



Australian Competition and Consumer Commission

Submission to the Productivity Commission *Discussion draft: National Competition Policy Reforms*

10 December 2004

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Abbreviations

ACCC	Australian Competition and Consumer Commission
CoAG	Council of Australian Governments
Discussion draft	<i>Review of National Competition Policy: Productivity Commission Discussion Draft</i>
EMS	<i>Emerging market structures in the communications sector report prepared by the ACCC</i>
FERC	Federal Energy Regulatory Commission (of the United States)
HFC	Hybrid fibre coaxial
NCP	National Competition Policy
NEM	National Electricity Market
OECD	Organisation of Economic Cooperation and Development
TPA	<i>Trade Practices Act 1974 (Cth)</i>

Executive Summary

This submission considers those proposals relevant to the responsibilities of the ACCC that were contained within the *Discussion draft into National Competition Policy Reforms*. The ACCC broadly supports the proposed recommendations that will affect its role as the relevant competition and economic regulator across the economy. This submission suggests how proposals for reform in trade practices, energy and telecommunications could be enhanced to deliver further benefits.

National Competition Policy (NCP) reforms have broadened the scope of the conduct provisions of the *Trade Practices Act 1974* (TPA) to generally allow it to function as the economy-wide law to protect competition within the economy. The extension of this law has been a key driver in promoting competitive conduct across the economy and providing incentives for competitive behaviour by firms previously outside the scope of the TPA. The authorisation provisions of the TPA continue to be an effective mechanism for allowing otherwise prohibited anti-competitive restrictions that can be demonstrated to be in the public interest.

The TPA's capacity to protect competition, and the positive benefits of doing so, can be enhanced through further law reform. To ensure that a national approach to consumer protection can be realised and that the TPA operates effectively to achieve its objective, the ACCC supports the draft proposal to conduct a review of consumer protection policy.

The scope of competitive pressures across the economy could be increased through removing derivative 'shield of the Crown' immunity claimed by private companies. This would allow the TPA to be consistently applied to all businesses. Consideration should be given to allowing the ACCC to appear at anti-dumping hearings where the competitive effects of imports were cited as substitutes in merger matters. These measures will provide further pro-competitive incentives.

There are further measures which are necessary to facilitate competitive markets. The TPA is not an effective instrument for promoting structural reform in integrated industries and this was recognised in the Hilmer Report and the Competition Principles Agreement. The ACCC identifies market structure issues as a priority requiring a response over and above the TPA in the energy and telecommunications industries.

In the telecommunications industry there is a need to determine if structural reform of Telstra is appropriate. In the absence of structural separation, then 'operational' separation of its business units, remaining under common ownership, is necessary to protect and promote competition.

The implications for the National Electricity Market, and the economy more generally, arising from vertical integration and generator market power in the electricity industry are important issues in the context of any considerations of promoting and protecting competitive market structures. This submission provides additional information on merger activity over the past five years and further analysis of the implications of generator market power and further re-aggregation. The ACCC encourages the Productivity Commission to closely review this material in finalising its recommendations.

Chapter 1 Introduction

The Productivity Commission's review of national competition policy reforms provides an opportunity for the community to comment on the effects and future direction of structural economic reform commenced in the mid-1990s. The *Discussion draft into National Competition Policy Reforms* (discussion draft) provides an important overview of the impact of NCP and the need to consolidate and extend the NCP framework.

The ACCC welcomes this opportunity to provide comments on the discussion draft's proposals and has identified areas where further reforms to NCP are important and are likely to provide ongoing benefits to the community and the economy. This submission recommends that draft proposals in relation to trade practices, electricity and telecommunications should be strengthened. These areas are relevant to the responsibilities of the ACCC and these comments are based upon its regulatory and TPA administration experience.

1.1 Discussion draft's analysis and recommendations

The Productivity Commission's discussion draft report on NCP reforms recognises that NCP has been a landmark achievement in economic reform and has despite, adjustment and implementation costs, yielded benefits to the community.¹ The transition costs have been incurred and there are further benefits to be accrued from additional reforms.

Specifically, the discussion draft identifies that the net benefits of NCP to the economy and the community are represented in:

- Australia's impressive productivity performance,² which has been reflected in growing real per capita incomes³
- reductions in prices for some, but not all goods and services⁴
- the increased range of goods and services available to consumers.⁵

These net benefits have contributed to improvements in Australia's economic performance over the decade.⁶ While these achievements have been impressive there are new challenges from globalisation, population changes and pressures to improve environmental outcomes.⁷ Meeting these challenges and sustaining the benefits of reforms requires Australia to continue to improve its economic performance.

¹ Productivity Commission (2004), *Discussion Draft: Review of National Competition Policy Reforms*, p.xiii.

² Productivity Commission (2004), *NCP Discussion Draft*, pp.38 – 39, 44

³ Productivity Commission (2004), *NCP Discussion Draft*, p.36

⁴ Productivity Commission (2004), *NCP Discussion Draft*, pp.52 – 57

⁵ Productivity Commission (2004), *NCP Discussion Draft*, pp.65 – 67

⁶ Productivity Commission (2004), *NCP Discussion Draft*, pp.xvi – xxi

⁷ Productivity Commission (2004), *NCP Discussion Draft*, pp.xvi – xxv

In recognition of emerging challenges to Australia's economic performance, the discussion draft made 18 proposals for further nationally coordinated reforms that are likely to yield significant benefits to the community.⁸ This submission directly addresses four of these proposals.

1.2 This submission

This submission makes recommendations to protect and promote competition which are intended to achieve a significant benefit for the community and the economy, specifically:

The TPA and protecting competition

The ACCC supports the discussion draft's proposals for:

- reviewing consumer protection policy to determine how its operation could be improved
- ensuring that those engaged in commercial activities cannot inappropriately claim derivative 'shield of the Crown' and gain exemption from the TPA

This submission reiterates the ACCC's view that consideration ought to be given to the appropriateness of exemptions under s.51(1) of the TPA and whether the authorisation provisions of the TPA should be the only mechanisms for allowing otherwise prohibited anti-competitive restrictions where they can be demonstrated to be in the public interest.

To protect competition, reforms are needed to prevent the use of anti-dumping laws after merger decisions to restrict competition. This is a new proposal from the ACCC.

