
ACCC's Retail Electricity Pricing Inquiry

Comments on the Preliminary Report

RBB Economics, 21 November 2017

1 Introduction and summary

On 16 October 2017, the ACCC released its Preliminary Report (PR) into retail electricity pricing in Australia which found that there was a “severe electricity affordability” problem across the National Electricity Market (NEM) and that price increases over the past ten years were “putting Australian businesses and consumers under unacceptable pressure”.¹

The ACCC's findings were wide-ranging. It found that there was insufficient competition in the generation and retail markets, which both raised prices and increased barriers to entry. It found that there had been over-investment in electricity networks, inefficient cost recovery, and higher than warranted rates of return due to the regulatory framework which led to increased costs for consumers. It found that some measures to improve environmental sustainability had been over generous and poorly targeted. It also found that the retail market was exceptionally complex and that retail deregulation had benefited some consumers and hurt others.

Although there were no firm recommendations aimed at easing the pressures on electricity prices for Australian households and businesses in the PR, it does contain strong hints as to the measures that will be examined during the next phase of the inquiry. These include placing constraints on further consolidation of ownership of existing generation assets, taking steps to unwind previous consolidation of generation assets (for example, of state-owned generators

¹ ACCC, *Retail Electricity Pricing Inquiry, Preliminary Report*, 22 September 2017, released 16 October 2017 (“PR”), page 5. The NEM is the wholesale electricity market that covers Queensland, New South Wales, Victoria, South Australia, Tasmania, and the Australian Capital Territory. Western Australia and the Northern Territory are not connected to the NEM and were outside the scope of the ACCC's inquiry.

in Queensland), and examining ways to reduce the existing network costs embedded in the system (for example, by writing down asset values compulsorily if required).

In terms of improving outcomes for small customers, the ACCC has flagged that it will consider whether regulatory intervention is required to ensure that advertised discounts are taken from a consistent base rate and/or whether a regulatory limitation on certain discounts (such as “pay on time” discounts) is necessary.

This submission sets out our observations on the ACCC’s preliminary findings and on the next steps it has outlined for the remainder of its inquiry.² In short, our view is that although the PR contains a comprehensive discussion of the factors that make up the electricity prices paid by Australian households and businesses and describes how those factors have changed over time, the ACCC has not in the PR established that the high prices across the NEM are the result of insufficient competition in either the wholesale or retail electricity markets. As a result, the findings set out in the PR do not support the heavy-handed solutions that the ACCC has flagged as the likely measures to help ease the pressures on electricity prices for those households and businesses.

In particular, the use of market shares and concentration levels to determine whether the wholesale (generation) market is subject to effective competition, and the use of EBITDA margins to assess whether some retailers are exploiting their market power and earning supernormal profits, may be the first step in any assessment into whether competition has failed in those markets. These measures, however, cannot, on their own, support the extreme measures that the ACCC has flagged it will consider in order to improve competition in those markets (such as preventing further consolidation and taking steps to unwind previous consolidation). Those measures should only be explored once the ACCC has carried out a serious competitive assessment of the generation and retailing markets and concluded that competitive forces have demonstrably failed to operate effectively in either (or both) of those markets.

In the one market where we would readily agree with the ACCC that competition is clearly not capable of operating effectively – the transmission and distribution network – the ACCC has flagged a number of areas where it believes that the economic regulation of those networks has led to poor results for electricity users. In such markets, economic regulators should be armed with the power to effectively regulate natural monopolies where competition has irretrievably broken down, and have the wherewithal to push back against efforts by network operators to gold plate their networks. But that power needs to be curbed by a process where the merits of their decisions can be subjected to an appeal. The ACCC’s support of the Government’s decision to limit the appeals that network operators can make against the Australian Energy Regulator’s (AER) decisions seems aimed only at trying to drive prices down rather than ensuring that the right balance is struck between affordable prices on the one hand and the ability of network operators to recover the costs of investing in safe, reliable networks on the other hand. Any measures that the ACCC explores during the next phase of

² At the time of preparing and submitting this submission, RBB Economics is not advising any party in relation to the issues raised in the PR.

the review aimed at compulsorily writing down asset values in order to wind back the clock and correct perceived past mistakes must be implemented by an authority capable of making those decisions and as part of a process that provides those affected with the option to appeal the merits of the decision in order to preserve the incentives for dynamic efficiency and to protect the interests of network owners who made those investments in the past according to the rules in place at that time.

