



Public Competition Assessment

20 April 2007

AGL Energy Limited and TRUenergy Pty Ltd – proposed swap of South Australian electricity generation assets

Introduction

1. On 4 April 2007 the Australian Competition and Consumer Commission (ACCC) announced that it would not be opposing a proposed swap of South Australian electricity generation assets between AGL Energy Limited (**AGL**) and TRUenergy. Essentially, the proposed transaction involved AGL acquiring the Torrens Island Power Station (TIPS) from TRUenergy and TRUenergy acquiring the Hallett Power Station from AGL.
2. The ACCC formed its view on the basis of the information provided by the merger parties and information arising from its market inquiries. This Public Competition Assessment outlines the basis on which the ACCC has reached its decision on the proposed acquisition, subject to confidentiality considerations.

Public Competition Assessment

2. To provide an enhanced level of transparency and procedural fairness in its decision making process, the ACCC issues a Public Competition Assessment for all transaction proposals where:
 - a merger is rejected;
 - a merger is subject to enforceable undertakings;
 - the merger parties seek such disclosure; or
 - a merger is approved but raises important issues that the ACCC considers should be made public.
3. This Public Competition Assessment has been issued because the ACCC considers that the proposed transaction raises important issues that the ACCC considers should be made public.
4. By issuing Public Competition Assessments, the ACCC aims to provide the market with a better understanding of the ACCC's analysis of various markets and the associated merger and competition issues. It also alerts the market to the circumstances where the ACCC's assessment of the competition conditions in particular markets is changing, or likely to change, because of developments.

5. Each Public Competition Assessment is specific to the particular transaction under review by the ACCC. While some transaction proposals may involve the same or related markets, it should not be assumed that the analysis and decision outlined in one Public Competition Assessment will be conclusive of the ACCC's view in respect of other transaction proposals, as each matter will be considered on its own merits.
6. Many of the ACCC's decisions will involve consideration of both non-confidential and confidential information provided by the merger parties and market participants. In order to maintain the confidentiality of particular information, Public Competition Assessments do not contain any confidential information or its sources. While the ACCC aims to provide an appropriately detailed explanation of the basis for the ACCC decision, where this is not possible, maintaining confidentiality will be the ACCC's paramount concern, and accordingly a Public Competition Assessment may not definitively explain all issues and the ACCC's analysis of such issues.

The parties

AGL

7. AGL is a publicly listed Australian energy company that retails gas and electricity to over 3.6 million customers. In South Australia, AGL is the largest retailer of electricity, servicing 68.7% of residential customers (as at 30 June 2006).¹
8. Prior to the transaction, AGL owned, or had an interest in, the following electricity generation assets in the National Electricity Market (NEM)²:
 - Hallett – a 180MW gas fired peaking generator located in South Australia. This power station is also capable of running on diesel;
 - Wattle Point – an intermittent, wind powered turbine located in South Australia with a generation capacity of 90.75MW;
 - Somerton – a 150MW gas fired peaking generator located in Victoria;
 - A 32.5% interest in Loy Yang A – a 2120MW coal fired baseload generator located in Victoria; and
 - A suite of hydro generation assets located in Victoria, with a capacity of approximately 592MW.

TRUenergy

9. TRUenergy is part of the China Light & Power Group (**CLP**), a diversified energy company listed on the Hong Kong Stock Exchange.

¹ Essential Services Commission of South Australia (2006), *Annual Performance Report – Performance of South Australian Energy Retail Market 2005/06*, November 2006, page 72.

² The NEM incorporates all states and territories in Australia except Western Australia and the Northern Territory.

10. TRUenergy retails gas and electricity to over 1.1 million residential and commercial customers across Australia, including South Australia. TRUenergy also owns a number of electricity generators in Victoria and South Australia.
11. Prior to the transaction, TRUenergy owned the following electricity generation assets in South Australia and Victoria:
 - TIPS – a 1280MW gas fired intermediate-peak generator located in SA. TIPS is the largest power station in South Australia and accounts for approximately one third of installed generation capacity in that state; and
 - Yallourn – a 1480MW coal fired baseload generator located in Victoria

Other industry participants

Origin Energy

12. Origin Energy is a major Australasian integrated energy company involved in gas and oil exploration and production, energy retailing and electricity generation. Origin retails electricity to customers throughout the NEM and owns a suite of generation assets in South Australia and Queensland.

