

Mr Gary Banks
Chairman
Productivity Commission
PO Box 80
Belconnen ACT 2616

18 January 2005

Dear Mr Banks,

Further comments on electricity market structures

I refer to the letter from Mr Rod Sims to the Productivity Commission dated 7 January 2005, which comments on the letter concerning electricity market issues that the Commission sent to you previously. The Commission wishes to comment on Mr Sims' letter. As you will see, there is agreement on many key issues, however, the Commission wishes to emphasise some important points.

First, the Commission considers that the most important issue concerns the separation of the transmission network from generation. We think that there is agreement on this and also that relying on section 50 of the *Trade Practices Act 1974* (TPA) to ensure this separation would involve a large degree of risk. The Commission believes that it would be particularly difficult to prevent common ownership of transmission and, say, an intermediate or peaking plant or to prevent integration across different regions. The recent acquisition of TXU by SP Energy matter raised both of these issues, and it appears that convincing a court of the competition problems in these areas would be a significant challenge. Further, section 50 cannot be used to prevent a transmission company from building a generation plant. It is our view that future debate should focus on appropriate mechanisms for, and the extent of, cross-ownership restrictions. If this issue were addressed, it is likely that many of the Commission's concerns about future merger activity in electricity would be alleviated.

Second, the Commission accepts that at present it can make no more than an in-principle case against cross-ownership between generation and distribution networks. Cross-ownership of distribution and retailing, which is reinforced by ringfencing rules, does not appear to have caused significant competition problems to date, but, the Commission's perspective is that it does not appear to have generated significant efficiencies to date. The Commission also questions whether significant efficiencies are likely to be gained from cross-ownership between generation and distribution. A risk-averse approach would be to impose similar legislative constraints on cross ownership of generation and distribution as for generation and transmission, recognising that if embedded generation becomes a substantial feature of the NEM, cross-ownership problems *may* emerge in the future. Alternatively, policy makers

might reserve the decision to regulate cross ownership in this area according to the evolution of market structures and whether competition problems arise.

Third, Mr Sims suggests that four to five generators are needed in each region to ensure effective competition at the wholesale level (not necessarily all base-loaders). While the Commission has not formed a view on the number of generators required in each region to ensure effective competition, we share similar concerns on this issue. Further, without commenting on what would constitute acceptable acquisitions, the Commission and Mr Sims appear to agree that further aggregation of base-load generation would generally be likely to influence pricing outcomes in the NEM. We would also appear to agree that if generation markets are effectively competitive and remain so, competition concerns about mergers of generation and retail activities would be somewhat mitigated. Finally the Commission concurs with Mr Sims's view that section 50 can continue to be relied upon to ensure effective competition in retailing, in an environment of largely separate generators and retailers. Issues arising from the vertical integration of generation and retail are further commented on below.

Subject to the requirement of competitive generation and retail in each region, the Commission has no particular view on the efficient long term structure of generation and retail markets. There would appear to be scope for consolidation in some generation and retail markets in the NEM, including between the two functional levels and especially across regions. The Commission would generally have few concerns with this consolidation, and its views are generally consistent with those of Mr Sims on this issue.

The Commission's concern, in *AGL v ACCC* and since, has been that we may be heading toward a more concentrated generation/retail structure than envisaged in Mr Sims' speech and latest comments. The Commission would regard such an outcome as unlikely to be effectively competitive.¹ It may be that section 50 could be relied on to prevent such an outcome, and the Commission would attempt to do this to prevent such a structure if no other avenues were available. However, the Commission considers that there would be a significant degree of risk in pursuing this approach (even leaving aside that section 50 clearly cannot be relied upon to address market structures that are already anti-competitive such as in NSW generation), particularly in light of the Federal Court's findings on market definition and analysis of market power.

