



## **Public Competition Assessment**

6 July 2012

### **AGL Energy Limited – proposed acquisition of Great Energy Alliance Corporation Pty Limited (owner of the Loy Yang A power station)**

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#### **Introduction**

1. On 24 May 2012, the Australian Competition and Consumer Commission (**ACCC**) announced its decision not to oppose the proposed acquisition by AGL Energy Limited (**AGL**) of the remaining interest in Great Energy Alliance Corporation Pty Limited (**GEAC**) (the **proposed acquisition**). AGL already had a 32.54 per cent shareholding in GEAC. GEAC owns the Loy Yang Power business (**LYP**), owner of the Loy Yang A power station. The ACCC formed the view that the proposed acquisition was not likely to have the effect of substantially lessening competition in any market in contravention of section 50 of the *Competition and Consumer Act 2010* (the **Act**).
2. The ACCC formed its view on the basis of the information provided by the merger parties, information arising from its market inquiries and other information available to the ACCC and Australian Energy Regulator (**AER**). 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**

3. 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 opposed;
  - a merger is subject to enforceable undertakings;
  - the merger parties seek such disclosure; or
  - a merger is not opposed but raises important issues that the ACCC considers should be made public.
4. This Public Competition Assessment has been issued because the proposed acquisition was not opposed by the ACCC but raised important issues that the ACCC considers should be made public.
5. By issuing Public Competition Assessments, the ACCC aims to provide the public with a better understanding of the ACCC's analysis of various markets and the associated merger and competition issues. It also alerts the public to

circumstances where developments in particular markets have led, or are likely to lead, to changes in the ACCC's assessment of competition conditions in those markets.

6. 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.
7. Public Competition Assessments outline the ACCC's principal reasons for forming views on a proposed acquisition at the time the decision was made. As such, Public Competition Assessments may not definitively identify and explain all issues that the ACCC considers arise from a proposed acquisition. Further, the ACCC's decisions generally 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.

## The parties

### AGL Energy Limited

8. AGL is an energy company listed on the ASX. AGL has a range of retail and wholesale gas and electricity interests:
  - *Victoria*: Gas and electricity retail operations, the Somerton power station (registered capacity: 160 MW, summer capacity: 134 MW) (peaking plant), and hydro generation assets (~700 MW). Prior to the proposed acquisition, AGL already held a 32.54 per cent interest in the Loy Yang A power station through its shareholding in GEAC.
  - *South Australia*: Gas and electricity retail operations and the Torrens Island Power Station (**TIPS**) (registered capacity: 1,280 MW, summer capacity: 1,252 MW). AGL is also involved in the development and operation of wind powered generation assets.
  - *New South Wales*: Gas and electricity retail operations, hydro generation assets and coal seam methane production and exploration interests.
  - *Queensland*: Gas and electricity retail operations, a 50 per cent interest in the Moranbah coal seam methane project and associated power station, and a 50 per cent interest in the former Enertrade gas merchant business. Additionally, AGL has upstream gas interests.
9. Most relevant to the proposed acquisition were AGL's electricity retail operations, peaking plant and hydro generation assets in Victoria and TIPS in South Australia.
10. AGL's shares of generation capacity in the Victorian and South Australian regions of the National Electricity Market (**NEM**) (excluding wind energy, small-scale renewable plants and regional interconnectors) prior to the proposed acquisition were as follows:

- Victoria: ~8 per cent
  - South Australia: ~36 per cent
  - Victoria/South Australia: ~14 per cent
11. AGL had a significant presence in electricity retailing in Victoria, with more than 20% of residential and small business customers in Victoria and over 20% of overall retail load in Victoria in 2011.

