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Submission to ACCC Retail Electricity Pricing Inquiry Recommendation 1 consultation

AGL Energy (**AGL**) welcomes the opportunity to make a submission in response to the consultation paper released by the Energy Security Board on the ACCC Retail Electricity Pricing Inquiry (**REPI**) Recommendation 1, which proposed that the National Electricity Law (**NEL**) be amended to:

> *"prevent any acquisition or other arrangement (other than investment in new capacity) that would result in a market participant owning, or controlling dispatch of, more than 20 per cent of generation capacity in any NEM region or the NEM as a whole.*
>
> *The provision should be designed to prevent market participants circumventing the 20 per cent cap, including by way of ownership structure or contractual arrangements."*

For ease of reference, we refer to the above proposal as Recommendation 1 or a market share cap.

Recommendation 1 not subject to any consultation

AGL believes it is important to recognise that there has not been any consultation on the need for, or effectiveness of, Recommendation 1 of the REPI. There was no discussion of the issues Recommendation 1 purports to address in the REPI preliminary report published in September 2017 (**Preliminary Report**), and no discussion, let alone consultation, on Recommendation 1 with any stakeholders.

Recommendation 1 not supported by any analysis

AGL does not support Recommendation 1 for the following reasons:

- An arbitrary market share cap appears to be an attempt to fix an issue that has not been identified in a number of in-depth inquires and market reviews, including the AER's most recent report into the performance of the wholesale market;
- The ACCC's final report in the REPI (**Final Report**) fails to demonstrate:
  - that the wholesale market is concentrated, with the ACCC's numbers showing that the NEM-wide market is far from concentrated;
  - a clear link between market concentration in generation and high prices to establish there is insufficient competition. Instead, the Final Report appears to merely assume this.
- Significant regulatory intervention in a complex market should not be implemented on the basis of an assumption, particularly a market undergoing significant transformation such as the National Electricity Market (**NEM**).

Recommendation 1 is arbitrary and does not consider changing market dynamics

The NEM is a market undergoing considerable transition and the ACCC's approach in the REPI was to look backward to find a solution to promote competition in the future. The NEM is also a market in need of considerable investment. Both the AER's wholesale market review and ACCC Final Report have noted the impact of policy uncertainty upon investment. In this context it is even more important for regulatory change and further market intervention to be considered carefully so as not to deter investment.

The 2017 report by Dr Alan Finkel AO into the future security of the NEM identified the need for investment in generation to ensure the reliability of the NEM. Relying on modelling by Energy Networks Australia and CSIRO, the Finkel Panel forecasted that $419 billion of expenditure on centralised generation by 2050 was required. Regulatory changes that impact on investment certainty therefore need to be heavily scrutinised and their potential impacts assessed before being adopted.

Next steps on Recommendation 1

AGL understands the ESB is tasked with advising the COAG Energy Council (**COAG**) with advice on Recommendation 1. AGL encourages the ESB to recommend to COAG to:

- undertake a proper analysis regarding the differing levels of concentration in generation and the impact that has on prices. By undertaking a root cause analysis, solutions can be developed that would address actual identified anti-competitive conduct in the NEM and safeguard competition in this time of change;
- consider whether regulatory intervention is necessary given dynamic factors in generation such as the increased use of renewable generation, changing technology, the retirement of coal-fired power plants, consumer demand factors within the context of broader issues such as consumer demand for renewables and government energy policy;
- have regard to previous reviews of Australia's competition law and policy (such as the Dawson review in 2003 and the Harper panel review in 2015), which have rejected previous calls to introduce market share caps and amend the substantial lessening of competition test in section 50 of *Competition and Consumer Act* 2010 (Cth) (**CCA**).

In relation to Recommendation 1 itself, AGL agrees with:

- the ESB observation in its consultation paper that "a capacity cap would operate as a relatively 'blunt' measure which would not fully capture the potential for exercise of market power"; and
- the questions that the ESB are raising, which highlight the complexity of the task that Recommendation 1 will set for the AER and makes it clear that it is more than just a matter of applying an objective test.

AGL considers there is already a way to prevent anticompetitive acquisitions from taking place using section 50 of *Competition and Consumer Act* 2010 (Cth) (**CCA**). This continues to be the most effective means to prevent further consolidation in generation that would harm competition.

If you have any queries about this submission, please Adelina Widjaja on (02) 9921 2239 or Kirsten Torrance on (03) 8633 7260.

Yours sincerely,

Beth Griggs
General Manager, Competition Regulation and Strategy

1. Executive summary

AGL does not agree with Recommendation 1 and considers that any competition concerns arising from further consolidation in wholesale electricity supply can be addressed through existing mechanisms in Australia's competition law. AGL's reasoning is summarised below and section 2 of this submission responds directly to the ESB's specific consultation questions.

Failure to consult on Recommendation 1

The ACCC indicated in its Preliminary Report that it would likely consider constraints on further consolidation of ownership of existing generation assets among other potential solutions to improve outcomes in wholesale markets.[1] However, there was:

- no detail on what these constraints would look like, nor was there any consultation between the Preliminary Report and the Final Report on the substance of such constraints;
- no discussion or consultation on why such constraints on further consolidation would be effective or necessary to improve competition in wholesale markets and improve affordability.

