



Australian Energy Regulator

Submission to the Ministerial Council on Energy Standing Committee of Officials

Consultation Regulation Impact Statement on separation of generation and transmission

22 September 2011

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Introduction

The Australian Energy Regulator (AER) welcomes the opportunity to comment on the Consultation Regulation Impact Statement (C-RIS) on separation of generation and transmission released by the Ministerial Council on Energy (MCE) Standing Committee of Officials on 11 August 2011.

This submission outlines the AER's views on the issues raised in the C-RIS. The submission makes the following points:

- The current provisions in the Competition and Consumer Act 2010 (CCA) are unlikely to be sufficient to prevent the potential market harm that may result from co-ownership of transmission and generation businesses.
- Appropriate safeguards for the pro-competitive structure of the electricity supply industry in the form of industry-specific provisions to deal with co-ownership of generation and transmission should be implemented to complement the provisions of the CCA.
- The preferred method of implementing such safeguards is through the introduction of a provision in the National Electricity Law (NEL) which limits the level of co-ownership of transmission and generation activities.

Background

Co-ownership of transmission and generation businesses has long been recognised to give rise to significant competition concerns. Since the commencement of the National Electricity Market (NEM) in December 1998 there have been a number of public inquiries that have addressed this issue.

In 2004, the Productivity Commission commenced a public inquiry into National Competition Policy (NCP) arrangements. As part of the inquiry the Productivity Commission sought views on the impact of the NCP reforms on the Australian economy and community, and areas where further reform was necessary. The ACCC made two submissions to this public inquiry, one in July 2004 and one in December 2004. While both submissions dealt with a number of competition issues, both discussed issues surrounding the co-ownership of generation and transmission businesses.

In January 2005, the Victorian Department of Infrastructure released an Issues Paper to discuss the appropriate framework for the regulation of cross-ownership of the different functions of the electricity and gas sectors. The ACCC submission included a discussion of issues regarding transmission-generation integration.

As the MCE has noted, there have been a number of market and regulatory changes relating to generation and transmission co-ownership since these public inquiries were conducted.¹ However, the AER considers that the ACCC's submissions to these previous inquiries are still relevant in the current regulatory regime. Accordingly, the following documents should be referred to in conjunction with this submission:

¹ As listed on p.2 of the MCE's CRIS

- The ACCC’s submission to the Victorian Department of Infrastructure’s Issue Paper ‘*Cross-ownership rules for the Energy Sector*’ in April 2005 (DOI Submission).²
- The ACCC’s submissions to the Productivity Commission’s review of NCP of July 2004³ (July NCP Submission) and December 2004⁴ (December NCP Submission).
- A report by Frontier Economics, ‘*Assessing generation – transmission mergers in the NEM*’ prepared for the ACCC in August 2004⁵ (Frontier Economics Report).

The need for structural separation of transmission and generation activities

The AER is of the view that effective separation of the transmission sector from generation is necessary in the NEM. The ACCC has previously discussed its concerns about vertical integration between generation and transmission, and its preference for the effective separation of the two activities.⁶ For example, in the DOI Submission the ACCC expressed the view that:

“effective structural separation of the operation and control of the transmission sector from generation is an important issue in the NEM where the incentive to discriminate against upstream and downstream rivals do exist. There are numerous possible methods to effect that discrimination. In some cases these are subtle, and therefore may be difficult to detect. Discrimination could occur through limiting or raising the price of access to monopoly services to competitors by:

- imposing terms for access (restricting access to the transmission network by delaying or degrading connections)
- investment and maintenance decisions (restricting the quantity and quality of the transmission service provided or pursuing improvements in the network performance for its affiliated interests)
- sharing commercially sensitive information regarding competing generators with its affiliated generator or retailer
- line rating decisions
- negotiation and processing of connection agreements.”

The AER remains of the view that the concerns raised by the ACCC in previous submissions are relevant to the NEM.

² ACCC, *Cross-ownership rules for the Energy Sector, Submission to the Victorian Department of Infrastructure*, April 2005 (**Appendix A**).

³ ACCC, *Submission to the Productivity Commission Review of National Competition Policy Arrangements*, 13 July 2004 (**Appendix B**).

⁴ ACCC, *Submission to the Productivity Commission Review of National Competition Policy Arrangements*, 10 December 2004 (**Appendix C**).

⁵ Frontier Economics, *Assessing generation – transmission mergers in the NEM*, August 2004 (**Appendix D**).

⁶ See Section 3.3 of the DOI Submission, section 5.3 of the July NCP Submission, and section 3.2 of the December NCP Submission.

Current cross ownership restrictions

Section 50 of the CCA prevents acquisitions of shares in a body corporate or assets of a person by a corporation where the acquisition would have the effect, or would likely have the effect, of substantially lessening competition in a market. If the ACCC considers that an acquisition contravenes s. 50 of the CCA and the parties do not agree to modify or abandon the acquisition, the ACCC can apply to the Federal Court for an injunction, divestiture or penalties.

A key purpose of the CCA is to protect competition in markets in Australia, including the NEM. The AER notes that whilst the application of s. 50 of the CCA will generally address competition issues arising from a particular acquisition effectively, it is not specifically designed to achieve the effective separation of generation and transmission activities in the NEM. As has been previously recognised, there may be specific issues in the NEM that s. 50 does not address:⁷

“...there are costs to vertical integration which may not be adequately captured by section 50. Mergers involving natural monopoly and contestable activities may allow a regulated entity to discriminate in favour of its upstream or downstream businesses. There are concerns that the regulated entity might discriminate as to the terms of access for rival competitors. These problems of a ‘regulatory evasion’ nature, which are consequent on the existence of information asymmetries, are unlikely to be fully captured in the substantial lessening of competition test in section 50.”