### **Loy Yang Power**

12. The Loy Yang Power Partnership manages the Loy Yang A power station in Victoria (registered capacity: 2,210 MW, summer capacity: 2,190 MW) and the adjacent brown coal open cut mine.
13. Loy Yang A is the largest base load power station in the Victorian region of the NEM. LYP's shares of generation capacity in the Victorian and South Australian regions of the NEM (excluding wind energy, small-scale renewable plants and regional interconnectors) are as follows:
- Victoria: ~20 per cent
  - Victoria/South Australia: ~15 per cent
14. The proposed acquisition would therefore lead both to the horizontal aggregation of generation assets and increased vertical integration between generation and retail markets. The ACCC considered the likely competitive effects of the proposed acquisition under these two broad headings.
15. The Loy Yang Power Partnership is owned by GEAC. GEAC shareholders included AGL (~32.5 per cent), the Tokyo Electric Power Company, Inc. (**TEPCO**) (~32.5 per cent), Ratch Australia (~14 per cent), MTAA Super (~13 per cent), Westscheme (~5.7 per cent) and Statewide Super (~2.5 per cent).
16. In 2003, AGL successfully sought a declaration from the Federal Court that the acquisition of an interest of up to 35 per cent of the Loy Yang A power station would not breach section 50 of the Act, subject to an undertaking given by AGL to the Federal Court. AGL also provided an undertaking to the ACCC under section 87B of the Act, which contained mechanical provisions to enable the ACCC to monitor compliance with the court undertaking. The Federal Court undertaking prevented AGL from acquiring more than a 35 per cent interest in the Loy Yang A power station and prevented it from being involved in the contracting, dispatch or bidding of electricity produced from the Loy Yang A power station.
17. Due to these undertakings, Loy Yang Marketing Management Company Pty Ltd (**LYMMCo**), wholly owned by Loy Yang Marketing Holdings Pty Ltd, managed the contracting, marketing and dispatch of electricity from the Loy Yang A power station. LYMMCo was owned by the GEAC shareholders other than AGL.

## Industry background

### Electricity

18. There are approximately 200 electricity generators of varying sizes operating in the NEM (excluding smaller imbedded generation). Generators are commonly characterised in terms of their capacity (which is the maximum amount of electricity that may be produced at a given time, usually measured in megawatts (MW)) and energy (which is the volume of electricity produced over a period of time, usually measured in megawatt hours (MWh) or gigawatt hours (GWh)).
19. Electricity produced by generators is transported at high voltage on a transmission system which connects regions of the NEM. Distribution networks then carry electricity from points on the transmission networks and deliver it at lower voltages to consumers through electricity connections at residential and commercial locations. The AER regulates the revenue received by the owners of the transmission and distribution networks.
20. Electricity retailers do not physically supply electricity to consumers. Rather, they pay for electricity consumed by their customers, including the transmission and distribution costs, and then bill their customers and provide them with related services. While most jurisdictions allow consumers to choose their energy retailer, jurisdictions other than Victoria apply some form of electricity retail price regulation.
21. The NEM is the wholesale spot market through which generators and retailers trade electricity. The NEM is operated by the Australian Energy Market Operator (**AEMO**), which acts as an intermediary between generators and retailers. Retailers pay AEMO for electricity consumed by their customers and AEMO pays generators for electricity they supply.
22. There are five regions of the NEM: Victoria, New South Wales, Queensland, South Australia and Tasmania, so a reference to a region of the NEM is equivalent to a reference to one of these states. These regions are physically linked by an interconnected transmission network (referred to as 'regional interconnectors'). In 2007, the Snowy region of the NEM was abolished, and Snowy Hydro now has scheduled generation units with 2,112 MW total registered capacity in Victoria (summer capacity: 2,082 MW) and 2,246 MW total registered capacity in New South Wales (summer capacity: 2,564 MW).
23. A spot price in each region of the NEM (referred to as the 'regional reference price') is calculated based on the bid of the most expensive generator required ('dispatched') to meet regional demand. The spot price may vary from region to region as a result of transmission losses incurred when electricity is transported across the network from where it is produced to where it is to be consumed and constraints experienced on interconnectors. Interconnector 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 adjoining regions of the NEM.

### *Risk management in the NEM*

24. Wholesale spot electricity prices are volatile, reflecting varying demand levels and the availability and costs of different types of generation. However retailers generally offer fixed electricity rates to their customers, and are therefore

exposed to the risk that the costs of purchasing wholesale electricity from the spot market will exceed the revenues they earn from their customers, described here as 'price risk'.

