Response to Preliminary Report

ACCC's retail electricity supply and pricing inquiry

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1. Executive summary

AGL welcomes the opportunity to respond to the ACCC's Retail Electricity Pricing Inquiry Preliminary Report dated 22 September 2017 (**Preliminary Report**).

AGL agrees with the ACCC's key conclusion that increases in retail electricity prices in Australia over the past 10 years were primarily caused by increased costs – in particular, network costs and most recently wholesale costs – rather than increases in retailer profit margins.[1]

AGL agrees that consumers have had trouble in comparing and understanding retail offers. As noted in AGL's submission to the Inquiry of 18 July 2017 (**Initial Submission**), AGL is taking various steps to make it easier for customers to compare offers, and monitor and control their electricity usage. AGL also understands the importance of supporting vulnerable consumers and is investing in numerous initiatives designed to assist those customers.

However, AGL does not agree with the ACCC's preliminary comments concerning the competitiveness of the retail and wholesale electricity markets or the effects of vertical integration between electricity generation and retail businesses.

AGL is concerned that the ACCC's preliminary comments:

- are based on observations regarding market structure and theoretical concerns about market power rather than any quantitative analysis or actual evidence of anti-competitive behaviour or outcomes;
- draw conclusions about the nature and extent of competition in the retail market on the basis of static market shares without properly examining the intense competition that sits behind those market shares. This fundamentally undermines the basis for these preliminary conclusions;
- in the same vein, focus on the experiences of individual retailers, rather than the effectiveness of the overall competitive process and consumer outcomes;
- fail to engage with the detailed studies and conclusions of the Australian Electricity Market Commission (**AEMC**) concerning the competitiveness of the Australian retail electricity market and the cause of increases in retail market prices;
- fails to properly consider jurisprudence of the Federal Court[2] and the Australian Competition Tribunal[3] concerning the assessment of competition in the retail and wholesale electricity markets;
- mistake the natural operation of the National Electricity Market (**NEM**), and its intentional market design, with a lack of competition in the wholesale market;
- do not give sufficient weight to the factors that have caused increases in wholesale market prices – in particular, the current tightening of demand and supply conditions and increasing fuel costs (in particular gas and coal); and
- fail to recognise that vertical integration is an efficiency enhancing (and price moderating) competitive response to the inherent risks of wholesale and retail electricity markets.

AGL also has significant concerns about any recommendations from the ACCC, government or other regulator that may distort the legitimate market responses of existing generation and retail businesses. Such intervention is not justified by current market dynamics and would further distort the incentives for

[1] ACCC Preliminary Report, pages 6, 29, 72.

[2] *Australian Gas Light Company v Australian Competition & Consumer Commission (No 3)* (2003) 137 FCR 317

[3] Australian Competition Tribunal, *Determination regarding application for authorisation of Macquarie Generation by AGL Energy Limited* [2014] AComp T1.

competitive responses to the present market conditions. This would inevitably lead to more significant longer term market failure.

2. Costs rather than retail margins have caused price increases

2.1. Network and wholesale costs have primarily driven price increases

AGL agrees that network costs and, more recently, wholesale costs have been the primary causes of retail price increases in Australia.

AGL also makes the following comments on the ACCC's preliminary findings concerning costs:

