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Manager MCE Secretariat  
Department of Industry, Tourism and Resources  
GPO Box 9839  
Canberra ACT 2601

By email: [MCEMarketReform@industry.gov.au](mailto:MCEMarketReform@industry.gov.au)

### **Regulatory Impact Statement – Council of Australian Governments Commitment to Separate Generation and Transmission**

The Energy Supply Association of Australia (esaa) appreciates the opportunity to comment on the Regulatory Impact Statement on proposals under the National Electricity Law to maintain separation of generation and transmission activities in the National Electricity Market.

esaa is the peak industry body for the stationary energy sector in Australia and represents the policy positions of the Chief Executives of more than 40 electricity and downstream natural gas businesses, including energy businesses in Western Australia. esaa member businesses own and operate some \$110 billion in assets, employ over 40,000 people and contribute \$14.5 billion dollars directly to the nation's Gross Domestic Product.

The Council of Australian Governments (COAG) committed in February 2006 to the development of provisions under the National Electricity Law (NEL) to maintain separation of generation and transmission activities in the National Electricity Market (NEM) in a form that complements the provisions of the Trade Practices Act (TPA) that prohibit the substantial lessening of competition.

The Regulatory Impact Statement (RIS) published on 15 October 2007 considers the COAG decision within the context of other regulatory options to address potential anti-competitive conduct by integrated entities.

The RIS proposes a preferred option for the development of amendments to the NEL to "insert a generation/transmission provision in the NEL containing an exemption test that would consider both a percentage and Megawatt (MW) level of ownership and control."<sup>1</sup>

The provisions would prohibit integrated ownership of generation and transmission activities, with exemptions for an integrated entity holding up to a 20 per cent share in a transmission activity, and a 5 per cent share in a generation activity, unless that generation activity is below 30 MW in capacity, or between 30 and 150 MW and used

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<sup>1</sup> *Regulatory Impact Statement, COAG Commitment to Separate Generation and Transmission*, MCE October 2007, p.17.

predominantly for network or grid support as approved in that context by the regulator of the provisions.

Although not stated in the RIS, it is assumed that the regulator will be the Australian Energy Regulator (AER), given its enforcement role for other provisions of the NEL.

Below is a summary of the proposal as outlined in the RIS, followed by a number of comments.

The general conclusion of the comments is that the proposal to apply industry-specific regulation to supplement the general competition regulation available under the TPA has not been justified by a demonstration of benefits in excess of costs. It is noted also that the development of the energy industry has included a significant trend towards separation of network and merchant assets given the different financial and business model requirements for managing those assets.

The proposed regulation therefore is not addressing any observable activity in the market to date, and the risk of activity emerging that would be caught by the proposed regulation is minimised substantially by commercial incentives for disaggregating rather than integrating generation and transmission activities.

More directly, in so far as there is any risk of any anti-competitive market behaviour emerging from a potential integration of electricity transmission and generation activities, the substantial regulation of third party access and related matters for monopoly electricity transmission (and distribution) networks under the NEL directly constrains the ability of the owners of those assets to exercise any market power in related markets.

The national electricity access regime is an industry-specific application of the national access regime in the Trade Practices Act (TPA), the intention of which is to safeguard competition in competitive markets such as power generation by regulating access to related essential monopoly infrastructure such as transmission networks in order to prevent the providers of the essential services exercising market power by denying access or charging monopoly prices for their services.

In these circumstances, the proposed regulation would establish an unnecessary precedent for industry-specific competition regulation in the energy sector which in turn would create a higher than necessary degree of sovereign risk for existing and new investors in the energy sector, and thereby potentially reduce investment or increase its cost (or both).

The RIS argues that the electricity third party access regime is insufficient for achieving the competition policy objectives of access regulation in the electricity sector, and that the electricity sector is sufficiently complex to deny the competition regulator the opportunity to adequately substantiate evidence of any anti-competitive behaviour in relation to integrated transmission and generation activities under the general powers of the TPA.

For reasons outlined below, this argument has not been substantiated. Any potentially anti-competitive behaviour by integrated transmission and generation

activities (if integration should ever emerge) should be addressed directly on a case by case basis on its merits under the general powers of the TPA. The latter approach would enable the more productive development of expertise in assessing potential competition risks in this specific area of the electricity sector, and the tailoring of more efficient and effective solutions if needed, rather than relying bluntly on a general prohibition.