The remainder of this short submission is set out as follows:

- Section 2 examines the findings in the PR that the wholesale (generation) market is highly concentrated and characterised by increased vertical integration and that these features are likely to be contributing to higher wholesale electricity prices. The evidence that the ACCC appears to rely on in the PR to support its finding that generators have market power is the “very high market shares” of certain generation businesses and the finding that wholesale prices in Queensland fell when the Queensland Government directed a state-owned generator to offer more capacity in the NEM and to alter its bidding strategy to put downwards pressure on wholesale prices. We believe that neither the “high market shares” of certain generators nor an example of a government effectively subsidising wholesale prices provides sufficient evidence that generators are exercising market power and a more comprehensive competition analysis that takes into account how the wholesale market operates is required before any of the “likely” measures that the ACCC will consider in the next stages of this inquiry, such as prohibiting further consolidation and taking steps to unwind previous consolidation of generation assets, are considered.
- Section 3 presents our observations on the effectiveness of the regulatory regime for natural monopoly transmission and distribution network operators. In the PR, the ACCC argues that given network operators receive a guaranteed return on their assets, there is an incentive to over-invest in assets if the rate of return is set too high. In theory, an effective regulatory system should be able to minimise the risk of over-investment, but in practice regulators face the tough task of setting a price which is affordable for households and businesses and which also provides sufficient revenues to operators to invest in safe and reliable networks. That task is made harder because of the information (and resource) asymmetry between network operators and the regulator. In that environment mistakes are inevitable. The ability of network operators to appeal against the merits of a decision taken by the AER is an important safeguard in the regulatory system which helps to ensure that the regulator strikes the right balance between consumers and network owners. It is disappointing, therefore, that the ACCC has thrown its support behind the Government’s decision to repeal the right of network owners to initiate a limited merits review of AER decisions. It is also concerning that the ACCC is, as part of the next phase of the inquiry, likely to consider compulsorily writing down assets to unwind previous decisions made by the regulator or the courts.
- Section 4 provides our response to the findings in the PR around the operation of the retail electricity market. Our view is that EBITDA is not a useful measure of whether firms are earning supernormal profits in a market and that the ACCC’s approach overlooks the

dynamic role that profits perform in a competitive market of rewarding success and providing incentives for investment and innovation.

The likely measures that the ACCC intends to explore to reduce complexity in the retail electricity market, such as ensuring that advertised discounts are taken from a consistent base rate and/or placing regulatory limits on some discounts to ensure that some consumers are not paying higher prices due to the conditionality of offers, contains a high risk of making the retail electricity market less rather than more competitive. Clamping down on discounts currently enjoyed by some consumers or trying to reign in some of the aggressive strategies that smaller retailers claim are being used by larger retailers to either retain or win back a customer from smaller retailers will take away one of the main selling points of competition in the market and place further upward pressure on prices. Similarly, introducing a reference or comparison price where the overall cost of an electricity offer is presented on either a per unit basis or a period of time is more likely to harm competition by making it easier for firms to coordinate their pricing with one another in a way that tips the market towards an outcome that involves a clear and substantial lessening of competition.

2 Do generators have market power?

2.1 Introduction

This section examines the claims in the PR that the generation market is highly concentrated and characterised by vertical integration and that both of these features are likely to be contributing to higher electricity prices. It begins by providing a brief overview of the NEM in Australia and sets out the approach that we would expect the ACCC to take in order to support its concern that generators are exercising their market power in the NEM.

2.2 The structure of the national electricity market

The NEM is a wholesale electricity market in which generators sell electricity and retailers buy electricity to on-sell to consumers. In very general terms, the electricity market comprises the following three levels of the supply chain:

- **Generators** generate electricity using either fossil fuels, such as coal and gas, or renewable sources, such as hydro, solar and wind.

The price of wholesale electricity is determined in a spot market in which the demand for and the supply of electricity is constantly matched. Generators bid to supply a given quantity of power every 5 minutes. Those offers are then stacked in order of rising price, and then scheduled and dispatched into production starting from the cheapest to the most expensive until demand is met. The marginal cost of the last generator that is dispatched – that is, the generator with the highest price for that particular five minute block – sets the “dispatch” price. A dispatch price is determined every five minutes, and every 30 minutes

the six dispatch prices are averaged to set the “spot” price which is paid to all generators for their dispatched electricity during that 30 minute period regardless of how they bid.³

- **Transmission and distribution networks** transport electricity on high voltage electricity transmission lines to local distribution networks and ultimately (on lower voltage lines) to end users. Transmission and distribution networks are typically described as “network operators”, although they are treated as two separate networks.

Each state has a single transmission operator and multiple local distribution networks. These networks are all considered to be natural monopolies and subjected to prescriptive price regulation.

- **Retailers** buy electricity at spot prices and on-sell it to end customers who are homes, offices, and factories.

In 1991, the Industry Commission (IC) was asked to examine the scope for improving the efficiency of electricity and gas supply and to report on institutional, regulatory or other arrangements which led to inefficient resource use.⁴ That report formed the basis of many of the recommendations adopted by the Special Premiers’ Conference later that year (now the Council of Australia Governments or COAG).

One of the most important recommendations of COAG was to restructure the electricity supply industry with the vertical separation of generation and retail from the natural monopoly elements of transmission and distribution. COAG envisaged that generation and retailing would be subject to effective competition and that the transmission and distribution systems – which were considered to be examples of extreme natural monopolies – would need to be subject to detailed price regulation.