- **Retail costs**: as explained in further detail in section [3.5] below, the increases in retail costs that have occurred over the past 10 years are not due to a lack of competition in the retail market. On the contrary, as competition in retail markets has increased post de-regulation, retailers' costs of acquiring and retaining customers have also, unsurprisingly, increased. Retail costs also reflect increased efforts to support vulnerable customers and regulatory burdens.
- **Wholesale costs**: Wholesale cost increases have been driven by the tightening of supply and demand conditions in the NEM (due to withdrawals of baseload generation capacity) and the increased costs of generation inputs, in particular gas and coal. AGL notes that the ACCC intends to undertake an in-depth analysis of wholesale costs for the 2016/2017 period for its final report. AGL also notes the ACCC's comment that changes in the wholesale spot price may not necessarily translate directly into retail bill changes in light of the long term hedging contracts retailers have in place. AGL submits that this is incorrect for the following reasons:
    1. Changes in the wholesale price will inevitably translate into retail bill changes. Structural changes in input costs (whether due to increasing generation fuel costs, mandatory environmental schemes or generation scarcity and need for investment in capacity) across markets affect all market participants and competitive processes, meaning that cost increases are passed on over time.
    2. The comment incorrectly assumes that retailers' hedging strategies are necessarily long term and that retailers' current tariffs would have been hedged against wholesale prices from more than 2 years ago.
    3. As explained in AGL's Initial Submission, retailers face substantial volume risk in addition to price risk which means that it is not possible for retailers to perfectly hedge their exposure to prevailing wholesale market prices.
- **Environmental costs**: AGL agrees that greater consideration needs to be given to the ways in which environmental schemes are impacting electricity supply costs. In particular, AGL considers that the overlay of different federal and state based schemes leads to significant uncertainty and increased costs. To ensure the overall efficiency of these schemes and to minimize the costs of complying with a range of different schemes, AGL considers that the various state based schemes should be replaced with a cohesive national scheme. AGL submits that the ACCC should consider the benefits of implementing a cohesive national scheme as part of its final report.
- **Network costs**: AGL agrees that increases in network costs have had a substantial impact on retail electricity prices over the past 10 years. However, AGL disagrees with the ACCC's suggestion that just because retailers are unable to disaggregate network costs means that changes in network prices do not necessarily translate in changes to the retailers' tariffs.[4] As noted above in respect of wholesale costs, structural changes in input costs affect all market participants and competitive processes and are

[4] ACCC Preliminary Report, page 65.

therefore passed on over time. AGL also notes that rule changes by the AEMC have already been introduced to address the potential for over-investment by network businesses.

2.2. Lower retail margins reflect effective retail competition

For the reasons described in its Initial Submission, AGL cautions against conclusions drawn from industry-wide analysis of retail margins. These analysis will inherently be uncertain due to the fact that retailers take different approaches to characterising and quantifying their costs and managing risk (in particular, when vertically integrated) and the fact that these analysis are based on accounting data rather than economic costs. AGL also agrees with the ACCC that its estimated margins will be overstated as they are based on EBITDA and do not account for retailers' depreciation, amortisation, tax and interest payments.[5]

Nevertheless, AGL notes the ACCC's estimate that, in most states, retail margins (as a percentage of estimated cost stack) were lower in 2015/2016 than they were in 2007/2008.[6] This is unsurprising given the effective competition that has developed in the retail markets in most states of Australia following price de-regulation.

However, it is also not surprising that the ACCC estimates retail margins have increased in more recent years in some states of Australia, at a time when retailers have had to bear significantly increased risk due to volatile wholesale market conditions and regulatory uncertainty. As the AEMC noted in its 2017 Retail Competition Review, a meaningful assessment of retailer profitability should take into account risk-adjusted net margins, which also account for the return of and on retailers' capital.[7]

3. The retail electricity market is highly competitive

The ACCC acknowledges in its Preliminary Report that there "*are many signs of competition*" in the retail electricity market in Australia, including the number of electricity retailers that have entered the market and the high rates of customer switching in the market.[8] The ACCC also notes that its review of internal retailer documents shows that retailers pay close attention to their competitors.[9] Notwithstanding this, the ACCC suggests that retail competition is not driving good outcomes for consumers.

AGL strongly disagrees with this suggestion and is concerned that the ACCC's preliminary comments on competition in the retail market:

- do not give sufficient weight to the key findings of the AEMC's in-depth annual retail market reviews which for the past few years have concluded that most retail electricity markets in Australia are effectively competitive. The AEMC has found that barriers to entry are generally not significant, that there has been significant increases in innovation (including by AGL, Origin and Energy Australia) and that market concentration has been steadily declining since de-regulation;
- fails to take into account the impact that the costs of winning and retaining customers in highly competitive markets, strategies to assist customers and investment in innovation, and increasingly complex regulatory compliance have had on retailer costs;

[5] ACCC Preliminary Report, page 75.
[6] ACCC Preliminary Report, page 75. While the ACCC estimates retail margins to have increased in New South Wales since 2007/2008, this appears to have been inevitable in light of the ACCC's estimate that retail margins in that State were negative 10 years ago. AGL notes that the ACCC estimates retail margins in New South Wales have risen to a level that is relatively commensurate with the retail margins in other states.
[7] AEMC, 2017 Retail Competition Review, page 8.
[8] ACCC Preliminary Report, page 120.
[9] ACCC Preliminary Report, page 96.

