

COMPETITION ISSUES IN THE ELECTRICITY INDUSTRY

The Australian Gas Light Company v Australian Competition and Consumer Commission

(No 3) ([2003] FCA 1525, Federal Court, Victoria District registry, unreported, 19 December 2003, French J)

Application by retailer for declaration of non-contravention of s 50 TPA – Partial acquisition of electricity wholesaler by electricity retailer – Whether likely to have effect of substantially lessening competition in a market – Market definition – Market transactions governed by bidding, dispatch and pool pricing – Pool price volatility – Acquisition of partial interest in generator creating natural hedge for retailer – Whether retailer likely to reduce hedge contract cover – Market power of base load generators – Whether generator with greater exposure to spot price more likely to exercise market power increasing price bids – ss 4, 50, 87B and 163A TPA.

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INTRODUCTION

The Federal Court has made a declaration that the acquisition by the Australian Gas Light Company (AGL) of a 35% stake in Loy Yang A power station (Loy Yang) is not likely to have the effect of causing a substantial lessening of competition in contravention of section 50 of the *Trade Practices Act*, subject to AGL giving certain undertakings to the Australian Competition and Consumer Commission (ACCC). The decision has many implications for the electricity community, and broader relevance for the Australian business community.

BACKGROUND

AGL is a major electricity, gas and energy related services retailer in Australia. Loy Yang, a brown coal-fired power station, is a major producer of electricity. Loy Yang is able to generate approximately 2000MW of electricity available for dispatch into the National Electricity Market (NEM).

AGL was a member of a consortium which proposed to acquire Loy Yang. The other consortium members were the Commonwealth Bank and Tokyo Electric Power Company (TEPCO). The consortium and the ACCC had engaged in extensive negotiations in relation to the proposed acquisition after the ACCC expressed concerns that the acquisition might raise issues under section 50 of the *Trade Practices Act* (TPA). The ACCC rejected various undertakings offered by the consortium, publicly stating that it remained of the view that the acquisition would lead to a less competitive and less efficient market structure, resulting in higher prices and increased barriers to entry. AGL instituted proceedings seeking a declaration that the proposed acquisition would not contravene section 50.

THE ARGUMENTS AND THE COURT'S DECISION

AGL was required to establish that the acquisition was not likely to cause a substantial lessening of competition in any relevant market.

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Market Definition

The ACCC and AGL agreed that there were separate retail markets for the supply of electricity to residential and small business customers in Victoria, and for the supply of electricity to industrial and commercial customers in Victoria.

However, the parties differed on the appropriate wholesale market definition. AGL alleged that there was a single market for the supply of electricity and electricity derivative contracts in the NEM. The ACCC asserted that there was a separate market for the generation and supply of electricity to NEMMCO, and a separate market for the supply of electricity derivative contracts, and that both of these markets were confined geographically to Victoria.

Justice French held that there was, as AGL contended, one NEM-wide market for the supply of electricity and derivative contracts.

AGL was required to establish that the acquisition was not likely to cause a substantial lessening of competition in any relevant market.

Market Power of Loy Yang

The ACCC asserted that Loy Yang already possessed market power, and that following the acquisition Loy Yang would have more incentive to exercise its market power to increase the price of electricity. This argument was an integral plank of the ACCC's argument that the acquisition would substantially lessen competition in the market (see below).

To prove the existence of market power, the ACCC relied on:

- econometric evidence that purported to show the ability of Loy Yang to increase the pool price (this is discussed further below); and
- the market behaviour of Loy Yang in summer 2001, when Loy Yang engaged in a bidding strategy that had the effect of increasing spot prices in the market at that time.

In the summer of 2001, Loy Yang adopted a strategy of exposing itself to the pool price for the summer period by adopting a low level of hedge contract cover. Over the summer period it hoped demand would be high, and bidding and rebidding by Loy Yang would have the effect of increasing the spot price, and consequently the forward contract price. Largely due to extreme weather conditions, the strategy worked, to the extent that spot prices for that period were high on average, and forward contract prices rose for a period thereafter.

