

Submission to the Department of Infrastructure

Re: Submission on Review of Cross Ownership Restrictions for the Energy Sector in Victoria



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Review of Cross Ownership Restrictions for the Energy Sector in Victoria

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1 Introduction

This submission on the above matters is from United Energy Distribution and Multinet Gas (hereafter 'the companies').

United Energy Distribution Pty Ltd (UED) is one of five electricity distribution businesses operating under licence within the State of Victoria. UED's network provides services to some 600,000 end-use customers in Melbourne's southern and eastern suburbs, with its area of operation confined to geographically defined boundaries set out in the Distribution Licence. Multinet Gas Distribution Pty Ltd (Multinet) is one of three gas distribution businesses in Victoria and is the only urban distributor servicing some 626,000 gas connections in Melbourne's eastern suburbs

The companies are pleased to be given the opportunity to comment on this issue given the changes over time to the cross ownership rules and the moves to a national regulatory model. The issues raised in this paper are:

- Given the interrelationship of the Victorian cross-ownership provisions with the Trade Practices Act (TPA), are there benefits from retaining the current Victorian cross-ownership provisions?
- Is it appropriate to apply State-based quantitative restrictions, given the increasingly national character of energy markets?
- Are measures in addition to the TPA required to protect the pro-competitive structure of the energy sector? Are quantitative ownership limits capable of being struck that could apply to all potential merger cases, and that remain relevant over time?
- Can a competitive generation sector be maintained in Victoria through the TPA as it stands, or does it require other forms of regulatory intervention?
- Could the State's policy objectives be better met by a different Victoria-specific cross-ownership regime?
- Is it appropriate to place sole reliance upon the TPA provisions for regulating changes in ownership in the national energy markets?
- Should the Australian Competition and Consumer Commission (ACCC) release expanded merger guidelines that deal expressly with the energy sector?

This submission argues that there are no strong reasons to maintain the cross ownership rules in Victoria given its current role. In addition, economic principles do not support structural separation but rather support the case by case merger assessment currently in Section 50 of the TPA. This is because both vertical and horizontal mergers have both costs and benefits, which are best assessed through the merger provisions of the TPA which look at each specific merger in terms of the costs and benefits.

As a result this submission favours the removal of the State-based structural separation laws in the Gas Industry and Electricity Industry Acts.

2 Comments on the Issues 2 and 3

Issue 2 – Is it appropriate to apply State-based qualitative restrictions, given the increasing national character of energy markets?

Issue 3 – Could the State’s policy objectives be better met by a different Victoria-specific cross ownership regime?

2.1 Forms of Integration

The genesis of the structural separation model according to the Issues Paper was:

The purpose of these restrictions was to preserve – at least from a transitional period – the pro-competitive structure of the electricity and gas sectors that was put in place as a component of the reforms to the energy sector.¹

There are two basic forms of integration: vertical integration and horizontal integration. Vertical integration refers to a merger between firms that operate at different stages of the electricity or gas supply chain. The electricity supply chain consists of electricity generators that produce electricity, transmission companies that transport electricity from the power stations to residential or commercial premises and retail companies that sell this power to the ultimate users. Examples of a vertical merger include a merger between a generator and a transmission company; or a generator and a retailer; or a transmission company and a retailer; or a generator, a transmission company and a retailer.

Horizontal integration refers to integration between firms at the same functional level in the supply chain for example between two electricity generators or between two gas retailers. Horizontal integration can involve a merger between two firms producing homogeneous commodities or heterogeneous commodities.

2.2 Possible Costs of Enforced Structural Separation

The main costs of structural separation are the foregone integration efficiencies, which are important source of both cost reductions and new product and service development.² The sources of these efficiencies include:

- economies of scale and scope;
- internalising externalities (including service quality, coordinated investments and regulatory externalities); and
- risk management.

A presumption in favour of structural separation may have made some practical sense when the goal was to “shake up” the heavily bureaucratized structures that characterised the government business enterprises of the early 1980s. However, concerns about the

¹ Department of Infrastructure, Issues Paper, Cross Ownership Rules for the Energy Sector, February 2005, p. 1.

² The analysis in this submission is largely based on a major study for the Regulators Infrastructure Forum undertaken by NECG and titled “Submission to the Productivity Commission Inquiry into National Competition Policy”, October 2005, Submission No.134.

governance problems for government business enterprises have now been largely addressed through conduct policies such as commercialisation, competitive neutrality, ring fencing, open access and other conduct regulations.