- ignore the efficiencies that can result from economies of scale and scope and the fact that a market can be effectively competitive even where some players have relatively higher market shares than others;
- do not examine the evidence of the effective competition that is occurring in the market, including the vigorous competition that occurs between AGL, Origin Energy and Energy Australia; and
- seem to be disproportionately focused on the experiences of smaller retailers rather than the overall effectiveness and outcomes of the competitive process.

3.1. The AEMC's findings concerning retail price increases

Since 2014, the AEMC has been tasked with undertaking independent reviews of the competitiveness of the Australian retail electricity market for the Council of Australian Governments (COAG). The AEMC undertakes these detailed annual reviews using data and information from a wide variety of sources including retailers, consumers, the Australian Energy Regulator (**AER**), Australian Energy Market Operator (**AEMO**), the Clean Energy Regulator, Tariff Tracker, other stakeholders and international experience and information where relevant.[10]

In its most recent 2017 Retail Competition Review, the AEMC found that:

1. the retail electricity market in Australia is effectively competitive; and
2. recent increases in retail electricity prices have not been caused by the state of competition in the retail market.

Specifically, the AEMC concluded that:

> *"[Retail price increases are] being driven by increases in wholesale energy market costs, which affect the costs of businesses competing in the retail sector. The increases in wholesale energy market costs and hence retail energy prices, are driven by factors that are unrelated to the state of competition within the retail energy sector itself.*
>
> *The increases in wholesale energy market costs for retailers arise from:*
>
> - *a lack of investment due to the uncertainty created by a lack of integration between current energy and emissions reduction policy mechanisms;*
> - *the retirement of Hazelwood in March 2017, which supplied capacity of 1600 MW equivalent to around 20 per cent of Victoria's electricity consumption. This came on top of the retirement of the Northern Power Station in May 2016, which supplied 546 MW in capacity; and*
> - *increases in gas prices, partially due to high demand for gas export markets and the moratoria on gas exploration and development.*
>
> *The factors that are increasing wholesale costs are also contributing to the decline in the availability of wholesale hedging contracts. This has the potential to have a detrimental impact on retail competition."*[11]

3.2. Concentration levels have been steadily declining post-deregulation

The ACCC suggests that current levels of market concentration raise concerns about the effectiveness of competition in the retail electricity market.

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[10] AEMC, 2017 Retail Competition Review, page 8.
[11] AEMC, 2017 Retail Competition Review, page i.

AGL submits that there are two weaknesses with this suggestion:

1. it ignores the fact that there have been substantial decreases in concentration levels in the retail markets that have transitioned from regulation; and
2. concentration levels alone do not provide a basis for concluding that a market is not effectively competitive, or that any of the participants in the retail market hold market power or that there has been, or is likely to be, an exercise of market power.

In its 2017 Retail Competition Review, the AEMC concluded that in all NEM jurisdictions (except Tasmania) from 2014 to 2016:

- the combined market shares of Origin Energy, Energy Australia and AGL decreased;
- the share of 'second tier' retailers has increased; and
- the market concentration levels (measured by HHI score) have decreased.[12]

The AEMC also found that these changes in market shares and concentration levels were more pronounced over a longer term period. From 2010 to 2016, smaller retailers have been able to gain substantial market share in Victoria (14.6%), New South Wales (10.1%) and South Australia (8.6%) – the jurisdictions that have benefitted from de-regulation the longest. AGL submits that the ACCC is incorrect to suggest that these gains in market share by 'second tier' retailers are 'relatively minor' or are a sign that competition has failed to meaningfully challenge the largest retailers.

