



COMMONWEALTH OF AUSTRALIA

COMPETITION AND CONSUMER ACT 2010

IN THE AUSTRALIAN COMPETITION TRIBUNAL

File No: ACT 1 of 2014

RE: APPLICATION FOR MERGER AUTHORISATION OF MACQUARIE
GENERATION

Applicant: AGL ENERGY LIMITED

ACCC ISSUES LIST

Date of Document : 7 April 2014
Filed on behalf of : The Australian Competition and Consumer Commission

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1. Introduction

- 1.1. This Issues List is filed in accordance with the direction of the Tribunal dated 31 March 2014.
- 1.2. The ACCC notes that the views expressed in this document are provisional.

2. Likely future with and without the proposed acquisition

- 2.1. The Tribunal must not grant an authorisation unless it is satisfied in all the circumstances that the proposed acquisition would result, or be likely to result, in such a benefit to the public that the acquisition should be allowed to occur: section 95AZH(1) of the *Competition and Consumer Act 2010* (Cth) (the Act). The Tribunal has determined the test to require it to identify and assess the public benefits and detriments likely to result from the proposed acquisition, and weigh the two. This test is known as the 'net public benefits' test.
- 2.2. To assess the proposed acquisition for the purposes of the net public benefits test, the Tribunal has considered it useful to compare the likely future 'with' the proposed acquisition and separately, 'without' the proposed acquisition.
- 2.3. AGL considers that the relevant future without the proposed acquisition involves Macquarie Generation remaining owned and operated by the State of NSW.
- 2.4. The ACCC's provisional view is that the future without the proposed acquisition would involve either Macquarie Generation:
 - a. remaining owned and operated by the State of NSW; or
 - b. being sold to another purchaser (which does not have a significant retail base in NSW).

3. Public benefits

- 3.1. The ACCC's provisional view is that the public benefits AGL asserts flow from the proposed acquisition can be achieved by other means, are not certain to materialise and are unlikely to be significant. The ACCC notes in many instances AGL has not attempted to quantify the benefits and that the benefits (many of which may largely accrue to AGL) are likely to be at the expense of the broader community which will likely pay more for electricity.
- 3.2. AGL's public benefit claims are set out in its Form S application at paragraphs 21.1 to 21.45. Broadly these claims are:
 - a. more reliable, long-term, base load electricity supply into the NEM, at lower cost and with reduced environmental impact, as a result of increased maintenance and capital expenditure under the proposed acquisition;
 - b. lower costs in the generation and wholesale supply of electricity and lower costs in the retail supply of electricity to end-users as a result of vertical integration efficiencies created by the proposed acquisition; and
 - c. increased prospects of useful public infrastructure being developed in NSW (with a reduction in the need for NSW to consider alternative funding

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arrangements) as a result of the State of NSW receiving the sale proceeds from the proposed acquisition.

3.3. Each of these claims is considered in more detail below.

Increased availability and efficiency from AGL ownership of Bayswater and Liddell

3.4. AGL claims that following the proposed acquisition it will:

- a. invest approximately \$345 million in the maintenance of, and capital expenditure on, the Bayswater and Liddell power stations over the projected life of those assets, in addition to the planned levels of future investment in Bayswater and Liddell of current Macquarie Generation management;
- b. apply 'whole of life' planning principles and AGL's technical capability and expertise to the maintenance and operation of the Bayswater and Liddell power stations; and
- c. capture annual cost savings in labour costs [REDACTED] and improve Macquarie Generation staff engagement to create value.

3.5. As a result of these increased efficiencies, AGL asserts that there will be:

- a. higher levels of likely availability, lower risk of unplanned plant failure, a reduced requirement for AGL to have other higher cost generation plants on line but not generating at full capacity and likely reduced incidence of plant start ups;
- b. reduced environmental impacts, safer operation of plants, reduced overall cost of maintenance, repair and capital investment and increased prospect of extending the operating period of the Bayswater plant or preserving that option at lower cost; and
- c. reduced price volatility and lower prices in the wholesale supply of electricity into the NEM, potential deferral of further investment in base load generation assets in NSW, thereby delivering a more reliable, long-term, base load electricity supply into the NEM, at lower cost, and with reduced environmental impact.

3.6. AGL also claims that all else equal, higher levels of likely availability of the generation units at the Bayswater and Liddell power stations will result in increased supply of hedge contracts for electricity retailers.

3.7. AGL further claims that it will employ (or will retain contractors which, in turn, will employ) further technicians and other labour in the Hunter Valley region, in implementing its planned increased levels of capital and maintenance expenditure at Bayswater and Liddell.