International Power

13. International Power is the largest private generator of electricity in Australia, with over 3700MW of generation capacity in South Australia, Victoria and Western Australia.
14. International Power also retails electricity in South Australia and Victoria via a joint venture that it has with energy retailer Energy Australia.

Flinders Power

15. Flinders Power is a wholly owned subsidiary of Babcock and Brown Power and owns and operates a number of generation assets in South Australia. Flinders Power provides more than 40% of South Australia's wholesale electricity requirements.

The Heywood and MurrayLink interconnectors

16. The Heywood and MurrayLink interconnectors are the transmission lines linking the South Australian and Victorian regions of the NEM. They have a combined capacity of 680MW, but tend to become constrained (operate at less than full capacity) particularly at times of high demand in South Australia.

The proposed transaction

17. In summary, the transaction involved:
 - AGL acquiring TIPS and associated gas supply and storage contracts from TRUenergy;

- TRUenergy acquiring Hallett, and all rights to develop the power station, from TRUenergy; and
- TRUenergy acquiring derivative contracts from AGL struck against the South Australian node in quantities that are material but substantially less than the capacity of the Torrens Island power station.

Timing

18. The following table outlines the timeline of key events in this matter:

Date	Event
2 February 2007	ACCC commenced review under the Merger Review Process Guidelines
26 February 2007	Closing date for submissions from interested parties
15 March 2007	Indicative timeline extended by one week
4 April 2007	ACCC announced that it would not oppose the proposed transaction

Market inquiries

19. The ACCC conducted market inquiries with a range of industry participants, including competitors, potential competitors, customers, industry bodies, financial intermediaries and other interested parties. Submissions were sought in relation to the substantive competition issues.

Market Definition

20. The ACCC considered the relevant markets in this matter to be:

- The wholesale supply of electricity in South Australia;
- The supply of financial (hedge) contracts to South Australian electricity retailers; and
- The retail supply of electricity to residential customers in South Australia.

The supply of wholesale electricity in South Australia

Product market

21. Generators primarily earn revenues by selling physical electricity into the NEM and also via hedge contracts they enter into with electricity retailers and other counter-parties. However, electricity retailers can only acquire physical electricity from the NEM. The hedge contracts that they enter into with generators (and other counter-parties) are not contracts for the supply of physical electricity; rather, they are types of risk management instruments.

22. In *Australian Gas Light Company v Australian Competition & Consumer Commission (No.3) [2003] FCA 1525 (Loy Yang)*, Justice French found that, for the purposes of that matter³:

“...derivative contracts ought to be regarded as an integral part of the pricing and payment arrangements between generators and retailers in relation to the underlying product, which is electrical energy, and which they deal with ‘as if’ it had been sold from supplier to retailer.”

23. Under the ‘purposive’ approach to market definition as applied by the Australian Courts⁴, the relevant market will depend on the matter under consideration.
24. In *Re QCMA and Defiance Holdings (1976) ATPR 40-102*, the Trade Practices Tribunal held that:

“... a market is a field of actual and potential transactions between buyers and sellers amongst which there can be strong substitution, at least in the long run, if given sufficient price incentive.”

25. Although electricity derivatives (also referred throughout this document as hedges and financial contracts) and physical electricity are both related to the supply of electricity, the underlying characteristics of these product classes are dissimilar in the context of demand side and supply side substitutability. If retailers are unable to purchase electricity via the NEM, there is no alternative supply available; retailers are not able to substitute the hedge contracts that they hold for physical electricity, nor is a hedge contract a means of paying for the acquisition of physical electricity. As such, while the ACCC accepted that hedging is an essential activity for generators and retailers, it did not accept, for the purposes of this matter, that they formed part of the same product market. Rather, in this instance, the ACCC found that an electricity derivative could be considered as an essential input for participating in the wholesale market for supply of electricity in South Australia and the retail market for the supply of electricity to residential customers in South Australia.
26. However, the ACCC notes that the competition analysis of this matter would not be materially different if a product market that encompasses both physical electricity and hedge contracts were adopted.