3.3. Vigorous competition between AGL, Origin Energy and Energy Australia delivers positive consumer outcomes

Indeed, a fundamental weakness in the ACCC's analysis of retail competition in the Preliminary Report is its failure to consider the significance of the vigorous competition that exists between Origin Energy, Energy Australia and AGL. By focusing largely on the position of 'second tier retailers', the ACCC runs the risk of reaching conclusions and making recommendations that are designed to protect the position of individual retailers, rather than the competitive process and outcomes for consumers.

The Australian Competition Tribunal emphasised the importance of focusing on the competitive process rather than the position of second tier retailers in its consideration of AGL's acquisition of Macquarie Generation:

> "…*AGL post-acquisition is likely to be driven to win market share from Origin or Energy Australia. That may make the task of small retailers getting a significant share of the SME or domestic consumer business a challenging one. That is, of course, the nature of competition*….*The Tribunal cannot conclude that a more atomistic market structure that favours a particular class of competitors is intrinsically better for consumers in the long run. It is the competitive mindset that matters, not market structure."* [13]

There is substantial evidence of the vigorous competition that occurs between AGL, Origin Energy and Energy Australia. In its 2017 Retail Competition Review, the AEMC noted that the rates of switching in the retail electricity market were high and highest between AGL, Origin and Energy Australia.[14] The AEMC

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[12] AEMC, 2017 Retail Competition Review, page 43.

[13] Australian Competition Tribunal, *Determination regarding application for authorisation of Macquarie Generation by AGL Energy Limited* [2014] AComp T1 at [369] – [370].

[14] AEMC, 2017 Retail Competition Review, pages 74 – 75. The AEMC also noted that the rates of switching in the retail electricity market are higher than numerous other markets in Australia, including markets for banking, car insurance, mobile and phones, internet, home insurance and health insurance (page 82).

also found that discounts and average prices paid for AGL, Origin and Energy Australia had decreased from 2014/15 to 2016/17.[15]

This shows that there is effective competition resulting in very positive consumer outcomes in the retail electricity market. This includes vigorous competition from "second tier" retailers.

3.4. Retention and win-back strategies benefit consumers

Of particular concern in the Preliminary Report is the ACCC's suggestion that "aggressive" retention and win-back strategies of established retailers are making it difficult for second tier retailers and therefore impeding effective competition.[16] AGL is concerned that the labelling of these strategies as "aggressive strategies" of established retailers may be interpreted as a reference to market power. In AGL's view, these market practices are evidence of the rivalry that is the hallmark of competitive markets. It is also important to recognise that these strategies are used by all types of retailers in the market – not just the more established retailers.

It is also important for the ACCC not to overlook the fact that retention and win-back strategies are ultimately for the benefit of consumers. As the ACCC acknowledges only in passing in the Preliminary Report, *customers benefit financially from retention and win-back strategies*.[17] A further consumer benefit not recognised by the ACCC is the fact that these strategies provide a safety net for detecting incorrect or fraudulent customer transfers. This is particularly important given the prevalence of door-knocking[18] and, in AGL's experience, the number of transfers that are not legitimately initiated by the customer.

AGL submits that:

- by focusing predominantly on the position of smaller retailers, the ACCC has not given sufficient weight to these consumer benefits; and
- introducing restrictions on the use of retention and win-back strategies in order to protect smaller retailers would damage the competitive process and would not be in the interests of consumers.

3.5. Barriers to entry are not significant

The AEMC has historically found that barriers in the retail electricity market are not significant and concluded this year that they remain stable.[19] To the extent that there are barriers to entry and expansion, the AEMC identified them as relating to the current conditions in the wholesale electricity market and the divergence of jurisdictional regulatory arrangements from national arrangements, particularly in Victoria.[20]

3.6. Retailers of all sizes are investing in innovation

In the Preliminary Report, the ACCC acknowledges the AEMC's findings that retailers have introduced a range of innovative measures aimed at increasing pricing diversity and assisting consumers to manage their electricity bills.[21] The ACCC also notes that there are currently over 1600 different offers generally available for small customers throughout the NEM and that this number continues to increase.[22]

However, the ACCC goes on to suggest that a lack of innovative tariff types and service options indicates that the retail electricity market is not effectively competitive. AGL submits that this suggestion is not

