

Australian Competition & Consumer Commission
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Submitted by email to ElectricityMonitoring@accc.gov.au

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ACCC monitoring of electricity supply in the National Electricity Market – discussion paper

The Australian Energy Council (AEC) welcomes the opportunity to make a submission to the ACCC's discussion paper.

The AEC is the industry body representing 23 electricity and downstream natural gas businesses operating in the competitive wholesale and retail energy markets. These businesses collectively generate the overwhelming majority of electricity in Australia and sell gas and electricity to over 10 million homes and businesses.

Introduction

The AEC is supportive of many of the recommendations in the ACCC's Retail Electricity Pricing Inquiry (REPI) that are aimed at boosting competition in generation and retail, lowering costs in network, environment schemes and retail, enhancing consumer experiences and outcomes and improving business outcomes.

Numerous inquiries into the National Electricity Market (NEM) have found no evidence of sustained inappropriate behaviour by participants and the AEC considers higher prices are not the direct result of concentrated market share. This was most recently reconfirmed by the Australian Energy Regulator's (AER) 2018 Wholesale Electricity Market Performance Report which found that: "despite the market's vulnerability to the exercise of market power, we did not identify sustained untoward behaviour in most regions." And that "achieving consistent energy policy settings is important if we are to continue to rely on market signals to deliver an effectively competitive wholesale electricity market over the long term."

The AEC considers that the lack of clear and consistent energy policy is the most significant contributor to avoidably high prices and correcting this should be the key objective of government and institutions.

Frameworks for Analysis

The AEC recommends that a range of different frameworks are used for the ACCC's monitoring activities. Generally an efficient market framework is the most relevant to analyse and evaluate the electricity market, particularly for the wholesale market. However, in the retail market, a legal framework is required to understand dynamics which are affected by the laws that regulate the retail market. For example, the regulations that create the "retailer of last resort" and "explicit informed consent" have large impacts on the way the market operates and how retailers structure their businesses. A legal framework might enable the ACCC to identify law reform which could lead to more efficient market outcomes.

The AEC notes much of the analytical frameworks that have previously been used to assess electricity market operations are based on a historical model of power coming from large, usually coal-fired, power stations, being handled by a large energy company and retailed one-way to passive, price-taking customers.

However this model is rapidly being overtaken by events in the industry, particularly by:

- the introduction of new supply technologies with much smaller scale-economies;
- new energy business models; and
- active consumers.

The profound effects upon the industry's competitive processes have been analysed in our report "NEM Structure in light of technology and policy changes" prepared by our consultant, Rajat Sood.¹

These industry changes will mean monitoring that was developed around the old industry paradigm will be poorly constructed and possibly misleading. Further, the sheer complexity and business forms that will emerge in the new paradigm mean monitoring must be carefully considered. The ACCC needs to recognise the challenges of the new environment and the limitations that an external monitor would have in completely grasping it.

Duplication

The ACCC should avoid duplication of functions with other bodies. In particular the AER has been developing Wholesale Electricity Market Performance reporting approaches for over twelve months in consultation with the industry. The AEC considers the AER has the greatest understanding of the wholesale market and has developed the most sophisticated tools available to undertake this. There should be no need to duplicate any of their efforts. Instead their findings could be directly adopted in order to meet the Treasurer's directive with respect to wholesale markets reporting.

The Energy Security Board (ESB) is also presently developing a number of key performance metrics that cover all aspects of the industry. These higher-level metrics can be more insightful than the more detailed approaches of the REPI, particularly in a time of fundamental industry change. Before developing its own methodologies, the ACCC should consider whether these metrics may adequately satisfy the Treasurer's directive.

The AEMC undertake extensive reporting on the competitiveness of the retail market, while the state regulators retain market monitoring powers and publish annual reports. It is important that the ACCC does not duplicate the work of these other agencies as it undertakes its work.

It is important to note the potential that the ACCC may reach different conclusions to other market monitoring bodies such as the AER. In December 2017 the AER released a special report into high prices in the NSW wholesale electricity market.² It found that a significant cost driver for increased wholesale prices was the increase in fuel costs and although it acknowledged the NSW market was dominated by five large generators the AER "have not seen the sorts of opportunistic bidding we would traditionally associate with the exercise of market power in electricity markets (such as rebidding capacity into extreme high prices)".³ In the ACCC's REPI final report, it underplayed the role of higher fuel costs and drew different conclusions.⁴

Datasets

The requirements placed on retailers to produce data for REPI were onerous and costly to comply with. Wherever possible the ACCC should seek to use datasets that are objectively attainable from retailer systems.

¹ <https://www.energycouncil.com.au/media/14945/20181213-final-report-advice-on-nem-structure-in-light-of-technology-change-stc.pdf>

² AER 'electricity wholesale performance monitoring NSW electricity market advice' December 2017, p. 3

³ Ibid.

⁴ ACCC 'Retail Electricity Pricing Inquiry Final Report' June 2018, p. 68.

We recommend the ACCC continue to work with retailers to ensure the data collected is consistent and obtaining it does not place unnecessary costs on retailers.