Industry structures and protecting competition

The ACCC supports the discussion draft's proposals for further consideration of structural separation measures within the telecommunications industry, but, at a minimum 'operational separation' of Telstra's business units is necessary to protect and promote competition and ensure competitive outcomes. That said, operational separation is very much a second best option.

Generator market power manifests in unique ways, and poses risks to the competitiveness of electricity markets. This submission provides additional information on merger activity over the past five years which has caused the ACCC to consider the implications of generator market power in detail. Generator market power raises some unique issues which should be considered in terms of how policy measures can promote competitive market structures at a more fundamental level. This submission does not propose any change to s.50 or other provisions of the TPA. The ACCC encourages the Productivity Commission to closely review this material in finalising its recommendations.

⁸ Productivity Commission (2004), *NCP Discussion Draft*, pp.xvi – xxviii

1.3 Features of this submission

This submission provides information to enable further exploration of issues relating to vertical integration and generator market power. Key features of this submission include:

- “Assessing electricity generation mergers in the National Energy Market (NEM) - Report prepared for the Australian Competition and Consumer Commission” by Frontier Economics. **Appendix A**

This report deals with generator – generator merger issues. It examines the unique characteristics of electricity markets, and the various measures of market power in the industry. A market simulation of a hypothetical horizontal merger is also provided to illustrate potential pricing implications of generation mergers.

- “The Exercise of Market Power in the NEM: An analysis of Price-Spike events in the NEM January- June 2003” by Dr Darryl Biggar, economic consultant to the ACCC. **Appendix B**

This paper investigates the exercise of market power by Victorian base-load generators in the NEM. The paper presents a detailed analysis of events where base-load generators are able to use their bidding behaviour to spike prices and also to influence the operation of interconnectors in order to gain access to higher priced regions in the NEM.

- “Assessing generation – transmission mergers in the NEM – Report prepared for the Australian Competition and Consumer Commission” by Frontier Economics. **Appendix C**

This report examines vertical integration between electricity transmission and generation. It argues that vertical integration is more likely to result in the exercise of market power where one or more segments of the integrated entity are a monopoly. As a case study, the report examines the acquisition by Singapore Power of TXU Australia and highlights the potential areas for the exercise of market power in the wholesale and retail electricity markets.

- “Regulation, Industry Structure and Performance in the Electricity Supply Industry”, 2000 OECD Economics Department Working Papers No.238” by Faye Steiner. **Appendix D**

In this paper one of the primary empirical findings is that the unbundling of generation and transmission, expansion of third party access, and introduction of electricity markets reduces both industrial end-user electricity prices and the ratio of industrial to residential prices. Unbundling of generation and transmission and private ownership each serve to improve the utilisation of capacity in electricity generators.

- Summary of merger and acquisition matters under s.50 of the TPA matters in the electricity industry over the past five years. **Appendix E**

Since the creation of the NEM, the ACCC has received a large number of applications for informal clearance in relation to electricity mergers. The attached table provides an overview of the parties to those proposed mergers and the outcomes of the ACCC's assessments under s.50 of the TPA.

Chapter 2 Protecting competition

The 1995 NCP reforms extended the scope of the competitive conduct provisions of the TPA across the economy to cover previously excluded forms of economic activity and opened key sectors of the economy to competition. These were part of measures specifically introduced to protect and promote competition, when in the public interest, across the economy.

After nearly a decade of operation, the discussion draft concludes that much of the revamped competition and regulatory architecture introduced as part of the 1995 NCP reforms appears to be operating effectively.⁹ It notes, however, that there are shortcomings in particular aspects of the competition framework that require change¹⁰ particularly in relation to consumer protection policy and trade practices issues.

Though the ACCC largely supports the discussion draft's proposals in relation to trade practices matters, this chapter explores the areas where the ACCC believes that further reforms are necessary and are likely to benefit to the community and the economy.

2.1 Consumer protection policy

Protecting competition is a fundamental part of any consumer protection framework. This is encouraged by providing incentives to first ensure the efficient supply of goods and services, subject to public interest requirements and secondly to provide incentives to ensure that the purchase of products and allocation of society's resources are not distorted through undesirable conduct.

A national review into consumer protection policy

The ACCC supports the discussion draft's proposed review into consumer protection policy. It is timely to consider the role of consumers in competitive markets. Also, while the framework for consumer protection works reasonably well, there is a need to reconsider its effectiveness and interaction with the community after a decade of structural reform and changes to Australia's markets.

Due to these changes, it is necessary to review if the current framework facilitates consumer participation in markets and make appropriate adjustments if necessary. This is important because the framework serves to protect consumers from unscrupulous traders (who exist in both competitive and uncompetitive markets), and also enhances and strengthens the development of competitive markets and efficient outcomes. When consumers can make effective choices, markets will operate more competitively. It might also be necessary to consider whether aspects of regulation remain appropriate where a more competitive market environment exists.

However, not all consumer protection measures are about facilitating choice. There are laws that address non-competition issues - for example laws relating to the safety of

⁹ Productivity Commission (2004), *NCP Discussion Draft*, p.210

¹⁰ Productivity Commission (2004), *NCP Discussion Draft*, p.210

certain products such as electrical appliances, microbiological contamination in food and safety requirements for prescription and other drugs. In assessing consumer protection, it is important to consider the public benefits that arise from these laws as well as their competition affects. It is well recognised within NCP and the TPA that competition must be in the public interest.

The role of information deficiency as a rationale for consumer protection is an important element of a national review of consumer protection policy. Consideration should also be given to associated issues such as switching and search costs as these may affect decision-making by consumers and their capacity to choose between competing products and services. A review also provides an opportunity to consider the ability of consumers to obtain and use information to make choices, including the role of intermediaries. Where relevant, the non-competition related benefits of regulation should also be considered.

Regulatory issues

The ACCC acknowledges the importance of avoiding regulatory duplication and where possible designing frameworks that are flexible and responsive.

The proposed review's consideration of mechanisms for coordinating policy development and application across jurisdictions and for avoiding regulatory duplication provides an opportunity to assess related issues, including:

- information sharing between regulators
- areas of jurisdictional uncertainty or overlap
- gaps in regulatory coverage
- inconsistency of regulation
- costs to businesses of inconsistency or uncertainty.