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[15] AEMC, 2017 Retail Competition Review, pages 111 – 112.
[16] ACCC Preliminary Report, pages 105-106.
[17] ACCC Preliminary Report, page 106.
[18] AGL ceased door-knocking practices a number of years ago however, as noted by the ACCC, this is still a common practice in the retail electricity market. ACCC Preliminary Report, page 134.
[19] AEMC, 2016 Retail Competition Review, page 91; AEMC, 2017 Retail Competition Review, page 14.
[20] AEMC, 2017 Retail Competition Review, page 14.
[21] AEMC, 2017 Retail Competition Review, pages 130-133; ACCC Preliminary Report, page 101.
[22] ACCC Preliminary Report, page 121.

supported by the available evidence of innovation and ignores the factors which contribute to current tariff structures. In particular:

- The ACCC appears to have ignored the AEMC's findings that retailers of all sizes are increasingly investing in, and offering, non-price based innovative products and services. In its 2017 Competition Review, the AEMC noted that:

  > "*Shifts in consumer preferences and attitudes about how energy is consumed, coupled with rapidly evolving technology, have created opportunities for retailers and new energy service providers to diversify their product and service offerings. This increasing competitive pressure from retailers with different business models is forcing traditional retailers to compete not just on price, but also on value-added product and service offerings.*"[23]

- Tariff structures should not be viewed as an indicator of innovation or effective competition. AGL understands the ACCC's concern with discounting off standing offers being the predominant tariff structure. However, this structure is a function of:
  1. market practices that developed through price regulation;
  2. the structure of network tariffs; and
  3. most significantly, the ongoing consumer preferences and expectations for discounts.

AGL has attempted to engage with consumers on alternative tariff structures other than discounts. These attempts have proven to be largely unsuccessful. AGL's experience is that customers are most receptive to discount based product marketing, such that any unilateral attempt to cease marketing on this basis would expose retailers to a rapid loss of customers. AGL is prepared to engage with the ACCC to discuss industry-wide actions that could be taken to address these tariff structure issues, noting that any industry-led initiatives could involve competition law risks.

Examples of some of the products and services that AGL has developed include:

- "Electric Car Plan";
- guaranteed discount – for customers that seek certainty;
- direct debit discount – for customers that choose to set and forget their energy;
- pay on time discount – rewarding customers for paying their energy bills by the due date;
- double up reward – rewarding customers with multi-product discounts;
- online sign-up – rewarding customers with up-front rebates for using digital channels;
- "Free Day" – rewarding customers with whole day free power;
- "Free Month" – rewarding customers with whole month free power;
- pre-paid – rewarding customers through bonus (used to offset energy charges) that pre pay their energy usage;
- fixed rates – providing certainty for energy rates for the whole contract term;
- different payment methods (including PayPal and Australia Post over the counter);
- monthly billing; and
- bill smoothing – where customers pay the same amount every month that considers seasonal energy use fluctuations.

[23] AEMC, 2017 Retail Competition Review, page iii.

3.7. Retail cost levels are not indicative of ineffective competition

The ACCC suggests that increased retailer costs raises questions about whether competition in the retail market is effective. AGL believes that any examination of retailer costs and trends occurring in them needs to have regard to the conditions in which the businesses are operating and how they have changed over time.

Factors that have contributed to increasing retailer costs include:

- **Costs to acquire/retain and innovate post de-regulation:** AGL will work with the ACCC to explain the costs that are incurred by retailers in attracting and retaining customers. The more competitive the market is, the higher the costs a retailer must incur in seeking to effectively retain and grow its customer base. Retailers also invest significant sums in technology, systems and processes to better serve and attract customers. AGL invests approximately $50-100m each year in improving its operating systems and customer services and technologies.
- **Strategies to assist customers**: the increasing focus on assisting vulnerable customers and investing in technology and strategies to assist all customers to better manage their electricity usage and costs has, in turn, increased retailers' operational costs.
- **Regulatory compliance costs**: as noted by the AEMC in its 2017 Retail Competition Report, the divergence of regulatory arrangements from national arrangements and a lack of coordination between jurisdictions are increasing operating and compliance costs for retailers that operate on a national level.[24] The significant amount of regulatory oversight and inquiries that AGL is subject to – particularly over the course of 2016/2017 – has also contributed to [substantial] increases in its operational costs.