3.8. The ACCC's provisional view is that:

- a. with the possible exception of the labour cost savings, it is highly likely that the efficiencies identified by AGL will be realised absent the proposed

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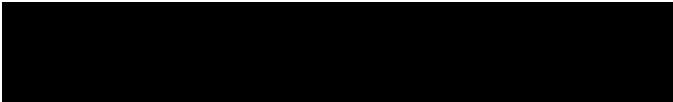
acquisition. In this regard the ACCC notes that the State of NSW and Macquarie Generation considers [REDACTED]

- b. with the possible exception of the labour cost savings, the benefits of the efficiencies identified by AGL are likely to be offset to a significant degree by the cost of achieving the efficiencies;
- c. the labour cost savings, if realised, may constitute a public benefit, however there is some doubt as to whether all of these savings would be achieved in the absence of the proposed acquisition, whether these savings would be achieved in the near future and whether these savings are material;
- d. when taken as a whole, the proposed acquisition will result in a reduced supply of hedge contracts to retailers, not an increase in the supply as claimed by AGL;
- e. the benefits of achieving the efficiencies are likely to mainly accrue to AGL. Specifically:
 - a. any effect the achievement of these efficiencies may have on the wholesale price of electricity is uncertain, and potentially very small as the claimed efficiencies will have minimal effect on the marginal cost of generating electricity in NSW or the NEM more broadly. Moreover, when considered as a whole, the proposed acquisition, by creating or increasing AGL's market power in the supply of electricity in the NEM, may result in higher wholesale electricity prices; and
 - b. the efficiencies are unlikely to result in lower electricity prices for end-users. Rather, the proposed acquisition, by creating a market structure less conducive to competition will likely result in higher electricity prices for end-users; and
- f. As there is no evidence to suggest any efficiency benefits will flow through to the broader community, this should be taken into account when attributing weight to them.

3.9. Moreover, AGL has not attempted to quantify the value of most of the claimed efficiency benefits. The process of quantifying such benefits would shed greater light on which of the claimed efficiencies generate benefits over and above the cost of achieving those benefits, which claimed benefits are transfers between parties (and hence not an efficiency) and the assumptions underpinning the likely attainment of the claimed efficiencies.

Issues for consideration – public benefit claim: increased availability and efficiency from AGL ownership of Bayswater and Liddell

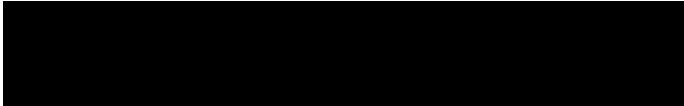
- 1. Is there a real chance that the claimed efficiencies would eventuate in the future without the proposed acquisition?
- 2. What is the value of the claimed efficiencies?



3. What are the costs of achieving the claimed efficiencies?
4. Who are the beneficiaries of the claimed efficiencies? Will the benefits flow through to the broader community or will the claimed efficiencies mainly accrue to AGL?
5. Will the claimed efficiencies flow through to lower electricity prices to end-users? If so, how and why will this occur? If they are passed through, will they be offset by other consequences of the proposed acquisition resulting in end-users paying more for electricity?

Vertical integration efficiencies

- 3.10. AGL claims that vertical integration of AGL with the Macquarie Generation assets will result in significant cost reductions and other efficiencies.
- 3.11. According to AGL, the combined AGL/Macquarie Generation entity is likely to incur lower costs than the sum of the costs of the stand-alone retailer and stand-alone generator operations currently. AGL claims these costs savings will come from:
 - a. aligning the preferences as to the duration and structure of hedge contracts (variable quantity or fixed quantity);
 - b. avoiding the transaction costs and hold-out risks of securing hedge contracts to manage its energy purchase cost risk/energy sales risk; and
 - c. avoiding the costs of failing to cover all of its market risks with hedge contracts, or avoiding the very high costs of doing so.
- 3.12. AGL claims in the competitive context within which AGL will operate, these efficiencies are likely to result in lower wholesale and retail electricity prices in the NEM or NSW.
- 3.13. The ACCC's provisional view is that:
 - a. the efficiencies from vertical integration identified by AGL (if realised) constitute public benefits;
 - b. these benefits will accrue solely or largely to AGL and will largely not be shared by the broader community;
 - c. these efficiencies are unlikely to result in lower wholesale and retail electricity prices, rather the proposed acquisition when considered as a whole will likely result in higher wholesale and retail electricity prices in NSW and/or the NEM more broadly;
 - d. these efficiencies will not result in lower electricity prices for end-users - rather the proposed acquisition when considered as a whole will likely result in higher electricity prices for end-users;

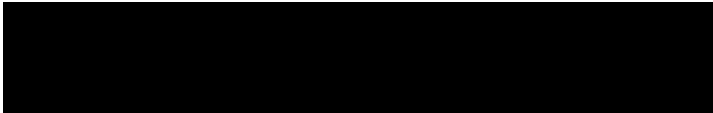
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- e. vertical integration will alter the relevant market structure and there are considerable detriments associated with the resultant market structure (these detriments are discussed further in Section 4 (Public Detriments) below); and
 - f. as AGL has not sought to quantify the size of these efficiencies:
 - it is not possible to conclude they are significant; and
 - it is difficult to net off the costs of vertical integration necessary to achieve these efficiencies.

