



21 February 2014

By email: mergers@accc.gov.au

Jeremy Jose and Daniel McCracken-Hewson
Mergers Branch
Australian Competition & Consumer Commission

Dear Sirs

Statement of Issues on AGL Energy Limited – proposed acquisition of the business and assets of Macquarie Generation

The Consumer Action Law Centre (**Consumer Action**) welcomes the opportunity to comment on the Australian Competition and Consumer Commission's (**ACCC**) *Statement of Issues on AGL Energy Limited – proposed acquisition of the business and assets of Macquarie Generation*. For brevity, in the rest of this letter we refer to Macquarie Generation, as MacGen. This submission is endorsed by the Consumer Utilities Advocacy Centre.

About Consumer Action

Consumer Action is an independent, not-for-profit, campaign-focused casework and policy organisation, offering free legal advice, pursuing consumer litigation and providing financial counselling to vulnerable and disadvantaged consumers across Victoria. Consumer Action is also a nationally-recognised and influential policy and research body, pursuing a law reform agenda across a range of important consumer issues at a governmental level, in the media, and in the community directly. We have a significant and detailed history in providing consumer advocacy across energy issues in both Victoria and nationally.

We have a particular focus on energy consumer policy, and believe that effective competition and robust consumer protections are mutually reinforcing. We regularly work on areas of concern for consumers in the national energy market in relation to current regulatory reform in the energy sector and perceived market failure.

Consumer Action currently sits on AGL Energy's (**AGL**) Customer Council, which meets three times a year. We have been a member of this council for approximately six years. We have a collaborative relationship with AGL which allows us to raise consumer concerns to it directly. We remain independent, however, and pursue regulatory action and media where we believe necessary.

This submission was developed with the assistance of Bruce Mountain of Carbon and Markets Economics (**CME**), with funding support from the consumer Advocacy Panel (**CAP**). The views

Consumer Action Law Centre

Level 7, 459 Little Collins Street Telephone 03 9670 5088
Melbourne Victoria 3000 Facsimile 03 9629 6898

info@consumeraction.org.au
www.consumeraction.org.au

expressed in this submission do not necessarily reflect the views of the CAP or the Australian Energy Market Commission.

Overview

The privatisation of MacGen as a single business, irrespective of whether it was a trade sale or public offering raises significant competition concerns. It is disappointing that the New South Wales Government has chosen such a privatisation strategy. In addition, as explained and supported in this submission, we submit that the proposed acquisition of MacGen by AGL raises additional concerns and we conclude that there is a very high likelihood that the acquisition of MacGen by AGL will result in a substantial lessening of competition. This will translate into higher prices for consumers, possibly substantially so.

Before proceeding in this submission we would like to refer to our previous submissions to the ACCC on AGL's acquisition of Australian Power and Gas and its acquisition of the Loy Yang Power Station. In those submissions we focussed much of our concern on the detriment of further vertical integration, i.e. lower contract market supply and liquidity, and the barrier that this presented to potential merchant generators and to retailers.

This concern also applies in the case of AGL's proposed acquisition of MacGen. AGL's acquisition will drastically reduce the demand for contracts (in respect of its own NSW retail load). Even more importantly, as our analysis in this submission suggests, it will drastically reduce contract supply (above and beyond AGL's NSW retail load). This is because AGL will have an incentive to withhold MacGen capacity and in order to extract the gains from this commercial strategy, it will reduce the volume of MacGen production that it is willing to offer to the contract market.

The purpose of the *Competition and Consumer Act 2010* (the **C&CA**) is to enhance the welfare of Australians by promoting competition, and acquisitions that substantially lessen competition are prohibited, unless authorised. The counter-factual for the assessment of a substantial lessening of competition is the level of competition (and hence market outcomes) that would occur without the acquisition. Sub-sections 50(3)(a) to (i) of the C&CA set out the matters that the ACCC is required to consider in assessing whether an acquisition will substantially lessen competition. In our submission we provide evidence specifically relating to sections 50(3)(a), (b), (d), (e) and (i).