Adjustments to the consumer framework in these areas could assist in achieving a more consistent and national approach to consumer protection.

In addition to education activities and achieving compliance with the TPA, the ACCC is also of the view that self and co-regulation in certain circumstances can perform an important function in producing a net benefit to consumers. To achieve this outcome self and co-regulatory models must be well designed, effectively implemented and be properly enforced. Such schemes can only deliver a net community benefit if they are effective.

The ACCC recognises that there is some uncertainty as to which self and co-regulatory models are effective and in which environments they are more likely to succeed. The ACCC intends to partly address the issue through providing a guideline on what it considers to be effective voluntary industry codes of conduct. However, a further national review on self and co-regulatory approaches may also assist further consideration and application of these instruments.

The scope of a proposed review

The discussion draft's proposed review could focus on:

- determining if the existing consumer protection framework facilitates consumer participation, and include suggestions to improve the framework if required
- considering the public, competition and non-competition benefits that the consumer protection framework provides
- considering impact of switching and search costs, along with role of intermediaries on consumption choices
- reviewing self and co-regulatory models of consumer protection, and
- assessing the scope to improve information sharing between regulators, regulatory coverage, reducing uncertainty and increasing consistency and reducing compliance costs to business.

2.2 Trade practices issues

Part IV of the TPA is the economy-wide competition law administered by the ACCC which protects competition in functioning markets. Since the introduction of NCP it has undergone several reviews to enhance its effectiveness, despite this the ACCC's TPA administration experience leads it to believe that further reforms are warranted in the areas discussed below.

Shield of the crown¹¹

NCP reforms have extended the application of the TPA by removing 'shield of the Crown' immunity to government commercial activities that were previously outside the scope of the TPA. It has been an important reform providing incentives to improve competitive conduct for commercial activities of governments and government enterprises. As activities involving government, government enterprises and private firms increase there is a growing necessity to ensure that all commercial economic activities are subject to the TPA.

The recent decision of the High Court in *NT Power Generation Pty Ltd v Power and Water Authority* confirms and expands the application of the TPA to government businesses. As a result, there is no need for legislative change to bring government businesses within the scope of the TPA. However, there is still uncertainty as to whether a private firm contracting with government is covered by the TPA.

¹¹ It is the ACCC's submission, as put in *Australian Competition and Consumer Commission v Baxter Healthcare Pty Ltd, State of Western Australia, State of South Australia and State of New South Wales*, that other than contracts protected by transitional provisions of the *Competition Policy Reform Act 1995*, any immunity from the TPA conferred in relation to Crown entities should not extend beyond that provided to the Crown where it is not carrying on a business and, in particular, should not extend to parties engaging in business dealings with Crown entities.

This issue is now subject to a hearing in the Federal Court in *Australian Competition and Consumer Commission v Baxter Healthcare Pty Ltd, State of Western Australia, State of South Australia and State of New South Wales*. If the ACCC's submissions in the Baxter litigation are ultimately upheld, corporations contracting with the Crown would not be capable of deriving its immunity and would be subject to the TPA.

The issue of whether the law as drafted allows private firms contracting with the Crown to derive protection from the Crown's immunity (where it exists) will only finally be determined when the issue is considered by the High Court. Even if the Baxter litigation were to go on appeal to the High Court a decision on the issue could not be expected before 2007.

The ACCC recommends, in view of the strong policy grounds for limiting Crown immunity, that legislative change remove the scope for claims on derivative 'shield of the Crown'. The alternative is to risk an uncertain outcome through a court's interpretation of the existing law. Such legal reform could be rolled into NCP legislation amendments following the conclusion of this and the planned Council of Australian Governments (CoAG) inquiry into NCP.¹²

Balancing competition and the public interest

NCP measures sought to extend competition, and only restrict it where it was in the public interest. As part of NCP, a Legislation Review Program (LRP) was implemented to assess and recommend the removal of competition restrictions and this has served to facilitate market-based reforms across the economy. The public interest considerations of the LRP have been complemented by the authorisation provisions of the TPA and exemptions under s.51(1) of the TPA as mechanisms for allowing otherwise prohibited anti-competitive restrictions.

The draft concludes that it is not convinced about the need for legislative change in relation to s.51(1) exemptions as these restrictions on competition have been subject to the LRP and because many of the exemptions are of a 'transitory' nature.¹³ The ACCC reiterates its view that consideration ought to be given to the appropriateness of exemptions under s.51(1) of the TPA and whether the authorisation provisions of the TPA should be the only mechanisms for allowing otherwise prohibited anti-competitive restrictions that can be demonstrated to be in the public interest.

Unlike s.51(1) exemptions, the authorisation process is conducted in a consistent and transparent manner with the assistance of interested party consultations to enable a full consideration of the relevant issues. The process is subject to independent review, by the Australian Competition Tribunal and has proven itself to be an effective mechanism for weighing anti-competitive detriments with public benefits. The use of a single mechanism for allowing otherwise prohibited conduct is consistent with the use of the TPA as the economy-wide instrument for protecting competition.

¹² Treasurer (Commonwealth of Australia), Hon. Peter Costello MP (23 April, 2004), Media release No. 023: *Productivity Commission Inquiry into National Competition Policy Arrangements*.

¹³ Productivity Commission (2004), *NCP Draft Discussion*, p.215

2.3 Mergers, anti-dumping and competition

In addition to consumer protection policy and trade practices issues, the ACCC believes that reforms are warranted in relation to mergers and acquisitions and anti-dumping laws to protect competition and ensure that legitimate imports provide an effective discipline on domestic firms.

Section 50, the mergers and acquisition provision, of the TPA is intended to be the economy-wide safeguard for competitive market structures. It contains the matters that may be taken into account when considering the effect, or likely effect, of a merger or acquisition.¹⁴ Amongst, other matters, the actual and potential level of imports are taken into account.¹⁵ Firms involved in mergers or acquisitions will submit information on the actual and potential level of import competition in support of the application.

Where Australian producers claim that dumped or subsidised imports cause or threaten material damage to Australian industry, an application can be made for anti-dumping or countervailing measures under the *Customs Act 1901* and the *Customs Tariff (Anti-dumping) Act 1975* (Customs laws). In considering an application under these laws there does not appear to be scope for parties outside the affected industry¹⁶ to participate in the process to determine if dumping or subsidised imports are adversely affecting the market.