Issues for consideration - public benefit claim: increased vertical integration efficiencies

- 6. What is the value of the claimed vertical integration efficiencies?
- 7. What are the costs of achieving the claimed vertical integration efficiencies?
- 8. Who are the beneficiaries of the claimed vertical integration efficiencies? Will the benefits flow through to the broader community or will the claimed vertical integration efficiencies mainly accrue to AGL?
- 9. Will the claimed vertical integration efficiencies result in lower wholesale electricity prices in NSW or the NEM more broadly?
- 10. Will the claimed vertical integration efficiencies result lower electricity prices for end-users? If so, how and why will this occur? If they are passed through, will they be offset by other consequences of the proposed acquisition resulting in end-users paying more for electricity?
- 11. Will the claimed vertical integration efficiencies be offset by the detriments created as a result in the change in market structure?

Funds invested in NSW public infrastructure

- 3.14. AGL claims that the contribution of the net proceeds from the sale of Macquarie Generation to the Restart NSW Fund will deliver the following public benefits:
- a. increased prospects of useful public infrastructure being developed in NSW, with the wider economic and social benefits that completion of such infrastructure will bring;
 - b. a reduction in debt funding otherwise required from the NSW Government to fund infrastructure projects;
 - c. increased prospects of the NSW Government retaining its AAA credit rating, and lower cost of debt;
 - d. a reduction in the prospect of decreased public transport and other existing NSW Government subsidies and/or decreased public expenditure on existing NSW Government programs;
 - e. reduced prospects of increased taxation by the NSW Government;

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- f. a reduction in the prospect of NSW Government capital being diverted away from other NSW Government investment priorities; and
 - g. reduced call for contributions from Commonwealth funds for NSW infrastructure projects.

3.15. The ACCC's provisional view is that:

- a. The State of NSW, as owner of Macquarie Generation, currently receives an ongoing income stream. AGL has failed to consider the public benefits from the State of NSW continuing to own Macquarie Generation – including the ability of the State of NSW to use the income stream from the assets to fund borrowings for future infrastructure projects;
- b. Any benefit flowing to the State of NSW, or the public of NSW more broadly, from the sale of Macquarie Generation will be the difference between the sale proceeds and the State of NSW's retention value of the asset (which reflects the value to the State of NSW of retaining the asset) or the proceeds from selling the asset to another party (whichever is greater). The retention value figure is not known from the current available information and will be required for the Tribunal to be able to assess this claimed benefit;
- c. as AGL has not attempted to identify or quantify the benefits from the infrastructure projects likely to be funded by the sale proceeds, it is difficult to conclude if those projects will result in a net public benefit; and
- d. it is likely that the State of NSW will continue to invest in socially beneficial infrastructure with or without the proposed acquisition.

Issues for consideration – public benefit claim: funds invested in NSW public infrastructure

- 12. Will the proposed acquisition increase the prospects of socially beneficial public infrastructure being developed in NSW? If so, how and why will this occur?
- 13. What are the implications for the State of NSW's financial capacity to fund infrastructure projects from the loss of the future income stream from Macquarie Generation?
- 14. What is the likely value of the claimed infrastructure benefits?

Magnitude of the public benefits

- 3.16. No other public benefits have been identified as likely to result from the proposed acquisition. Accordingly, the Tribunal's task will be to assess the magnitude of the public benefits associated with efficiencies which are claimed by AGL to be likely to result from the proposed acquisition.
- 3.17. The magnitude of the public benefits associated with the claimed efficiencies is likely to be impacted by both their quantum and their likelihood of occurring. Based on the limited information provided by AGL in its application, the ACCC's provisional view is

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that the public benefits claimed to be likely to result from the proposed acquisition appear uncertain and in any case are unlikely to be significant.

Issues for consideration – magnitude of public benefits

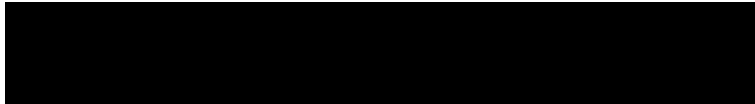
15. Are there any other public benefits that are likely to result from the proposed acquisition? If so, what is the magnitude of any such benefits?
16. Which of AGL's claimed public benefits are likely to occur and which are uncertain?
17. Which of AGL's claimed public benefits are likely to largely accrue to AGL and which are likely to accrue to the community more broadly?
18. What is the magnitude of each of the public benefits identified as resulting from the proposed acquisition?
19. To what extent will the magnitude of the public benefits be affected by Macquarie Generation remaining owned and operated by the State of NSW; or being sold to another purchaser in the future without the proposed acquisition?