25. From the opposite perspective, generators also face a level of price risk, particularly since their financing and investment decisions may be based on projected spot prices which they anticipate will deliver an expected rate of return.
26. Generators and retailers seek to manage risk associated with the wholesale electricity spot price volatility by entering into financial derivative contracts. These contracts are commonly known as 'hedge contracts' (for the purposes of describing the relevant markets, they are referred to as 'financial (hedge) contracts'). There are two main types of hedge contracts:
  - **Over-the-counter** hedge contracts (**OTCs**) where two parties (typically a generator and a retailer) enter into a bilateral contract (either directly between the counterparties or assisted by a broker). OTCs may be in standard form or tailored to the particular needs of the parties.
  - **Exchange traded** hedge contracts (**ETCs**), also known as electricity futures products, which are traded on the Sydney Futures Exchange.
27. In its simplest form, a hedge contract specifies an agreed 'strike price' and the counterparties will pay one another according to the difference between the spot price (i.e. the spot price in one region of the NEM) and the strike price. The two most common types of hedge contracts are swaps and caps:
  - **Swaps:** A generator sells a contract under which – in relation to an agreed volume of electricity – the generator must pay the retailer the difference between the spot price and the strike price during times that the spot price is higher than the strike price, and the retailer will pay the difference to the generator during times that the spot price is lower than the strike price. This means that a generator is effectively 'committed' to generate the contracted volume of electricity, unless it chooses to bear this spot price risk itself or enters into another swap to cover its liability.
  - **Caps:** A generator sells a contract under which – in relation to any electricity consumed by the retailers' customers at a time when the actual spot price exceeds the strike price – the generator will pay the difference to the retailer. The retailer will pay a premium to reflect the fact that the generator would be foregoing revenue that it would otherwise receive when the spot price exceeds the strike price.
28. As retailers have no choice as to the amount of electricity that they must purchase on the spot market on behalf of their customers – since there is no certainty as to the volume of electricity that will be consumed by a retailer's end user customers in a given trading period – this means retailers are also exposed to the risk that their customers' use may exceed the volumes covered by hedge contracts, described here as 'volume risk'.
29. Increasingly, generators and retailers are managing their price and volume risk by vertically integrating. The more that a party is vertically integrated, the less it will need to trade hedge contracts to manage this risk. Therefore the extent of vertical integration may have implications for other parties who need to enter into hedge contracts to manage their price and volume risk.

## ACCC review timeline

30. The timeline of key events in this matter is as follows:

### ACCC review timeline

Date	Event
24 February 2012	ACCC commenced review under the Merger Review Process Guidelines.
16 March 2012	Closing date for submissions from interested parties.
3 April 2012	ACCC requested further information from the merger parties. ACCC timeline suspended.
26 April 2012	ACCC received further information from the merger parties. ACCC timeline recommenced.
9 May 2012	Former proposed date for announcement of ACCC's findings (17 May 2012) amended to allow merger parties to provide further information.
24 May 2012	ACCC announced it would not oppose the proposed acquisition.

## Market inquiries

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

## Market definition

32. The ACCC considered the proposed acquisition in the context of markets for:

- the wholesale supply of electricity in Victoria and in a combined Victoria and South Australia, in both cases taking into account interconnector flows;
- the supply of financial (hedge) contracts under which payment is based on the regional reference price in Victoria; and
- the retail supply of electricity in Victoria.

## Wholesale supply of electricity / supply of financial (hedge) contracts

### *Product dimension*

33. In defining the relevant markets for the purposes of examining the proposed acquisition, the ACCC considered whether the wholesale supply of electricity and the supply of financial (hedge) contracts should be included in the same market.
34. The ACCC considered that, from a demand and supply side perspective, financial (hedge) contracts are complementary to, rather than a substitute for, the wholesale supply of electricity. That is, financial (hedge) contracts are not contracts for the supply of physical electricity – they are a type of risk management instrument.
35. While the ACCC is aware of instances in which generators or retailers may carry on business without financial (hedge) contracts in place, the ACCC took the view

that financial (hedge) contracts are an essential input to sustainably participating, on a material scale, in the wholesale and retail electricity markets.

36. Accordingly, the ACCC took the view that the supply of financial (hedge) contracts should not be considered to be in the same market as the wholesale supply of electricity, whilst recognising the close connection between the markets.

*Geographic dimension (wholesale supply of electricity)*

37. The ACCC did not consider it necessary to reach a definitive view on the scope of the geographic dimension of the relevant market for the wholesale supply of electricity. Either or both a Victorian or combined Victorian/South Australian market may be relevant. There are degrees of substitution and constraint within and between regions which make it relevant to consider both a narrow and a broader market. Regardless of the geographic dimension considered, the ACCC takes into account 'imports' of electricity via regional interconnectors in its assessment.
38. The ACCC considers that the degree of competitive constraint resulting from electricity imported from another region of the NEM (i.e. another state) varies depending on the circumstances. For instance, electricity imports from generators in an adjoining region typically act as a very limited competitive constraint at times of high demand (and hence high prices) since this is when interconnectors between regions are more likely to have reached the limit of their capacity, preventing imports of electricity from that adjoining region. Moreover, the AER has observed that, due to the phenomenon of 'disorderly bidding' and intraregional transmission congestion, interconnector flows may actually be lower at times of high demand (and hence high prices) in a region.
39. The ACCC therefore focussed on the potential competitive impact of the proposed acquisition in:
- the Victorian region of the NEM, since this is where the Loy Yang A power station is located; and
  - a combination of the Victorian and South Australian regions of the NEM, since there is some correlation in demand patterns in these regions and AGL has significant generation assets in South Australia (TIPS).
40. Having found that the proposed acquisition was not likely to result in a substantial lessening of competition on the basis of these geographic dimensions, it was unnecessary to consider the possibility that the geographic scope of the market might be broader.