In certain instances, the paper, chemical, plastics and cement industries, have cited the competitive effects of imports in their merger applications, but have had record of seeking to have imports constrained under the Customs laws. It is the ACCC's view that the relationship between the TPA and the Customs laws should be reformed to ensure that the Customs laws are not used to restrict competition to the benefit of firms at the expense of legitimate competitive outcomes. Scope for the misuse of the TPA and the Customs laws would be minimised through:

- allowing an interested party, such as the ACCC, to make submissions in anti-dumping matters where the parties involved had been through a merger process
- legislating that interested party submissions would be taken into account in anti-dumping decisions.

2.4 Conclusions on protecting competition

Though NCP has extended the scope of competition across the economy there are areas for improvement. The ACCC supports a limited review of consumer protection policy to ensure that it is relevant and contributes to the effective and efficient supply and demand for goods and services.

Pro-competitive incentives would also be enhanced by removing scope for claims on derivative 'shield of the Crown' and prevent a misuse of the Customs laws. These

¹⁴ s.50(3), *Trade Practices Act 1974*

¹⁵ s.50(3)(a), *Trade Practices Act 1974*

¹⁶ s.269TC, *Customs Act 1901* (Cth)

measures would ensure the application of the TPA to commercial activities and ensure laws are not used to inappropriately to restrict competition.

These measures would strengthen the capacity of the TPA to protect competition.

The TPA is the most appropriate means of balancing competition and non-competition matters.

Chapter 3 Protecting competition in infrastructure industries

3.1 Introduction

Australia's NCP reforms sought to extend the scope of the TPA to protect competition, through the application of the competitive conduct provisions of the competition law to those sectors of the economy where it had not applied previously. It is recognised that in markets where effective competition is only emerging or is not possible for natural monopoly reasons, additional policy solutions may be necessary to complement the role of s.50, and competition law generally, in promoting competition. This might include industry specific measures to address market structure concerns.

CoAG agreed to industry specific structural and legislative reforms to promote competition in key sectors of the economy. An important component of the reforms of public sector monopolies is consideration of structural separation including vertical disaggregation of contestable and non-contestable business elements.

The CoAG reforms recognised that special policy issues arise in respect of infrastructure industries that involve natural monopoly elements. There are two broad sets of issues with natural monopoly infrastructure. First, how to address the problems associated with natural monopoly. For example, whether the network element should be regulated, and if so, what form that regulation should take.

Second, there are additional issues where there is integration between natural monopoly infrastructure and contestable services. The vertically integrated service provider has the ability and incentive to discriminate against rivals in related markets, in favour of its own businesses. Anti-competitive discrimination by vertically integrated monopolists can impede effective competition with implications for efficiency in the sector, and in downstream sectors through distorted signals for consumption and investment.

In principle, natural monopoly elements should be kept separate from contestable sectors. There may also be costs arising from regulation which policy makers may introduce to deal with the natural monopoly problem, and in some circumstances, this should be assessed on a case by case basis. At the same time, there can be benefits arising from vertical integration.

Structural separation can take many forms. Structural separation is important in promoting and protecting competitive outcomes. In Australia, structural separation measures are not included in the TPA. Therefore, any pro-competitive industry restructuring requires specific policies in addition to general competition laws. Going forward, the different circumstances of the electricity and telecommunications industries lends support to tailored policy responses to promote and protect the operation of competitive markets.

This chapter discusses the issue of vertical integration in the electricity and telecommunications industries, and also touches on the market power factors that are unique to the electricity generation sector.

3.2 Issues in protecting competition in the electricity industry

Recent trends in the electricity industry show that generation markets are becoming more concentrated, and there have been proposals to re-integrate networks with contestable elements of the industry. Failure to address re-aggregation in the industry could lead to an unwinding of the benefits of the CoAG structural reforms. As in our previous submissions, the ACCC encourages a review of re-aggregation in the energy sector and possible policy responses.

This submission provides further material on the extent and implications of re-aggregation in the electricity industry. The ACCC considers that the attached material would be a useful input into any review. The ACCC also encourages the Productivity Commission to review this material in formulating its recommendations.

The attached material is as follows:

- Analysis of the implications of horizontal aggregation in the generation sector (Frontier Economics September 2004). **Appendix A**
- How and in what circumstances market power can be exercised (Paper prepared by Dr Darryl Biggar to the ACCC). **Appendix B**
- Analysis of the implications of vertical integration, particularly where it concerns network elements (Frontier Economics August 2004). **Appendix C**
- Assesses the effects of vertical restructuring of generation, transmission and the effect of access in the electricity industry (Faye Steiner, OECD). **Appendix D**
- The extent of integration and aggregation in the last four years (An indicative summary prepared by the ACCC December 2004). In the past five years, more than 60 applications for informal merger clearances involving all elements of the electricity supply chain (generation, transmission, distribution and retail) have been received. This attachment lists all of the merger proposals and their outcomes. **Appendix E**

The discussion below supports points raised in these papers.

Horizontal mergers of generators

The ACCC remains concerned that the electricity generation sector is becoming increasingly concentrated, and that the potential for some generators to exercise market power is high at particular times. Having received several applications for informal clearances of horizontal generation mergers, the ACCC has considered generation market power issues in detail. Generation market power manifests in very unique ways, and raises some important issues which should be considered in the context of how policy measures could promote more competitive market structures.