The rest of this submission proceeds as follows:

- Firstly we examine whether MacGen has the ability to exercise market power by withholding capacity. We conclude it does. This is a necessary but not sufficient condition to conclude that there will be a substantial lessening of competition.
- Second we examine whether AGL has an incentive to exercise market power by withholding MacGen capacity from the market. We conclude it does and then explain how this will result in a substantial lessening of competition.
- Third we explain why AGL has a greater incentive to exercise its newly gained market power compared to other potential buyers of MacGen.

Shortly after having complete the substantive work for the submission, the ACCC released a proposed undertaking by AGL. We have not analysed that submission in detail, however from our preliminary analysis we conclude that this undertaking is unlikely to address our concerns. In particular:

- The volume of capacity that the AGL is undertaking to contract is inadequate;
- The duration of the undertaking is inadequate; and
- The pricing arrangements for the contracted are opaque and susceptible to gaming.

More generally we are sceptical that undertakings of any form can adequately address our concerns.

Does Macquarie Generation have the ability to exercise market power by withholding capacity?

To establish whether MacGen is likely to have the ability to exercise market power we have examined data on NEM prices and demand in NSW, power flows on the interconnectors to Victoria and Queensland and output from the Bayswater and Liddell generating units. We examined these data for all half-hourly settlement periods from 1 January 2007 to 31 December 2013 and also for the 422 settlement periods (0.3% of the time) that NSW spot prices were above \$300/MWh during this period. Prices in these 422 settlement periods raised the demand-weighted average price over this full period by 29% from \$38.4/MWh to \$49.7/MWh. The relevant data are summarised in Table 1.

Table 1. NSW price, demand and MacGen production since 1 Jan 2007

	All settlement periods from 1 Jan 2007 to 31 Dec 2013	All settlement periods from 1 Jan 2007 to 31 Dec 2013 when NSW spot prices were greater than \$300/MWh
Demand-weighted average price (\$/MWh)	\$49.7/MWh	\$2,030/ MWh
Peak demand (MW)	14 595	14 595
Average demand (MW)	8 673	12 281
Peak MacGen output (MW)	4 675	4 674
Average MacGen output (MW)	2 920	3 568
Average capacity factor (Average MacGen output / Peak MacGen output)	62%	76%
Average MacGen output/ average NSW demand	33.7%	29.1%

Average imports into NSW from QLD and VIC were slightly lower (770MW) in those settlement periods when prices were above \$300/MWh, than they were when prices were below \$300/MWh

(792 MW). At just 7.9% of average demand when prices were above \$300/MWh, imports were much less significant than production from the MacGen units (29.1% of average demand).

Our concerns about the ability of MacGen to exercise market power relates mainly to those few settlement periods when demand is substantially above its average levels. A histogram of NSW demand from 1 Jan 2007 to 31 December 2013 shows that for 93.3% of all settlement periods, demand in NSW was below 11,200 MW. At or below this level, and having regard to NSW generation capacity in NSW and interconnector capacity, the ability of the MacGen units to raise NSW prices by withdrawing capacity can be expected to be relatively limited.

However, as demand rises above these levels, the gap between supply and demand narrows. Table 1 shows that the average NSW demand when prices exceeded \$300/MWh was 12,281 MW. During these settlement periods, MacGen production rose to 3,568 MW, equivalent to 29.1% of demand during these settlement periods. Clearly a very significant proportion of the market demand, during peak demand periods, is being met by production from a single generation business. This level of supply-side dominance is comparable to that enjoyed by AGL's Torrens Island Power Station in South Australia.

Our concern is that the size of MacGen in relation to the market demand will mean that withdrawal of a substantial proportion of its capacity at times of high demand will exhaust the ability of MacGen's competitors to replace the withdrawn MacGen capacity. MacGen will therefore be able to raise prices by withdrawing capacity at times of very high demand. Such a scenario is well documented in South Australia in respect of AGL's Torrens Island Power Station capacity withdrawal during periods of high demand in South Australia in the period from 2008 to 2010.¹

For these reasons and having regard to the level of demand that occurs at times of extreme prices (as shown in Table 1) and also to the proportion of MacGen capacity as a proportion of demand it is self-evident that MacGen can be expected to have significant ability to raise prices by withdrawing capacity. Indeed, as the ACCC is no doubt aware this has been made quite clear in public pronouncements by MacGen's previous Chief Executive Officer.²

While we would agree that MacGen's ability to significantly raise prices will be limited to the times that demand is close to peak levels, this does not mean that the impact on average prices will not be significant and substantial. Specifically, as we noted earlier, NSW spot prices were above \$300/MWh for just 0.3% of the period from the start of 2007 to the end of 2012 (422 half-hourly settlement periods), but prices in these 422 settlement periods raised the demand-weighted average price over this period by 29%, from \$38.4/MWh to \$49.7/MWh.