*Geographic dimension (supply of financial (hedge) contracts)*

41. In relation to the supply of financial (hedge) contracts, the ACCC considered the proposed acquisition on the basis of a geographic dimension corresponding to the Victorian region of the NEM. The ACCC formed the view that this geographic dimension is appropriate having regard to the fact that payments under a financial (hedge) contract are based on differences between the strike price and the regional reference price in a particular region of the NEM.

42. Market inquiries indicated that a retailer seeking to manage price risk associated with its customer load in one region of the NEM will very rarely (if ever) enter into a financial (hedge) contract under which payments are calculated by reference to the spot price in a different region of the NEM, since this is not an effective way to manage price risk. This primarily reflects the fact that at times of high demand in a NEM region (and hence a high regional reference price), there is often a significant divergence from the spot price in other NEM regions.
43. Market inquiries indicated that, for similar reasons, a generator will rarely enter into a financial (hedge) contract under which payments are calculated by reference to the spot price in a region of the NEM in which it does not have generation assets with sufficient capacity available.
44. Generators and retailers may participate in AEMO auctions for “inter-regional settlement residues” (**IRSR**). These residues arise because there is a surplus to AEMO when selling electricity across an interconnector and there is a difference between the regional reference prices on either side of the interconnector. When this occurs, generators in the exporting region are paid the lower price for the exported electricity but the retailer in the importing region pays for that electricity at the higher regional price. Settlement Residue Auctions (**SRAs**) allow market participants to bid for entitlements to a proportion of the total IRSR, which to some extent can mitigate the effects of price divergences between regions of the NEM. However, market inquiries indicated that SRAs are only used to a limited extent and do not provide sufficient protection such that they facilitate entering into financial (hedge) contracts under which payments are calculated by reference to the spot price in a different region of the NEM. IRSRs appear only able to be used in such a way by larger market participants that have operations in both of the relevant adjoining regions of the NEM.
45. The ACCC therefore formed the view that the relevant geographic dimension in which to consider the impact of the proposed acquisition upon the supply of financial (hedge) contracts is the Victorian region of the NEM.

### **Retail supply of electricity**

#### *Product dimension*

46. Consistent with previous reviews, the ACCC considered it appropriate to assess the proposed acquisition in the context of the retail supply of electricity, rather than the combined retail supply of electricity and gas.
47. The ACCC considers that the retail supply of electricity can be distinguished between two broad categories of customers, being:
  - **residential and small business customers** who typically consume up to 160MWh of electricity per annum; and
  - **industrial and commercial customers** who typically consume in excess of 160MWh of electricity per annum.
48. Market inquiries suggested that the requirements of these categories of customers differ significantly, with a particular impact on the level and type of risk management required by retailers to service these categories of customers. Those differences mean that some retailers focus on only one category. For example, these differences include:

- the volume of electricity supplied per customer – due to their more significant electricity requirements, commercial and industrial customers may negotiate arrangements with a retailer or establish a competitive tender process, whereas residential and small business customers will be offered a standard product and retailers seek to maximise the number of customers they have rather than target customers with greater electricity requirements;
  - customer management – due to the greater number of their customers, retailers supplying residential and small business customers generally need to expend a greater proportion of their revenue on customer service;
  - demand-side management – commercial and industrial customers may have the ability to reduce their level of demand or consumption, allowing a retailer to reduce its exposure to the spot price at times of high price; and
  - the levels of demand during the day – commercial and industrial customers' use tends to be relatively steady during business hours, and therefore predictable, whereas residential customers' consumption peaks in the morning and evening on weekdays and can vary much more on different days, particularly when there are very high or low temperatures.
49. The ACCC did not consider it necessary to reach a definitive view on whether there was a single retail market or separate markets for these retail customer groups. The ACCC recognised that the competitive effects of the proposed acquisition may differ between retailers that primarily supply one of these customer groups, in particular, with regard to the risk management requirements of such retailers.

#### *Geographic dimension*

50. The ACCC observed that some electricity retailers operate across more than one NEM region. However, it is necessary for a retailer to also secure a number of inputs specific to a region. In particular, a retailer would need to acquire a retail licence and negotiate financial (hedge) contracts with generators located within that region. Therefore, a retailer of electricity in one region cannot switch its operations quickly and without significant investment to supply another region.
51. In light of the above factors, the ACCC considered the competitive effects of the proposed acquisition in Victoria only, whilst recognising that competitive effects on a wider geographic basis may be relevant for other acquisitions.