It is widely acknowledged that generators, at times, have the incentive and ability to withhold capacity from the spot market in order to cause high spot prices. Another complicating factor is that a generator with a relatively small degree of market share can also have market power and the ability to set prices. Some of the unique characteristics of the generation sector and the National Electricity Market (NEM) that need to be taken into consideration in the context of ensuring that there is effective competition in the electricity industry include:

- Electricity cannot be economically stored, so electricity must be differentiated in the market by the time of day/week/year.
- Demand is highly inelastic, especially in the short-term. A market share which would not cause concern in other industries may lead to generator market power.
- Generators can exercise market power by ‘withholding’ generation capacity at peak periods and spiking prices. It only takes a few such events to have a large impact on prices. For example, an additional five hours of wholesale prices at their cap (VoLL) can raise the average wholesale price in a year by almost 19 per cent.
- Congestion or outages on a transmission network will have a large impact on the relevant geographic market definition.
- The usual safe haven thresholds for market concentration may be too high for the electricity generation sector.¹⁷ The internationally noted electricity industry expert, Steven Stoft, claims that demand inelasticity makes “market power at least ten times worse in power markets than in most other markets.”¹⁸
- Generally firms which are not operating at capacity can expand their output to offset an attempt at an exercise of market power. Traditional concentration measures assume that all firms can expand their output at the margin and therefore overstate competition in the market, as this is often not the case in the electricity industry.¹⁹

It is clear that the greater the capacity that a generator amasses through mergers and acquisitions, the greater its incentive and ability to exercise market power. The impact on prices paid by downstream users can be substantial which in turn can deter and distort downstream investment, especially in energy intensive industries.

Appendix B is a paper by Dr Darryl Biggar that explains how generators can exercise market power by withholding capacity at times of high demand. The paper also analyses generator behaviour during price spike events between January and June 2003.

¹⁷ See for example Borenstein, S.; Bushnell, J.; and C. Knittel (1999) “Market Power in Electricity Markets: Beyond Concentration Measures,” *POWER Working Paper PWP-059*, University of California Energy Institute, February; Deb, R.; Macatangay, R.; and S. Deb (2002) “An Analysis of Generation Market Power in the Midwest Interconnect,” *The Electricity Journal*, April; Stoft, S. (2002) *Power System Economics*, IEEE Press, Piscataway; and Blumsack, S., Perekhodtsev, D. and Lave, L., (2002), *Market Power in deregulated wholesale power markets: issues in measurement and the cost of mitigation*, *The Electricity Journal*, November 2002, 11-24.

¹⁸ Stoft, S. (2002) *Power System Economics*, IEEE Press, Piscataway, p.356.

¹⁹ See Biggar, Darryl, “Background Note” in OECD, (2002), “*Competition Issues in the Electricity Sector*”, DAF/COMP(2003) 14 April 2003.

Appendix A is a report by Frontier Economics (September 2004) that assesses in detail generator – generator merger issues, examining the unique characteristics of electricity markets, and the various measures of market power in the industry.

Vertical mergers of contestable and non-contestable segments of the electricity industry

Certain proposals for vertical re-integration raise competition concerns, particularly those involving a merger of networks with contestable elements of the electricity industry. The recent acquisition of TXU by SP Energy, which concerned all four key aspects of the electricity supply chain is an example.²⁰ This activity demonstrates that existing electricity entities are interested in vertically reintegrating and raises the question of whether this is appropriate.

It is the ACCC's view that there is a strong incentive for an integrated firm holding a monopoly in the provision of a network service in the electricity industry to discriminate in favour of the vertically integrated firm's own operations and against non-integrated competitors in upstream and downstream markets.²¹

Such conduct is likely to occur within the electricity industry because:

- Regulatory regimes were set up on the basis of structural separation. Rules to counter problems which may arise where an integrated monopolist uses market power did not form part of the focus of the governing legislation.
- Generally there are considerable difficulties associated with stopping a monopolist using vertical integration to evade regulatory disciplines, especially when the regulator depends on information provided by the regulated entity.²²
- Network service monopolists' revenues are capped (given the constraint on profits placed by regulatory revenue caps set under the National Electricity Code) and this creates incentives to capture monopoly rents foregone through engaging in price and non-price discrimination in related markets.²³

²⁰ The ACCC's competition concerns regarding this acquisition were in relation to the common ownership of transmission and generation assets. These concerns were addressed through a court enforceable undertaking that provides for the separation of the transmission and generation businesses.

²¹ These issues were touched upon in our previous submission, *ACCC, Submission number 145 to the Productivity Commission inquiry into the National Competition Policy*, 24 November 2004

²² See Frontier Economics August 2004, *Assessing generation – transmission mergers in the NEM*, Report prepared for the Australian Competition Consumer Commission (attached to this submission)

²³ In the short run modelling of both Mandy (2000) and Weisman & Kang (2001), restrictions on monopoly profits in the monopoly market was one of the factors which led to their conclusion that discrimination was likely in a connected market to which they applied 'plausible' data. In their long-run modelling (allowing entry) Bustos and Galetovic (2003) found that large monopolists should be of concern to regulators, since they would discriminate unless they were implausibly more efficient than downstream firms (in their downstream operations). This modelling is illustrative that over a long term horizon the balance of incentives to foreclose competition in an affiliates market may swing in favour of exercising market power. D. Mandy, *Killing the Goose that may have laid the Golden Egg : Only the data know whether sabotage pays*, *Journal of Regulatory Economics* 17:2 157 – 172; Weisman and Kang, *Incentives for Discrimination when upstream monopolists*

- The monopolist could apportion ‘other’ costs to its regulated asset base as a means of increasing its relative cost efficiency in the competitive sector.²⁴

The issues have been recognised by the United States Federal Trade Commission, which noted that an integrated entity has an incentive to evade regulatory constraint to earn a higher profit and that the unregulated market may give it the means to do so, by discriminating against competitors in the unregulated market. It might also shift costs between the regulated and unregulated market.²⁵

The capacity of the regulator to effectively police such conduct is questionable and in any event less desirable given the ACCC’s view that structural solutions are better than heavy handed behavioural regulation. The Productivity Commission has previously acknowledged that vertical separation would lead to more light handed regulation, when discussing the joint application of vertical separation combined with forms of access regulation.²⁶

Vertical integration between electricity generation and transmission is explored in more detail by Frontier Economics (August 2004) in Appendix C. This report looks in detail at the likelihood and the likely effect of an exercise of market power where one or more segments of the integrated entity are a monopoly.

Benefits and costs of vertical integration

NECG’s submission to the inquiry notes that benefits of integration can accrue from facilitating ‘risk management’ between retailers and generators.²⁷ The ACCC’s prior submission noted that such mergers are not necessarily undesirable, provided competition is present in both markets. However, where integration involves a network service provider and a generator it is difficult to determine how integration efficiencies could arise to offset the risks of potentially negative effects on competition.