4. Wholesale market – no evidence of lack of competition

AGL strongly disagrees with the ACCC's preliminary comments that insufficient competition in the wholesale market has led to higher electricity prices and raised barriers to entry.[25]

These comments:

- are predicated on artificially narrow state-based markets, an approach that has been rejected by both the Federal Court and the Australian Competition Tribunal;[26]
- appear to be based on observed levels of generation concentration rather than any analysis of market outcomes or evidence of anti-competitive behaviour; and
- do not sufficiently recognise that recent wholesale price increases reflect the natural operation of the NEM, which was designed to attract increased generation investment <u>through higher prices</u> during times of tight supply and demand conditions.

As explained in detail in AGL's Initial Submission and as recognised by the AEMC in its 2017 Retail Competition Review, the recent increase in wholesale electricity prices is clearly attributable to:

1. the withdrawal of existing generation capacity, primarily baseload generation, in part due to the increased proportion of intermittent and/or unpredictable generation capacity (e.g., solar and wind generation);

[24] AEMC, 2017 Retail Competition Review, page iii.
[25] ACCC Preliminary Report, page 5.
[26] Australian Competition Tribunal, *Determination regarding application for authorisation of Macquarie Generation by AGL Energy Limited* [2014] ACompT 1 at [280]; *Australian Gas Light Company v Australian Competition & Consumer Commission (No 3)* (2003) 137 FCR 317 at [387].

2. insufficient investment in new baseload generation capacity, due to the uncertain investment climate and the unavailability of a key fuel source (gas) to underwrite new baseload generation; and
3. increases in generation fuel costs (gas but also black coal) and potential shortages of key fuel sources – primarily gas but also coal, as explained in AGL's submission to this Inquiry regarding its difficulties obtaining and getting coal onto its generation site in NSW. When input prices increase, spot prices will be higher. In this regard, AGL acknowledges and supports the ACCC's focus on increasing domestic gas supply in Australia.

There is no evidence that a lack of competition has contributed to higher wholesale prices.

4.1. Artificially narrow approach to assessing the market

The Preliminary Report assesses market structure on an artificially narrow state basis. This approach completely ignores the interconnected nature of the regions and the role of competitive supply across regions in moderating spot price outcomes.[27] It also ignores the reasoned conclusions of the Federal Court and the Australia Competition Tribunal that the wholesale electricity market is NEM-wide.[28] The Court and the Tribunal both found that, as a result of interconnectors, periods of price separation between the states within the NEM did not occur with sufficient frequency, duration or predictability for there to be separate state based wholesale markets within which competition should be considered.[29]

It is only when interconnects are physically constrained that regions are isolated and generators within the state are subject only to competition from other generators in that state.

4.2. Conclusions cannot be drawn from current concentration levels

As the ACCC recognises in the Preliminary Report, the current levels of concentration in the NEM reflect:

1. the relatively recent withdrawals of substantial generation capacity, including the end of life closures of the Engie owned Hazelwood power station and the Alinta owned Northern and Playford B power stations; and
2. the failure of higher prices in the NEM to attract new baseload investment, due to political and regulatory uncertainty.

Current concentration levels do not, of themselves, provide a basis for the ACCC to conclude that the wholesale market is not competitive, that any of the participants in the wholesale market hold market power or that there has been, or is likely to be, an exercise of market power. In any event, as explained in the report prepared by Frontier Economics (**Frontier Report**) and submitted to this Inquiry by AGL, the NEM *"falls firmly in the "unconcentrated" category, even after recent generation mergers*".[30] This conclusion is based on the widely recognised Herfindahl-Hirschman index (**HHI**) measurement of concentration and the ACCC's own guidance regarding when market concentration (based on HHI) is likely to lead to competition concerns.[31]

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[27] AEMO, "*National Transmission Network Development Plan*", December 2015, page 3.
[28] Australian Competition Tribunal, *Determination regarding application for authorisation of Macquarie Generation by AGL Energy Limited* [2014] AComp T1; *Australian Gas Light Company v Australian Competition & Consumer Commission (No 3)* (2003) 137 FCR 317.
[29] Australian Competition Tribunal, *Determination regarding application for authorisation of Macquarie Generation by AGL Energy Limited* [2014] AComp T1 at [280]; *Australian Gas Light Company v Australian Competition & Consumer Commission (No 3)* (2003) 137 FCR 317 at [387].
[30] Frontier Economics, *Effects of vertical integration on capacity bidding behaviour (supplementary AGL submission to ACCC Issues paper),* August 2017, paragraph 34.
[31] *Ibid,* paragraphs 31 – 34.