4. Public detriments

- 4.1. The ACCC's provisional view is that the proposed acquisition is likely to lead to significant public detriment. Markets work well when firms are subject to competitive constraints from other firms in the market or those that could readily enter into it.
- 4.2. The ACCC's provisional view is that the proposed acquisition is likely to raise barriers to entry and expansion for electricity retailers in NSW and result in a permanent market structure dominated by three large vertically integrated 'gentailers'. The ACCC considers that such a market structure would be likely to lead to significantly higher electricity prices to consumers in NSW compared to a market structure where smaller electricity retailers can readily enter and expand.
- 4.3. The ACCC also recognises that the proposed acquisition would represent a significant aggregation of generation capacity across the NEM, resulting in AGL owning the largest amount of generation capacity in NSW, Victoria and South Australia and significantly more than any other operator in the NEM. The ACCC's preliminary view is that this gives rise to the potential for adverse wholesale market outcomes in NSW and the NEM.

Markets in which to assess the competitive effects of the proposed acquisition

- 4.4. The ACCC's provisional view is that there are two markets relevant to the assessment of the proposed acquisition's effect on competition:
 - a. a market for the generation and wholesale supply of electricity in NSW and/or the NEM; and
 - b. a market for the retail supply of electricity to end-users in NSW.

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- 4.5. The ACCC considers that there is a distinct market for the retail supply of electricity to end-users in NSW. There are substantial differences in retail markets between different States, including the relevant regulatory framework and licensing requirements. In addition, as outlined in more detail below, the ACCC considers that retailers supplying end-users in NSW largely require hedge contracts which reference the spot price in NSW, an input required by retailers in NSW and not in other States.

The competitive effects of the proposed acquisition

Retail supply of electricity

- 4.6. The ACCC's provisional view is that the proposed acquisition would raise barriers to entry and expansion for electricity retailers in NSW and also result in the creation of a permanent market structure dominated by three large vertically integrated entities to the detriment of NSW consumers. The ACCC considers that there are three key issues to be considered by the Tribunal in its assessment of AGL's application:
- a. The nature of the risk management instruments (hedge contracts) required by electricity retailers to effectively manage the risks associated with supplying electricity to end-users in NSW;
 - b. The ability of electricity retailers, particularly those that are not vertically integrated, to obtain the hedge contracts that they require to effectively compete in NSW following the proposed acquisition. This includes the ability and incentive of AGL to supply such products to them and whether the trading of hedge contracts in NSW will remain sufficiently liquid to meet their requirements; and
 - c. Whether the retail market structure likely to arise in NSW following the proposed acquisition will lead to materially less competitive outcomes than the likely market structure in the absence of the proposed acquisition.

Hedge contracts required by retailers in NSW

- 4.7. Appropriately priced and customised hedge contracts are a critical input for electricity retailers and a reduction in their availability, including an increase in the price or a deterioration of the terms of supply of such contracts, would represent an increase in barriers to entry and expansion in the market for the retail supply of electricity.
- 4.8. The ACCC accepts that electricity retailers are able to use a wide range of risk management products to manage risks associated with supplying electricity to their retail load. However, the ACCC also considers that many electricity retailers, particularly smaller retailers that are not vertically integrated, are more effectively able to compete when they can acquire swap contracts referenced to the NSW spot price to cover their NSW retail customers' demand as this provides certainty over the costs of supply. Therefore, the ACCC considers that access to appropriately priced and customised swap contracts referenced to the NSW spot price is critical to the ability of smaller retailers to enter and expand in the NSW market for the retail supply of electricity.
- 4.9. The ACCC also understands that retailers are able to use swap contracts that reference the spot price in another region to cover risks associated with their NSW retail customer load. However, the ACCC's view is that such swap contracts are not an effective alternative for contracts referencing the NSW spot price. This is because


swap contracts that reference non NSW spot prices expose retailers to the risk of price separation between those regions and therefore does not provide an effective hedge against high NSW spot prices. This undermines the risk management purpose of acquiring hedge contracts, creating additional material costs for that retailer and potentially causing that retailer cash flow management problems which hedge contracts can mitigate. These factors undermine the effectiveness of hedge contracts referenced to spot prices in different regions and create additional costs and uncertainty for retailers that use them.