## **RIS Proposals**

The RIS includes the following points:

- (i) There is no clear historical evidence in the NEM of a company engaging in anti-competitive conduct through its ownership of both generation and transmission assets (p.12 of the RIS).
- (ii) The intent of the proposed provisions is to reduce the risk of a substantial degree of market power being exercised in the NEM through the potential future emergence of cross ownership in generation and transmission assets (p.12, *ibid*).
- (iii) Cross ownership of generation and transmission would provide incentives and opportunities to exercise market power to stifle or prevent competition in the generation sector (pp.7-9).
- (iv) Alternative regulatory options are insufficient to address the risk identified, *viz.*:
  - (a) section 50 of the TPA (which prevents mergers likely to result in a substantial lessening of competition) is too general a test to capture activities such as discrimination in favour of upstream or downstream associated businesses in the electricity sector (p.9), would be difficult to use to assess the potential for anti-competitive behaviour following a generation/transmission merger (p.11), and would not be available to prevent a transmission company building generation assets given that section 50 is directed at preventing anti-competitive mergers (p.5);
  - (b) the network access regime established under the National Electricity Law “does not provide sufficient safeguards to deal with generation/integration issues”, is designed to deal with monopoly rent but not structural issues, is concerned primarily with access negotiations rather than operational decisions of market participants that may have market power, is too difficult to amend to deal with potential anti-competitive behaviour from integrated entities, and would be unlikely to manage the various locational and capacity strategies that integrated entities may develop to exercise market power (pp.10-11);
  - (c) the conduct provisions of Part IV of the TPA are difficult to apply to establish anti-competitive conduct in relatively complex technical electricity markets, and can only be used after the conduct has been undertaken, thereby potentially exposing new investors to the disincentive

of having to enter a market where monopoly power may already exist (p.11);

- (d) the prices surveillance power under Part VIIA of the TPA is not available for regulating electricity prices (p.11);
  - (e) NEMMCO's role in co-ordinating NEM power system security and deciding which generators get dispatched is not material to various investment and operational decisions of an integrated generation and transmission business that may impact adversely on competitors (p.12).
- (v) Of five options discussed for implementing the COAG decision, amending the NEL to limit cross ownership of generation and transmission to a maximum percentage and MW level of generation ownership control is preferred over a simple quantitative limit on cross ownership, a general prohibition of cross ownership, an amendment to section 50 of the TPA, or the status quo (ie, relying on section 50 of the TPA); each of four non status quo options includes an exemption test based generally on a demonstration to the satisfaction of the regulator of no anti-competitive or lessening of competition effects.

## **Comments**

The following comments are provided on the proposals outlined in the RIS:

### *Energy industry trend towards separation of merchant and network assets*

The national energy market reforms disaggregated the former vertically integrated state electricity commissions and provided for competition in generation and retailing, and regulation of monopoly network assets.

A further significant development in market structure in the energy sector following the national reforms has been the trend to specialisation in either merchant or network assets, particularly where assets are privately owned. The reasons for this trend include the different costs of capital for competitive and regulated assets, and the different business models and skills required to manage competitive and regulated activities.

In these circumstances, the absence of commercial drivers for integrating generation and transmission assets, and as noted in the RIS, the absence of evidence in the NEM of a company engaging in anti-competitive conduct through its ownership of both generation and transmission, suggests that the problem being addressed by the proposed regulation is unlikely to emerge. Should a problem emerge, it has not been demonstrated that the regulation of networks under the NEL, and the general competition provisions in the TPA, are incapable of addressing and correcting any substantive concerns.

### *The adequacy of section 50 of the TPA*

Section 50 of the TPA prohibits restricts merger activity that would have the effect of substantially lessening competition.

The adequacy of section 50 to regulate competition issues in the energy industry, and common ownership of transmission and generation assets in particular, has been discussed a number of times, in particular in:

- (i) an issues paper released in January 2005 by the Victorian Department of Infrastructure (DOI) to discuss the regulation of different functions of the electricity and gas sectors, and the relative merits of the energy cross ownership regulations in Victoria in particular;<sup>2</sup>
- (ii) a discussion of market structure issues in the energy sector in the *Review of National Competition Policy Reforms* published by the Productivity Commission (PC) in February 2005;<sup>3</sup> and
- (iii) a discussion of regulatory inadequacies in the January 2007 report to COAG by the Energy Reform implementation Group (ERIG);<sup>4</sup>

The three discussions above, and the various submissions to them, do not provide a unanimous view on the adequacy of section 50 in relation to the energy sector and the mandatory separation of transmission. In summary, the analysis and conclusions of each are:

- (i) in the case of the DOI cross ownership issues paper, that sole reliance should be placed upon the TPA provisions for regulating changes in ownership in the national energy markets, on the basis that structural reform and other pro-competitive measures in the energy sectors such as the regulated determination of terms and conditions of access to networks and the power for the regulator to issue ring fencing guidelines for electricity transmission have adequately addressed the market power of networks and in particular severely circumscribe the ability of a transmission company to favour an affiliated generator;<sup>5</sup>
- (ii) in the case of the PC review of national competition policy reforms, the review noted the opposing views on the adequacy of section 50,<sup>6</sup> and in particular the difficulties in assessing, in the case of common ownership of transmission and generation assets, the relative merits of allowing market forces to determine market structure or imposing structural rules, and recommended that an independent national review should be initiated into competition implications of cross ownership of transmission and generation assets in the electricity industry;
- (iii) in the ERIG Report, the ERIG noted that vertical mergers of generation and transmission were neither desirable nor likely to be effectively regulated through

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<sup>2</sup> *Cross-ownership Rules for the Energy Sector*, Issues Paper, Department of Infrastructure, Victoria, January 2005.