Six months passed between the release of the Preliminary Report (September 2017) and Final Report (July 2018), giving the ACCC ample opportunity to consult with stakeholders who were actively engaged with the ACCC on the issues it had raised throughout the REPI.

No analysis to support Recommendation 1

In its Preliminary Report, the ACCC stated that the focus for the remainder of the REPI was to "identify practical, viable and meaningful measures that will ease the pressures on electricity prices for Australian households and business".[2] Yet in the Final Report, there is no analysis to show why Recommendation 1 would achieve this stated goal and do more than place an artificial restriction on ownership of generation.

The ACCC appears to have concluded that a restriction is necessary because the levels of concentration in all regions of the NEM have created a wholesale market structure that is not conducive to vigorous competition, resulting in high wholesale and retail prices. These conclusions have been reached by assumption only rather than hard facts and proof of misuse of market power, assumptions which have not been supported by other reviews conducted by the AER and AEMC.

In particular, AGL notes that:

- the wholesale electricity market is not concentrated on a NEM-wide basis and appears to be only moderately concentrated on a regional basis or concentrated due to factors not related to acquisition activity such as government policy and plant closures. Using the Herfindahl-Hirschman Index (**HHI**) as a measure of market concentration and the ACCC's own NEM-wide market share figures in the Final Report,[3] concentration in the NEM is well below what would be considered concentrated;[4]
- there is no link between alleged concentration levels and high prices, and the AER makes clear in its *Wholesale electricity market performance report* published in December 2018 (**AER Wholesale Report**) that there are other factors influence prices and any concentration, while providing some participants with greater potential to exercise power, did not mean that those participants have an incentive to do.

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[1] ACCC, *Retail Electricity Pricing Inquiry – preliminary report*, 22 September 2017, p 151
[2] ACCC, *Retail Electricity Pricing Inquiry – preliminary report*, 22 September 2017, p 151.
[3] ACCC, *Retail Electricity Pricing Inquiry – final report*, Figures 2.2 and 2.3.
[4] AGL understands that the calculation of HHI is dependent on a number of assumptions and the boundaries of the relevant market.

The AER concluded that short term behaviour was not a significant contributing factor to recent energy price rises;[5]

- there is no analysis to show why dispatchable generation capacity is the most appropriate metric. This metric ignores the competitive dynamics in the market, including the increasing competitive constraint penetration of renewables, demand response and distributed generation are exercising – they are in fact operating to displace dispatchable generation;
- Recommendation 1 adopts both a regional and NEM-wide geographic market definition but there is a clear legal precedent that the relevant scope of the generation market is NEM wide.[6] Looking at generation on a region by region basis does not recognise the constraints placed by interconnectors on generation due to capacity limitations or outages, nor does it recognise the fact that many generators operate their generation on a portfolio basis across jurisdictions;
- as the Federal Court has found, an ability to opportunistically bid to increase the spot price in period of high demand reflects only a temporary or "intermittent phenomenon" and not an ongoing ability to price without competitive constraint, particularly taking into account the possibilities of new entry and upgrade of interconnectors;[7]
- the 20 per cent level is arbitrary. The ACCC uses 20 per cent in its *Merger Guidelines* as an informal safe harbour or notification threshold. In Recommendation 1, 20 per cent is being used to establish which acquisitions will be strictly illegal;
- market share caps have been considered and rejected in previous reviews of Australia's competition laws, including the Dawson Review (2003) and Harper Review (2015).

Tension between Recommendation 1 and market design

There is a clear tension between the assumptions underlying Recommendation 1 and market design. The ACCC did acknowledge in the Final Report that high prices at times of tight supply and demand is a feature of the current market design of the NEM as an energy only market.[8] However, AGL observes that this fundamental premise of market design was not given appropriate weight in developing Recommendation 1. Instead, the focus was placed on alleged market concentration and assertions of the impact of this on market structure and behaviour.

Practical implementation

If an analysis is conducted that supports a finding that market concentration is an issue, then the practical implementation of Recommendation 1 needs to be considered, which the ACCC has not done. A market share cap raises the following practical issues:

- how to calculate market shares – even where the market and market share metric has been restricted in the manner suggested, it is not clear how this could be practically implemented given:
    - it is possible to calculate share of dispatchable generation in several ways, such as by nameplate capacity, actual generation output over a particular periods in time (over a year or for specific trading intervals or shorter time periods), or factoring in AEMO's capacity ratings which take into account factors such as maintenance, forced outages and capacity factors;

[5] AER, *Wholesale electricity market performance report*, December 2018, p iv.
[6] See for example: *AGL v ACCC (no 3)* [2003] FCA 1525 at [387]; *Re Application for authorisation of acquisition of Macquarie Generation by AGL Energy Limited* [2014] ACompT 1 at [6]-[10].
[7] *AGL v CCC (no 3)* [2003] FCA 1525 at [493].
[8] Final Report, p 41.