The ACCC characterised this strategy as an exercise of market power. AGL (and Loy Yang) characterised this bidding strategy as a high-risk strategy, engaged in because of the pressure of loan covenants and successful due to abnormally hot weather and other fortuitous events. AGL pointed to the fact that the high prices in 2001 had led to a spate of new generation within six months which caused the prices to drop again. This, AGL argued, showed that the market was competitive, and no generator had the ability to cause a sustainable increase in the price, and therefore had no market power.

French J found that the assertion Loy Yang had market power was not supported, either by the econometric evidence or by the events of 2001. In respect of the bidding strategy adopted by Loy Yang in 2001, French J said it did not have the characteristic of market power, but rather of “moderately well informed betting on the market”. He said that while Loy Yang is in a position to respond in times of high demand in a way has the effect of increasing the spot and forward prices, this ability is only transient, and not sustainable. This, French J found, does not equate to market power. French J said that, to the extent the bidding regime did permit price spiking and economic

withholding of capacity, this was a market mechanism for signalling the need for new capacity. Further, French J commented that this is what had occurred in 2001 – the market responded in a competitive way, with new investment in generation assets and interconnectors following the high prices of the summer period.

The Competitive Effect of the Merger

The ACCC argued that the acquisition was likely to have the effect of substantially lessening competition on the following grounds:

- *The “natural hedge” argument:* The ACCC put forward a argument based on the following assertions:
 - AGL's 35% interest in the profits of Loy Yang would provide AGL with a natural hedge of approximately 150MW. The ACCC argued that AGL would be shielded from any losses on a fluctuating pool price, because it would have a 35% interest in Loy Yang's profits. The ACCC asserted that this equated to a hedge of approximately 150MW.
 - In reliance on that hedge, AGL would reduce its hedging requirements by the amount of the natural hedge ie approximately 150 MW. AGL would be most likely to reduce its hedge level with Loy Yang, or another Victorian baseload generator.
 - As all other retailers are “fully hedged” the effect of AGL's reduction in hedges would be to reduce overall the amount of electricity hedged in the NEM. Loy Yang, (or the other baseload generators losing the 150MW of hedged capacity with AGL) would not be able to replace these hedges with other retailers. Loy Yang would have more generating capacity exposed to the pool.
 - Because Loy Yang would be forced to have increased pool exposure, Loy Yang would have more incentive to exercise its market power and engage in bidding behaviour designed to “spike” the pool price.
 - Loy Yang's price spiking behaviour would lead to an increase in pool price for electricity, and therefore an increase in the forward hedge contract price. The ACCC contended that this would equate to a substantial lessening of competition.

In proposing this theory, the ACCC relied almost solely on the complicated econometric modelling evidence provided by an American economist. The ACCC did not introduce any evidence from current participants in the electricity industry in support of its arguments. AGL rebutted the ACCC's theory by introducing its own contradictory economic evidence, and by calling industry participants to testify against the likelihood of the ACCC's theory and the likely effect of the acquisition.

French J did not accept that AGL would obtain a “natural hedge” through the acquisition of a 35% stake in Loy Yang, nor, as noted above, that Loy Yang had market power. His Honour considered the ACCC's economic evidence in detail, comparing it with AGL's economic evidence and, in particular, AGL's industry evidence. Justice French concluded that the scenario forwarded by the ACCC was not likely, and found that the ACCC's economic evidence was not useful in determining the relevant issues. French J concluded that the econometric model relied upon by the ACCC was not capable of being used to test 'real world' outcomes – it had no way of simulating the long term competitive response of other participants in the market to any attempt by Loy Yang to exercise its market power.