That separation happened across Australia, although as the ACCC notes in the PR, some of those reforms have been recently unwound with a number of mergers between generators and retailers (referred to as “gentailers”). The network businesses, however, remain vertically separated from generation and/or retail businesses and have remained subject to detailed price regulation.

2.3 How do generators exercise their market power?

Two reasons are presented in the PR as leading to higher wholesale prices – the structure of the wholesale market and the potential for strategic conduct by large generators.

2.3.1 Structure of the wholesale market

Section 3.1.1 of the PR states that an effective wholesale market is critical to delivering affordable electricity to households and businesses and that relies on competition between

³ See p.81, PR. A separate spot price is determined for each region of the five NEM regions and spot prices are subject to a cap of \$14,200 per MWh and a floor of -\$1,000 per MWh.

⁴ Industry Commission, 1991. *Energy Generation and Distribution*. Report No. 11, Canberra.

generators to deliver low prices.⁵ The ACCC's finding in the PR is that competition in the wholesale market is not effective.⁶

"It is clear that market concentration overall, and the very high market shares of particular generation businesses in some NEM regions, is a risk to wholesale prices. The NEM is designed to operate with effective competition among generators and any sustained ability for generators to exercise market power is a barrier to effective competition."

Given that the architects of the restructured electricity supply industry believed that the generation market would be subject to effective competition and that a recent wide-ranging review by Productivity Commission in 2013 also found that the generation market is "now open to competition",⁷ a finding by the ACCC in the PR that competition in the generation market is not operating as expected would imply that the ACCC believes that a major rethink of electricity policy is needed in Australia.

It will be interesting to see how the ACCC determines whether, in fact, the generation market is subject to effective competition during the next phase of the inquiry. Market shares and concentration levels may be a useful place to start an assessment into the level of competition into wholesale markets, but it is not the end of the analysis.

In this market, market shares are particularly incapable of revealing whether a generator has market power. Because electricity cannot be stored, even a smaller generator is likely to have a substantial, although transient, degree of market power because they know that they will be the marginal generator at a particular part of the day in one part of the NEM. And given that any firm with a downward-sloping demand curve for its product will have "market power", the ACCC needs to explain what it means for a generator to have a sustained ability to exercise market power and provide evidence to show that prices are higher than some competitive benchmark.

A further issue is that high wholesale prices are not necessarily a sign that the generation market is not subject to effective competition, and may, in fact, be an indication that the market is working exactly as intended. If, for example, there is considerable spare generation capacity then the market price will tend towards the variable operating costs of the marginal or most expensive plant that needs to be dispatched in order to meet demand. In these conditions, many baseload plants may put in a low (or even a negative) bid to ensure that they are dispatched. In this example, low prices are not a sign that the market is subject to intense competition but simply reflect the fact that it would be costly for generators to switch the plant off, and during those periods, they are happy to receive the variable costs of the marginal plant if the alternative is to receive nothing at all.⁸

⁵ PR, p. 79.

⁶ PR, p. 81.

⁷ Productivity Commission 2013, *Electricity Network Regulatory Frameworks*, Report No. 62, Canberra, p 93.

⁸ AEMC 2013, *Potential Generator Market Power in the NEM*, Final Rule Determination, 26 April 2013, Sydney, page 11.

However, during periods of peak demand and where capacity is tight, peak generators will enter the market and make a bid that is high enough to cover the costs of operating a plant for the relatively small number of hours when their plant is needed. During those peak periods, the price will be considerably higher than during off peak periods or periods where there is considerable capacity available, and those prices – which are paid to all generators dispatched, not just the marginal generator – will be high enough to induce entry of peak generators and to recover the fixed costs of other generators including base load generators.

What this means is that low or high prices and price spikes, rather than indicating how competitive the market is, simply reflect how the wholesale market actual operates. As the Australian Energy Market Commission has observed:⁹

“The prices that occur at times of scarcity must be high enough and occur frequently enough to attract sufficient new investment in supply when needed. A cap on prices that is set too low will limit revenue and will be insufficient to retain generation or attract entry of new generating facilities.”

Spot price volatility is an inherent and necessary feature of a market with the characteristics of the NEM. Flexibility in spot pricing is essential for maintaining a reliable system given the range of factors that impact on the dynamics of both demand and supply of electricity.”

In some parts of the PR, the ACCC seems to accept that high prices are not necessarily a problem. The ACCC acknowledges, for example, that a large generator would know that for a significant period of the day, the dispatch of at least part of their capacity will be essential to meet demand, particularly in some regions. This knowledge enables them to bid a high price for at least some of their generation capacity in the knowledge that their generation will be dispatched even at that high price. This behaviour was accepted as normal competitive behaviour within the context of the National Electricity Rules.