<sup>3</sup> *Review of National Competition Policy Reforms*, Productivity Commission Inquiry Report, No. 33, 28 February 2005.

<sup>4</sup> *Energy Reform: the way forward for Australia*, a report to the Council of Australian Governments by the Energy Reform Implementation Group, January 2007.

<sup>5</sup> DOI *op. cit.* pp.5-8, 10-12, 15-16.

<sup>6</sup> See in particular Box 8.3, pp.191-2 of PC *op. cit.*

section 50, and that specific ownership restrictions are a low risk alternative strategy in this case, and that the any such rules would have to carefully consider how such rules would apply to government-owned electricity assets.<sup>7</sup> The RIS notes that the COAG decision on developing specific recommendations to maintain separation of generation and transmission is not intended to result in any divestment of interests by State or Territory governments that have beneficial interests in the relevant assets.

A significant factor in the debate was a concern that the trend to vertical integration of generation and retailing activities represented a potentially anti-competitive development inconsistent with the disaggregation of the industry undertaken in the initial government reforms of the energy sector. That concern has been comprehensively analysed and dismissed.

However, most agree that the integration of transmission and generation activities raises more genuine concerns (as noted at pages 7-8 of the RIS). The unresolved issue is whether the general powers of the TPA are sufficient to address any market power problems that may emerge from any future integration of transmission and generation.

The case for supplementing section 50 with industry specific provisions for the electricity sector is based largely on the premise that the electricity sector has unique and complex characteristics that require special attention.

The issue of the complexity of the electricity sector in respect of applying the general competition law has been discussed at various levels in each of the three reviews cited above and in some submissions to them. While there is no unanimous position, the arguments put by specialists in competition law do not support conclusively the conclusion that there is something unique about the electricity sector that warrants special provisions.

For example, the report commissioned by ERIG on *“The Effectiveness of the Trade Practices Act to Guide Mergers in the Australian Electricity Market”* noted that:

*“The TPA, as it currently applies, is effective, provided the ACCC is able to gather evidence to substantiate its a priori assessments of market power and the effects of mergers on competition. The provisions of section 50 allow the ACCC to address all in-principle sources of lessening of competition, across all types of horizontal and vertical electricity industry mergers.”<sup>8</sup>*

The majority of submissions to ERIG noted that there is no evidence that section 50 has failed in the electricity industry.<sup>9</sup>

While the concerns about potential market power problems emerging from any future integration of electricity transmission and generation are valid, it is not clear that any potential problem could not be adequately addressed under the TPA.

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<sup>7</sup> ERIG, *op. cit.* pp.128-129, p. 135.

<sup>8</sup> Acacia CRE Competition and Regulatory Economics, 22 November 2006, p. ii.

<sup>9</sup> ERIG, *op. cit.* p.132

Comment is sometimes made that, because electricity is a product that cannot be stored, with the result that buyers do not have the option of deferring purchase decisions when presented with inappropriately high prices, that this is a sufficient reason to regulate the sector more directly.

Two points can be noted in this regard: first, electricity can be (and usually is) pre-purchased at contracted prices and the presence of these forward markets substantially addresses any concerns that may arise from the inability to store electricity, and secondly, the preservation of competition in the generation and retailing sectors provides the most efficient means of ensuring that buyers have choice and that any incentive to sustain non cost reflective energy prices is disciplined. The preservation of competition in the merchant sectors is addressed directly by network regulation, which is discussed next.

#### *The adequacy of the national electricity access regime*

The RIS argues that the access regime for electricity transmission is not sufficient to comprehensively prevent an integrated generation/transmission company from harming competition in the generation market. The RIS states that the electricity access regime does not provide sufficient safeguards to deal with generation/transmission issues, and that operational decisions of market participants that relate to market power are outside the scope of access negotiations,

Two points are noted in relation to these claims:

- (i) the electricity access regime, as an applied version of the national access regime in the TPA, is specifically designed to deal with the principal source of market power of essential service monopoly infrastructure by denying the providers of its services the opportunity to deny access or charge prices that are above cost; and
- (ii) any operational decisions in the sense used in the RIS that are potentially anti-competitive can be dealt with under the general competition regulation powers if sufficient analytical rigour is developed and applied, and moreover be dealt with more directly if the exact circumstances of any alleged anti-competitive activity are assessed and remedied rather than relying on a general proscription of transmission/generation cross ownership.

