significant financial impacts on the market. However, there are additional complexities. For example, the ACCC's recent consultation on the Snowy derogation has raised the issue of whether intra-regional constraints can impact on the physical capacity of an interconnector. In this circumstance, while an interconnector itself may not be constrained, constraints within a region can mean that the interconnector's full capacity cannot always be utilised, which can result in generators bidding into the market at high prices. This is one of the many complex issues that must be considered when determining market definition and market power.

Given the impact and importance of generation sector to the electricity industry and the potential for the unravelling of the 1990s reforms to disaggregate the generation sector, the ACCC is of the view that additional, NEM-wide cross ownership provisions, could be an effective complement to the role of section 50 in protecting competition. The ACCC has not considered in any detail how this may be done, but there may be a number of options to do this, including considering the appropriate thresholds for generation-generation mergers.

- ***NSW Government Proposal***

As I mentioned earlier, there were reports recently that the NSW Government is looking at options for restructuring the industry there, and that this might involve a merger of Energy Australia and Delta Electricity. But in the last day or so there has been speculation that the NSW government has abandoned this idea in favour of a proposal to sell its retail businesses to the private sector.

As noted previously, around 95% of the NSW generation sector is currently concentrated amongst three government-owned generators. This is exactly the type of market structure that provides opportunities to exploit market power. While the exact details of the latest proposal are as yet unknown, the ACCC would encourage proposals that would disaggregate ownership of electricity assets in that state. NSW is a key region in the NEM and any merger and acquisitions proposed within that market will obviously attract close scrutiny

Gas

By contrast with the electricity sector, there has been little acquisition activity raising substantial competition concerns in the gas sector in recent years.

The Commission, for example, did not release any public comments in relation to the Duke acquisition. The final acquirer of the Duke assets was Alinta. Alinta's bid did not raise any competition concerns and Alinta never approached the Commission.

One interesting trend in recent years has been the move by banks and other financial institutions to purchase gas pipelines then float these assets as an infrastructure trust.

AMP for example created DUET, or Diversified Utilities and Energy Trust which owns 60% of the Dampier to Bunbury Gas Pipeline.

Westpac is now the majority owner of the Hastings Fund Management, which purchased all of the assets of EPIC apart from Dampier to Bunbury and floated these off in a separate trust called Hastings Diversified Utilities Fund. The fund has since acquired Kent Water in the UK.

ANZ has also taken interests in smaller pipeline assets in Victoria and Western Australia which it intends to float in a trust.

Perhaps the most notable event in this area was the acquisition last year of Western Australia’s Dampier to Bunbury Natural Gas Pipeline (DBNGP) by the Duet Consortium.

Prior to the change in owner, it had been argued that the experience with that pipeline reflected a failure of regulation under the National Gas Code. EPIC bought the pipeline and, disappointed with the return proposed by the regulator in the first access arrangement under the Code for this pipeline, refused to consider any proposals for much needed capacity expansion unless the returns on the existing investment were substantially increased.

But the real problem was that Epic Energy paid around $1 billion too much for the DBNGP believing that, somehow, the clear implications of coverage of the pipeline under the Gas Code would not apply to them. A secondary problem was inadequate treatment of expansion under the Gas Code. One of the Productivity Commission's recommendations on reform of the Gas Code would address this problem.

In competitive markets, if someone pays too much for an asset, especially if the price is well above replacement cost, then they can expect to face substantial losses. But in the case of the DBNGP, EPIC was able to hold the state and gas consumers to ransom so as to limit the losses on its mistake.

This was despite the fact that a number of users wanted to fund expansion of the pipeline. The problem was ultimately resolved with limited damage in the sale of the pipeline to the Duet Consortium.

The ACCC gave in-principle agreement not to intervene in the Duet Consortium bid despite our concern about the involvement in the consortium of Alinta, a major player in the Western Australian downstream gas market.

We were concerned that Alinta Limited's 20 per cent interest in the Duet Consortium would give it the ability to affect anti-competitive outcomes in relevant downstream markets, making it much harder for new entrants to retail gas and generate electricity in Western Australia.

In response, the Duet Consortium offered court-enforceable undertakings designed to alleviate the ACCC's competition concerns. These undertakings prevent Alinta from being involved in any commercial negotiations between the Duet Consortium and other shippers that transport gas down the DBNGP. The agreed terms also include assurances on the future expansion of the DBNGP, and a 20 year commitment not to seek revocation of coverage.

Previously the ACCC had stated that it would closely consider the competition effects of all significant vertical integrations of energy supply chains, especially if the proposed integration involves parties with significant downstream interest such as Alinta has in Western Australia.

Energy infrastructure investment - the record under ACCC regulation

All of this of course comes at time when Australia's infrastructure record and the role played by regulators like the ACCC has become a hot button issue.

If you were to believe some of the more exaggerated commentators and industry lobbyists, you could be forgiven for thinking investment in gas and electricity has all but ground to a halt as a result of ACCC regulation.

The reality of course is very different. Just last month the ACCC paved the way for $1.4 billion in new investment in electricity transmission alone in NSW and the ACT over the next five years with its final revenue cap decisions for covering TransGrid and EnergyAustralia.

Together with the ACCC's previous decisions, investment in NSW and ACT transmission networks will amount to around $2.6 billion, which more than doubles the value of transmission assets (in replacement cost terms) in just ten years.

And if you've been listening to the gas pipeline industry you might well be forgiven for thinking investment in that sector has dried up.

Yet, according to the pipeline industry association's own figures, 14,000 km new transmission pipelines have been laid in Australia since 1997. This amounts to a doubling in the length of transmission pipelines in Australia to 28,000 km in just seven years.