- a focus on dispatchable generation does not take into account the increasing constraint intermittent or flexible generation and new technologies which may not be fully dispatchable;

- how to account for dynamic factors – in the AER Wholesale Report, the AER noted that the market is undergoing significant transformation with coal-fired capacity being retired, renewable generation rapidly rising and new products emerging.[9] However, market shares are a blunt tool and a point-in-time snapshot that tells us little about what is happening in the market;
- how to account for shifting market shares – investment decisions and acquisition activities do not happen quickly and market participants will not be able to foresee how market shares (however they are calculated) may shift over a transaction timeline as capacity enters and/or leaves the market. It is possible to imagine, given the changing nature of the market, a transaction that does not breach the cap when it is first initiated breaching the cap before the transaction is completed due to the closure of a power station by a competitor or other market movements.

There are no clear answers to the questions above and each method will have advantages and disadvantages, highlighting the practical difficulties with implementing a market share cap. AGL is firmly of the view that consideration of these issues makes clear that any cap of the sort contemplated in Recommendation 1 must be attached to a market as defined by the usual competition law process applied in respect of the provisions of the CCA.

Applying and enforcing Recommendation 1

Given the practical considerations above, a market share cap gives rise to enormous uncertainty when market participants are considering acquisitions and other arrangements in generation. This uncertainty may inadvertently chill investment and/or prevent efficiency enhancing acquisitions and arrangements from occurring. It may leave inefficient, high emission dispatchable generation power stations under ownership that is unable to invest in the necessary upgrades, which would have been the case had AGL been prevented from undertaking previous acquisitions that the ACCC has objected to (the Loy Yang example is discussed further below in section 2.1.5).

Should the ESB be minded to recommend the implementation of Recommendation 1 to COAG, which AGL considers is not appropriate, the application of the restriction should be limited in the following way:

- the level of the cap should be increased significantly and calculated on the basis of NEM-wide capacity only;
- the market share cap should not apply to acquisitions of, or other arrangements involving, capacity that is not yet operational. The acquisition of a development site or contractual arrangement related to committed capacity should not be prevented by the cap given that such transactions are often necessary for new generation to be supported;
- before taking any action the AER must be required to consider dynamic factors and consult with market participants on how any share calculation is to be undertaken and the AER's preliminary views;

Further, the AER should not be given enforcement powers, including any power to seek divestment orders or unwinding of any merger or contractual arrangements.

- Such powers are properly exercised by the ACCC within the framework of the CCA which is more than adequate at resolving issues of aggregations of market concentration which result in competitive harm as previous reviews of Australia's competition law and policy have concluded.

[9] AER, *Wholesale electricity market performance report*, December 2018, p 4.

- The uncertainties around implementation and application highlight that the AER would be seeking to apply an ‘objective test’ to circumstances that do not permit such an analysis – the process required is a competition assessment akin to one the ACCC undertakes in enforcing section 50 of the CCA.
- The AER’s role should be purely advisory within the context of the ACCC’s role in enforcing section 50 of the CCA (eg referring acquisitions to the ACCC for further consideration or assisting the ACCC’s review).

If the ESB considers that the AER should have enforcement powers, there needs to be a broader consideration of whether the ACCC is to remain the cross-sector competition authority given Recommendation 1 potentially results in an overlap between the duties of the ACCC and the AER.

2. Consultation questions

2.1. Factors that have not been adequately considered by the ACCC

Are there factors which stakeholders feel have not been adequately considered by the ACCC that would have a material impact on determining either:

1. the per cent market share at which the ownership cap is set

2. whether the cap should be set in terms of nameplate capacity or some other measure.

For example, how should factors like the dynamic nature of market responses and constraints caused by generators operating in the relevant geographic area, be taken into account?

The ACCC envisaged exemptions for cases where there is takeover of a portfolio from an entity with no NEM generation capacity at the time. Should flexibility also be considered for entities which own only a very small amount of generation capacity located in another NEM region?

2.1.1. *Insufficient analysis of competition concerns justifying restrictions on further consolidation*

The Final Report contains a series of assumptions around levels of market concentration and an alleged link between concentration levels and high prices which purport to lend support for the implementation of Recommendation 1. While AGL appreciates the level of concerned raised by the ACCC, it does not consider that the case has been made for why further consolidation in the wholesale market should be restricted through the application of a market share cap.

AGL considers that the ACCC's conclusions around concentration levels need to be challenged because:

- The ACCC's own NEM-wide market share figures reveal that the market is not concentrated. The HHI for generation capacity and generation dispatch is under 1300, which is below the level (2000) that the ACCC would find competition concerns;
- The ACCC focuses on regional market shares to its own benefit but an HHI analysis again shows that certain regions are better described as moderately concentrated, and other reasonable alternative ways of calculating market share result in a similar conclusion;
- In some cases, the alleged increase in concentration levels the ACCC has identified are not due to acquisitions but are the result of:
    - state government decisions to restructure its generation businesses (in the case of Queensland);
    - the closure of power stations such as Hazelwood in Victoria and Playford and Northern in South Australia.