Geographic dimension

27. In the NEM, the spot price in each region is based on the bid of the most expensive generator required to meet regional demand. The spot price may vary from region to region because of two aspects of the transmission network.
28. First, losses are incurred from where electricity is produced to where it is to be consumed. These losses can lead to different prices in adjoining NEM regions.

³ At paragraph 382

⁴ See for example *Singapore Airlines v Taprobane Tours WA Pty Ltd (1991) 33 FCR 158*.

29. Second, constraints can be encountered when electricity is transported across the network. These constraints, particularly when they influence the operation of interconnectors into a region, can lead to electricity prices for that region being set independently from the other regions.
30. South Australian generators often bid capacity into the pool at or close to their marginal cost. However, generators in other regions will also be dispatched into South Australia, subject to the prices they bid relative to other generators, and taking into account transmission losses and constraints. Thus, the degree of competition depends significantly on the level of interconnection between regions. Therefore, when assessing the constraint provided by generators outside the SA region, it is useful to think of an interconnector as being a generator with a varying marginal cost.
31. Market inquiries revealed that generators in Victoria, NSW and the Snowy region have all been effectively dispatched into SA at different times. However, the ACCC noted that, particularly during periods of high demand for electricity in South Australia, there is often a substantial reduction in the interconnectivity between the Victorian and South Australian regions, which severely limits the ability of non-SA generators to compete with South Australian generators at these times. It is noted that TIPS accounts for a large degree of total output in South Australia during these times and is often the price-setting generator.
32. Therefore, the ACCC considered the proposed transaction on the basis that the geographic scope of the relevant market was the South Australian region plus the SA-Victoria interconnectors.
33. Having found that the transaction was unlikely to result in a substantial lessening of competition on the basis of a South Australian geographic market, it was unnecessary to consider the possibility that the geographic scope of the market may be broader.

The supply of financial (hedge) contracts to South Australian electricity retailers

34. As noted, hedging is an essential function for both generators and retailers in managing risk in the South Australian region.
35. Market inquiries indicated that it was desirable for South Australian retailers to obtain various types of hedge contracts referenced against the South Australian node. Hedge contracts referenced against other regional reference nodes (nodes), or against the difference in pool prices between the SA and Victorian nodes, can also be used by retailers. However, market inquiries suggested that these contracts were weak substitutes only, because they did not match the risk profile of South Australian retailers as well as SA contracts do. The ACCC considered that contracts other than those referenced against the SA node could be used to supplement a retailer's risk management strategy, but that basing a strategy on only these contracts would be risky.

36. Products referenced against precipitation and temperature can also be used to manage risk in some circumstances, however the ACCC found that these were weak substitutes for most SA electricity hedges and were designed to hedge against price increases resulting from unusual weather events.
37. As such, the ACCC considered that the relevant product market consisted primarily of financial contracts referenced against SA pool prices, with a competitive fringe of contracts referenced against other nodes and contracts referenced against price differentials between the SA and Victorian nodes.

The market for the retail supply of electricity to residential customers in South Australia

38. South Australian electricity customers are contestable and are therefore free to choose their electricity retailer. Presently, there are nine active retailers of electricity for residential customers in South Australia. However, the South Australian market is highly concentrated amongst four retailers – Essential Services Commission of South Australia (ESCOSA) data suggests that the four major retailers account for 99.7% of the market as at 30 June 2006.⁵
39. Market inquiries revealed differing views on the geographic scope of the relevant retail market. Some in the market argued that South Australia should be considered a separate geographic market, whereas others contended that the retail market was NEM-wide.
40. Market inquiries revealed that, to be a viable retailer of electricity in South Australia, a retailer must have a South Australian retail electricity license, access to hedge cover, a marketing department and a billing system.
41. With respect to access to hedge cover, market inquiries indicated that it is highly desirable, as an electricity retailer in South Australia, to have a hedge profile referenced primarily against the SA node. As noted above, hedges struck against other nodes, or against the difference in price between two nodes, were found to be imperfect substitutes for SA hedges. Market inquiries suggested that sustainable retail entry and competition would not occur in the absence of a risk management portfolio consisting of SA-based risk management instruments.
42. Therefore, in assessing the matter, the ACCC started from the basis of a South Australia geographic market. Having found that the transaction was unlikely to result in a substantial lessening of competition on this basis, it was unnecessary to consider the possibility that the market incorporated retailers outside of South Australia.

