Australian Competition & Consumer Commission

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Competition issues arising out of the leasing of assets in South Australia

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1. Introduction

Today, I will raise a number issues arising out of the leasing of electricity assets in South Australia. These include:

- Issues arising from the privatisation of electricity assets in South Australia and their effects on competition in the South Australian electricity market, with particular emphasis on mergers;
- The effect of the federal system on the consistency in regulatory approaches;
- How the Commission is preparing for its role as the national regulator of transmission networks; and
- Finally, the emerging issues developing in the South Australian electricity market.

2. Privatisation and Mergers and Acquisitions Issues

The Commission will continue to play an increasingly important role in the electricity industry in assessing mergers and acquisitions between generators, transmission networks, distribution networks and retailers. This is particularly relevant in the context of privatisation and with South Australia's long term leasing agenda for its electricity assets.

Section 50 of the *Trade Practices Act* prohibits mergers or acquisitions, which result, or are likely to result in a substantial lessening of competition in a market.

The Commission assesses merger and acquisition proposals to determine whether they are likely to breach this test. Section 50 sets out a number of criteria that must be taken into account in assessing the potential competitive impact of a proposed merger or acquisition.

Factors to be taken into account include:

- The level of market concentration;
- Barriers to entry;
- Import competition;
- Countervailing power;
- Price and profit margin effects;
- Dynamic characteristics of the market;
- Availability of substitutes; and
- The level of vertical integration.

The Commission's Merger Guidelines outline the approach adopted in assessing these factors.

Parties to a proposed merger are encouraged to discuss their proposal with the Commission on an informal basis as soon as there is a real likelihood that an acquisition may occur. Parties may approach the Commission either on a confidential basis or on the basis that the proposed acquisition is in the public domain.

I will initially discuss the processes the Commission undertakes in analysing privatisations and potential mergers. I will then move on to the competition issues relevant to the South Australian electricity market.

Administrative Issues in Assessing Privatisation Matters

(a) When to approach the Commission?

In privatisation matters the vendor, potential bidders, or both may approach the Commission. Generally, it is up to the parties to approach the Commission on an informal basis. In most cases, both vendors and potential buyers seek the Commission's views, neither party wishing to run the risk of the Commission seeking to take action after a winning bid has been announced.

In some cases, the Commission has been requested to give an indication of its views to parties who wish access to such information in order to put together a bidding consortium, and to ensure that they do not choose partners with high regulatory risk. As such approaches are usually made prior to a privatisation process commencing, it is often difficult to provide a meaningful view, as all the facts are not known. Also, the Commission feels that as a matter of procedural fairness it does not wish to convey views which may disadvantage parties in forming a consortium without full knowledge of the circumstances, and certainly not without allowing that party an opportunity to make submissions to the Commission.

(b) Confidentiality/Market Enquires

It is the usual practice of the Commission in assessing merger matters, to seek the views of other market participants regarding the competitive environment and the likely effects of a particular acquisition. However, in privatisation matters, once bidders are short-listed their identity is usually confidential, so no market enquires can be made. In those circumstances, the Commission's approach is usually to:

- Rely on previous enquires and information regarding the market involved;
- Make limited enquires on a "no names" basis where possible; or
- Make some enquiries regarding bidders who have been publicly named (sometimes press articles speculate on the identify of likely bidders, so the Commission may make some enquires on the basis of such speculation without confirming the identity of bidders).

Where full market enquires cannot be conducted, the Commission will qualify its views by reserving the right to make such enquires when the successful bidder is announced. This practice is in line with the Commission's approach in relation to all confidential mergers, and in this regard, successful bidders are in no more or less of a position of certainty than any other private parties who have negotiated a merger and then submit it for the Commission's assessment.

(c) What level of certainty can bidders expect from the Commission?

The level of certainty that bidders can expect from the Commission in providing its views depends on the level of disclosure of information, and opportunity to make market enquires.

The Commission recognises the need for bidders to obtain as much certainty as possible. Parties can usually expect to obtain one of three responses in the bidding phase:

- An advice that the Commission will not oppose the proposed bid at this time but reserves right to make market enquires and consider any further information which becomes available (for example sale documents, consortium agreements, data room information);
- An advice that the Commission sees some preliminary issues may arise and cannot form a view without making some market enquires; and
- An advice that the Commission has some preliminary concerns that the proposed bid may breach s 50.