There is also limited analysis of the link between the alleged concentration levels and high prices.

AGL notes that the AER conducted a more detailed analysis of the causes of high prices and market concentration in its *Wholesale electricity market performance report,* published in December 2018. The AER found that:

- reasons for high prices include the exit of low-cost coal generation with higher cost generators filling this gap and higher fuel costs;

- while there are a few vertically integrated participants that control significant generation, making the market potentially vulnerable to the exercise of market power, these market participants may not have an incentive to do so.

The AER concluded that short term behaviour was not a significant contributor to recent price rises.[10]

Even assuming the levels of concentration alleged by the ACCC, high spot prices and spot price volatility alone do not constitute evidence of the existence of market power or the exercise of it. As the Federal Court has found, a generator's ability to opportunistically bid to increase the spot price in periods of high demand does not necessarily translate to having market power:[11]

> *"…I do not accept that such inter-temporal market power reflects more than an intermittent phenomenon nor does it reflect a longrun phenomenon having regard to the possibilities of new entry through additional generation capacity and the upgrade of interconnections between regions. It does not amount to an ongoing ability to price without constraint from competition*".

The market share cap also appears to be unnecessary given that in both the AER and ACCC reviews, the biggest concern has sat with Queensland, which is characterised by significant state ownership of generators. Any attempt to use the issues noted in Queensland to infer concerns with the wider NEM will not be helpful. The issues that have been noted in Queensland are in relation to factors unique to Queensland and are not reflective of the wider NEM, nor will a market share cap address the concerns raised in Queensland.

Without a proper basis for its introduction, Recommendation 1 falls at the first hurdle.

2.1.2. *No analysis underlying use of dispatchable generation capacity and regional market definition in Recommendation*

In addition to no analysis to show why Recommendation 1 is required, there is no analysis in the Final Report to show:

- why the normal process of market definition should be ignored;
- why dispatchable generation capacity is the most appropriate metric. This metric ignores the competitive dynamics in the market, including the increasing competitive constraint and penetration of renewables, demand response and distributor generation are exercising – they are in fact operation to displace dispatchable generation;
- why capacity should be looked at on a region by region basis when the legal precedents are clear that the relevant scope of the generation market is NEM wide.[12] Looking at generation on a region by region basis does not recognise the constraints placed by interconnectors on generation due to capacity limitations or outages, and the fact that many generators operate their generation on a portfolio basis across jurisdictions;
- why market shares alone should prevent an acquisition or other arrangement that results in further consolidation in generation from taking place.

In relation to the last point, it is widely accepted that a firm's market shares are not indicative of competitive harm or market power. In the Final Report, the ACCC noted that it does not typically favour market share

[10] AER, *Wholesale electricity market performance report*, December 2018, at p iv.
[11] *AGL v CCC (no 3)* [2003] FCA 1525 at [493].
[12] See for example: *AGL v ACCC (no 3)* [2003] FCA 1525 at [387]; *Re Application for authorisation of acquisition of Macquarie Generation by AGL Energy Limited* [2014] ACompT 1 at [6]-[10].

caps and recognised their limitations.[13] The ACCC, however, did not then go on to elaborate on why applying such a cap in the wholesale electricity market should be introduced despite those limitations.

AGL agrees with the ACCC that market share caps have limitations. This is recognised in the merger factors in section 50 of the CCA, which contains a non-exhaustive list of eight factors for the ACCC to consider in determining whether a merger would have the effect or likely effect of substantially lessening competition. Market concentration is just one of the section 50 factors, and the ACCC, in its *Merger Guidelines*, states that:[14]

> *"…market concentration is not determinative in itself. For example, firms can gain a high market share by adopting more efficient technology, lower costs and reducing prices…It is the link between concentration and the strength of competition that is important for merger analysis and this ultimately requires consideration of all relevant factors before a final conclusion can be reached".*

In discussing concentration thresholds that may raise horizontal concerns, the ACCC further states that concentration thresholds are not to be taken as implying a presumption as to whether or not a merger will be likely to result in a substantial lessening of competition.[15]

The courts and the Australian Competition Tribunal (**Tribunal**) have long recognised that they are only a starting point for analysing market power and competitive effects, as they only provide a static snapshot of a competition in a market. For example, the High Court in *Queensland Wire* noted that:[16]

> "*a large market share does not necessarily mean that there is a substantial degree of market power. To borrow the words from Reed J.'s opinion for the court in United States v. Columbia Steel Co. (1948) [1948] USSC 97; 334 US 495, at p 528, "(t)he relative effect of percentage command of a market varies with the setting in which that factor is placed."*

The Federal Court in *AGL v ACCC (no 3)*, considering an application by AGL for a declaration that AGL acquiring an interest in Loy Yang Power would not breach section 50, similarly stated that:[17]