#### **With and without test**

52. In assessing a merger or acquisition pursuant to section 50 of the Act, the ACCC must consider the effects of the transaction by comparing the likely competitive environment if the transaction proceeds (the “with” or “factual” position) to the likely competitive environment if the transaction does not proceed (the “without” or “counterfactual” position).
53. In the absence of the proposed acquisition, the ACCC considered that the status quo was the relevant competitive environment against which to assess the proposed acquisition, i.e. it was likely that LYP would continue to operate as a standalone generator.

54. In assessing the likely competitive environment without the transaction, the ACCC had regard to certain issues associated with the financial position and creditworthiness of LYP and the extent to which these issues may impact upon its ability to enter into appropriate risk management arrangements in the foreseeable future.
55. The ACCC considered that, if the proposed acquisition did not proceed, there was a risk that LYP would be limited in its ability to enter into hedge contracts. The extent of such limitations was largely dependent on whether counterparties would be willing to enter into hedge contracts with LYP.
56. The ACCC was not in a position to determine the precise impact of the financial position and creditworthiness of LYP upon its ability, in the absence of the proposed acquisition, to enter into hedge contracts in the foreseeable future.
57. On balance, the ACCC took the view that LYP was likely to continue to face financial difficulties and therefore to face some level of constraint on its ability – but no impact on its incentive – to supply hedge contracts during the period over which the impacts of the acquisition were to be considered.
58. In relation to the market for the wholesale supply of electricity, on the other hand, the ACCC considered that there was little prospect of LYP ceasing to generate and supply electricity due to its financial position and that it would continue to be an active participant in the market for the wholesale supply of electricity with or without the proposed acquisition.

## **Competition analysis**

### **Horizontal aggregation of generation capacity**

59. The ACCC considered whether the aggregation of LYP's generation capacity with AGL's existing generation capacity which would result from the proposed acquisition would be likely to have the effect of substantially lessening competition in the market for the wholesale supply of electricity in Victoria or a combined Victoria and South Australia.

### *Economic withholding*

60. It is relevant to set out in some detail the mechanism by which wholesale spot market prices are set in each region, and how individual generators can influence price by a strategy known as 'economic withholding'.
61. Generators offer their output for sale in the wholesale (spot) market by 'bidding' portions of their capacity into price categories known as price bands. Generators are dispatched on an economic basis (the least expensive generators are dispatched first) subject to transmission constraints and the "ramp rates" of generators (i.e. the speed with which they can raise/lower output).
62. The maximum bid that a generator can submit is \$12,500/MWh. Subject to certain regulatory rules, a generator is able to re-bid its capacity by shifting capacity from one price band to another. Different circumstances in the relevant regional wholesale market will create different incentives for how a generator might re-bid its capacity.

63. The main way that generators can increase spot prices is to economically withhold output. This is done by withdrawing some of their generating capacity from lower price bands and submitting it into higher price bands. This is distinguished from ‘physical withholding’, where a generator removes capacity entirely from the market (for example, by announcing that several units are off-line). A strategy to economically withhold capacity will usually occur at times of high demand, particularly when a generator must be dispatched to meet total market demand in a particular region. At such times, a generator would be in a position to materially influence prices in the relevant spot market. A generator’s ability to influence prices in this way will be greater when interregional interconnectors are constrained and adjoining regions are unable to ‘export’ additional electricity into the relevant region.
64. A generator will only be successful in an economic withholding strategy if it is not subject to competitive pressure from other generators. If there is competitive pressure in the market, the generator faces the risk that the output it has withdrawn and bid at a high price will be replaced by the output of other generators at lower prices and as a result the spot price does not materially increase.
65. In addition, a generator must have sufficient generation capacity available to engage in such a strategy. In particular, it will have a reduced incentive to engage in such a strategy to the extent that it needs to supply electricity to support its hedge contract commitments – i.e. it will not benefit from a high spot price to the extent that the spot price exceeds the strike prices under its hedge contracts as the generator must pay the counterparty the difference between the spot price and the strike price during times that the spot price is higher than the strike price.