The ACCC's very serious suggestion that manipulative conduct by generators has likely contributed to higher prices in the NEM is not supported by evidence. AGL notes that it takes compliance with the National Electricity Rules and Law very seriously and its activities in the wholesale market are subject to close oversight by the AER and AEMO. In a submission to this Inquiry of 13 September 2017, AGL explained the way in which coal shortages in New South Wales in 2017 had forced AGL to ration coal and alter its bidding behaviour to reduce dispatch of generation.

As the ACCC acknowledged in the Preliminary Report, in 2016 the AEMC introduced a rule which provided clearer guidance about appropriate generator bidding behaviour in the wholesale market and requires generators to provide information and records regarding bidding behaviour to the AER on request.[32] The fact that the AER has not taken any enforcement action regarding manipulative bidding behaviour strongly suggests that there is no evidence of such behaviour.

4.3. The NEM was designed to operate this way

The predominant cause of increases in wholesale electricity prices is the tightening of supply and demand conditions in the NEM as well as increases in gas prices. This should not be viewed as a sign of ineffective competition – it is simply the NEM functioning precisely as it was designed to function.

As the ACCC identifies in the Preliminary Report:

- the NEM was designed to provide clear signals to the market and attract new generation investment at times of short supply; but
- it has been widely recognised that ongoing policy uncertainty, particularly in relation to federal and state based environment schemes, has undermined investor confidence in the NEM.[33]

The interests of consumers will be best served by the ACCC and policy decision-makers focusing on addressing this policy-driven market failure. The ACCC's purely theoretical comments regarding current concentration levels in the wholesale market do not provide any basis for considering regulatory or political intervention aimed at unwinding or otherwise influencing the legitimate market responses of existing generation businesses. Such intervention would only increase the disincentives for new investment in generation capacity and lead to further disruption of the intended operation of the NEM.

AGL therefore urges the ACCC to focus on the signals and incentives for new baseload generation investment as the key wholesale market issue for its final report.

5. Vertical integration is an efficient competitive response – concerns regarding its impact on prices and contract markets are misplaced

AGL notes that the ACCC intends to explore the impacts of vertical integration further in its final report.

AGL also notes the ACCC's comment that it is not concerned by vertical integration per se.[34] The ACCC is right to make this comment: vertical integration is an efficient competitive market response to managing risk, which has had a moderating effect on wholesale electricity prices, rather than contributing to price increases. The natural tendency for electricity retailers to manage their risks through vertical integration and the benefits that result from this integration have been recognised by the Federal Court and the Australian Competition Tribunal.[35]

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[32] ACCC Preliminary Report, page 94.

[33] ACCC Preliminary Report, page 86; AER, "*State of the Energy Market Report*", May 2017, page 42.

[34] ACCC Preliminary Report, page 82.

[35] Australian Competition Tribunal, *Determination regarding application for authorisation of Macquarie Generation by AGL Energy Limited* [2014] AComp T1 at [253]; *Australian Gas Light Company v Australian Competition & Consumer Commission (No 3)* (2003) 137 FCR 317 at [214].