In other parts of the PR, however, the ACCC seemed to support measures aimed encouraging behaviour that was not normal competitive behaviour within the context of Rules simply to try to push down wholesale prices. For example, the ACCC discusses in the PR how the Queensland Government, when concerned about prolonged high wholesale prices in Queensland, directed the state-owned generator to offer more capacity into the wholesale market and to alter its bidding strategy to put downwards pressure on wholesale prices. The ACCC notes that this intervention achieved immediate results and reduced the prices for futures contracts for the 2017-2018 summer months in Queensland by around 20 per cent.¹⁰

The clear implication in the PR is that the ACCC welcomes the Queensland Government's intervention because it led to lower prices than those that would have been achieved if the market was allowed to operate in the usual way.

⁹ *ibid*, p. 11.

¹⁰ PR, p. 81

There is no evidence in the PR to suggest that the ACCC's tacit support for the government's intervention into the wholesale market in Queensland will translate into a recommendation that other state governments engage in similar conduct to drive wholesale prices down. In our view, the ACCC should adopt a clear position in the next phase of the inquiry that governments resist from intervening in the wholesale market by pursuing a pro-consumer policy of lowering prices in a way that distorts price signals. Such distortions may achieve short term political gains by pushing prices down and making electricity more affordable for users in some parts of the NEM, but carry the risk of deterring entry by peak generations who respond to those price signals and use high prices to fund necessary investments in generation assets.

The measures that the ACCC has indicated that it will consider during the next phase of the inquiry include constraints on further consolidation of ownership of existing generation assets and taking steps to unwind previous consolidation of generation assets.

In our view, a blanket prohibition on mergers involving generation assets and taking steps to unwind previous consolidations would be a step too far. Any solutions considered in the next phase of this inquiry should not originate from a political dislike of high prices but should only be proposed after a clear market failure has been identified that enables a generator or a group of generators to increase prices above a competitive benchmark (which relates to the level of workable or effective competition in this market) for a sustained period of time.

Identifying such a market failure needs to go beyond looking at the level of concentration in the market and the market shares of generators. In a joint submission to the US Federal Energy Regulatory Commission (FERC), the Department of Justice (DOJ) and the Federal Trade Commission (FTC) (together referred to as "the Agencies") cautioned FERC against the use of market structure measures such as the level of concentration and encouraged it to use other types of evidence such as a supply curve analysis. In their submission to FERC, the Agencies provided an example of the analytical framework that could be used to assess when a generator might be able to exercise market power.¹¹

That framework considered the ability that an individual generator had through its control of generating capacity to withhold output at relatively low cost. The Agencies stated that the effect of withholding capacity shifted the supply curve to the left which could raise the market price of electricity. But, importantly, the Agencies noted that for a generator to be able to exercise market power, it must be able to offset losses that it incurs from selling less output from withheld capacity by earning higher profits on sales from its infra-marginal capacity.

This means that in order to exercise market power profitability, a generator – regardless of its market share – must have both the *ability* to affect market price (by controlling capacity from which it can withhold output at a relatively low cost) and the *incentive* (the infra-marginal capacity must be able to recover the profits lost on the withheld capacity). This requires a detailed, fact-based assessment and requires the competition authority or regulator to identify the costs of various "stacks" of capacity and to determine their relationship with the market price.

¹¹ Comment of the US Department of Justice and the Federal Trade Commission to the US Federal Energy Regulatory Commission, November 28, 2016, pp 9-10.

That assessment does not require the authority to form a view on whether prices are “high” or “low”. What is needed, instead is a view on where the market price is in each region of the NEM and an assessment of the ability and incentive of particular generators to affect that market price by unilaterally exercising their market power. This means that the ACCC will need to resist the temptation to see high prices in the wholesale market as a sign that competition is no longer functioning effectively. As discussed above, spot price volatility is an inherent and necessary feature of a market with the characteristics of the NEM, and so the relevant benchmark will need to allow for price spikes. And given the ability for any given generator to be a “marginal” generator at any point in time, it needs to be able to distinguish between transient pricing power and substantial market power.

Such an approach should also be used to assess whether further consolidations of generators should be allowed. That is, if a generator with market power was seeking to acquire another generator and if that acquisition would not lead to a substantial lessening of competition in the relevant market (by not affecting the ability or incentive of the merging parties to withhold capacity) then it is unclear why that merger would not be allowed to proceed. Unless the ACCC is looking to depart from the way that it currently assesses mergers and revert to a test that simply measures market shares and concentration levels rather than apply a (better) test that looks at whether competition in the relevant market will be lessened by the consolidation, we see no merit to that likely measure being explored by the ACCC during the next phase of the inquiry.

2.3.2 The potential for strategic conduct by large generators

In addition to the structural factors discussed above, the ACCC also considers that generation businesses engaged in “strategic conduct”, and that this conduct is also likely to have contributed to higher prices.