#### *Generation capacity*

66. The ACCC noted that, post-acquisition, the generation capacity of the merged firm would increase as follows (excluding wind energy, small-scale renewable plants and regional interconnectors):
- Victoria: AGL would increase its share of capacity from ~8 per cent to ~27 per cent;
  - Victoria/South Australia: AGL would increase its share of capacity from ~14 per cent to ~29 per cent.
67. The ACCC recognised that market shares of the merger parties can be of less use in analysing the potential competitive impact of the proposed acquisition, since generators have different marginal costs and flexibility of output and their behaviour will depend on a range of factors, including the extent of their hedge contract commitments.
68. In its analysis, the ACCC also took into account:
- the role of regional interconnectors, noting that they often operate well below their nominal capacity during peak periods;
  - wind energy, noting the difficulties associated with predicting the level of output from wind plant; and

- planned new generation capacity in Victoria and South Australia and the potential for construction to be brought forward in response to price signals in the NEM. AEMO provided the ACCC with relevant information on planned new generation. Given the lead times involved, the ACCC focussed on committed projects which have development approvals in place.
69. The ACCC considered that, importantly, post-acquisition, there would remain at least five key participants in either Victoria or a combined Victoria/South Australia: AGL, TRUenergy, International Power, Snowy Hydro and Origin (currently expanding its generation capacity at the recently commissioned Mortlake plant).

#### *Contract position*

70. The ACCC considered the extent to which, following the proposed acquisition, AGL would be net 'long' in generation – i.e. would have available more generation capacity than would be required to support its retail load – and may therefore have an increased incentive to engage in economic withholding (as described above). The extent of any net long position following the proposed acquisition would primarily depend on the extent to which the capacity of AGL's generation assets combined with the capacity of LYP would exceed the generation required to support its retail load. However, it would also depend on the extent to which AGL's generation is effectively committed to third parties under hedge contracts (serving to reduce its long position) and, conversely, the extent to which AGL enters into hedge contracts with third parties to support its retail load (serving to increase its long position).
71. The ACCC was able to forecast the net position of AGL in the period immediately following the proposed acquisition (if it were to proceed) based on the contract position of AGL and LYP prior to the proposed acquisition. However the ACCC recognised that the net position of AGL is subject to change at short notice and ultimately would depend on its commercial strategy both in the market for the supply of hedge contracts and in the market for the wholesale supply of electricity. AGL's strategy would depend on a number of factors, including the forecast supply and demand conditions in the market.
72. Due to confidentiality, the ACCC is not able to comment on the current net position of AGL or LYP. However, it is in the public domain that LYP has entered into a hedge contract directly with a major industrial consumer of electricity, Alcoa of Australia, which will effectively commit LYP to supply approximately 820 MW of its generation capacity from 2016 which, with future expansion options, could represent more than half of LYP's generation output.<sup>1</sup>

#### *Conclusion*

73. Taking into account the considerations described above, the ACCC used a range of modelling techniques to assist with identifying likely price impacts in the market for the wholesale supply of electricity in Victoria or a combined Victoria and South Australia.
74. After reviewing all of the evidence available to it, the ACCC concluded on balance that the aggregation of generation capacity arising from the proposed acquisition would not be likely to substantially lessen competition in the market

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<sup>1</sup> Alcoa of Australia Limited and Loy Yang Power, Joint Media Statement, 1 March 2010.

for the wholesale supply of electricity in Victoria or in a combined Victoria and South Australia. A decisive factor in forming this view was the competitive constraints provided by existing players and the potential for investment in new generation – importantly, post-acquisition, there would remain at least five key participants in either Victoria or a combined Victoria/South Australia. In addition, the Alcoa contract will effectively commit a significant proportion of LYP's generation capacity and therefore decrease AGL's ability and incentive to engage in economic withholding from 2016.

### **Vertical integration of generation and retail activities**

75. Given AGL's significant presence in the retail supply of electricity in Victoria and relatively limited generation capacity in Victoria prior to the proposed acquisition, the proposed acquisition would result in increased vertical integration of AGL's position in Victorian retail and wholesale electricity markets. In addition, the proposed acquisition would result in the removal of LYP as a stand-alone generator in Victoria.
76. The ACCC considered the impact of this increased vertical integration on the supply of hedge contracts in Victoria. As a result of the balancing between AGL's generation capacity and retail load, post-acquisition AGL would have a significantly greater 'natural hedge'. Since generation assets benefit from high spot prices and a retail business benefits from low spot prices, having a balanced portfolio of generation capacity and retail load substantially reduces the overall level of price risk borne in the electricity wholesale supply market and therefore reduces the need to enter into hedge contracts with third parties.
77. As a general proposition, to the extent that AGL would have a natural hedge following the proposed acquisition, this would – relative to LYP remaining as a stand-alone generator – reduce its need to purchase hedge contracts to cover its retail load and reduce its need to sell hedge contracts backed by LYP's generation capacity.
78. The ACCC therefore considered whether the proposed acquisition would have detrimental impacts on competition due to a reduction in liquidity in the financial (hedge) contract market. In particular, the ACCC considered whether the proposed acquisition was likely to impact on the availability of hedge contracts for non-vertically integrated third parties and any potential for the proposed acquisition to increase barriers to entry or expansion in the markets for wholesale or retail supply of electricity.