⁵ Essential Services Commission of South Australia (2006), *Annual Performance Report – Performance of South Australian Energy Retail Market 2005/06*, November 2006, page 72.

Competition analysis

43. The ACCC considered a number of issues regarding AGL's proposed acquisition of TIPS. These concerns predominantly related to AGL's incentive and ability to raise prices in the relevant wholesale market and the likelihood of the proposed acquisition increasing barriers to entry in the relevant retail market.

Likelihood that the proposed transaction would give AGL the ability and incentive to raise prices in the wholesale market

44. When assessing whether a merger would be likely to substantially lessen competition, section 50(3)(e) requires the ACCC to take into account whether a merger would allow acquirer to "significantly and sustainably increase prices or profit margins."
45. Economic analysis undertaken by the ACCC suggested that, when demand in South Australia is high and the Vic-SA interconnector is constrained, TIPS appears to have the ability to bid strategically to increase average SA pool prices by at least 5%.
46. However, the proposed acquisition would not have given AGL any extra ability to raise prices in the SA node above and beyond the ability held by the current owner of TIPS, TRUenergy. The ACCC considered that AGL would participate in the same competitive environment as TRUenergy, the previous owner of TIPS, and was therefore likely to face the same competitive constraint from other generators both in South Australia, and in other states via the interconnector. This competitive constraint was unlikely to change post-transaction.
47. Regarding AGL's incentives, market participants raised concerns that AGL would have a greater incentive to raise SA pool prices than TRUenergy possessed. The ACCC's assessment of this issue is given below; however, the ACCC notes that this overview is in part restricted by the ACCC's obligation to maintain confidentiality of certain information provided to it.
 - (a) Potential incentive to influence ESCOSA's forthcoming review of the regulated electricity retail tariff
48. The ACCC considered whether AGL could exercise market power in the wholesale market, through TIPS, in such a way as to increase the wholesale energy component of the regulated retail tariffs in South Australia. These tariffs are determined by ESCOSA, taking into account the relevant electricity entity's prudent controllable costs, among other factors specified in the *Essential Services Commission Act 2002*.

49. In terms of the section 50 ‘with and without’ test, the ACCC considered whether the proposed transaction would provide AGL with greater incentive to pursue this strategy than the situation without the acquisition of TIPS. As the ‘prescribed’ electricity retailer in South Australia, AGL must offer customers the choice of purchasing electricity on a regulated tariff. The ACCC considered whether, if AGL were able to increase pool prices in SA, this would have a corresponding effect on wholesale (including hedge contract) prices and, in turn, result in ESCOSA increasing the regulated tariff.
 50. Market inquiries indicated that the regulated tariff acts as a kind of ‘cap’ on the prices of market contracts,⁶ and that the average price charged by retailers for market contracts is just below this tariff. As such, although all retailers would have stood to gain from an increase in the tariff, it was argued that AGL had the most to gain as it had the largest customer base.
 51. While the ACCC accepted that AGL may have had this incentive post-transaction, market inquiries indicated that this strategy would be difficult to effectively implement. One reason is that AGL would have to reduce TIPS’s dispatch to increase wholesale electricity prices. This would need to be offset by a longer term increase in retail prices.
 52. Notwithstanding the processes undertaken and things taken into account by ESCOSA when determining regulated tariffs, the ACCC also considered that there were already possible strategies open to AGL to attempt to influence the tariff review, if it wished. Finally, the ACCC considered that TRUenergy may have already had the incentive to influence ESCOSA’s review process, because, as a provider of market contracts, it would presumably also benefit from an increase in regulated retail tariffs, as outlined above.
- (b) Increase revenues for AGL’s wholesale business
53. It was put to the ACCC that, post-transaction, AGL would have the ability and incentive to increase pool prices without inflicting losses on its retail business. This issue was considered based on the assumption that AGL’s retail load would be fully hedged from a combination of it owning TIPS and hedge cover obtained from financial contracts with other generators.
 54. Again, the ACCC recognised that AGL may have this incentive, however it noted that, given AGL’s retail load relative to the capacity of TIPS, any increase in pool prices and an associated rise in hedge contract prices, although increasing its wholesale revenues, would have also increased its retail costs, post-transaction. In order for this strategy to be profitable, AGL would have to pass through the increased retail costs to retail prices. The ACCC concluded that this was unlikely, having regard to factors including the role of the regulator and other South Australian retailers in constraining AGL’s retail prices.