> *"Competition in a market is not assessed by a snapshot view of participant behaviour at a particular time. The theatre of competition is a theatre of real actors and shadow actors. The shadows are cast by the potential for new entry. The competitive process is informed by the rivalry of the participants and the potential rivalry of potential participants. Competition so understood is conceptually distinct from the idea of the market and the elements of market structure which may constrain or facilitate it. Those structural elements are referred to, inter alia, in the factors set out in s 50(3) of the Act.'*

Similarly, Tribunal cases have highlighted that:

- The number of firms in the market, their market shares and market concentration can only be the starting point of an analysis of competitiveness in markets;[18]

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[13] ACCC, *Retail Electricity Pricing Pricing Inquiry – final report*, p 90.
[14] ACCC, *Merger guidelines*, November 2008 (updated November 2017), at [7.7]-[7.8].
[15] ACCC, *Merger guidelines*, November 2008 (updated November 2017), at [7.15].
[16] *Queensland Wire Industries Pty Ltd v Broken Hill Pty Co Ltd* [1989] HCA 6; (1989) 167 CLR 177 at [19] (as per Mason CJ and Wilson J).
[17] *AGL v CCC (no 3)* [2003] FCA 1525 at [350].
[18] *Application by Chime Communications Pty Ltd (No 2)* [2009] ACompT 2 at [51].

- Market shares provide a snapshot of a market but tell us nothing about the conduct in the market leading to that market share, or about dynamic interactions in the market, and predictions of dynamic changes and competitive initiatives by rival firms.[19]

AGL notes that market share caps have been considered previously in reviews of Australia's competition policy and laws. In the Dawson Committee review of the *Trade Practices Act 1974* (the precursor to the CCA), the issue came up in the context of creeping acquisitions of retail grocery outlets by major supermarket chains.[20] The Dawson Committee rejected market share caps as a solution to creeping acquisitions, noting concerns that they would "stifle competition and protect the unsustainable position of inefficient competitors" and potentially operate to deny consumer access to the products or services offered by an efficient producer.[21]

The issue was revisited during the Harper Panel's 2015 review of Australia's competition law and policy but the panel did not find evidence of harmful acquisitions proceeding because of a gap in the law on creeping acquisitions.[22] In fact, the Harper Panel noted that submissions offered near universal support for the substantial lessening of competition test in section 50 of the CCA.[23]

In light of the above, seeking to regulate ownership of generation or other contractual arrangements through a market share cap is problematic from a first principles perspective as it presumes the existence of market power at a particular level of concentration. It also presumes that mergers which result in certain market share thresholds being exceed will necessarily result in competitive harm.

2.1.3. *Level at which the cap is set is arbitrary*

In addition to setting a market share cap, the 20 per cent figure is completely arbitrary. Even if the ACCC's analysis had firmly shown a link between levels of concentration and pricing, it is unclear how the ACCC reached this percentage. Its statement that this is appropriate in the context of the market structure of the NEM,[24] and why a high threshold (30 per cent) not appropriate, tells us little as to why ownership of generation capacity in excess of this threshold results are automatically anti-competitive and should be prevented.

We note that 20 per cent has been used in the ACCC's *Merger Guidelines* as a safe harbour of sorts, with the ACCC encouraging merger parties to notify the ACCC if the merged firm will have a market share of greater than 20 per cent post-merger.[25] However, there is no presumption that mergers resulting in a post-merger market share of over 20 per cent result in a substantial lessening of competition and should be strictly prohibited. The 20 per cent threshold suggested in Recommendation 1 is completely inconsistent with the 20 per cent 'safe harbour' threshold in the Merger Guidelines.

As detailed further below, the 20 per cent market share raises issues of certainty in its application to electricity generation, which will make it difficult to enforce and create investment uncertainty.

[19] *Re Qantas Airways Limited* [2004] ACompT 9 at [430]-[431].
[20] Trade Practices Act Review Committee, *Review of the Competition Provisions of the Trade Practices Act*, January 2003, at pp 66-68
[21] Trade Practices Act Review Committee, *Review of the Competition Provisions of the Trade Practices Act*, January 2003, at p 67.
[22] Harper Panel, *Competition Policy Review: Final Report*, March 2015, at pp 321-323.
[23] Harper Panel, *Competition Policy Review: Final Report*, March 2015, at pp p 314.
[24] Final Report, p 91.
[25] ACCC, *Merger guidelines*, November 2008 (updated November 2017), at p 7.

2.1.4. *Market share calculation in electricity generation raises complex issues*

While the calculation of market share appears straightforward, it raises complex issues in relation to what is the market and who is in the market. Consideration needs to be given to the transition occurring in generation technology as well as the underlying regulatory framework. There have been a number of significant reviews which have resulted in changes to the regulatory framework, for example reviews by the AER, AEMO, AEMC, and the Finkel Review as well as the REPI. The structure of the market is evolving and may not remain a purely energy only market in the short term as additional charged services are developed and provided to meet changing technology needs, for example Frequency Control Ancillary Services. As the market continues to transition any calculation will not be a strict objective test and so inherently will contain subjective elements.