The OECD recognises that restrictions on competition caused by discrimination, generally harm consumers.²⁸ Crew, Kleindorfer and Sumpter’s study shows that absent

participate in Downstream Markets, Journal of Regulatory Economics 20:2 125-139 at p 125; Bustos and Galetovic, *Vertical Integration and Sabotage in Regulated Industries*, June 2003, Universidad de Chile Centre for Applied Economics Working Paper No 164. Mini (2000) found empirical evidence of discrimination by a vertically integrated provider by analysing their negotiations with competitors. Mini, *The role of incentives for opening monopoly markets : comparing GTE and BOC Corporation with local entrants*, Journal of Industrial Economics, 43:379-424. For more on the problems of vertical integration see the publication prepared by Darryl Biggar for the OECD, *Restructuring Public Utilities for Competition*, 2001, ISBN 92-64-18726-X. Frontier Economics (2004) Op. Cit. give examples of how discrimination might occur at pp. 16-18.

²⁴ Frontier Economics (2004) Op. Cit at page 18.

²⁵ Federal Trade Commission (1995), Comments of the Staff of the Bureau of Economics of the Federal Trade Commission, In the Matter of Promoting Wholesale Competition Through Open Access Non-discriminatory Transmission Services by Public Utilities, Recovery of Stranded Costs by Public Utilities and Transmitting Utilities; Proposed Rulemaking and Supplemental Notice of Proposed Rulemaking, Docket Nos. RM95-8-000 & RM94-7-001

²⁶ Productivity Commission (2001), *Inquiry Report: Telecommunications Competition Regulation*

²⁷ NECG 2004, *Submission Number 134 to the Productivity Commission inquiry into the National Competition Policy*.

²⁸ OECD, *Recommendation of the Council concerning Structural Separation in Regulated Industries*, 26 April 2001 – C(2001)78.

major economies of scope between downstream and upstream operations, that divestment is welfare superior.²⁹ An OECD working paper by Steiner looked at data from 19 countries. On the basis of her empirical analysis Steiner reported that an unbundling of generation and transmission corresponded to economic benefits.³⁰ Structural separation of monopoly sectors along with the implementation of access regulation has been found to be a key element in keeping end user costs down in the Australian electricity industry.³¹ The Steiner article is attached at Appendix D in addition to the other papers which have already been attached to previous submissions.

3.3 Protecting and promoting competition in the telecommunications industry

The TPA is intended to be applied as the economy-wide competition law to protect competition in functioning markets. Where competition is limited other instruments must be used to promote and develop competition. In the telecommunications sector, market liberalisation and the introduction of an access regime to the industry's natural monopoly component have fostered improvements in competition.

Despite reforms, concerns remain about the extent of vertical and horizontal integration within the dominant firm, Telstra. The ACCC agrees with the discussion draft that these issues should be considered outside the TPA and that they should be considered within a cost/benefit framework before structural reform of the telecommunications industry. As a minimum, 'operational separation' of each of Telstra's business units, but remaining, under its ownership is required if full structural separation does not occur.

Options for telecommunications industry structural reform

While the ACCC endorses the discussion draft's proposals, it offers the following additional comments in relation to the structural configuration of Telstra and alternative mechanisms for addressing Telstra's market power. These build upon the ACCC's views outlined in its previous submission to this inquiry into NCP.

Structural configuration of Telstra

The discussion draft contemplates the possibility of structural separation of Telstra, subject to more detailed analysis of the associated costs and benefits. However,

²⁹ M. Crew, P. Kleindorfer, J. Sumpter "Bringing Competition to Telecommunications by Divesting the RBOC's", in M Crew and M. Speigel (2004), *Obtaining the best from Regulation and Competition*, Kluwer Academic Publishers, Boston.

³⁰ See F. Steiner, *Regulation, Industry, Structure and Performance in the Electricity Supply Industry*, OECD Working Papers No. 238 March 2000 at page 7, 'the unbundling of generation and transmission, expansion of Third Party Access, and introduction of electricity markets reduce both industrial end user electricity prices and the ratio of industrial to residential prices...unbundling of generation and transmission and private ownership each serve to improve the utilisation of capacity in electricity generation'.

³¹ ACIL Tasman, (2004 Jan.), *Impacts of Access Regulation Gas and Electricity prepared for the Australian Competition and Consumer Commission*, p.xiii

structural reform can take many forms. The ACCC suggests any cost-benefit analysis could consider the following possibilities:

- horizontal separation (loosely defined), involving the splitting of potentially substitutable functions of the business – such as parallel networks
- vertical separation, involving the separation of complementary upstream and downstream functions of the business.

Horizontal separation: recommendations in Emerging Market Structures report

The ACCC has already made specific recommendations regarding certain types of horizontal separation that might be considered. Specifically, it has recommended that consideration be given to the costs and benefits of Telstra being required to divest the Hybrid Fibre Coaxial (HFC) network in full.

The analysis for this recommendation is set out in detail in the ACCC's *Emerging Market Structures in the Communications Sector* report (the EMS report). It was prepared in response to a specific request for advice on the extent to which emerging market structures are likely to affect competition in the communications sector. It should also be noted that because of the request, the EMS report did not consider the issue of vertical separation of Telstra's operations, other than to recommend the divestiture of its 50 percent shareholding in Foxtel.

Vertical separation

While the ACCC sees considerable benefits arising in the event that Telstra be required to divest its HFC network, there are alternative options for structural reform which could also be explored in a detailed review.

For example, consideration could be given to some form of separation of wholesale services from the downstream retail businesses to which such wholesale services are inputs. One intention of this approach would be to minimise the incentives for the wholesale service provider to discriminate in the provision of services such that competition in the downstream market is compromised.

An assessment of this type of separation model would, amongst other things, require consideration of the benefits of increased competition and the effects on investment incentives of the incumbent firm and potential new entrants.

Costs and benefits of structural separation

There has been considerable debate regarding the merits of structural separation which has focussed on whether the benefits of separation outweigh both implementation and longer-term costs.

The draft has recognised some of the benefits that might result from vertical separation.³² These include more efficient prices, a less intrusive regulatory regime and improved relationships with, and more efficient pricing for, downstream firms. The

³² Productivity Commission (2004), *NCP Discussion Draft*, p.197

Productivity Commission also suggests that it would be unlikely that vertical separation would have much impact on retail prices since these are kept in check by the current regulatory regime.