Issues for consideration – retail supply of electricity: hedge contracts required by retailers in NSW

20. What are the contractual instruments used by non-vertically integrated electricity retailers in NSW to effectively manage risks associated with the retail supply of electricity (including risks associated with the electricity spot price and customer volumes)? In particular:
- a. To what extent do electricity retailers in NSW require swap contracts (as opposed to other risk management tools including cap contracts) to effectively manage the price risk associated with their retail load?
 - b. To what extent do electricity retailers in NSW require over-the-counter (OTC) contracts entered into directly with a generator (or assisted by a broker), including OTC contracts customised to the needs of the electricity retailer, as opposed to exchange traded contracts (ETCs) which are standardised in nature to effectively manage the price or volume risk associated with their retail load?
 - c. To what extent are electricity retailers in NSW able to effectively manage risks associated with supplying electricity to NSW retail customers by purchasing forward contract instruments which reference the spot price in other regions of the NEM?
 - d. To what extent are electricity retailers in NSW able to effectively manage risks associated with supplying electricity to NSW retail customers by participating in AEMO Settlement Residue Auctions (SRAs) to purchase inter-regional settlement residues (IRSRs)?
21. To what extent would a reduction in the availability of hedge contracts as identified in 20.a – 20.c above, an increase in price of these contracts or a deterioration in the terms of supply of such contractual instruments represent an increase in barriers to entry or expansion for the retail supply of electricity in NSW?


Ability of retailers to obtain hedge contracts

- 4.10. The ACCC does not agree with AGL's submissions that the sources of hedge contracts in NSW available to non-integrated electricity retailers in NSW, other than Macquarie Generation, are sufficient to support a competitive retail market. In addition, the ACCC's provisional view is that AGL's ownership of Macquarie Generation is likely to result in a material reduction in the combined AGL/Macquarie



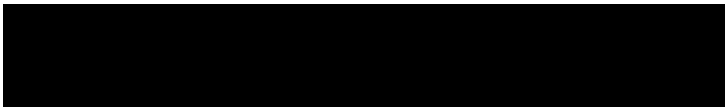
Generation's incentive to supply hedge contracts to other retailers, relative to any other likely alternative owner.

- 4.11. The ACCC considers that the generation portfolios owned by independent generators in NSW are the most reliable and viable source of supply of hedge contracts used by retailers to manage risks associated with the retail supply of electricity in NSW. The ACCC considers that baseload generators, which are the most secure and reliable sources of significant volumes of swap contracts, are a particularly important source of such contracts.
- 4.12. The ACCC recognises that vertically integrated generators may have some incentive to supply hedge contracts, however it considers that the importance of such generators as a firm and reliable source of supply of hedge contracts is affected by a number of factors, including:
- a. The capacity of such generators will not be offered to support hedge contracts in the open market to the extent that the generator's output is used as a 'natural hedge' to support the generator's integrated retail offering;
 - b. Vertically integrated generators have an incentive to grow their retail operations to take advantage of the natural hedge that their generation provides, which is likely to result in a diminution of the amount of surplus capacity that such generators have available over time, as their retail operations expand; and
 - c. To the extent that alternative sources of supply are not sufficient to meet the demand of other retailers for hedge contract cover, the ACCC considers that vertically integrated generators have an incentive to use their market position to prevent competing retailers from gaining access to the types of hedge contracts that they require on terms which enable them to be strongly competitive with the integrated generator's retail arm.
- 4.13. The ACCC's provisional view is that, following the proposed acquisition, the total volume of appropriately priced and customised hedge contracts available for other retailers in NSW would be diminished for a number of reasons. The ACCC considers AGL would use the output of Macquarie Generation to support its retail load and, to the extent that it then is able to grow its retail presence over time to balance its retail and generation output, the total volume of hedge contracts traded between parties in NSW would diminish.
- 4.14. In addition, the ACCC's provisional view is that AGL would have a material incentive not to supply hedge contracts to competing retailers on terms which enable those retailers to vigorously compete with its retail business. This is because it appears that the potential profits associated with supplying electricity to retail end-users is greater than the potential profits associated with providing hedge contracts to other retailers.
- 4.15. The ACCC's provisional view is also that AGL would have the ability to act on that incentive due to the insufficiency of the alternative sources of hedge contracts in NSW to meet the requirements of competing retailers over time, which may otherwise constrain AGL from taking such a step. The ACCC considers that the combined AGL/Macquarie Generation entity would be in a position to practically or absolutely withhold such contracts from competing retailers in circumstances where there are insufficient alternative sources of supply to meet the current and future needs of emerging and expanding retailers in NSW.