⁶ Market contracts are contracts offered to retail customers where the price is not regulated.

55. Finally, the ACCC noted that, given the capacity of TIPS relative to the size of TRUenergy's South Australian retail load, TRUenergy already had the incentive to raise pool prices to increase its wholesale revenues. On this basis TRUenergy would also not have faced a corresponding increase in its retail costs. Therefore, the ACCC considered that AGL may actually have less incentive than TRUenergy in this regard.

(c) Increase the costs of AGL's retail competitors

56. The ACCC considered whether AGL might have the incentive to increase pool prices, and therefore hedge contract prices, to raise its retail rivals' costs post-transaction. However, the ACCC considered that such a strategy was likely to be expensive and high-risk, and likely to inflict losses on AGL itself. As previously noted, raising hedge contract prices would raise AGL's costs as well as those of other retailers. Therefore, for such a strategy to be profitable, AGL would need to recoup all losses incurred by winning a sizeable number of retail customers.

57. An associated concern was that AGL's acquisition of TIPS may significantly reduce the volume of hedge products available to other retailers, increasing barriers to entry and potentially causing some retailers to exit the market.

58. However, the ACCC took into account the presence of a number of vertically integrated generator-retailers in South Australia, including Origin Energy, TRUenergy and EnergyAustralia/International Power, and other information regarding the supply and demand for contract cover that was provided on a confidential basis by a range of parties. The ACCC concluded that, to the extent there might be a reduction in available contract cover, this was unlikely to be a persistent or long-term issue.

59. The ACCC further noted that TRUenergy, as a vertically integrated retailer itself, would presumably also have had an incentive to increase the costs of hedge contracts. Further, as noted above, given the smaller size of its retail load relative to AGL's, this strategy may have been more feasible for TRUenergy.

60. Therefore, while the ACCC accepted that AGL may have an incentive to raise prices in the wholesale market post-transaction, it was not clear that these were substantially greater than TRUenergy's existing incentives, and AGL's ability to do so was not enhanced by the proposed transaction.

Likelihood the proposed transaction would raise barriers to entry into the retail market

61. Section 50(3)(b) requires the ACCC to take into account the height of barriers to entry into markets when assessing whether a merger would be likely to result in a substantial lessening of competition.

62. A significant number of market participants raised concerns that the proposed transaction would lead to a decrease in the liquidity of hedge products available to South Australian retailers. Market inquiries raised a concern that compared to the situation without the transaction, there would be a reduction in the volume of electricity derivatives traded, due to the natural hedge created between TIPS and AGL's large retail load in South Australia. This, it was argued, would decrease liquidity, and make the South Australian hedge market more difficult and risky to trade in. The ACCC therefore considered this concern in the context of whether the proposed transaction would raise barriers to entry into the retail market.
63. The ACCC acknowledged concerns raised by interested parties that there is poor liquidity in the market for electricity derivatives in South Australia, particularly in comparison to other regions in the NEM.
64. The ACCC also accepted that, in the short term, there was a possibility that the liquidity of hedge products referenced against the SA node may decrease as a result of this transaction. However, market inquiries, including confidential information provided to the ACCC by a number of relevant market participants, indicated that it was unlikely that this transaction would lead to a material long term decrease in the availability of hedge products in South Australia. Therefore it did not appear that this transaction significantly raised barriers to entry for retailing in South Australia when compared to the likely scenario were the transaction not to proceed, and it appeared unlikely there would be a substantial lessening of existing competition in the South Australian retail market.

Conclusion

65. The proposed transaction is unlikely to give AGL any increased incentive or ability to increase prices in the wholesale market, over and above those held by the current owner of TIPS, TRUenergy. As such, the proposed acquisition was considered unlikely to result in a substantial lessening of competition in the wholesale market.
66. Similarly, while noting concerns about the current liquidity of financial markets in South Australia, the ACCC concluded that the present transaction was unlikely to materially decrease the availability of hedge products, particularly in the long term. Therefore, the ACCC concluded that the transaction was unlikely to significantly raise barriers to entry into the retail market and unlikely to result in a substantial lessening of competition.