These "categories" of response are not exclusive, and undoubtedly situations will arise where the Commission may need to provide a different form of response to deal with particular fact situations.

Although it is inevitable that given the complex and changing nature of energy markets that such situations can arise, you can take some comfort in the fact that to date, in looking at the entire Victorian gas and electricity privatisations – that's about 15 sales, with roughly 4-5 bidders in each sale – the Commission has only advised bidders that it could not make a decision without market enquires on 2 occasions.

The Commission's role in the South Australian Privatisation Process

The South Australian government has liaised with the Commission on an ongoing basis since the reform package was announced to identify potential Section 50 issues, and the Commission has held discussions with some prospective bidders directly.

It is relevant to note that the Commission's role is not to assess the particular industry structure adopted by the South Australian Government, but to apply the s 50 test within the existing context. Nevertheless, the industry structure necessarily affects the competition issues that the Commission has to consider. In particular, the Commission notes that the structure of the South Australian market involves three generators, one transmission network, and one stapled distribution network/retailer. Given the limits of that structure, achieving adequate competition over time obviously touches on such issues as interconnection, new entry into generation and entry of interstate market participants.

The Commission has not reached a concluded view on any particular prospective bidders at this time, but would invite parties with a serious interest in participating in the sales process, who do have existing interests in the Australian energy industry, to contact the Commission to discuss their position.

Merger Issues

I do not intend to go into details regarding the broad range of competition issues which may arise in the context of the sale of electricity assets. However, I would like to draw your attention to some of the main issues which will undoubtedly arise in both this sales process and in future merger matters in the electricity industry.

Generally, the most challenging issues to consider will be:

- Convergence between gas and electricity utilities;
- Horizontal mergers proposals between electricity generators; and
- Assessing the competitive effects of vertical reintegration between generators, Transmission Networks and Distribution Networks.

Convergence is seen to be a growing trend within the energy industry. In this regard, the Commission is conscious of the potential for multi-product utilities to deliver real efficiencies and promote a dynamic competitive environment. On the other hand, energy markets are a long way from maturity yet, and the Commission will continue to scrutinise multi-product mergers to ensure that a merged firm does not acquire the ability to exercise significant market power in either or both the electricity and gas sectors.

The US and the UK experience shows that horizontal merger proposals within the electricity generation sector are another sensitive area. In these markets, the traditional approach to merger analysis of considering market share information does not always provide a good indication of whether a firm has the ability to exercise unilateral market power or if coordinated behaviour is likely to occur. For example, it is well known that generators with very small capacity can actually have a significant impact on prices, depending on their place in the merit order. Accordingly, in looking at these issues, the Commission needs to consider not just the rated capacity of firms in assessing mergers, but whether, in the context of the wholesale electricity pool, a firm would significantly increase its ability to exercise market power, or there is a significant increase in the potential for coordinated behaviour.

Vertical integration raises a whole range of issues, depending on the particular fact situation. However, one issue that is repeatedly arising in the context of energy matters is the overlap between regulatory regimes and section 50. Vertical integration issues are most likely to raise concerns under section 50 where they involve natural monopolies. Although the natural monopoly elements of the electricity industry are subject to regulatory control, the Commission believes that there is a role for

consideration of such mergers under section 50. In making an assessment, the Commission will take into account regulatory controls. However, it also takes into account whether vertical relationships may place significant pressure on the regulatory scheme. Vertical relationships may increase the incentive of market participants to attempt to evade regulation, which in many cases is seen as a second best solution to structural reform.

3. State vs National Regulation

The reforms in the National Electricity Market to date have tended to involve the separation of regulatory and commercial functions of the electricity authorities, for instance generation and retail are becoming part of the competitive market while transmission and distribution will be regulated. This vertical separation has facilitated the introduction of competition into generation and retail sectors, and provided access to the natural monopoly elements of transmission and distribution systems on a non-discriminatory basis.

Our federal system has been replicated in the regulation of the electricity market at national and state level. The Commission has a key role as national regulator of the transmission network. The state regulators have their role in such areas as distribution and retail pricing. This requires a coordinated approach to common issues, which ensures there is no unnecessary inconsistency or overlap.