The strategic conduct identified in the PR relates to the rules that dictate the way that generators participate in the market. For example, generators submit offers to the market operator to dispatch specified quantities of electricity at bid prices. Although electricity is dispatched every five minutes, in order to help the market operator forecast market prices, generators provide bids to the market operator a day in advance.

In the PR, the ACCC noted that there has been a concern for some time that the rules allow for manipulation because large generators can submit re-bids late in a 30 minute period at a much higher price in order to drive up the average settlement price for that 30 minute period. And because the price spike may occur in the last five minute block of the 30-minute block over which prices are averaged and a new 30 minute-block starts after the 5 minute block in which prices were “manipulated”, there is not enough time for other generators to be induced to enter.

We agree with the ACCC that this is an area where the rules may need to be modified if strategic re-bidding is distorting market outcomes and leading to higher wholesale prices. But what seems to be missing from the PR is a clear definition of what it means by the term “manipulation” and an assessment of whether the type of strategic bidding raised by the ACCC

is *actually* distorting market outcomes and leading to higher wholesale prices rather than just having the *potential* to do so. For example, the ACCC has noted that in some instances, re-bidding actually drives prices down rather than up.

What is also needed in the next phase of this inquiry is an assessment by the ACCC into the incentives that generators have to engage in strategic conduct. The ACCC has indicated in the PR that larger generators are most likely to benefit from strategic re-bidding because their capacity is more likely to be critical to meet demand. But as the ACCC has also noted, given that larger generators are more likely to be vertically integrated with retailers, what incentive would they have to bid wholesale prices up if this damages their downstream interests?

In our opinion, it is not enough for the ACCC to throw its support behind any changes to the rules designed to address strategic bidding “to the extent that this rule change can limit any exercise of market power”.¹² Instead, it needs to actually determine if the rule change will actually limit the exercise of market power. It should also as part of this review assess whether a generator or a group of generators in a NEM region or across a number of regions have market power (using the analytical framework we set out above), determine whether those generators have the incentive to engage in such conduct (given the likely effect on the retail market in which they also operate), and finally to assess whether the conduct is actually having the effect of distorting prices or substantially lessening competition and increasing wholesale prices.

3 Effective regulation of the network businesses

When the electricity supply industry was restructured in the 1990s in Australia, the transmission and distribution networks – the “poles and wires” businesses – were generally considered to be natural monopolies meaning that electricity could be transmitted and distributed at lower cost by having one network operating in the relevant area rather than two or more networks.¹³

In order to ensure that the owners of a network business could not favour their own generation or retail business and therefore that they lacked the incentive to exclude rival generators or retailers from accessing their networks, the owners of transmission or distribution networks were not able to also own generation assets or retail businesses.

But even though network operators now have little incentive to deny access to firms operating either upstream (generators) or downstream (retailers), they may – in the absence of any competition from alternative networks – be able to charge higher prices and derive monopoly profits. As a result, network operators were subjected to detailed price regulation. Up until 2006, the states and territories administered the economic regulation of electricity network operators. In 2006, the AER (which is responsible to the ACCC for governance and efficient

¹² PR, p.95.

¹³ A natural monopoly typically involves significant fixed costs and relatively small marginal costs, so that average costs decline with output. It is this decline in average costs, which are also referred to as economies of scale, that mean that one provider can meet the total market demand at a lower cost than when there is more than one provider in the market.

management of resources) became responsible for the economic regulation of all electricity network operators in the NEM.

With regard to price regulation, the role of the AER, in short, is to set the amount of revenue that network operators are allowed to recover from customers in accordance with the rules set by the AEMC, which allow network operators to recover their efficient costs and an appropriate return.

Given that network costs represent a substantial share of the price of electricity to households and businesses in Australia – in 2015-16, network costs accounted for 48 per cent of the amount billed to residential customers in the NEM¹⁴ – it is critical that the AER closely scrutinise any expenditure proposals put forward by network operators and only allow those that represent reasonable, efficient and necessary expenditures to be passed on to households and businesses.

In theory, an effective regulatory system should be able to minimise the risk of over-investment, but in practice regulators face the tough task of setting a price that can help ensure electricity is more affordable for households and businesses while at the same time allowing network operators to recover their efficient costs and an appropriate return on their investment.

This task is difficult, in large part, because the AER has to rely on the network operators to provide most of the technical and financial information that it relies on in order to regulate prices. But even if it had all of the relevant information, a regulator cannot be expected to always get it right. Mistakes are inevitable. Errors of fact or law will sometimes be made. Discretion will occasionally be exercised incorrectly. And sometimes decisions may even be made that will be unreasonable having regard to all of the circumstances.