A major justification for the structural separation of public utilities was a concern over the possibility that a vertically integrated incumbent will attempt to use its market power in the non-contestable components of its business to create market power in potentially competitive markets.

However, while a vertically integrated firm that has substantial market power in the essential service market may have an ability to leverage that market power, it is not clear it will do so. In effect, while a 'leverage' strategy would increase the integrated firm's revenues in the potentially competitive markets, it would reduce its revenues from the sales of its essential service. The net outcome for the integrated firm's profits is at best ambiguous, as the Issues Paper has admitted by the reference to the recent AGL Case where the risk management efficiencies were an important reason for the vertical merger between a retailer and a generator.

There are no sound economic principles, which support the introduction of strict quantitative restrictions on mergers between energy utilities. Rules that seek to impose particular structures on businesses may have benefits but they also have substantial costs.

If structural separation is retained or expanded, there is a risk that important integration efficiencies will be lost. In many cases, these foregone efficiencies will lead to significant increases in cost and reductions in the ability to innovate.

Set against this background, there are strong arguments for leaving mergers entirely to market forces to determine the appropriate vertical structure of firms. At the very least, the merits of any vertical merger must be considered on a case-by-case basis. The merger provisions of the TPA provide an important means by which such a case-by-case assessment can occur.

In addition, there is a variety of existing conduct regulations that could ameliorate any resulting anticompetitive impacts from greater vertical integration that could be considered as part of any merger determination by the ACCC.

2.3 Possible Benefits of Vertical Integration

There are a number of potential benefits of vertical integration in utility markets.

2.3.1 Economies of scale and scope

An important feature of utility industries is the significant role played by the investment in sunken assets where an essential input in the production process is fixed with respect to output. Thus there are substantial economies of scale and scope in these utility industries which can be captured by both horizontal and vertical mergers.

At the vertical level, it may be possible to achieve some of the scale and scope economies without actual integration. However, when it comes to new uses of the existing infrastructure or innovation, unrelated firms may not be willing to undertake the investment to develop these markets in the absence of coordination in the investment decision. Such coordination from vertical integration reduces the risk and costs of the new use.

The infrastructure owner, on the other hand, has a strong incentive to maximise the potentially profitable uses of the infrastructure. Vertical separation may therefore impede

the development of new uses for the infrastructure by increasing the risks and the costs associated with the development of new markets.

2.3.2 Internalising externalities

The integration of firms is an effective way to solve a range of co-ordination problems that would otherwise create adverse external effects. These co-ordination problems include:

- ensuring opportunities for relationship-specific investments are fully exploited and opportunistic behaviour (the hold-up problem) is effectively addressed;
- ensuring prices reflect the impacts on demands for complementary goods and services and addressing quality issues including the maintenance of system integrity.

Hold-up problems are relatively common in utility markets given the risk involved in the transaction. The upstream firm must commit substantial sunken resources without guarantees as to the cost recovery from downstream users. At the same time, potential users may need to undertake investments whose value is dependent on the conditions of upstream supply. While regulation itself may reduce the risk of each party acting opportunistically, the efficacy of that regulation is inherently uncertain and especially problematic where new products and services are concerned. Where coordinated investment in innovative products or services are undertaken a more risk-management approach is required and the integration of the upstream and downstream activity may provide the most efficient way of managing the hold-up problem.

Network industries often have certain operating requirements dictated by the need to maintain system integrity or the safety and security of the services. When a single firm owns and operates the entire network infrastructure, it will take account of the impact of each of the various uses it controls, ensuring that the infrastructure is not damaged. If more than one firm is involved, however, then the costs of any damage will potentially be spread amongst all firms, not just the delinquent firm. As such, the incentives for any single firm to ensure that system integrity is maintained will be weakened. Monitoring compliance when more than one firm is involved will then increase regulatory costs.

2.3.3 Risk management

The ability of vertical integration to mitigate risks is clearly an important consideration in the assessment of integration in the electricity and in other industries. The need to manage long-term risk is an inherent feature of investment in utility industries, reflecting the highly durable nature of their assets and their almost complete locational specificity.