Transmission network regulator

The Commission will assume responsibility for the regulation of transmission networks in the National Electricity Market on a progressive basis over the next three and a half years. The Commission will oversee a transmission revenue regulatory regime using a revenue cap methodology based on an incentive orientated CPI-X formula. The code provides guiding principles on the revenue cap that the Commission must take into account including:

- Equitable allocating of efficiency gains between network users and owners;
- Providing owners with a sustainable commercial revenue stream;
- Preventing monopoly rents;
- Fostering efficient investment within the transmission sector and in upstream and downstream of that sector;
- Fostering the efficient use of existing infrastructure;
- Promoting competition in upstream and downstream markets;
- Providing reasonable regulated certainty and consistency; and
- Reasonable recognition of pre-existing government policies regarding transmission asset values, revenue paths, and prices.

In accordance with the Code, the Commission has released a draft decision of the Statement of Regulatory Principles *(Draft Regulatory Principles)*. I will discuss the *Draft Regulatory Principles* in more detail a little bit later.

State Regulators:

The States and state regulators, such as IPART in New South Wales, the Office of the Regulator - General in Victoria and the SA Electricity Regulator (when appointed) will have ongoing roles in the regulation of the distribution and retail networks. The South Australian State Government currently undertakes the role as regulator, with a proposal to establish a new independent regulator.

The ongoing roles of these bodies include:

- Distribution network pricing;
- Environmental protection;
- Safety regulation; and
- Franchise customer pricing.

The Commission has taken the lead in establishing its Energy Committee (in which state regulators participate) and in the development of the Regulators' Forum, both as ways of maintaining regulatory consistency. The Commission's Energy Committee

provides the regulators with the opportunity to voice their concerns and opinions on matters before the Commission. The Regulators Forum also provides an appropriate forum for discussing relevant issues.

These arrangements have proved to be constructive and useful for all concerned. However, the issue of consistency is one that needs to be monitored to ensure that regulatory costs do not dissipate the benefits of competition and energy market reform.

The Regulatory Framework

As was mentioned previously, the Commission will progressively become the regulator of transmission network assets on a progressive basis over the next three and a half years. One of the first stages, is the release of the *Draft Regulatory Principles*.

Draft Regulatory Principles

As national regulator for transmission, the Commission is responsible for developing national guidelines and rules for applying these guidelines. In May this year, the Commission released the *Draft Principles for the Regulation of Transmission Revenues* (*Draft Regulatory Principles*) which establishes guidelines as to how the Commission will regulate the industry.

In assuming its role as regulator of transmission revenues in the National Electricity Market, the Commission's aim is to adopt a regulatory process that eliminates monopoly pricing, provides a fair return to network owners, and creates incentives for managers to pursue ongoing efficiency gains through cost reductions. In achieving these aims, the Commission is aware of the need to minimise compliance costs and to establish an objective, transparent and light handed regulatory process.

The framework outlined in the *Draft Regulatory Principles* is based on a revenue cap as required by the Electricity Code. The Commission has adopted a building block approach based on forecasts of cost of service over the regulatory period. The

emphasis of this approach is on delivering benefits to network customers while providing network owners/operators with sufficient incentive to achieve efficiencies and retain benefits over the regulatory period.

The Commission is currently undertaking a public consultation process on the *Draft Regulatory Principles*. This follows from the seminars presented by Commission staff on the proposals in the *Draft Regulatory Principles* and a conference on depreciation is scheduled for September. The Statement of Principles will be finalised shortly afterwards.

South Australian Electricity Pricing Order

The South Australian Government has recently submitted the Electricity Pricing Order (EPO) to the Commission for approval. The EPO sets out the network regulatory, retail pricing and other arrangements, which the South Australian Government considers necessary transitional steps to full implementation of the regulatory and pricing arrangements contained in the Code.

In deciding whether or not to approve the derogation, the Commission will consider the EPO in terms of its effectiveness in promoting:

- Competition, efficiency and competitiveness within the industry;
- Benefits to facility owners and access seekers;
- Upstream and downstream benefits to suppliers and users; and
- Benefits to the public interest.

In assessing its EPO, we will adopt the same approach as we did when assessing Victoria's Tariff Order prior to the privatisation of PowerNet in 1997.

That process involved:

- No transmission derogations beyond 31/12/2002;
- Highlighting any concerns prior to the sale to avoid any surprises in 2003; and

- Independent regulation of distribution.

In limiting the period of derogations, the Commission recognises the need for a transition period but also considers that the national market must eventually operate unhindered by government intervention. Accordingly, the Commission has set 2002 as an appropriate end-date for these arrangements.

To facilitate the process of reviewing the EPO, the Commission has engaged a consultant (NERA) to examine the proposed arrangements. A similar process was followed in 1995 in relation to the Victorian Tariff Order proposals.