The Commission would also like to make a few further comments on integration of generation and retail:

- the Commission recognises that vertical acquisitions of generators by retailers can be an important risk management measure, particularly where contract markets are thin;
- the Commission has already approved a number of vertical acquisitions between generation and retail (particularly acquisitions of peaking generators

¹ *Australian Gas Light Company v Australian Competition Consumer Commission* (no.3) [2003] FCA 1525.

by retailers where retailer risks are most prominent). The Commission does not have a *per se* objection to this vertical integration;

- however, and in relation to Mr Sims' point that 'thin' hedge markets would not be problematic, it should also be recognised that greater vertical aggregation results in reduced contracting. To the extent that 'thin' contract markets are a problem (and a justification for vertical aggregation), then further vertical aggregation will exacerbate this problem. This was the substance of the Commission's 'bandwagon effect' argument in AGL v ACCC. However, the Federal Court's decision suggested that there was no particular reason to attribute this bandwagon effect to the AGL transaction.
- nonetheless, the Commission also recognises that a market structure that is predominately made up of integrated generation/retail companies may also be effectively competitive. Indeed, the structure outlined by Mr Sims would probably make for more competitive and efficient electricity markets than are currently available. It is unclear whether these markets would be more competitive and efficient than markets with largely separate base-load generators and more effective generator competition (than in NSW for instance). A point of difference between the Commission's perspective and that of Mr Sims, is in relation to the prospects for independent generators to enter a predominately integrated generation/retail market structure - the Commission doubts whether such a generator would succeed where the contracting environment were relatively illiquid.

The Commission would also like to make some observations on why electricity markets are different to other markets. After outlining the eight sets of unusual economic and physical attributes of electricity, the internationally renowned electricity markets expert Paul Joskow concluded:²

While there are many competitive industries that have one or perhaps two of these attributes, it is hard to think of any commodity market that has all of them. Moreover, it is precisely these attributes of electricity that led to vertical integration between generation and transmission and either to extensive horizontal integration or to multilateral cooperative agreements between neighbouring vertically integrated system operators. Ignoring these unusual attributes of electricity, and ignoring how and why historical governance arrangements evolved for dealing with them (Joskow, 1997, 2002), is a very bad mistake. Replacing these hierarchical governance arrangements with well functioning decentralized market mechanisms is a very significant technical challenge, about which even the best experts have disagreements. Accordingly, it should not be surprising that electricity restructuring and competition programs have inevitably been a process that involves a lot of learning by doing and ongoing changes to market rules, regulatory arrangements, and governance institutions.

² The *Difficult Transition to Competitive Electricity Markets in the U.S.*, Paul L. Joskow, AEI-Brookings, July 2003, p.11

It is this reasoning that drives the need, recognised in this debate and supported by the Commission's research, for horizontal disaggregation levels in competitive electricity generation markets beyond those generally regarded as necessary in most, if not all, other markets. While a court might recognise such differences and needs in electricity markets in future proceedings, this cannot be guaranteed. As well as the issues with the AGL v ACCC decision which have already been outlined, and the particular characteristics of electricity outlined by Joskow, courts are not a good forum for exploring the development of competitive markets in network industries traditionally dominated by vertically integrated, often publicly owned, monopolies. Such industries are usually the subject of policy development (even policy 'trial and error') over years if not decades. The NEM has been developing since 1990 and it is generally recognised that policy development is far from complete. The Commission believes that it is extremely difficult for a court to be injected into the middle of this policy development process and fully understand all the implications of its decision.

Fourth, we agree that future market changes, such as greater interconnection and improved inter-regional hedge arrangements, may improve the competitive discipline that can be applied by generators across region boundaries. This may lead to a change in the competitive environment in each region, such that greater concentration than envisaged by Mr Sims may be consistent with effective competition. But the Commission considers that it is too early to make assumptions about, or to count on, the imminent implementation of these changes, particularly since they most likely rely on agreement regarding policy changes.

Finally, the Commission would like to emphasise that to address the market structure issues outlined above does not necessarily require a divestment power in electricity generation. The Commission believes that a limit on acquisitions (or potentially investment) when a certain market share threshold is reached may be sufficient, by relying on new players in generation to meet market growth and dilute incumbent market power where desirable. The current Victorian legislation provides a good example.

If you have any queries concerning the issues raised in this letter, please do not hesitate to contact me on (02) 6243 1142.

Yours sincerely

Ed Willett
Commissioner

C.c. Mr Rod Sims
Director
Port Jackson Partners Limited