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- 4.16. The ACCC has also formed the provisional view that the proposed acquisition would lead to a material reduction in the liquidity of hedge contract trading in NSW. This is because AGL would seek to take advantage of the potential efficiencies from vertical integration by using the output of Macquarie Generation as a natural hedge for its retail load in NSW. This will significantly reduce the volume and type of forward contract trading which will occur in NSW, as AGL will no longer purchase the volume of contracts that it would otherwise use to manage risks associated with its NSW retail load and Macquarie Generation will no longer supply contracts to the extent that its output is used to support the natural hedge. The removal of AGL and Macquarie Generation as two significant participants who actively trade large volumes of hedge contracts will adversely impact the liquidity of the hedge contract trading in NSW. The ACCC considers that this reduction in liquidity is likely to materially reduce the breadth of contracting options available to retailers in NSW which would affect their ability to appropriately manage risks associated with their NSW retail load, deterring new retail entry and hindering the potential for expansion by emerging retailers.
- 4.17. The ACCC understands that financial intermediaries and the ASX Energy exchange are important sources of hedge contracts. However, the ACCC considers that these are secondary sources of supply and will only provide or facilitate the supply of hedge contracts to the extent that the relevant instruments are ultimately backed by a generator. The ACCC's provisional view is that a reduction in the volume or liquidity of hedge contract trading activity in NSW, arising from AGL's vertical integration and its use of the natural hedge afforded by Macquarie Generation to support its retail activities, could result in a reduction in the market participation of financial intermediaries in NSW, or could result in an increase in the premium that such parties charge to provide services in NSW. This would make it more difficult for non-integrated retailers to obtain appropriately priced and customised hedge products to meet their current and future needs for entry and expansion in the NSW retail electricity market.

Issues for consideration - retail supply of electricity: ability of retailers to obtain hedge contracts

22. Who are the providers of hedge contracts used by electricity retailers in NSW to manage risks associated with the retail supply of electricity to customers in NSW? To what extent do each of the following potential providers of hedge contracts provide a firm and competitive source of risk management for electricity retailers in NSW:
- a. Macquarie Generation;
 - b. Delta Electricity;
 - c. Snowy Hydro;
 - d. generation assets owned by Energy Australia and/or Origin;
 - e. financial intermediaries (e.g. ANZ, Westpac);
 - f. contracts traded on the ASX Energy exchange;
 - g. generators not located in NSW; and/or
 - h. any other provider.

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23. To what extent would these alternative sources of hedge contracts used by electricity retailers in NSW, other than Macquarie Generation, provide a competitive constraint on the combined AGL/Macquarie Generation seeking to practically or absolutely withhold such contracts from competing retailers?
 24. To what extent would AGL have an incentive to sell competitively priced and customised hedge contracts to independent retailers in NSW, despite the possible effect on its retail business?
 25. To the extent that AGL uses Macquarie Generation as a 'natural hedge' against its existing retail customer load in NSW, what impact would the resulting reduction in liquidity in the trading of hedge contracts in NSW have on the ability of retailers to obtain access to hedge contracts at competitive prices and sufficient breadth of contracting options to manage their risks associated with the retail supply of electricity to customers in NSW?

Market structure following the proposed acquisition

- 4.18. The ACCC's provisional view is that the proposed acquisition is likely to result in a market structure dominated by three large vertically integrated 'gentailers': Origin Energy, EnergyAustralia and AGL, in a way that has not been seen in any other market in the NEM.
- 4.19. The ACCC does not accept AGL's submission that the electricity retail market in NSW is likely to be competitive following the proposed acquisition, nor does it accept that competition from Origin and EnergyAustralia would be likely to be effective in the absence of a threat of entry and expansion by other retailers.
- 4.20. The ACCC provisional view is that that competition between three large, vertically integrated, 'gentailers' is likely to become muted over time without the existence or threat of competition from other strong retailers. The ACCC considers that 'second tier' retailers provide an important competitive constraint on the pricing behaviour of the larger firms and that they contribute to the development of innovative products and services for customers in the market. The ACCC considers that the threat of entry or expansion by such firms represents a dynamic source of competition and that the proposed acquisition would prevent or hinder this source of competition by creating a significant barrier to non-integrated retailers meaningfully participating in the NSW market.
- 4.21. The ACCC notes that following the proposed acquisition, the three major vertically-integrated retailers would have approximately 70 per cent of electricity generation capacity and approximately 80 per cent of electricity generation output in NSW as well as over 85 per cent of the retail electricity load in NSW. The ACCC considers that this would represent a highly concentrated market structure, particularly in light of the fact that the ACCC also considers that the proposed acquisition would raise barriers to entry and expansion for non-integrated retailers in NSW.
- 4.22. The ACCC considers that a lack of liquidity in the trading of hedge contracts creates uncertainty about whether independent retailers will be able to source electricity risk management products at competitive prices and on appropriate terms, creating a barrier to entry and expansion and a risk to businesses. It has formed the provisional view is that the market structure that is likely to arise following the proposed acquisition would not be conducive to the maintenance and development of liquid

trading hedge contracts. The ACCC considers that this reduction in liquidity in the trading of hedge contracts in NSW would limit the ability of non-integrated retailers to exert a strong competitive constraint on the major 'gentailers' over time and hence would further consolidate the gentailers' position in the market.

Issues for consideration - retail supply of electricity: market structure following the proposed acquisition

26. To what extent will the impact of the proposed acquisition result in a market structure dominated by three vertically integrated 'gentailers' in NSW, or the NEM more broadly in the longer term?
27. To the extent that the proposed acquisition did result in such a market structure, in what ways and to what extent would this market structure be more or less competitive than the market structure which is likely to exist in the absence of the proposed acquisition?
28. Is the proposed acquisition likely to result in a lessening of competition in the market for the retail supply of electricity in NSW?