Firstly, market share is based on the definition of the market. Before applying any market share cap, the precise boundaries of the market will need to be defined, and be regularly assessed and amended as regulation and technology evolve. The AER will also need to consider what technologies comprise the market. A simplistic definition that only includes dispatchable generation based on nameplate capacity, or other capacity metric, will likely result in absurd outcomes. For example, as old thermal baseload generation is retired, generation that compromises the "market" under current expectations will likely shrink, which may result in one or two participants holding an almost 100 per cent market share of the wholesale electricity "market" when the reality is that the thermal/dispatchable generation is a small portion of the generation mix. This is not an unrealistic eventuality – investment in renewable technology is increasing because it is economically efficient to do so, encouraged by state government renewables targets and potentially other government policies.

Secondly, there are difficulties with determining how market share is to be assessed. Even if dispatchable capacity were considered an effective metric, there is a question as to what is dispatchable capacity. As technology evolves what is considered dispatchable will increasingly become a subjective test, creating uncertainty as to application over time. This means that companies cannot assume how the AER applies the market share cap in one instance will be how it applies it in another, making it difficult for companies to predict and test before initiating a transaction whether or not it is likely to breach the cap. For a test to be truly objective, there has to be certainty of application and this market share cap simply does not provide that.

Contractual arrangements create challenges for market share assessments. For example, how will joint ventures be considered when a company may only have a portion of the offtake arrangement and responsibility for the bidding of the asset in the wholesale market but do not own or operate the asset? The existence of a wide range of contractual structures is another reason why the practical implementation of Recommendation 1 is far more difficult than the ACCC have anticipated.

Further, and quite apart from the evolution of technology, nameplate capacity may not actually reflect a company's share of realisable dispatchable generation. For example, a company may own large aging thermal plant that has a large nameplate capacity. However, due to technical constraints from the age of the plant and inefficiencies of older technology that plant may no longer be able to recognise that capacity. Accordingly, that company might not actually control more than 20 per cent market share due to the reality of operating its plant, despite on paper appearing to. A further consideration which undermines the fairness in considering nameplate capacity is the availability of fuel to operate that plant. In periods of drought or gas constraints, the ability for "dispatchable" generation to be dispatched may be constrained. Any calculation of capacity will not take this into account but demonstrates the arbitrary nature of this calculation.

The ESB's consultation paper suggests adjustment measures be applied to measure average dispatch of other technologies to account for available capacity that is available in other regions, and include the capacity owned or controlled by affiliated entities. This may not result in a fair outcome. A generator may have dispatchable capacity in an adjoining region, however, that region may have significant penetration of renewables resulting in the percentage of dispatchable capacity being very large but the ability of the generator to compete with that generation to be very limited.

Further, adjustment for this factor does not take into account the consumption demands of the adjoining region and technical capabilities of interconnectors. If the purpose of a cap is to prevent misuse of market power, the company may in fact not have market power and so be unfairly discriminated against because of the nature of the market.

Thirdly, a market share calculation will be relevant at a point in time only. It fails to take into account the foreseeable changes to ownership within the NEM. For example, AGL has given notice to the market of its intention to mothball Torrens Island Power Station A progressively commencing 1 July 2019 and close Liddell in 2022. This will significantly change market share of relevant generation for AGL and other participants over the next 3 years. Companies that make investment decisions do not do so quickly. A company, with a smaller share of relevant capacity, may commit considerable resource and effort to potential acquisition of generation only to find that they are unable to acquire the asset due to the closure of dispatchable generation by a competitor which changes their market share. This raises additional risk and uncertainty for companies who are currently considered to have a smaller share and may likely discourage them from further investment decisions within the NEM.

2.1.5. *Potential detrimental impact of market share cap on investment in generation*

Given the difficulties involved with calculating a market share cap, imposing a market share cap may impact mergers and acquisitions activity, as companies cannot be certain whether a transaction they are considering would breach the cap. As noted above, this cap will give rise to questions for further acquisitions by even those companies that currently have a small presence in generation because they cannot foresee what other participants may do and its impact on the AER's calculation of market share at the time at which a transaction is being considered.

The market share cap may also prevent efficiency-enhancing acquisitions from taking place and may leave inefficient, high emission dispatchable generation power stations under ownership that is unable to invest in the necessary upgrades. For example, when AGL acquired the Loy Yang A power station business as part of a consortium in 2003, it was acquiring the business from capital constrained owners who were facing considerable difficulties in managing their debt and a significant proportion of generation dispatch was uncontracted. Since AGL acquired the power station, taking full ownership in 2012, AGL has invested significantly in Loy Yang A, including:

- in 2014, \$60 million on an integrated control and monitoring system conversion project that gave the power station state of the art digital controls;[26]
- \$120 million invested in refurbishing a generation unit and upgrading its electrical systems and performing other work on a dredger at the Loy Yang mine. This was one of the largest capital projects in the history of the power station and completed in January 2019;[27] and
- In its half year results, AGL announced a further investment of \$25 million to upgrade the turbines at Loy Yang, which will be completed by 2021 and boost output without increasing carbon emissions.