Relationship between Wholesale and Retail Prices

As state-based regulators have found when attempting to regulate retail prices, this is an extremely complex and judgemental challenge. The business of prudent retailing requires assembling a complex portfolio of wholesale positions and risk management, matched to the retailer's corporate objectives and risk appetite. The retailer must contemplate how its customers will consume and when, and which wholesale positions can be relied upon to meet them. This results in a probabilistic spread of possible commercial outcomes, and financiers' natural risk aversion obliges the retailer to approach the spread of outcomes asymmetrically, and contained within their risk management practices.

The relationship between wholesale and retail prices will be difficult to measure. A wide range of factors influence retailers' pricing decisions and the wholesale price represents only part of that equation. We would caution against an analysis that attempts to draw out a direct correlation which may not be able to factor in the full commercial reality of retail pricing decisions.

All these challenges are made more complex again as a result of the industry changes underway. In particular the attraction of customers to behind-the-meter generation further complicates the connection of wholesale to retail prices.

Wholesale Profitability

When considering the competitive functioning of a market, it is not meaningful to analyse any particular firm's actual profitability, as this will be purely a function of its individual circumstances rather than revealing anything intrinsic about its industry. For example, its accounting profitability will be most affected by historic financing matters, such as the carrying value of the business' assets. When considering the economic conditions of an industry, studying firms' accounting profit is not meaningful; as arbitrary re-valuations can occur at any time.

Instead the question of "profitability" should be approached theoretically. The ACCC should develop a concept of an "efficient new-entrant" generating firm and determine whether current wholesale conditions imply equal, greater or less than economic profitability for such a new-entrant. This firm should incorporate a typical range of generator technologies, and its ultimate product should be a form of firm contract that can be safely sold to a retailer.

This approach of considering a theoretical new-entrant generating firm avoids the challenges of contemplating vertical integration and transfer pricing. If a real firm has, by virtue of an efficient structure, been able to achieve greater accounting profit, then this is not in itself an indication of industry extra-normal economic profit, any more than, say, a generator who happened to have been purchased at a bargain price is as a result able to earn high accounting profits before its assets are revalued.

The AEC supports the need to consider the energy-only nature of the NEM. Economic costs encompass scarcity rents as well as such things as expenditures on fuel used to generate electricity. What would be problematic is if misguided regulatory policy required that bids reflected within-period, marginal, incurred costs or set an unduly low upper bound to prices."⁵

Hedge Contract Markets

In respect of hedge contract markets, there are a number of major changes underway, both being created organically by the market itself and also through regulatory development, for example:

- the contract markets are developing products around the need to "firm" variable generation⁶;

⁵ www.aemc.gov.au/sites/default/files/content/c196404a-e850-46bd-8ae2-41600f8454bb/Professor-George-Yarrow-and-Dr-Chris-Decker-%28RPI%29-Bidding-in-energy-only-wholesale-electricity-markets-Final-report.PDF

⁶ <https://www.energycouncil.com.au/analysis/firming-renewables-the-market-delivers/>

- the Australian Energy Market Commission is presently considering a rule change that will lead to an industry-led market making mechanism⁷ which is likely to lead to increased liquidity and increased price and volume transparency.
- AEC members through the AEC's Wholesale Market Working Group agreed to re-instate the AFMA survey of Over the Counter (OTC) transactions. It is understood that members are now working with AFMA to further enhance the survey.

It is important to allow these processes to play-out to ensure that the threat of invasive hedge contract market monitoring does not stifle market participant's self initiated efforts to support regulators through increased transparency.

Monitoring policy developments

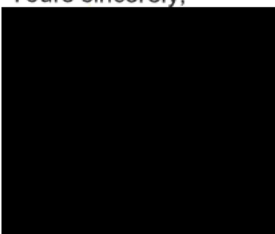
Our report "NEM Structure in light of technology and policy changes" contemplates some policy developments regarding the nature of NEM competition as well technology developments. Rajat Sood considers⁸ competitive outcomes will be affected by policy measures to:

- Introduce more cost-reflective network tariffs and smarter metering;
- Support demand-side integration;
- Apply a shorter settlement period;
- Accelerate transmission flow-path development.

A significant barrier to effective competition and a driver for higher electricity prices is policy uncertainty. Uncertainty over carbon policy is exacerbated by ad hoc interventionist policies pursued by federal and state governments. The ACCC identified a number of policies in its REPI report that contributed to higher prices. It should continue to monitor the effects on the market of implemented policies as well as threats of heavy-handed intervention such as the *Prohibiting Energy Market Misconduct* Bill which includes a divestiture power. These policies can prevent new players from entering the market, distort price signals required for investment and reduce healthy competition. It will be important for the ACCC to apply a consistent methodology to monitor the impacts of policy changes over the longer term.



Yours sincerely,



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⁷ <https://www.aemc.gov.au/rule-changes/market-making-arrangements-nem>

⁸ <https://www.energycouncil.com.au/media/14945/20181213-final-report-advice-on-nem-structure-in-light-of-technology-change-stc.pdf>