¹ Mountain, B. R. (2012). *Electricity Market Power in South Australia: A report for the Energy Users Association of Australia*. Melbourne, Energy Users Association of Australia; Australian Energy Regulator (2012). *State of the Energy Market*; Biggar, D. and M. Hesamzadeh (2011). *Modelling the hedging decisions of a generator with market power*. Melbourne, Australian Energy Regulator.

² In the Australian Financial Review on 29 February 2012, Mr Russell Skelton, CEO, explained that in response to the introduction of carbon prices "...Macquarie is considering options to stay profitable which include reducing output to increase the price of power on the National Electricity Market. 'We have done it in the past to respond to varying market circumstances'".

Finally, recognising that the ACCC must assess probable real world futures in assessing whether the merger will result in a substantial lessening of competition, in this sub-section we would like to address the question of the effect of changes in future demand on the capacity of MacGen to profitably withhold capacity in future. Specifically we would like to respond to the ACCC's Statement of Issues (at 86), which suggests that "... if electricity demand in the NEM continues to decline or experiences very low rates of growth, it is less likely that the proposed acquisition would provide AGL with opportunities to engage in profitable withholding in the foreseeable future. Conversely, if demand increases at a greater rate there is an increased risk that market conditions would be favourable for withholding in the foreseeable future".

We accept that there is a strong relationship between the extent and duration of very high demands and the consequential impact on prices (and hence impact of capacity withholding). This is borne out clearly by the data, presented in Figures 2 and 3 below, which show that as peak demands in 2012, 2013, and 2014 year-to-date (to 14 February 2014) have diminished relative to demands in the periods from 2007 to 2011, so the extent and duration of extreme spot prices have diminished. However, we do not believe that this supports the ACCC's conclusion that "... if electricity demand in the NEM continues to decline or experiences very low rates of growth, it is less likely that the proposed acquisition would provide AGL with opportunities to engage in profitable withholding in the foreseeable future."

The reason for this is that there is already evidence of seasonal or permanent moth-balling of capacity in South Australia (Northern Power Station), Victoria (units in Yallourn), and in Queensland (Swanbank). This capacity mothballing is likely to restore the narrow gap between supply and demand that has existed before 2012. The ACCC's conclusions on the impact of possibly declining peak demand in future needs to take account of this.

Figure 2. Price duration curve for highest priced 72 settlement periods from 2007 to 2013

