SUBMISSION TO SENATE ECONOMICS LEGISLATION COMMITTEE INQUIRY INTO TREASURY LAWS AMENDMENT (PROHIBITING ENERGY MARKET MISCONDUCT) BILL 2018

My background

I am Managing Director of Craig Emerson Economics Pty Ltd, an economic advisory firm whose clients include businesses in the energy sector. In the period 2009-2010, I was Australian Minister for Competition Policy and Consumer Affairs. I was invited by the Senate Economics Legislation Committee to make a submission to its inquiry into this bill.

General observations

The bill provides the Commonwealth with the power to regulate the margins of electricity retailers, a form of price control that could readily be extended to producers, wholesalers and retailers in other industries that the government of the day considers politically sensitive. These include grocery retailing, petrol retailing, banks, private health insurance providers, wholesalers in the dairy, grain and fruit and vegetable industries, and suppliers of fodder for farm animals.

While price control might be politically appealing in the short run, economic theory and practice tell us it weakens or removes incentives for new investment and innovation, discouraging new entrants into a market, creating supply shortages in the longer term and forcing up prices beyond those that would have prevailed in the absence of the controls.

A classic example in economics textbooks is rent control. It is popular with existing tenants, but in the longer run landlords do not have the incentive to maintain their properties, while new property investors have little or no incentive to enter the market. Rental accommodation shortages eventually occur and tenants live in dilapidated premises. The shortage of rental accommodation causes rents to rise and eventually the rent controls are eased or removed.

Only in wartime and its immediate aftermath have Australian governments systematically sought to control prices other than in monopolised markets. This bill breaks new ground and will inevitably lead to demands for the Government to control the prices of other goods and services. In view of the precedent set in this bill, those extra demands will be difficult to resist: if it's good enough to control power prices it's good enough to control supermarket and petrol prices.

Main provisions of the bill

The bill prescribes various forms of prohibited conduct. These include failure to pass on sustained reductions in costs incurred by electricity retailers and failure to enter into contracts with small businesses and residential electricity users. By

way of legislative provisions and examples, the bill goes some way to explain what does and does not constitute a failure to pass on cost reductions. In this respect, the bill provides more clarity than the original bill circulated during the last term of the parliament.

But even with these examples there is significant ambiguity as to what constitutes prohibited conduct. Take Example 2.9 in the Explanatory Memorandum:

> **Example 2.9**
> *"Over a three year period, wholesale prices trend upward for the first two years, and begin to fall in the third year to the point where there has been a sustained and substantial reduction.*
>
> *In the first two years, a retailer does not increase its prices and absorbs the higher prices which would otherwise flow through to its consumers. All else held constant, when considering the retailer's pricing over the longer term, it may be considered reasonable for that retailer to make only small adjustment, or no adjustment, to its prices in the third year."*
> [Emphasis added]

A more likely scenario when wholesale electricity prices rise is for the retailer to absorb some of the price increase and pass on the remainder to consumers. It is unclear what the retailer's obligations are in those circumstances. The compressed margin at the peak of the wholesale price rise appears to constitute the benchmark for the bill's purposes and unless that compressed margin is maintained when prices fall – in this example, beyond the third year – the retailer might be considered to have engaged in prohibited conduct.

In effect, the ACCC would be expected to undertake continuous monitoring of each electricity retailer's prices, making judgements as to what is and is not "reasonable" and therefore whether or not those prices constitute prohibited conduct. Retailers will not know from one period to another whether they are breaking the law: it will be up to the ACCC to assess whether a price movement is reasonable, which is a subjective judgement.

More generally, an increase in input costs will be borne by a combination of consumers in the form of higher prices and retailers in the form of reduced margins. It is these reduced margins that become the benchmark for the bill's purposes. As long as the reduced margin continues to cover variable costs, the retailer will continue to supply electricity. But this reduced margin would not ordinarily be sufficient to justify new investments or the replacement of ageing investments – just as a regulated margin on a landlord would not ordinarily allow for the cost of replacing rental accommodation or proper repairs and maintenance of existing properties.

So, just like the case of rent control, the longer-term outcome is bad for both the producer and the consumer. But in the long run politicians are dead, defeated or

retired, so the architects of the Treasury Laws Amendment (Prohibiting Energy Market Misconduct) Bill 2018 will not need to care about its longer-term adverse consequences for electricity consumers. Another government will be left to pick up the pieces.

Compared with the original bill, this bill appears to interpose the ACCC between the alleged engager in prohibited conduct and the Treasurer and, in the case of forced divestiture, between the courts and the Treasurer. These amendments might reflect Treasury advice that giving politicians the power to regulate electorally sensitive industries would greatly elevate perceptions of sovereign risk.

Notwithstanding these legislative restraints, the bill will increase risk premiums for the electricity retailing industry and the electricity supply industry more generally. At a time when Australia needs more investment in electricity supply, the bill, by retarding incentives for new supply, is a retrograde step whose adverse consequences will be felt by consumers in the future.

Comments on forced divestiture

The penalty of forced divestiture has not been used as a penalty for any industry by any previous Australian government, Coalition or Labor. Under the existing *Competition and Consumer Act 2010* the only circumstances in which court-ordered forced divestiture can be contemplated are where an acquisition has occurred that has the effect or would be likely to have the effect of substantially lessening competition, or where the ACCC has granted an authorisation for an acquisition that is based on false or misleading information provided by the applicant.

Forced divestiture appears to have been included to give effect to the political undertaking to wield a “big stick” against the electricity supply industry. While the circumstances in which the “big stick” of forced divestiture is swung are constrained, the bill opens the way for the inclusion of similar “big stick” penalties for any industry whose pricing behaviour the Government finds politically unpalatable. In terms of market structure, the electricity supply industry is not materially different from the grocery, petrol, banking and insurance industries.

If forced divestiture is good for the electricity supply industry, it is plausible that the Government, under political pressure for consumer price rises, will find it good for the grocery, petrol, banking and insurance industries.

Concluding remarks

The bill has not arisen out of any representations from the ACCC. Indeed, the ACCC has described the forced divestiture provisions as “extreme.” Nor at any time when I was Minister for Competition Policy and Consumer Affairs developing the Competition and Consumer Act 2010 did the ACCC make

representations to me to introduce price controls of non-monopolised businesses or forced divestiture.

Rather, this bill was a pre-election commitment to wield a "big stick" against electricity retailers for high electricity prices. This was despite the Government already committing to implement recommendations of an ACCC inquiry, including a Default Market Offer.

The bill regulates retail margins at the level prevailing when retail prices are high, obliging retailers to lower their prices commensurately when underlying costs fall. By regulating margins when they are likely to be at their smallest, the bill is effectively a form of price control. While this might be politically popular in the short run, it will reduce incentives for new and replacement investment, for innovation and for new market entry. In the longer term, the bill will increase electricity prices.

The forced divestiture provisions will elevate perceptions of sovereign risk, retarding investment at a time when new investment in the electricity industry is desperately needed. Again, the consequences of stifling new investment will be felt not immediately but in the longer term.

The bill is readily adaptable to other politically sensitive industries, including the grocery, petrol, banking and insurance industries, which share similar market characteristics as those in the electricity retailing industry. Indeed, Nationals politicians have already begun advocating its extension.