Further, s. 50 cannot prevent transmission companies from building new generation capacity in the NEM.

The ACCC has also previously noted that there are a number of issues with maintaining effective separation through the Transmission Ring Fencing Guidelines it issued in 2002 (and which the AER adopted in 2005).⁸ The main concern raised by the ACCC was that in the absence of structural separation the Guidelines may have limited impact on the exercise of market power due to difficulties in verifying compliance with and enforcing the Guidelines.

The AER is of the view that these concerns still apply to the NEM. Section 50 of the CCA and the Transmission Ring Fencing Guidelines are not likely to be sufficient to deal with the competition concerns that transmission and generation co-ownership present.

Cross-ownership restrictions in other sectors

The introduction of cross-ownership restrictions between transmission and generation in the NEM would not be unprecedented. Restrictions on cross-ownership are present in other sectors, such as broadcasting and airports.

Part 5 of the *Broadcasting Services Act 1992* (BSA) contains a number of provisions which deal with media diversity and ownership. The provisions include statutory control rules which restrict the combined reach of licences, the control of licences in

⁷ See Section 3.4 of the DOI Submission, and 5.3 of the July NCP Submission.

⁸ See Section 3.4 of the DOI Submission.

the same licence area, and the holding of specified directorships.⁹ Part 5 also contains media diversity rules which restrict cross-media ownership.¹⁰

Many of the restrictions contained in the statutory control and media diversity rules rely on the concept of ‘control’. The BSA contains rules to determine when a person is in a position of control.¹¹ The rules provide that a person with a company interest in excess of 15 percent will be regarded as in a position to control a company. However, the rules also note that the concept of control of a licence, newspaper, or company, is complex and cannot always be determined by the size of the interest held in that company. As a result the Australian Communications and Media Authority has the power to undertake a qualitative assessment to determine whether a person is in a position to exercise control of a company, licence or newspaper.

The *Airports Act 1996* also contains co-ownership restrictions. The act prohibits an airline owning a greater than five percent stake in an airport operator.¹² The DOI Submission notes that these restrictions ‘recognise the fact that a level of control of the essential facility (even small) could lead to the ability to discriminate in favour of one’s own business.’

Preferred regulatory option

The C-RIS sets out three options for the reduction or removal of market power concerns associated with co-ownership of generation and transmission in the NEM. The AER is of the view that for the reasons set out in this submissions that maintaining current arrangements (Option A), is not the preferred method of dealing with the concerns. The current provisions of the CCA may not be sufficient to deal with the competition concerns that transmission-generation integration pose.

The AER is of the view that there should be effective separation of generation and transmission activities. The C-RIS sets out two ways to do this, through the enhancement of the Transmission Ring Fencing Guidelines (Option B), or the insertion of a provision into the NEL (Option C). The AER considers that the appropriate way to ensure the effective separation of generation and transmission businesses is to introduce a provision into the NEL that limits the level of cross-ownership, such as that set out in Option C of the C-RIS.

The AER supports the view that the NEL provision should prohibit co-ownership of transmission and generation except in limited circumstances. As suggested in Option C:

- a Transmission Network Service Provider (TNSP) should be permitted to hold a maximum interest in a generator of five percent
- a generator should be permitted to own a slightly higher interest in a TNSP.

This asymmetric regulation of TNSPs and generators is appropriate due to the risks posed through ownership of competitive services by a monopoly service provider.

⁹ See ss. 53, 54, 55 and 56 of the BSA.

¹⁰ See ss. 61AB and 61AEA of the BSA.

¹¹ See s. 7 and Schedule 1 of the BSA.

¹² See ss. 44 to 47 of the *Airports Act 1996*.

Where a TNSP has an interest in a generation asset, it has the ability and the economic incentive to discriminate against rival generators, regardless of the level of the interest in the generator. This means a low limit should be placed on the interest a TNSP can have in a generator. It is probable that a five percent limit will be low enough to prevent such discrimination, while still allowing a TNSP to own generation assets necessary to support its network. Conversely, a generator with a stake in transmission assets does not have the ability to discriminate against its generation rivals unless it is able to exercise control of the TNSP. As a result it may be appropriate that a generator be permitted to hold a greater than five percent interest in a TNSP. Setting such a limit should be approached with caution, as a generator with even a low level of interest in a TNSP may have a competitive advantage due to the information it has access to through its ownership stake in the TNSP. This advantage may even extend to the influence and information it receives through a board appointment it receives as a result of its voting interest.

For the reasons outlined above, the AER considers that an approach as suggested in Option C of the C-RIS is the preferred regulatory approach. This approach complements the provisions of the CCA which deal with mergers and acquisitions, avoids the problems associated with monitoring of compliance and enforcement of the Transmission Ring Fencing Guidelines, and is consistent with views previously expressed by the ACCC.¹³

Appendices

Appendix A

ACCC, *Cross-ownership rules for the Energy Sector, Submission to the Victorian Department of Infrastructure*, April 2005

Appendix B

ACCC, *Submission to the Productivity Commission Review of National Competition Policy Arrangements*, 13 July 2004

Appendix C

ACCC, *Submission to the Productivity Commission Review of National Competition Policy*, 10 December 2004

Appendix D

Frontier Economics, *Assessing generation – transmission mergers in the NEM*, August 2004

¹³ See Section 3.4 of the DOI Submission.