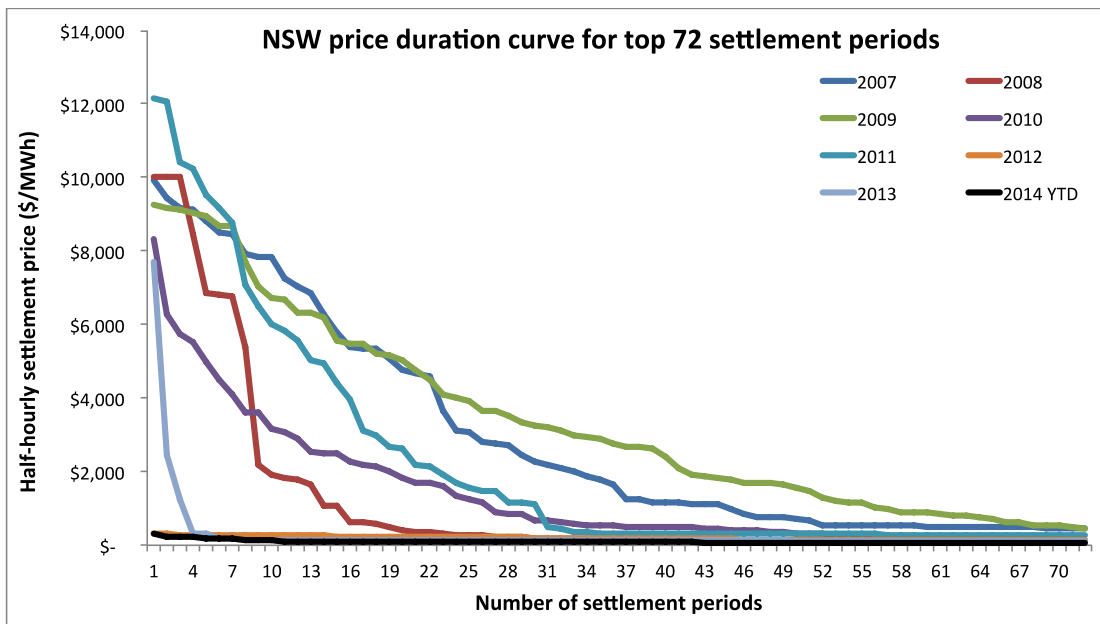
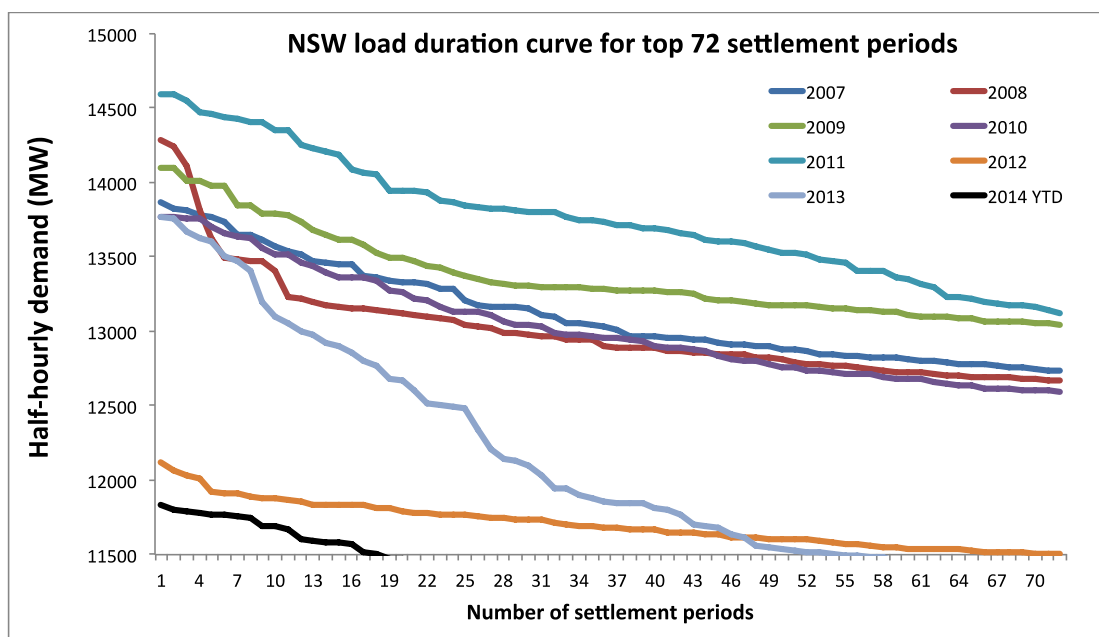


Figure 3. Load duration curve for highest 72 settlement periods in each year from 2007 to 2013



Does AGL have an incentive to exercise market power by withholding MacGen capacity?

To establish whether AGL has incentive to exercise market power by withholding MacGen capacity, it is necessary to establish that AGL would be more profitable as a result. Concluding that such an outcome would be contrary to section 50(3)(d) would nonetheless be susceptible to the counter-argument that higher market prices would provoke an investment response by AGL’s competitors and that such additional generation capacity would stimulate competition and hence reduce prices. If this counter-argument is valid, then such lessening of competition as would occur through AGL’s acquisition of MacGen might be temporary and hence not of enduring concern. Therefore to sustain the argument that AGL has an incentive to exercise market power by withholding MacGen capacity, it is necessary to demonstrate that by withholding MacGen capacity, AGL is able to substantially lessen competition and that this is likely to endure. In this sub-section we set out why we believe this to be the case.