### *Liquidity of financial (hedge) contract market*

79. The ACCC considered that, to a large extent, the proposed acquisition would result in AGL reducing the hedge contracts purchased from third parties to support its retail load and reducing the hedge contracts sold to third parties backed by LYP's generation. This was likely to reduce the number of distinct possible counterparties to hedge contracts. The ACCC considered that this could reduce the overall liquidity of the financial (hedge) contract market, however the ACCC did not consider that this alone was likely to give rise to a substantial lessening of competition in the relevant markets. In particular, Snowy Hydro and International Power would continue to have significantly more generation capacity available than they required to support their retail load.

80. The ACCC also considered specifically whether the reduced availability of AGL or the removal of LYP as a counterparty to hedge contracts could have a detrimental impact on competition. Such an impact would be based on the significance of hedge contracts provided by AGL or LYP to participants in wholesale and retail electricity markets and the extent to which this reduction or removal may increase barriers to entry or expansion in those markets.

*Barriers to entry (retail supply of electricity)*

81. The ACCC found that the key requirements for entering a retail electricity market are obtaining a retail licence, the ability to purchase hedge contracts that sufficiently manage price and volume risk, the financial capability to meet AEMO's prudential requirements for participating in the NEM, and the establishment of marketing, customer service and billing capabilities.
82. The ACCC considered whether the removal of LYP as a standalone generator in Victoria would be likely to significantly raise barriers to entry for new retail entrants into Victoria.

*LYP's incentives to facilitate new entry and expansion in retail markets*

83. The ACCC noted that LYP was the only major generator in Victoria without a presence in retail markets. The ACCC considered that LYP was unlikely to become vertically integrated by expanding into retail activities so long as GEAC's ownership structure remained as it was prior to the proposed acquisition, since AGL would not support such expansion.
84. However, the ACCC noted that LYP remained independent of AGL in relation to its contracting, dispatch and bidding activities due to the undertakings AGL gave previously to the Federal Court and ACCC. Market inquiries indicated that those undertakings had been highly effective in this regard. In circumstances where LYP was not likely to establish a retail business, the ACCC therefore considered that LYP had the ability and incentive to promote new entry into electricity retailing and to support the expansion of retailers without their own generation assets ('standalone retailers'), partly because this would serve to reduce the dependence of LYP on counterparties with their own generation. This incentive was considered likely to remain in the foreseeable future if the proposed acquisition did not proceed.
85. By comparison, a generator with its own retail business (including AGL following the proposed acquisition) would have a reduced incentive to support new retail entry and expansion of the retail base of competing 'standalone' retailers since that would risk cannibalising its own retail business.
86. The ACCC considered the extent to which standalone generators had supported – and would be likely to continue to support – new retail entry and expansion, including by providing customised hedge products to standalone retailers.

*Customised hedge products*

87. Customised hedge products enable the effective management of price and volume risk by having either or both of the following two attributes (which are not generally available through standard OTC contracts or ETCs):

- **Load following arrangement**, where the generator bears all of the financial risk associated with fluctuations in the retailer’s customer load – for which a premium is paid by the retailer. The arrangement essentially shifts volume risk to the generator and requires the generator to manage this risk on behalf of the retailer. The volume hedged under a load following hedge is at a pre-determined price, therefore removing spot price risk, and reflects the retailer’s actual customer loads during the period covered by the product. This provides the retailer with certainty when pricing its retail offering.
- **Reallocation arrangement**, which reduces the retailer’s exposure to AEMO and therefore the level of prudential requirements that the retailer must satisfy. This is achieved by reducing the amount that the retailer must pay to AEMO for the supply of electricity by the amount that the generator would have paid the retailer under the hedge contract.

88. Market inquiries indicated that:

- customised hedge products have particularly supported new entry and expansion of standalone retailers with residential and small business customers in Victoria, by allowing them to effectively manage price and volume risk associated with their retail load until they achieve sufficient scale to be able to rely solely on standard OTC contracts and ETCs;
- other retailers with residential and small business customers in Victoria have been less dependent on customised hedge contracts since they have existing businesses and therefore substantial capital backing, previous experience in electricity retailing and/or existing generation assets in Victoria. These retailers are described here as ‘large’ new entrants; and
- due to different characteristics of commercial and industrial customers, customised hedge products are less critical for new entry and expansion of retailers targeting these customers.