Wholesale supply of electricity

- 4.23. AGL is currently the largest electricity generator in Victoria (with 29 per cent of capacity) and South Australia (with 38 per cent of capacity). Following an acquisition of Macquarie Generation, AGL would also become the largest electricity generator in NSW (with 28 per cent of capacity). It would also own the lowest cost generators in each of these states.
- 4.24. The ACCC's provisional view is that because AGL has a large portfolio of generation assets across the NEM, including the largest share of generation in Victoria and South Australia, a withdrawal of electricity supply that causes an increase in wholesale spot prices will be a more profitable strategy, and therefore may be a more likely strategy, for AGL compared to other likely owners of Macquarie Generation. This is because the benefits of the higher prices caused by a withdrawal of supply would be spread across a larger generation portfolio.

Issues for consideration – wholesale supply of electricity

29. Would the proposed acquisition provide AGL with an increased ability and incentive to withhold generation capacity from the market in a manner which would result in a material increase in aggregate spot market price outcomes in one or more regions of the NEM, relative to any other likely owner of Macquarie Generation?
30. Would AGL have an increased ability and incentive to effect the premature retirement or mothballing of some or all of Macquarie Generation's assets in order to cause a material increase in aggregate spot market price outcomes in one or more regions of the NEM, relative to any other likely owner of Macquarie Generation?



Other detriments

- 4.25. There may be other public detriments that the ACCC has not addressed in this document but which are identified by market participants.

Issues for consideration – other detriments

31. Are there any other public detriments that are likely to result from the proposed acquisition and what is the magnitude of any such detriments?

5. Conditions of authorisation

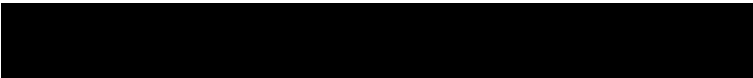
- 5.1. AGL has requested that the Tribunal grant authorisation of the proposed acquisition subject to conditions. The conditions are set out in Annexure H to AGL's application (the conditions). The effect of the Tribunal granting authorisation of the proposed acquisition on the conditions, is that AGL would be subject to the following obligations:
- a. AGL must offer, or enter into, a prescribed quantity of products priced with reference to the NSW regional reference price (RRP) (either an exchange-traded futures contract (ETF) or an over the counter (OTC) product that is on the same terms as the equivalent ETF product), for a period of six and a half years beginning on the date six months after completion of the Proposed Acquisition (**Liquidity Obligation Term**).
 - b. The quantity of products AGL is to offer, or enter into, is at least 250MW of such products in each NEM trading interval during the first 26 whole weeks of the Liquidity Obligation Term, and at least 500MW of such products for each NEM trading interval for the balance of the Liquidity Obligation Term.
 - c. The proposed orders are intended to facilitate the supply of products priced with reference to the NSW RRP to parties other than AGL, by requiring AGL to offer, or enter into, the required quantity of products for the NEM trading interval by one or more of the following methods (other than products involving Macquarie Generation, or for which AGL is the purchaser):
 - i. offering or entering into products that are OTC products directly with NSW retailers (other than AGL, EnergyAustralia or Origin);
 - ii. placing an offer to enter, or entering, into OTC products through a broker with a NSW retailer or person that holds an Australian Financial Services Licence (AFSL) (other than to AGL); and/or
 - iii. executing one or more price or quantity orders for ETF products placed on the futures exchange operated by ASX Energy Limited (ASX) (other than an order in relation to which AGL is the purchaser or acquirer).



- d. The conditions deem that AGL has offered to enter into the required quantity of products (less the quantity that has already been entered into), where, in respect of a NEM trading interval, AGL has offered to enter into a minimum quantity (being 20MW) of products, which includes that NEM trading interval, over 120 trading days in the previous 12 months at a price that is no more than \$0.75 higher (measured in \$/MWh) than the most recent trading day's clearing price for the equivalent ETF product immediately before the day on which the offer was made, or the price of the last trade on the ASX for which AGL was not a party (**Offer Condition**).
- e. In relation to NSW retailers:
 - i. AGL must negotiate in good faith, on request of a NSW retailer other than AGL, Origin Energy or EnergyAustralia, to enter into a product, provided that the Offer Condition has not already been satisfied; and
 - ii. If requested by a NSW retailer, AGL must offer a quantity of the requested product to that retailer. For each business day, the quantity of the products that is to be offered to NSW retailers, pursuant to this condition, is capped at an aggregate of 50MW for each trading interval of products entered into with all NSW retailers for that day. This obligation applies afresh each business day. The price of the offer must be no more than \$0.75 higher (measured in \$/MWh) than the most recent trading day's clearing price for the equivalent ETF product immediately before the day on which the request was made or the price of the last trade on the ASX for which AGL was not a party. This obligation does not apply if the Offer Condition has been satisfied for the NEM trading interval.