Withholding some part of MacGen’s capacity, and thereby driving up spot prices, will be advantageous to AGL (in absolute terms and relative to its competitors) for the following reasons:

1. It will raise the revenue that AGL obtains from any unhedged sales from MacGen.
2. It will increase the volatility of spot prices thereby increasing the price of spot price hedges (whether forwards or futures, caps, options or swaptions).
3. It will reduce the supply of hedges thereby forcing up their prices.

AGL’s NSW sales will not be detrimentally affected by higher spot or contract prices since AGL will be internally hedged through its ownership of MacGen. We understand that AGL’s retail load in NSW, including the Tomago smelter load, is only likely to account for around half or less of MacGen possible annual production. AGL is therefore like to have substantial amount of excess, potentially uncontracted capacity.

AGL's competitors will be detrimentally affected by AGL withholding to the extent to which they do not meet their own retail load through their own generation. The effect will be particularly severe on new entrant retailers who do not own or control generation capacity. By driving up prices in this way AGL will therefore be able to particularly disadvantage new entrant retailers and thereby impede competition.

In order to achieve these outcomes, AGL will need to forego the operating profit for the amount of capacity that it withholds from the market, and for which it might otherwise have obtained income from the spot market and/ or under contract. However, since NEM prices can rise to \$13,100 / MWh, there is scope for prices to increase by several orders of magnitude to offset the lost production compensated at otherwise much lower prices. In South Australia for example in 2008 and 2009 the output from the Torrens Island Power Stations was a little over half its capacity in the 85 hours (for both years in total) when prices in South Australia were greater than \$300 / MWh. Despite halving production its Torrens Island Power Station production during these 85 hours, AGL obtained \$283m of spot market revenue (55% of its total) in these 85 hours compared to \$223m (the remaining 45%) in the remaining 17 374 hours.

Clearly operating profits forgone for lost production when capacity is withheld is insignificant if the consequence of capacity withholding is substantially higher spot prices. On the basis of the evidence provided in the previous section, we believe this will be the case in New South Wales if AGL controls the MacGen units—just as it has been the case in South Australia from 2008 to 2011 following AGL's acquisition of the Torrens Island Power Station in 2007.

Finally we do not expect any financing constraints on AGL's ability to withdraw capacity from the market. AGL has announced that it will fund the intended acquisition by way of a renounceable rights issue to existing shareholders raising approximately \$1.2 billion, and will then raise \$350 million of bank debt. This will almost certainly mean that AGL's trading strategy will be unconstrained by its lenders.

We now turn to the counter-argument that higher market prices will provoke an investment response by AGL's competitors and that this will result in additional generation capacity that would once again increase supply and hence reduce prices. Our response to this is to note that such new investment would be predicated not on high prices that reflect market scarcity, but on high prices that reflect the exercise of market power. An investor in such additional capacity would stand the risk that AGL could once again make its withheld capacity available, thus jeopardising the profitability of their investment. Of course this would temporarily reduce AGL's profitability, but the end result will be that it will be able to drive competitors out from the market and will then be able to resume its strategy of withholding capacity with even more confidence that it can dominate any future new entrant that might seek to take it on. Potential entrants (and their financiers) will understand this and consequently hold back.

An examination of the situation in South Australia is instructive. The high priced events in South Australia from 2008 to 2011 delivered \$374 million of spot market revenue for the 729 MW of Open Cycle Gas Turbine plant in South Australia.³ Assuming, hypothetically, that this plant were unhedged (i.e. exposed to spot prices), this translates into revenue of \$0.5 million per MW – only

³ Mountain, B. R. (2012). *Electricity Market Power in South Australia: A report for the Energy Users Association of Australia*. Melbourne, Energy Users Association of Australia.

slightly less than the plant would have cost to build. Yet, despite what would appear to be an obviously profitable investment opportunity, there has been no hint of new generation investment in South Australia either by the major incumbent retailers (Origin and Energy Australia), by major incumbent generators (Alinta), or by prospective new entrant independent power producers or independent retailers. The high prices in South Australia from 2008 to 2011 reflect the exercise of market power, not genuine scarcity. This outcome is consistent with our hypothesis, and we suggest a reference for what can be expected in New South Wales should AGL be allowed to acquire the MacGen units.