The OECD³³ has argued that vertical separation would bring the incumbent's incentives into line with those of a non-integrated carrier, facilitating non-discriminatory access. It is the ACCC's view that increased access and more efficient pricing of wholesale services have flow-on effects that are potentially large. It could facilitate increased competition in downstream markets, thereby driving further efficiency gains, innovation and reduced prices, to the benefit of consumers.

While retail price controls are already in place, the absence of effective competition across a range of retail services suggests that when considered as a group, prices generally still exceed cost.³⁴ As such, increased retail competition that might be expected to result from vertical separation could be expected to deliver significant benefits to consumers as this gap is eroded.

In its submission to the current inquiry, NECG argues that there are many costs involved with structural separation, including lost economies of scale and scope, the ability of integrated firms to internalise externalities, and risk management costs. It argues that structural issues are best resolved by market forces than by regulators.

The ACCC considers that the rationale for a government review of the structural configuration of firms such as Telstra, already subject to regulation, is not eliminated by recognising that structural separation does have some costs. Indeed, it is in recognition of such costs that the ACCC's position has been, and remains, that a thorough review of the costs and benefits of structural reform in the telecommunications sector be undertaken.

Alternatives to structural separation – 'operational' separation

The ACCC considers some form of full structural separation should be subject to a rigorous cost-benefit analysis, but recognises that the outcome of such a study is uncertain.

The ACCC is firmly of the view, however, that an increased degree of 'operational' separation of business units within Telstra would be desirable in the event that genuine structural separation does not proceed. The discussion draft suggests that '[t]he recently introduced requirement for Telstra to produce separate wholesale and retail accounts could deliver similar benefits to vertical separation without some of the costs'.³⁵

The ACCC's experience in administering the accounting separation arrangements suggests that the extent to which they facilitate the identification of anti-competitive

³³ Organisation of Economic Cooperation and Development (2001), *Restructuring Public Utilities for Competition*

³⁴ Telstra currently earns a margin of over 9% across its fixed voice products. See *Imputation and Non-Price Terms and Conditions Report Relating to Accounting Separation of Telstra for the June Quarter 2004*, ACCC, October 2004.

³⁵ Productivity Commission (2004), *NCP Discussion Draft*, p.198

behaviour is marginal at best. In most cases, investigations into allegedly anti-competitive conduct require the ACCC to collect very detailed, specific data which cannot be captured through periodic accounts reporting.

By contrast, operational separation combines the separation of financial accounts with further changes to the firm's organisational structure. For example, the wholesale business could be separated explicitly from the retail business, with some form of internal pricing transfer being used to manage the relationship between the different entities, which would continue to share common ownership.

Under this arrangement, each business would have its own management, location and information systems, and operate as an independent profit centre with specific objectives. The wholesale business would be expected to treat both its internal retail counterpart and external third party retailers at arm's length and on a non-discriminatory basis. Legal or corporate separation is a potential variation where the entities take the form of legally separated firms.

One aim of this more stringent separation is to better align the incentives of management with competition objectives. For example, the ongoing ACCC investigation of Telstra's wholesale and retail broadband prices illustrates the potential for conflicting management interests within a vertically integrated firm. Under the current arrangements, one executive has responsibility for both Telstra Bigpond and Telstra wholesale. There are incentives for a manager in this position to seek to improve Telstra's share of the emerging retail broadband market at the expense of its wholesale operations.

The ACCC notes the recent media reports that Telstra proposes to establish its wholesale business as a standalone division.³⁶ This proposal, if enacted, is well short of the measures that the ACCC has suggested in this, and other submissions, that are necessary to improve the competitiveness of the telecommunications sector.

By contrast, the separation approach provides stronger requirements on an independent carrier to refrain from discriminatory behaviour than does simple accounting separation. It is anticipated that operational separation would enable blatantly discriminatory or collusive behaviour to be more easily identified. However, as with accounting separation, the underlying incentives would not be expected to change significantly, since the separate business units would ultimately be answerable to a single board of directors.

³⁶ The Australian Newspaper (Michael Sainsbury, Katherine Murphy) (3 December 2004), *Telstra's network split for sell-off*, p.1

3.4 Conclusions of protecting and promoting competition in the infrastructure industries

Electricity industry

The ACCC's July Submission touched on the issues raised above and noted that the Parer Report had also assessed some of these issues. In relation to Parer's recommendation, our submission pointed to some of the limitations of implementing electricity specific merger guidelines and encouraged the Productivity Commission to conduct its own review of the issues.

The initial NCP reforms aimed to promote competitive market structures in electricity through structural separation of natural monopoly infrastructure services from contestable services. The structural separation measures were taken separately from those contained in the TPA. Vertical re-integration of natural monopoly and contestable sectors, are a reversal of the intention of that policy. Reliance on the TPA alone raises risks of increasing integration in the electricity industry.

This raises the question of whether it is appropriate to rely solely on the TPA to protect competitive market structures. There is a strong case for structural separation in the electricity industry. Policy makers might also consider whether alternative policy options could be introduced as an additional competition safeguard. These might include specific policies that go beyond the current competition laws to ensure that natural monopoly elements of the electricity industry are kept separate from the contestable areas of the industry. This submission provides material to aid the Productivity Commission's assessment of the implications of vertical integration in the electricity industry.

In addition to the issues raised by vertical integration of network and contestable sectors, there are some specific factors in the electricity generation sector which require further consideration by policy makers.

The unique ways that generator market power can occur threaten the competitiveness of the NEM. Increased concentration of the generation sector highlights that risk further. The unique characteristics of the electricity industry means that market power can, in some circumstances, be exercised by even relatively small players. Continued re-aggregation in the NEM and the associated consequences of reduced competition could exacerbate this problem. Specific policies, in addition to the provisions of the TPA, may be necessary to address these market power concerns.

This submission does not propose any change to s.50 or other provisions of the TPA. Indeed, it is difficult to see how this could address the problems posed by the generation sector. However, the extent and impact of generation reaggregation, and the options for addressing this issue should be considered. Policy makers might consider further options for structural reform, and measures for protecting reforms once they are in place. This submission provides material that illustrates the problems arising from generator market power to assist the Productivity Commission in finalising its recommendations.