5. Assessing the broader regulatory issues and concerns

There are a number of issues that have major implications on the South Australian market that need to be addressed if the potential benefits of electricity reform and the move to a NEM are to be fully realised and passed onto all customers.

Interconnection

There are outstanding issues concerning interconnection. The Australian electricity industry has traditionally consisted of jurisdictionally based vertically integrated public utilities. As such, there is very little interconnection between the jurisdictions of the National Electricity Market at the present time.

Chapter 5 of the Code establishes an avenue for planning and undertaking regulated interconnection. Currently there are proposals before the Commission dealing with unregulated options. Regulated assets earn a return in accordance with Chapter 6 of the Code, while unregulated assets earn a return through transactions in the market. Chapter 5 describes decision processes and criteria, under which interconnectors may become part of a transmission network's regulated asset base. In essence, an augmentation may receive approval to enter the regulated asset base (before it is built) if it passes a "*Customer* benefits test" administered by NEMMCO.

These rules governing interconnection came into the spotlight when NEMMCO rejected the application for the proposed South Australia - New South Wales interconnector (SANI) to be a regulated interconnector. Indeed, NEMMCO found the *Customer* benefits test to be highly volatile, which would make it difficult for any proposed inter-regional augmentation to satisfy the criterion. The NSW Government believed the test was deficient and placed it on the issue register (meaning that the National Electricity Market would not commence until the issue was resolved to their satisfaction).

To resolve the impasse that then emerged, NEMMCO approached the Commission to undertake a review of the criterion to determine whether new interconnectors shall be able to derive regulated revenues in the National Electricity Market.

In April this year, the Commission released a staff paper proposing a market benefit augmentation test. This entails a wider measurement of net benefit than the original test outlined in the Code. The test proposed by Commission staff would capture benefits accruing to generators. The "market benefit" test therefore includes the consumers and producers of electrical energy, and includes the consumption and provision of network services.

In late July, NECA submitted an application to the Commission for authorisation of a Code change that incorporates the net public benefit test determined by the Commission for new regulated interconnectors and network augmentations.

Vesting Contracts

On 25 June 1999, applications for authorisation of the South Australian vesting contracts were lodged with the Commission. The South Australian Treasury and the participating generators and incumbent retailer have submitted a set of vesting contracts which cover the franchise load and expire at the end of 2002, consistent with the timetable for customer contestability.

These contracts have been arranged by the South Australian Government between the three generators and ETSA, as the retailer. They cover that portion of the electricity load (known as the franchise load) still governed by regulated (rather than competitive) tariffs. They aim to provide a range of outcomes, including:

- progressive exposure to competition;
- hedging protection for retailers against volatile spot prices;
- they also involve insurance arrangements between generators in the event of outages and interconnector shortages;
- they serve as constraints on the generators market power; and
- revenue stability for generators and retailers.

Authorisation will be required when these government owned generators and retail businesses are transferred to private ownership.

The issue for the Commission is to assess whether the public benefits claimed by the applicants are sufficient to outweigh the anti competitive outcomes of the contracts. The Commission has called for submissions on the contracts and requested the South Australian Treasury to hold a public forum on the issues.

So far, several issues have been raised which the Commission is examining further. These include:

- the effectiveness of the contracts in constraining market power, given the dynamics of the South Australian Electricity Market;
- the effect that contract coverage may or may not have on the availability of capacity for contestable customers;
- the price levels in the contracts, in view of the modelling of new entry prices and competitive bidding in a constrained market; and
- the terms of the contracts in light of the overall development of the natural market.

The Commission intends to release its draft determination in the near future. If a pre decision conference is not called, the draft determination will be finalised by the

Commission. In the event of a pre decision conference being called, interested parties will have an opportunity to respond to the Commission's draft decision and comment further on vesting contracts.

6. Conclusion

In short:

- The Commission will assess the effect of privatisation and mergers on competition in the South Australian electricity market on a case by case basis. While the Commission expects merger activity to continue it must ensure that it does not undermine the basis of these reforms;
- The Commission is keen to ensure that a consistent approach in regulation, given the federal structure. The Commission is assisting this process with the establishment of the Energy Committee and the Regualtors Forum; and
- The Commission has also developed a set of principles for the regulation of transmission networks. Through this, it is assisting to make transparent the regulatory approach that it will undertake in regulating networks.