Unless these risks can be effectively managed, the higher costs they entail must affect both price levels and the long-term investment. One of the most effective ways in which risk-management can be enhanced is through vertical integration. As a result, as the need to ensure efficient investment becomes more pressing, allowing vertical integration to proceed may help secure the timely capacity expansion.

2.4 Conclusion on Issues 1 and 2

Given the uncertainties about the costs and benefits of vertical integration the best practice regulatory approach must be to consider each merger on its merits.

This conclusion raises the question of why the ACCC considers that the merger regulations in section 50 (s. 50) of the *Trade Practices Act 1974* are not a sufficient mechanism to evaluate mergers between electricity utilities and that state based structural separation rules are needed.

While it is true that electricity has some unusual properties, the mere existence of those properties does not invalidate the principles underlying merger regulation and nor should it alter the analytical approach adapted to merger evaluation. These features should simply be accounted for when assessing barriers to entry and the impact of the merger on competition and (where authorisation is being sought) welfare. This is all the more the case given that a central element of National Competition Policy was to secure consistency of treatment across utility industries.

Structural issues in respect of infrastructure industries are best governed by market forces, rather than by regulators who try to second-guess the efficient boundaries for utility firms. Where structural issues do arise in vertical mergers, they should be addressed relying on the economy-wide provisions of s. 50 of the *Trade Practices Act, 1974*.

3 Comments on Issue 5

Issue 5 – Is it appropriate to place sole reliance upon the TPA provisions for regulating changes to ownership in the national energy markets?

3.1 Horizontal Mergers

The above discussion of vertical integration has concluded that economic principles require that each merger is considered on its merits which supports an approach such as with the TPA s. 50 merger rules.

As outlined above an important feature of utility industries is the significant role-played by investment in sunken assets. Thus there are substantial economies of scale and scope in these utility industries which can be captured by both horizontal and vertical mergers. At the horizontal level, these scale and scope economies provide a strong efficiency justification for integrating through mergers.

3.2 The Cost and Benefits of Horizontal Mergers

The Issues Paper argues that:

It follows from this that the concept of market power is inherently horizontal – it refers to the ability to prevent buyers from shifting to alternative, that is, substitute, sources of supply. Thus, it is clear how the horizontal structure of the market can affect the extent of competition, because with more (or fewer) participants in a market, each participant may have less (or more) ability to sustainably raise prices above cost.³

In addition to the above position the ACCC appears to be particularly concerned about horizontal mergers between electricity generators. They appear to be worried that such mergers would reduce the intensity of competition in what is a competitive market. However, it is not clear that a simple increase in the number of competing firms automatically results in an increase in competition.

Conversely, it is not clear that a reduction in the number of competing firms automatically reduces competition. A small number of firms may still offer a competitive environment and the issues of the ease of new entry and the role of imports is also important in merger determinations. Indeed, under s. 50 of the TPA determining whether or not a particular

³ Department of Infrastructure, op cit, p. 4.

merger is likely to substantially lessen competition is the central component of merger regulation.

3.3 Conclusion on Issue 5

Again the conclusion is that merger deliberations must be considered on a case by case basis given the unique aspects of each horizontal merger in terms of the number of firms, the dynamic market conditions and the ease of new entry.

Creating industry-specific merger control powers also runs contrary to the thrust of National Competition Policy. Such an approach would introduce distortions in the way essentially similar transactions are dealt with in different industries and it would avoid the accountability of testing the merits of merger decisions in the Courts which have operated to clarify much of the general merger law.

4 Comments on Issue 6

Issue 6 – Should the Australian Competition and Consumer Commission (ACCC) release expanded merger guidelines that deal expressly with the energy sector?

While the ACCC is concerned that the TPA s. 50 is not the best model for managing mergers in the electricity industry the companies consider that this conclusion is wrong. In this context the companies consider that merger guidelines might assist in explaining the ACCC's position with mergers in the electricity sector.

5 Comments on Issues 1 and 4

Issue 1 – Given the interrelationships of the Victorian cross ownership provisions with the TPA, are there benefits from retaining the current Victorian cross-ownership provisions?

Issue 4 – Can a competitive generation sector be maintained in Victoria through the TPA as it stands, or does it require other forms of regulatory intervention?

The companies support the removal of the Victorian cross ownership provisions and the total reliance on the TPA to determine merger activity in utility industries in Australia.