An important regulatory safeguard is the ability of network operators to challenge the merits of the AER's decision in court. This is not just a theoretical possibility for network operators who disagree with the AER's decisions. Appeals on the merits of the AER's decisions have been made and the PR reports that since 2014, the results of these appeals added \$3.2 billion to the revenues of network operators and that "no decisions of the Tribunal have resulted in a decrease in revenues for the regulated business compared to the AER's original decision".¹⁵

It is easy to see why the AER would be in favour of the decision to remove limited merits review of its decisions. Removing the right for network operators to appeal the merits of a decision makes it easier for the AER to hide behind errors of law and enable it to wield its considerable discretion incorrectly.

It is less easy to see why the ACCC supports moves to introduce legislation to remove limited merits review in respect of AER electricity network determinations. The role of the ACCC during this inquiry is not to make life easier for the AER (even though it is responsible for its governance and the efficient management of its resources) but rather to make recommendations regarding the competitiveness of the electricity supply industry.

¹⁴ PR, p.108.

¹⁵ PR, p.113.

Repeated failures by the AER on appeals of its decisions are not necessarily bad for consumers if they result in prices that lead to more reliable or secure networks. For the purposes of this inquiry, rather than take a firm, pro-consumer position that households and businesses can only be better off with lower electricity prices, the ACCC should state clearly that effective regulation of electricity networks requires the interests of households and business to be balanced against those of network operators and that even higher prices could be consistent with consumer welfare if they lead to worthwhile investments in electricity networks.

While the decision to remove limited merits review is likely to be out of the ACCC's hand, the decision to examine ways of reducing the existing network costs embedded in the system, for example, by writing down asset values either voluntarily or compulsorily is not. It is not clear to us how a non-expert regulator, on the basis of limited desk research, can even identify what investment is wasteful and what is not and come to the view that compulsory write-offs may be necessary. Seeking advice from the AER – whose decisions about whether the expenditure proposals of network operators have been reasonable or not have often been overturned on appeals – on which costs should be written down is unlikely to be reliable and a separate process should be established to determine whether and how such an extreme measure should be implemented. Given that such a process carries serious risk of appropriating assets that were invested in the network in good faith and according to the rules in place at the time, it is essential that the decisions coming out of any such review be subject to a full merits review.

4 Are there issues with retail competition?

It is hard to get a sense from the PR on whether the ACCC believes that competition in the retail market is effective or not. On the one hand, the ACCC reports that many households and businesses are concerned about the level of complexity in the retail market and that the considerable price dispersion in the market makes it difficult for consumers to understand and compare all of the offers available to them. The ACCC also expressed concern that high (and growing) retailer costs and margins may indicate that the retail market is not subject to effective competition.

On the other hand, there is evidence in the PR that competition in the retail market appears to be working well. Households and businesses benefit from the widespread availability of discounts; around 80 per cent of all generally available offers include some form of discount. They also benefit from the aggressive strategies of established operators looking to either “save” or “win back” a customer who is looking to move or has moved to an alternative retailer. And almost 70 per cent of consumers in a survey reported in the PR said that they were happy with their electricity retailer.¹⁶

Although the ACCC is still examining the options for reforms to the retail electricity market and is rightly mindful of the potential for any well-meaning reforms to have unintended

¹⁶ PR, p.125.

consequences, it has indicated in the PR that it will consider whether regulatory intervention is required to ensure that advertised discounts are taken from a consistent base rate and/or whether a regulatory limitation on pay on time discounts is necessary to ensure that consumers are not paying higher prices due to the conditionality of offers.

In our view, any reforms to the operation of the retail electricity market should only be proposed once the following two conditions are met. First, the ACCC needs to be satisfied that competition in the retail electricity market is no longer operating effectively – that is, that the market has failed. Second, given the potential for unintended consequences and the risk of government failure, the outcome of any intervention needs to lead to a better outcome than the continued operation of ineffective competition in that market.

We discuss each of these below.

4.1 Is the retail electricity market subject to effective competition?

A number of reasons are discussed in the PR to explain the lack of effective competition in the retail electricity market. This section discusses the ACCC's approach to two: high EBITDA margins and the potential barriers to entry into the retail electricity supply market.

4.1.1 High EBITDA margins

The ACCC states that when retail profitability “*is ‘too high’ (however this is determined), this may be an indication that a level of supernormal profits are being obtained and that particular firms are exercising market power*”.¹⁷

EBITDA is an accounting measure that is often used to assess a firm's financial performance. It is, as the ACCC has noted in the PR, an incomplete measure of profitability. EBITDA margins exclude depreciation, amortisation, tax and interest payments that firms may make. If retailers have high fixed costs, for example, EBITDA margins will overstate the true profit made by retailers.

EBITDA margins can change for reasons unrelated to market power. For example, a retailer may incur losses during the establishment phase when it is entering a new market and offering aggressive tariffs to win customers from established operators. As these firms mature (and out compete the more established firms), they would seek to earn sufficient profits to offset the losses incurred during the start-up phase. Some firms – even larger, established vertically integrated firms – may earn high EBITDA margins because they provide superior service to households and businesses or operate from a lower cost base than other firms.