The ACCC encourages the Productivity Commission to consider the material presented in this submission in the context of how the risks of increased concentration and

vertical integration in the electricity industry could be addressed. In the meantime, the ACCC will consider, in more detail, the ways that an electricity-specific policy could respond to the unique characteristics of the electricity industry, and thus enhance the TPA's role of protecting competition, and may provide the Productivity Commission with further material on this subject.

Telecommunications

To further promote and protect competition within the telecommunications sector it is appropriate to conduct a cost/benefit analysis of the possible structural separation of Telstra. This will assist in identifying the net benefits or net costs associated with options for the structural reform or preservation of the existing structure of the telecommunications industry. 'Operational' separation is required as a minimum, if Telstra's structural separation does not proceed.

Appendix A Generation mergers (Frontier Economics)

“Assessing electricity generation mergers in the National Energy Market (NEM) - Report prepared for the Australian Competition and Consumer Commission” by Frontier Economics.

(see attached)

Appendix B Market power in the National Electricity Market (Dr Darryl Biggar)

“The Exercise of Market Power in the NEM: An analysis of Price-Spike events in the NEM January- June 2003” by Dr Darryl Biggar, economic consultant to the ACCC.

(see attached)

Appendix C Generation-transmission mergers (Frontier Economics)

“Assessing generation – transmission mergers in the NEM – Report prepared for the Australian Competition and Consumer Commission” by Frontier Economics.

(see attached)

Appendix D Electricity industry performance (Faye Steiner, OECD)

“Regulation, Industry Structure and Performance in the Electricity Supply Industry”,
2000 OECD Economics Department Working Papers No.238” by Faye Steiner

(see attached)

Appendix E Electricity industry merger activity

Summary of merger and acquisitions under s.50 of the TPA matters in the electricity industry over the past five years.

SUMMARY OF SECTION 50 MATTERS INVOLVING THE ELECTRICITY INDUSTRY IN THE PAST FIVE YEARS

Year	Proposal	Description and location of assets	Applicant	Clearance given ?	Outcome
2000	Joint venture between AGL and ACTEW	ACT distribution and retail	AGL	Yes	Joint venture established.
2000	Sale of Powercor	VIC retail and distribution business	CitiPower CKI/HEI	Yes Yes	CKI/HEI acquired the Powercor distribution network and Origin acquired the associated retail business.
2000	Proposal to sell Shell's 50% interest in Callide C	QLD generation	Intergen	Yes	Acquisition proceeded.
2000	Privatisation of ElectraNet	SA transmission	ABB/Macquarie Bank/ Powerlink CKI/AMP/Hastings	Yes Yes	CKI led consortium was successful bidder.
2000	Privatisation of ETSA Power	SA retail business	AGL	Yes	AGL was the successful bidder.

			GPU	Yes	
			Edison Mission	Yes	
			CKI/HEI	Yes	
			Powergen	Yes	
			Utilicorp	Yes	
2000	Privatisation of Flinders Power	SA generation	NRG	Yes	NRG was the successful bidder.
			AES	Yes	
			Contact Energy	Yes	
2000	Privatisation of Synergen and Optima	SA generation	Boral	Yes	International Power was the successful bidder.
			Edison Mission	Yes	
			TXU	Yes	
			AES	Yes	
			NRG	Yes	
			International Power	Yes	
			Santos	No	
2000	Sale of Yallourn Energy	VIC generation	AES	Yes	A new entrant (CLP) was the successful

			International Power	No	bidder.
2001	Proposal to acquire CMS interest in Loy Yang Power	VIC generation – Loy Yang A	Duke Energy	Yes	CMS interest in Loy Yang A sold to GEAC in 2003.
2001	Proposal to acquire co-generation facility.	VIC generation - Maryvale generator	Duke Energy	Yes	Acquisition did not proceed.
2001	Merger of NorthPower, Advance Energy and GS Energy	Various NSW retail and distribution businesses	NSW Government	Yes	Merger proceeded and called of Country Energy.
2001	Sale of Sithe Energies	NSW generation	International Power NRG Energy	Yes Yes	Sale did not proceed.
2002	Sale of AES Australia	VIC generation – Ecogen	International Power	No	Sale assets acquired by new entrant.
2002	Proposal to acquire Horizon Energy	Various generation interests	RWE	Yes	Acquisition did not proceed.
2002	Sale of CitiPower	VIC distribution and retail businesses	Origin Energy AGL Macquarie Bank CKI/HEI	Yes Yes Yes Yes	Origin Energy was the successful bidder.

			United Energy	Yes	
			Singapore Power	No	
			International Power	No	
2002	Sale of NRG Australia	Various generation interests including Flinders Power in SA	AGL	No	Sale did not proceed, most assets still owned by NRG.
			CKI/HEI	No	
			International Power	Yes	
			Contact Energy	Yes	
			CLP	Yes	
			Atco	Yes	
			EPD	Yes	
2002	Sale of Pulse Energy	VIC retail and distribution business	AGL	Yes	Pulse Energy acquired by AGL.
			International Power	Yes	
			TXU	No	
2002	Confidential proposal	Generation	Confidential	Yes	Did not proceed.
2002	Joint venture construction and operation of Tarong North Power Station	QLD generation	Tarong Energy	Yes	Construction and trading arrangements proceeded.

2003	Expansion of geographical boundaries for AGL/ACTEW joint venture	ACT and surrounds	AGL/ACTEW	Yes	Joint venture expansion proceeded.
2003	Confidential proposal	Transmission	Confidential	No	Acquisition did not proceed.
2003	Sale of Loy Yang Power	VIC generation - Loy Yang A	Great Energy Alliance CKI/HEI	No No	Acquisition proceeded, undertakings negotiated.
2003	Acquisition of interest in Redbank Power Station	NSW generation	International Power	Yes	Acquisition proceeded.
2003	Sale of Southern Hydro	VIC generation	AGL IPR CLP	Yes Yes Yes	A new entrant (Meridian Energy) was the successful bidder.
2004	Sale of Edison Mission	VIC generation - Loy Yang B and Valley Power	International Power Stanwell	Yes Yes	International Power announced as the successful bidder, undertakings given.
2004	Sale of TXU Australia	Various interests in VIC and SA	Singapore Power Other party Confidential	No No	Singapore Power proceeded with the acquisition, undertakings given.