[26] https://www.agl.com.au/about-agl/how-we-source-energy/loy-yang-power-station
[27] https://www.agl.com.au/about-agl/media-centre/asx-and-media-releases/2019/january/agl-invests-120-million-at-loy-yang-to-improve-reliability-and-safety

Further, as found in a study by Frontier Economics 'Contract Liquidity in the NEM', May 2018 (which was commissioned by AGL and provided to the ACCC as part of the REPI) contract market liquidity increased following AGL's acquisition of Loy Yang.[28]

The impact on other contractual arrangements needs to be considered, for example Power Purchasing Agreements (**PPAs**), which do not confer ownership but may be included in a calculation of capacity (dependent on the approach taken). PPAs are important to underwrite investment, are economically efficient for the relevant parties, and assist in assuring the longer-term economic viability of a generator. If larger companies are unable to participate in this process because they are concerned about triggering the cap, it may impact the willingness of other investors to invest. It may also result in larger operators being unable to access sufficient capacity for their customer base increasing their costs which are ultimately passed to consumers.

Recommendation 1 explicitly states that investment in new capacity will be excluded, however, careful consideration must be given to the definition of new capacity. At what point in the decision-making process and construction of new capacity will it no longer be considered "new" and get included in the calculation of any market share cap?

If a market share is to be introduced, which AGL does not agree is necessary or appropriate, the above uncertainties need to be addressed, at the very least, by:

- excluding from the operation of the cap any investment (by way of ownership interest or contractual arrangement) in generation that is not yet operational, so that any new capacity that comes online is not added to a market participant's market share and acquisition of non-operational developments sites (including committed projects) do not trigger a breach of the cap; and
- in relation to PPAs and other contractual arrangements, AGL's view is that only those arrangements that allow the control of the dispatch of generation should be captured in any market share calculation and in considering whether that arrangement results in the cap being breached.

This minimum level of certainty is required to ensure the that incentives to make investments that are in the interests of the efficient operation of the NEM and the shift to lower-emissions power generation are not dampened, both of which have broader implications in relation to security of supply and environmental policy. Vertically integrated market participants have been the biggest investors in generation recent years. AGL has committed to five major power generation projects over the past year, more than any other company, totalling 1,200MW of new capacity and is a $2 billion capital investment.

As the ESB would be aware, ensuring investment certainty is crucial to the growth and reliability of the NEM. The Finkel Panel forecast that there would be $419 billion of investment in centralised generation by 2050 and such investment would be under threat through the introduction of an arbitrary market share cap.

[28] The Frontier Economics analysis demonstrated that the hedge volume turnover ratio increased from 5.59 to 5.91. The hedge volume turnover ratio was cited by the Australian Competition Tribunal in Application for Authorisation of Acquisition of Macquarie Generation by AGL Energy Limited [2014] ACompT 1. In effect, this ratio analysis demonstrates that there was an increase from 5.59 to 5.91 times the underlying capacity sold to retailers in the form of contracts following AGL's acquisition of Loy Yang.

2.2. International precedents are not applicable to Australia

Are there other approaches used in some international jurisdictions based on the actual potential to exercise market power that would be preferable to the ACCC recommended approach? What are the drawbacks of these approaches?

Internationally, competition authorities and regulators typically recognise that market share do not accurately measure the capacity to exercise market power and undertake transactions that lead to competitive harm. These regulators therefore do not tend to set arbitrary limits. Instead, preferring a case by case assessment for proposed acquisitions. In those jurisdictions where there are market share caps (limited to two examples), there are jurisdiction-specific reasons for doing so.

Singapore, is a clear example of a jurisdiction that has a market share cap. In 2016, the Energy Market Authority introduced a 25 per cent market share cap for both acquisition and investment in new capacity. Crucially, Singapore is a very different market to the NEM and should not be used as international precedent applicable to Australia for the following reasons –

- Singapore demand exhibits little seasonal pattern and capacity is fairly homogenous with over 95 per cent of supply generated by gas;
- a market share calculation may be a reasonable approximation of incentive to withhold capacity for benefit because of dominance of gas generation (over 95%); and
- due to the dominance of one type of generation, it is simpler to calculate market share because comparisons in generation are more like for like.

This is not a sensible approach in Australia because:

- there is volatility in demand driven by both season and location – consumption patterns differ by state;
- there is a mix of generation types and significant penetration by renewables which can be both dispatchable and non-dispatchable; and
- the complexity of the market, including the importance of financial arrangements, and the variability of drivers influencing participants results in a market share cap being a poor proxy for market power in the Australian context.

AGL would discourage the ESB from considering that the Singapore example is relevant to the Australian context.

In the United States (other than ERCOT in Texas), Europe and Great Britain there are no market share rules or caps. Instead, assessment of mergers use standards for assessing competitive effectiveness on a case by case basis. While some jurisdictions are strict in their assessment, it enables each jurisdiction to make a relevant assessment of the impact of any merger on the unique nature of its own market. AGL strongly suggests that the ESB should take note of this and recommend that no cap be implemented and instead reliance should continue on the CCA, which, as noted above, has undergone a recent and comprehensive review. Until it is found that it is no longer fit for purpose, arbitrary intervention should be discouraged.