None of those issues are discussed in the PR. The only attempt to identify whether EBITDA margins represent an exercise of market power or not in the PR is the discussion around Figure 2.40 which shows the average retailer percentage margins by state. The conclusion that the ACCC draws from that chart is that “profit margins across states were generally in the

¹⁷ PR, p.74.

range of 5 to 10 per cent” and that this margin was “somewhat higher than the margins allowed by jurisdictional regulators where retail prices were regulated” (5.7 per cent and 5.3 per cent).

The general comments made by the ACCC in the PR from a visual study of Figure 2.40 do not provide a sound basis for a finding that competition is not effective and that supernormal profits are potentially being obtained. A closer (although still visual) examination of Figure 2.40 shows that the margin in three of the five years for which data are provided in NSW show that margins below 5 per cent were earned (and in one of those three years, a negative EBITDA margin was earned). Similarly, the EBITDA margin earned in South Australia for one of the five periods shown was below 5 per cent and in another only marginally over 5 per cent. And all the EBITDA numbers presented in the PR are averaged, meaning that there would be some retailers in each state earning higher margins and some earning low (and even negative) margins.

So even if the relevant benchmark was the EBITDA margin allowed by jurisdictional regulators where retail prices were regulated, the evidence in the PR, does not appear to support a finding that supernormal normal profits are being obtained.

Given the size, scope and importance of this inquiry it is surprising to see the ACCC prefer an incomplete accounting measure such as EBITDA to a more economic measure in order to determine whether supernormal profits are being obtained. A more economic measure would look – over a relatively long period of time - at the difference between the revenues earned by retailers less their operational costs and the opportunity cost of the inputs used to provide the retail service and also recognise the important role that profits play in rewarding success and providing incentives for investment and innovation in this market.

4.1.2 Potential barriers to entry into the retail electricity supply market

Another factor presented in the PR as indicating that there is insufficient competition in the retail market is the potential for new retailers to face barriers to entry or expansion when trying to compete against more established, often larger, vertically integrated retailers.

The types of barriers to entry and expansion raised by many new retailers include incurring the up-front costs of direct marketing to win customers or lacking scale and therefore having higher costs (such as the fixed costs of billing systems or marketing) to serve per customer.

The ACCC does not state in the PR whether it agrees that some of the costs faced by new retailers represent barriers to entry and/or expansion, but it does mention that because smaller retailers have a smaller customer base over which they can spread those costs, their ability to offer competitive prices may be affected.

In the next phase of the inquiry it would be useful for the ACCC to draw a clearer distinction between the costs that a new retailer will necessarily need to incur in order to operate as a retailer in this market and the costs that represent real barriers to entry and expansion and which mean that competition in the retail market may be ineffective. In our view, many of the costs that new entrants consider to be barriers to entry or expansion are often costs that any

retailer needs to incur and (mis)characterising these as a barriers to entry or expansion risks creating the temptation for the ACCC to intervene into a market where competition is still operating effectively and could lead to policies of subsidising or protecting smaller players because of their lower efficiency. Neither of these would promote consumer interests or efficiency in the retail electricity market.

Another potential barrier to entry of new retailers discussed in the PR was the impact of vertical integration. The mechanism by which vertical integration affects entry of stand-alone retailers is through its effect on the ability of retailers to manage the risks associated with wholesale spot price volatility.

Retailers have two main ways of managing the risk associated with spot price volatility. One is by entering into financial “hedge” contracts to manage the net costs for electricity that they intend to buy in the future. Trading of those contracts can occur either over-the-counter or on the Australian Securities Exchange.¹⁸

The second way of managing the risk associated with spot price volatility is by the retailer vertically integrating its business with a generation business. The effect of vertical integration is that it provides retailers with a natural hedge against market volatility, potentially eliminating or minimising the need to purchase over-the-counter products or exchange traded hedging products.¹⁹

The theory of harm with regard to vertical integration raising barriers to entry is that the increasing reliance on vertical integration by large operators in the market has the direct effect of limiting the pool of potential generation counterparties for retailers to contract with and/or reduce the volumes of exchange-traded products available to stand-alone retailers. This theory of harm was raised by the ACCC during its (unsuccessful) opposition to AGL’s acquisition of the state-owned Macquarie Generation in NSW in 2014.

However, despite opposing a merger in NSW because it believe that vertical integration would create a barrier to entry to new retailers in that state, it has only found in the PR that limited access to hedging products only appears to be a significant concern in South Australia.

It would be useful during the next phase of this inquiry to get an understanding of why the ACCC’s concern around vertical integration in NSW in 2014 did not eventuate and why this is now only a potential concern in South Australia. It would also be useful to understand how Simply Energy – a stand-alone retailer with no ties to any generator in South Australia – has managed to gain a similar market share to EnergyAustralia – a vertically integrated gentailer – despite the limited access to hedging products in that state.