AGL has already submitted the Frontier Report to this Inquiry which concludes that vertically integrated generators bid in 4 to 6 per cent more of their capacity at lower prices compared to stand-alone generators.[36]

AGL submits that the ACCC should also take into account the following points when giving further consideration to vertical integration:

- Frontier's conclusions that (1) vertically integrated generators behaved more competitively on average than stand-alone generators and (2) there is no statistical evidence that the trend towards vertical integration has led to generators bidding higher prices in Australia.
- Frontier's conclusions are consistent with the economic theory of vertical integration: that it is a competitive and efficient response to market conditions that expands low-cost sources of supply and drives down prices for consumers.
- Vertical integration should not, by itself, diminish the ability of stand-alone generators and retailers to access the contracts they need to hedge price risk. Vertical integration withdraws an equal amount of supply and demand, leaving the market in the same balance as before and providing no reason on its own for prices for those contracts to rise.
- The inherent nature of electricity markets, including uncertainties resulting from volume (load) risk and regulatory and policy uncertainty, means that markets for electricity hedging contracts may not be particularly deep and liquid. Vertical integration has very little impact on liquidity in electricity contracts markets.

AGL submits that it would be incorrect and overly simplistic for the ACCC to conclude that vertical integration has limited retailers' access to hedging contracts or led to a lack of liquidity in contract markets. The current conditions in contract markets reflect the conditions of the broader wholesale electricity market – the tightening of supply and demand and policy uncertainty discouraging investment. This is considered at length by the AEMC in its 2017 Retail Competition Report.[37] As the ACCC itself notes in the Preliminary Report, the reduction in the availability of hedging products has been caused by the recent retirement of significant generation capacity.[38] This has also impacted vertically integrated retailers whose natural hedge does not eliminate their need to participate in the market for hedging contracts.

6. Initiatives to support and protect customers

6.1. Simplifying products and helping customers to make informed choices

AGL recognises the difficulties that some consumers have experienced in comparing and understanding retail offers. This is why AGL has been taking steps to help customers make informed choices about their energy options. This includes AGL's commitment to working with regulators, other retailers and community groups to develop a comparator metric across retailers that would enable consumers to easily compare different types of products. AGL has also taken steps to simplify its own product offerings and to introduce innovative services that enable consumers to monitor, manage and plan their electricity usage. These initiatives were described in detail in AGL's Initial Submission.

[36] Frontier Economics, *Effects of vertical integration on capacity bidding behaviour (supplementary AGL submission to ACCC Issues paper),* August 2017, pages 2-3.
[37] AEMC, 2017 Retail Competition Review, pages 57-62.
[38] ACCC Preliminary Report, page 104; This was also recognised by the AEMC in its 2017 Retail Energy Competition Review, page vii-viii.

6.2. Supporting vulnerable customers

AGL also recognises that there must be a safety mechanism to support vulnerable members of the community. As described in its Initial Submission, AGL has developed several initiatives to assist vulnerable customers and continues to prioritise its efforts in this area. These initiatives include:

- the **"Staying Connected" program**, which is AGL's hardship program approved by the AER. AGL has specially trained consultants that work with customers facing financial difficulties to establish affordable care plans and assist them with government support and concessions. These customers are also protected against disconnection and exempted from further collection action;
- the "**Affordability Initiative**", which involves a commitment of $6.5 million by AGL over three years to support hardship customers through financial counselling and vulnerable communities, energy savings partnership, debt relief and payment incentives and community funding; and
- the "**Fairer Way**" package, which involves the introduction of tailored products for AGL's most vulnerable customers.

7. Potential measures to improve market outcomes

The ACCC acknowledges that it was still at the relatively early stages of its Inquiry when it published the Preliminary Report.[39]

In the remainder of the Inquiry, AGL considers that the ACCC should focus on making recommendations that address the true cause of electricity price rises in Australia:

- rising wholesale prices due to the failure of the NEM to attract new baseload generation investment as a result of regulatory and political uncertainty and increasing fuel costs; and
- increasing network and environmental costs which have also been distorted by regulatory regimes.

In formulating these recommendations, the ACCC should consider the particular circumstances that have led to the current market conditions in the context of the intended operation of the NEM. AGL acknowledges and supports the ACCC's focus on increasing domestic gas supply in Australia. In the context of the electricity market, AGL believes the ACCC should continue to focus on cohesive policies and solutions that are intended to enable supply and demand to efficiently and naturally respond to market forces. Distortive regulatory or policy intervention by the ACCC, government or other regulators is not justified by current market dynamics.

[39] ACCC Preliminary Report, page 151.