- *The “bandwagon” argument:* The ACCC alleged that the acquisition was equivalent to vertical integration – AGL and Loy Yang would contract more with each other less with other market participants. The ACCC said this would lead to other industry participants vertically integrating (the so called “bandwagon” effect) which would in turn result in a decrease in the availability of hedge contracts and increased barriers to entry at both the generation and retail levels of the market.

His Honour indicated that he believed the transaction had the commercial character of an investment, rather than a vertical integration. In any event, even if it was a form of vertical integration, he found that retailers exhibited a natural tendency toward vertical integration. His Honour concluded that the practical considerations which create commercial pressure to vertically integrate would not be affected by the acquisition, and would continue irrespective of whether this acquisition took place. Therefore, the acquisition could not have the domino-like effect alleged by the ACCC.

- *Partial acquisition amounted to control:* The ACCC contended that, notwithstanding that AGL's 35% interest in GEAC would only be a minority interest, the acquisition would give AGL a significant degree of control over the dispatch and contracting functions of Loy Yang. This degree of control would mean that the anti-competitive effects outlined above (the natural hedge and the vertical integration) would be exacerbated. Further, even if the court did not accept that AGL would effectively have control over Loy Yang, the anti-competitive effects would be exacerbated by the natural tendency of Loy Yang management to consider the interests of AGL.

French J held that presence of other shareholders on the GEAC Board meant it was unlikely that the AGL directors on the Board would act in the interests of AGL, other than in the interests of Loy Yang. His Honour also found that AGL's shareholding would have would not allow it to control nor influence detailed marketing decisions of Loy Yang, and it was unlikely that Loy Yang would become “hostage” to AGL's interests as suggested by the ACCC. Further, there was no reason to believe that that management of Loy Yang would naturally accommodate AGL's perceived interests.

WHAT THE DECISION MEANS

Further Consolidation in the Electricity Industry?

The market definition adopted by the Federal Court will provide encouragement to industry participants considering further consolidation. However, while the ACCC decided not to appeal the decision of Justice French, it has stated that it does not accept the market definition and will, if necessary, test the issue again in the future. It therefore seems unlikely that French J's market definition will be adopted by the ACCC when considering any further consolidation in the industry.

The Merger Process

The process followed by AGL in obtaining Federal Court “approval” of the transaction is significant. The ACCC had made public statements opposing the acquisition, but did not propose to seek an interlocutory injunction to stop the transaction proceeding. Rather, it threatened to seek divestiture if the transaction completed. The ACCC contended that the Federal Court did not have jurisdiction to make a declaration in these circumstances, as there was no real matter at issue, only a hypothetical transaction. French J said that each case had to be decided on its own facts, but a declaration can be made in circumstances where the proposed acquirer has approached the ACCC in respect of the proposed transaction and the ACCC has stated its opposition and its intention to

act against it. His Honour also indicated that a declaration might be made where a third party indicated opposition to a proposed acquisition.

Vertical Integration and Partial Shareholdings

Also of broader relevance to the business community is the way in which French J considered the issues of vertical integration and partial shareholdings.

With respect to the ACCC's concerns as to the degree of vertical integration implicit in this acquisition, French J concluded that because the electricity industry demonstrated a clear tendency toward vertical integration, and because vertical integration could be achieved through a variety of means, this acquisition could not be said to have the effect of substantially lessening competition. This reasoning, like the market definition, may provide encouragement to other electricity industry participants looking to consolidate (and may similarly encourage participants in other industries that demonstrate tendencies toward vertical integration). However, like French J's market definition, the ACCC is unlikely to accept this reasoning without testing the issue further.

Similarly, the ACCC will work hard to confine French J's decision in respect of the effect of the partial shareholding to the facts of this case. In merger proposals the ACCC will continue to examine closely the company structure, the composition of boards and the information flows that will result from partial acquisitions. The ACCC is likely to maintain that, in certain circumstances, the acquisition of a minority shareholding can equate to more than a passive interest in the target, and lead to an overall anti-competitive effect in the relevant market.