And even if the increasing reliance on vertical integration by large operators in the market has the direct effect of limiting the pool of potential generation counterparties for retailers to contract with and/or reduce the volumes of exchange-traded products available to stand-alone retailers, it would be useful to see what remedies the ACCC proposes to address this concern

¹⁸ PR, p.55.

¹⁹ PR, p.102.

given the potential benefits of this pro-competitive hedging strategy and the strong pro-competitive justifications for vertical integration in general.

4.2 The very real risk of unintended consequences

The issues in the retail market that the ACCC is trying to address are the complexity that consumers have in engaging with the electricity market including the lack of innovation, and issues around the practice of discounting which the ACCC describes as “problematic” in the PR.

These concerns contain echoes of those that the UK’s Competition and Markets Authority (CMA) found when it undertook its market investigation into the UK energy market in 2016. The CMA recommended over 30 measures to drive down energy costs by increasing competition between suppliers and by helping customers to switch to better deals while protecting those less able to benefit from competition.

The inability of customers to engage with the retail electricity market may mean that households and business pay more for their electricity than they need to, but it doesn’t necessarily mean that the market has irretrievably broken down. As in the UK, where inert customers are widespread and make it harder for firms to gain share with competitive offers, careful intervention may in some cases be warranted to facilitate switching processes and/or to nudge consumers to switch. However, customers who struggle to engage with service providers and who switch rarely are found in many retail markets and it is often far from clear how to change their behaviour “for the better” or indeed whether an attempt to do so would simply make things worse.

At a minimum, in the next phase of the inquiry, the ACCC needs to determine the extent of the problem and to identify the market failure behind the concern. For example, the ACCC’s concern about the lack of innovation in retail tariffs does not seem to be supported by the fact that most customers are now on market rather than standing offers and that there are over 1,600 offers generally available for small customers and the number of offers available continues to increase.²⁰ And despite the complexity that consumers seem to have in engaging with the electricity market, the research reported in the PR suggests that 69 per cent of households are satisfied with their retailer.

The concern that we have is that the measures that the ACCC has flagged to address the (as yet unsubstantiated) concern that consumers find the market “complex” are likely to make things worse rather than better. For example, the ACCC’s support for a reference or comparison price where the overall cost of an electricity offer is presented on either a per unit basis or for a period of time has been made in response to a finding that it is not always clear to consumers what the discount that they are being offered applies to. But while providing more certainty about the nature of the discount received by consumers, such a move risks harming rather than promoting competition in two ways.

²⁰ PR, p. 121.

First, the development of a comparison or reference point may have the effect of stopping retailers from developing innovative tariffs if these do not enable consumers to compare their value against the reference rate.

Second, and more worryingly, the development of a comparison or reference point may make it easier for firms to coordinate their pricing with one another in a way that tips a market towards an outcome that involves a clear and substantial lessening of competition. The reference point could, for example, become an ACCC-endorsed concerted practice that helps firms to zero in on a focal point that could be used to form the basis of (and to monitor deviations from) any arrangement to limit competition.

A number of the ACCC's other likely measures in the PR also run the risk of unintended consequences. The support by the ACCC of a cap or some other form of regulatory limitation on conditional discounts such as "pay-on-time" discounts because the more vulnerable may not have the capacity to avail of themselves of those discounts and would, as a result, pay more for electricity will mean that some of the benefits of competition would be sacrificed by the ACCC in the pursuit of a distributional goal that is likely to be better achieved through more direct measures (such as targeted government welfare programs).

Related to that is the concern of smaller retailers that the market conduct of the more established retailers has significantly impeded their ability to gain market share, for example, through their aggressive strategies to either "save" a customer who has signed with an alternative retailer or to win back customers a short time after they have switched. Clamping down on aggressive competition, while welcome by the smaller retailers who find it hard to compete, would be more likely to suppress rather than promote competition in the retail electricity market and put further upward pressure on prices.

Finally, the ACCC's backing of government-run price comparison websites rather than commercial websites is difficult to comprehend. One of the reasons why the ACCC is likely to recommend that governments promote either the AER's price comparison website or a similar website developed by the Victorian Government is because the commercial websites are remunerated either directly or indirectly by the retailers that they promote through the site. But such remuneration models are common for price comparison websites in other markets such as health insurance, household appliances, hotel bookings, and car rentals. If the ACCC's disapproval for the remuneration model for commercial comparison websites aimed at helping consumers choose electricity retailers warrants intervention that is likely to crowd out commercial operators in this market, then similar interventions are likely to be needed in other industries where such websites are used. And the pitfalls of imposing government provision of such services to the exclusion of private providers need to be assessed alongside the potential benefits in any such move.

Rather than consider a solution that requires governments to expand into markets that are currently served by commercial operators, the ACCC should, in our view, examine how commercial price comparator websites in other markets operate and identify what safeguards can be put in place to ensure that commercial price comparators in this market help households and businesses make better choices about electricity retailers.