AGL further notes that the HoustonKemp report commissioned by the ACCC for the Final Report similarly urged caution before extrapolating overseas experience to Australia. In relation to the ERCOT market share restriction, HoustonKemp notes that Texas state legislation also contained highly prescriptive behavioural regulations in relation to bid mitigation, activities that materially reduce competitiveness of the market, voluntary market power mitigation plans. For vertically integrated generators, ERCOT also requires legal separation of businesses involved in retail and generation.[29] Again, jurisdiction-specific factors, such as generation mix, need to be considered before applying the ERCOT precedent. In addition to a vastly different regulatory framework with greater levels of prescription, the electricity market in Texas is dominated by gas fired generation (44 per cent) with nuclear and coal-fired generation also used for baseload power.

2.3. Application of a market share cap

What factors should be taken into account when determining the dispatchable capacity of a generation portfolio?

How should technologies such as variable renewable generation and demand response be accounted for?

How should capacity owned in adjoining NEM-regions or the ability of some generators to influence transmission flows factor into the calculation?

If a market share cap is to be implemented, which AGL strongly objects to, the factors we identify above at section 2.1.4 in relation to the difficulty in calculating the dispatchable capacity should be taken into account. Furthermore, if the purpose of the cap is to prevent misuse of market power, then the following should also be considered:

- how renewable generation should be considered, given that it exercises a significant constraint on dispatchable generation, but as it cannot be scheduled and there is no ability to control the natural resource(s) it cannot be considered to contribute to any ability to exercise market power. Because the operation of renewable generation relies on factors beyond the participant's control, it would be appropriate to include generation in the calculation of capacity but be excluded from the calculation of a participant's share when determining if that participant has breached the market share cap;
- as technology changes, rules should not be set based on generation types as they are likely to be quickly out of date, however, this then raises issues of certainty, what is dispatchable capacity will require a point in time subjective assessment, increasing uncertainty for the sector.

We are also of the view that demand response should be explicitly excluded from the calculation of the participant's share. The key purpose of demand response is to maintain the integrity and security of the system. Regulatory design should never compromise this. It is also often not relevant to the determination of dispatchable capacity, for example, curtailment is a contractual arrangement to ensure security of supply. Other forms of demand response such as through price signalling tariffs, whether through time of use or demand tariff, require behaviour change by an end-use consumer. A company is unable to control consumer behaviour, and this should not be a relevant consideration. Further, other forms of demand response such as the RERT require a contractual arrangement and then direction by AEMO.

Additionally, the potential impact on investment and the risk for the application of the cap to deter efficient acquisitions should be taken into account given the importance of investment in generation, as discussed above in section 2.1.5.

2.4. Enforcement of market share cap by the AER

What factors should be taken into account when determining the AER's enforcement powers in relation to the ownership cap?

[29] See HoustonKemp Economists, *International review of market power mitigation measures in electricity markets: A report for the Australian Competition and Consumer Commission*, May 2018, at pp 13-14

With regard to the compliance regime, what factors should be considered to ensure market participants are adequately incentivised to comply and cannot circumvent the cap (for example through changing company structures)?

No enforcement powers should be given to the AER.

Recommendation 1 was put forward by the ACCC as merely requiring the AER to enforce an objective cap. That is clearly not the case. There are subjective discretionary judgements involved in relation to defining the market, the market participants and what capacity should be included in a market share cap, all of which involve considering what kind of generation is competitive with each other. This is essentially a competition assessment of actual and potential rivalry, and also new entry and expansion.

Such competition assessments sit more appropriately with the ACCC who, as the competition authority for all sectors, should continue to undertake case by case assessments of competition. Recommendation 1 is essentially giving the AER sector-specific competition law enforcement powers and there has been no case made or detailed consideration given as to why that is necessary or appropriate.

Given that market shares are just a starting point for any competition assessment, the AER's role should be purely advisory – either referring to the ACCC a merger to consider under section 50 of the CCA through the ACCC's informal merger clearance process where it has not been notified, or, when it has been notified to the ACCC, identifying for the ACCC when it considers the 20 per cent share has been exceeded, on what basis and whether there are energy market-specific considerations relevant to the ACCC's competition assessment.

AGL disagrees with views that section 50 is not sufficient to prevent mergers that cause competitive detriment, including acquisitions by a large incumbent generator or gentailer.

AGL notes this issue was considered in the context of the creeping acquisitions debate on multiple occasions, with the most recent review noting near-universal support for the substantial lessening of competition test in section 50.[30] The inclusion of the word "substantial" is intended to capture only those that result in or are likely to result in competitive detriment. To the extent the ACCC has since experienced frustrations in enforcing section 50 because of that test, then those frustrations should be the subject of a detailed and considered review by an independent expert panel and consultation across sectors, similar to past reviews of the competition law.

[30] Harper Panel, *Competition Policy Review: Final Report*, March 2015, at pp p 314