Does AGL have a greater incentive to exercise its newly gained market power than would other buyers?

Recognising that the ACCC is required to consider whether or not the acquisition results in a substantial lessening of competition, the future state of energy markets with and without the acquisition needs to be considered.⁴ As noted above, the sale of MacGen by the New South Wales government is part of a privatisation process, and it is not proposed that MacGen will remain under its current ownership structure in the future. As such, the ACCC must consider whether this acquisition will result in a substantial lessening of competition compared to other potential outcomes – i.e., other buyers purchasing MacGen.

In our view, compared with other potential buyers, AGL has a greater incentive to exercise its newly gained wholesale market power precisely because of its substantial operation in the retail market. We submit that, as outlined above, AGL will have the incentive (and the ability) to withhold generation capacity, negatively affecting its retail competitors and limiting the ability of new entrants in the market. Robust retail competition, with the threat of new entrants, encourages competitors to differentiate and satisfy consumer preferences. Our submission is that such effective competition will be substantially weakened should the AGL acquisition proceed.

Response to the ACCC's request for comment

Our submission to this point has addressed some but not all of the issues that the ACCC is seeking comment on. For completeness we list all the issues on which the ACCC is inviting comment and point to where we have addressed them in this submission, or where appropriate add our response under each heading.

The likelihood and consequences of AGL withdrawing capacity to increase wholesale electricity prices in a number of NEM regions

Our submission has focussed principally on the New South Wales region. We agree with the ACCC's concern that there may be inter-regional effects. However, we note that at the times that the effect of capacity withdrawal of MacGen units is most likely to have a significant price impact (i.e. times of high demand and high spot prices) the interconnector capacity to and from NSW is not likely to be a significant factor affecting NSW supply and demand. For this reason, while we do not discount inter-regional impacts, we feel that our concerns about the impact of AGL's acquisition of MacGen units on NSW are sufficient cause in itself to disallow the acquisition.

⁴ AGL v ACCC (No 3) [2003] FCA 1525.

The extent to which any strategy of AGL to prematurely mothball or retire the Liddell power station is commercially realistic

As set out in the submission, we suggest withdrawal of capacity from the market is likely to be commercially attractive, and that AGL is unlikely to face constraints from its lenders in pursuing such a strategy.

The sustainability of current supply and demand conditions and the potential for increases in mothballing or retirement of generation capacity

We do not have strong views on the direction of future demand, although we consider continued reduction in average demand and stagnation in peak demand is likely and, as the ACCC has noted, not inconsistent with AEMO's projections. As noted, on the basis of recent mothballing decisions in South Australia, Queensland, and Victoria, we are confident that further plant retirement is likely.

The extent to which mothballed generation can readily recommence supply

We see no reason why seasonally mothballed capacity cannot restart quickly (within weeks). Plant that is mothballed and not expected to produce, even during peak summer or winter months, may take longer to restore, but can almost certainly be restored more quickly than it would take to develop new centrally-dispatched capacity.

The impact of the RET on the level of generation capacity in the market and the overall supply and demand balance

If the RET is to be met there will need to be a very significant expansion of centrally dispatched generation capacity, most likely wind and solar capacity. The policy and industry response is uncertain. However, even where wind generation has become a very significant proportion of production (in South Australia it is around 30% of regional production), its availability during extreme prices has been shown to be limited.⁵

The likely future growth rate of demand for electricity in the NEM and which (if any) of AEMO's low, medium or high forecast scenarios are likely to be accurate predictions of future demand

See answers to previous questions.

⁵ Mountain, B. (2013). "Market Power and Generation from Renewables: the case of Wind in the South Australian Electricity Market." *Economics of Energy & Environmental Policy* 2(1).

Please contact Janine Rayner, Senior Policy Officer on 03 9670 5088 or at janine@consumeraction.org.au if you have any questions about this submission.

Yours sincerely

CONSUMER ACTION LAW CENTRE

A handwritten signature in black ink that reads "Gerard Brody". The signature is written in a cursive, flowing style.

Gerard Brody
Chief Executive Officer