The RIS cites various locational and capacity strategies that integrated entities may develop to exercise market power as an example of complex operational matters that are too complex to be monitored and corrected if necessary under the enforcement powers of the access regime (pp.10-11 of the RIS). The strategies include locating generation at points that advantage the integrated generator relative to competing generators in terms of transmission capacity and/or pricing (regional) boundaries, or which influence the development of the network in ways that will advantage the integrated entity.

It has not been demonstrated that the putative conduct described in this section of the RIS is not capable of being remedied under the general powers of the TPA, but even if the competition regulator is unable to correct the conduct should it emerge,

these are strategies which, if they emerge, are directly addressed by the portfolio of regulatory measures in place or proposed for the electricity sector. For example, improvements to the locational pricing arrangements in the NEM would provide more transparent and efficient pricing and locational incentives, and reduce the scope for the potential subterfuges cited in the RIS. The development of the enhanced national transmission planning function as proposed by COAG in April 2007, with the explicit objective of guiding optimal investment between generation and investment across the power system,<sup>10</sup> is a targeted and efficient approach to transmission planning which the proposed general prohibition of integrated generation and transmission activities would be unlikely to usefully supplement.

#### *The precedent of the Victorian cross ownership provisions*

The RIS notes that other Australian legislative schemes which place specific restrictions on ownership include the provisions in Victorian legislation which provide for the separation of electricity generation, transmission and distribution sectors, and that the provisions recognise potential competition concerns regarding the ownership of both generation and transmission assets (p.5 of the RIS).

The Victorian provisions were introduced in 1995 and were transitional. The intention was to preserve the competitive dynamics of the industry structure established at the time of the disaggregation, corporatisation and sale of energy assets in Victoria, pending the application of the general competition test in section 50 of the TPA (substantial lessening of competition) from 1 January 2001.<sup>11</sup>

The Victorian provisions were subsequently amended to enable approval of exemptions to the provisions where the ACCC had advised that it did not intend to take action in relation to any merger that breached the ownership rules or had authorised the acquisition under the TPA.

In other words, the intent of the Victorian provisions always was to provide a transitional preservation of the industry structure created by the Victorian Government's privatisation program, and thereafter allow the industry structure to evolve efficiently, subject only to the general competition regulation provisions in the TPA.

#### **Risks of specific merger constraints**

The energy industry operates within the dual framework of effective competition and regulated monopoly infrastructure. As discussed above, this dual framework does not warrant special treatment beyond that provided by the industry-specific access regime to manage the monopoly power of the networks.

To differentiate the electricity industry based on factors such as the non-storable character of electricity or the importance to the economy of efficiently provided energy is counter-productive: a special set of rules could have the effect of distorting

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<sup>10</sup> COAG Communiqué, April 2007, *Supplementary Information, National Reform Agenda, Competition Reform*, pp.3-4

<sup>11</sup> *Victoria's Electricity Supply Industry, Towards 2000*, Department of Treasury and Finance, Victoria, June 1997, p.53.

the flow of investment away from the energy sector, and thereby reduce the degree of efficiency that should be promoted for investment in the energy sector. As noted in the Victorian cross ownership review issues paper:

*“A possible concern with imposing tougher rules for mergers in the energy sector than applies to other sectors of the economy (is that it) may distort the flow of investment away from the energy sector generally, which may cause harm to energy dependent industries. Given the large ongoing capital expenditure requirements of the sector as a whole, the potential to dissuade investment is an important consideration.”<sup>12</sup>*

It is not clear why the electricity sector should require specific provisions creating an absolute constraint against particular mergers, as opposed to the competition regulator examining each case on its merits.

## **Conclusion**

For the reasons outlined above, the proposal to develop specific regulatory arrangements to maintain the separation of generation and transmission activities in the NEM is unnecessary given the adequacy of general powers to regulate any anti-competitive developments under the TPA, the regulated provision of third party access to monopoly transmission under the national electricity access regime in the NEL, related measures to constrain anti-competitive opportunities for transmission companies that may participate in the competitive generation or retail markets, and the absence of substantial commercial incentives to merge generation and transmission assets.

The proposal will provide a precedent for superfluous industry-specific competition regulation in the energy sector that has the potential to increase sovereign risk for investors in the energy sector, at the potential cost of attracting fully efficient and timely investment in the electricity sector. It also represents a proliferation of regulation at a time when the COAG is generally committed to reducing unnecessary regulation.

For these reasons, the proposal to proceed with the development of industry-specific provisions to maintain separation of electricity generation and transmission activities should be re-assessed.

Yours sincerely



**Brad Page**  
Chief Executive Officer

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<sup>12</sup> DOI *op. cit.*, p.15.