89. The ACCC considered that the removal of LYP as a standalone generator with the incentive to support new entry and expansion of standalone retailers would be likely to have some impact on the availability of customised hedge products for standalone retailers or the terms on which those products were offered to standalone retailers. The ACCC therefore considered that the proposed acquisition was likely to have some impact on barriers to entry and expansion for standalone retailers targeting residential and small business customers in Victoria.

*Retail supply of electricity to residential and small business customers*

90. Given the likely impact on barriers to entry and expansion for standalone retailers targeting residential and small business customers in Victoria, the ACCC considered whether such an impact was likely to result in a substantial lessening of competition in this market having regard to existing levels of competition and the range of competitors currently active in this market.
91. The ACCC noted that there were 12 retailers supplying electricity to residential and small business customers in Victoria. In 2007, the AEMC found that competition in the Victorian retail market was effective and noted evidence of

strong rivalry between retailers.<sup>2</sup> More recently, in 2011, the Essential Services Commission of Victoria found that first tier retailers are pricing less aggressively than previously and that second tier electricity retailers are primarily the price leaders and discounters when supplying residential and small business customers.<sup>3</sup>

92. The ACCC considered that several of the second tier retailers in Victoria were likely to be capable of adequately managing their price and volume risk using standard OTC contracts and ETCs. Accordingly, a significant number of second tier retailers were not considered to be dependent on customised hedge products to support their expansion. The ACCC also noted that new retail entry had occurred in Victoria by players relying on standard OTC and ETC hedge contracts. In this context, and given the continued threat of 'large' new entry, the ACCC considered that the proposed acquisition was not likely to result in a substantial lessening of competition in the electricity retail market in Victoria.

*Barriers to entry (wholesale supply of electricity)*

93. The ACCC recognised that the proposed acquisition may have had impacts not only on barriers to entry for retailers, but also for generators (i.e. in the market for the wholesale supply of electricity). The ACCC noted that, given the very significant investment required for new generation capacity, a key consideration for a market participant considering entry or expansion in the market for the wholesale supply of electricity is the likely future prices for the wholesale supply of electricity and strike prices in hedge contracts. In many cases, a party without significant retail operations will only build new generation with a supporting long-term hedge contract in place.
94. Given the number of retailers that would remain available as counterparties to hedge contracts following the proposed acquisition, and the associated volume of retail load that would not be subject to a natural hedge associated with vertically integrated participants, the ACCC did not consider that barriers to entry and expansion in the market for the wholesale supply of electricity were likely to be raised sufficiently by the proposed acquisition to give rise to a substantial lessening of competition in that market.

## **Conclusion**

95. The ACCC formed the view on balance that the aggregation of AGL and LYP's generation assets would not be likely to result in a substantial lessening of competition in markets for the wholesale supply of electricity due to competitive constraints provided by at least five key generators and the potential for investment in new generation. In addition, the Alcoa contract will effectively commit a significant proportion of LYP's generation capacity and therefore decrease AGL's ability and incentive to engage in economic withholding from 2016.
96. The ACCC formed the view that the increased vertical integration that would result from the proposed acquisition (and consequent 'natural hedge' of AGL's generation and retail operations) would not be likely to have the effect of

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<sup>2</sup> Australian Energy Market Commission, 'Review of the Effectiveness of Competition in Electricity and Gas Retail Markets in Victoria', 19 December 2007.

<sup>3</sup> Essential Services Commission, 'Victorian Retail Energy Market Overview, 2010-11', December 2011.

substantially lessening competition in the relevant markets, having regard to existing levels of competition in generation and retailing in Victoria. In particular, Snowy Hydro and International Power would continue to have significantly more generation capacity available than they required to support their retail load.

97. The ACCC formed the view that the removal of LYP as a standalone generator in Victoria was unlikely to result in a substantial lessening of competition in the retail market for supply of electricity in Victoria. Although LYP would not have the same incentive to support new retail entry and expansion following the proposed acquisition, the ACCC took into account the number of existing retailers in Victoria which do not depend on customised hedge products and the continued threat of 'large' new entry.
98. On the basis of the above, the ACCC formed the view on balance that the proposed acquisition was not likely to substantially lessen competition in a relevant market and would therefore not contravene section 50 of the Act.

*Federal Court undertaking*

99. To proceed with the proposed acquisition of the remaining 67.46 per cent of GEAC, it was necessary for AGL to seek an order from the Federal Court discharging the undertaking which limited its economic interest in LYP to 35 per cent and its involvement in, and knowledge of, the dispatch and marketing activities of LYP.
100. Following the ACCC's decision not to oppose the proposed acquisition, AGL filed an application seeking this discharge. The application was heard on 30 May 2012 and the undertaking was discharged, taking effect from 22 June 2012. The ACCC did not object to the making of this order.