5.2. The ACCC's provisional view is that the proposed conditions are unlikely to address the public detriments arising from the proposed acquisition. The ACCC's provisional view is based on a number significant concerns regarding the likely effects of the proposed acquisition that cannot be addressed by conditions of authorisation. In particular, the ACCC is concerned that:

- a. Even if the conditions could effectively maintain liquidity in trading of the relevant hedge contracts, they do not address the permanent structural change that would result from the proposed acquisition and remain following expiration of the conditions and, therefore, the conditions do not and cannot address long term harm arising from the proposed acquisition.
- b. Behavioural conditions of the nature proposed, that require AGL to offer products in a narrowly defined manner that does not take account of potentially dynamic market conditions, cannot adequately replace naturally competitive trading of hedge contracts or be relied on to maintain a liquid market for the term of the conditions.
- c. If liquidity is lost during the term of the conditions, there is no mechanism to re-establish a liquid market. This is because the price-setting mechanism in the obligation references previous market trades.
- d. There are significant risks that AGL may be in a position to circumvent the conditions.



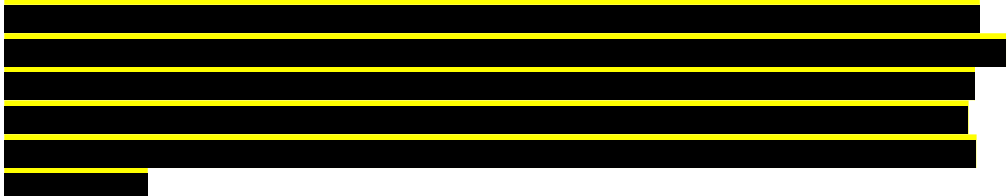
- e. Drafting conditions that effectively address the potential risks associated with behavioural obligations in a complex, potentially dynamic market is likely to be extremely difficult.
- f. It is not clear whether the quantity of 500MW will be sufficient to maintain liquidity throughout the term of the conditions.
- g. The conditions do not address any detriments associated with any reduction of competition in relevant wholesale markets for the supply of electricity caused by the aggregation of Macquarie Generation's generation portfolio with AGL's existing generation portfolio.

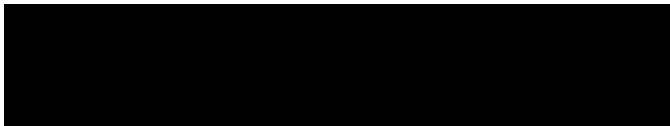
5.3. The ACCC is particularly concerned about the risk that AGL may directly or indirectly circumvent the conditions, rendering the conditions ineffective. Possible circumvention risks include:

- a. AGL may be in a position to circumvent the obligations by entering an off-setting transaction at the same time, or potentially another time, for example, by simultaneously entering two separate transactions – one to sell a product and one to buy the exact same product. This could be achieved through a financial intermediary, some of which are retailers (as defined in the conditions), for a potentially insignificant transaction charge. Such transactions could be entered off market such that there is no visibility and no impact on liquidity, and would instantly fulfil AGL's obligations pursuant to the conditions.
- b. It may also be open to AGL to strategically offer products to certain retailers that it is aware will not be in a position to accept the offer. For example, it could offer large quantities (potentially up to 500MW) to a small retailer who is financially incapable of accepting the offer.
- c. If at some stage during the term of the conditions there is a particular exchange product that is not being regularly traded such that the market for that particular product becomes illiquid, AGL could fulfil its obligations by offering that illiquid product knowing that it will not be accepted and will not add to liquidity in the market. AGL may be in a position to offer different exchange products at different times depending on which products are illiquid at any particular time. This is particularly the case as offers are only required to be open for one hour at a time.

5.4. Given the complexity of the markets, there may be of other circumvention risks that the ACCC has not yet identified.

5.5. In relation to the ACCC's concern that a set of static behavioural conditions of the nature proposed cannot address concerns in a potentially dynamic market, the ACCC notes the potential for a number of market changes throughout the term of the conditions, including:

- a. 

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- b. The conditions include a Review Event for circumstances beyond the reasonable control of AGL. If a Review Event occurred and the conditions were varied or suspended by the Tribunal, liquidity in the market may be lost and there is no mechanism to re-establish liquidity.

Issues for consideration – conditions of authorisation

32. In principle, are the conditions capable of effectively addressing any detriments arising from the proposed acquisition?
33. Are there any risks that might undermine the effectiveness of the conditions, including any risk that AGL may be able to circumvent the conditions?
34. Are there any likely market events or changes that could undermine the effectiveness of the conditions?