## DEPARTMENT OF THE ENVIRONMENT AND ENERGY SUBMISSION TO THE SENATE ECONOMICS LEGISLATION COMMITTEE INQUIRY INTO TREASURY LAWS AMENDMENT (PROHIBITING ENERGY MARKET MISCONDUCT) BILL 2019

The Department of the Environment and Energy welcomes the opportunity to make a submission to the inquiry of the Senate Economics Legislation Committee into the *Treasury Laws Amendment (Prohibiting Energy Market Misconduct) Bill 2019* (the Bill). The purpose of this submission is to provide clarity regarding the provisions of the Bill and how it will work in practice.

The Bill will provide strong powers to address misconduct in the electricity market. The Bill creates three new prohibitions against certain misconduct in electricity wholesale, contract and retail markets. Breaches will trigger a series of graduated and tailored remedies including Treasurer-issued Contracting Orders and court-issued Divestiture Orders. The prohibitions and remedies are discussed in the remainder of this submission.

### Background

In its 2018 Retail Electricity Pricing Inquiry (REPI) Final Report, the Australian Competition and Consumer Commission (ACCC) identified evidence of; a lack of competitive constraint in wholesale electricity markets, contract market illiquidity, and retailers taking advantage of confused and disengaged consumers.[1] In the report the ACCC supported "the introduction of a broader market manipulation rule, including powers to prevent businesses from exploiting cross-market positions (across physical and financial markets)".[2] Current rules in the wholesale electricity market only focus on the accuracy of information provided and do not effectively target behaviour related to possible manipulation of the market.[3] Electricity retailers were also identified as having played a major role in poor outcomes for consumers. [4] These issues contributed to electricity prices rising by 49 per cent over the decade to 2017-18.[5]

The ACCC identified that both the wholesale and retail markets are currently concentrated and this concentration has led to increased prices.[6] Concentrated markets also provide firms that hold a large share of the market the ability to exercise market power, potentially through anticompetitive conduct. Given the level of concentration in our electricity markets there is a risk that electricity businesses could manipulate markets to the benefit of themselves and to the detriment of consumers and the Australian economy as a whole.

The Bill is a targeted and time-limited intervention that aims to act as a deterrent to electricity businesses from engaging in the kind of behaviour that, in the current energy context, could result in poorer outcomes for Australian electricity consumers. The Bill is scheduled to sunset on 1 January 2026 to reflect two things. First, the period of operation of the legislation recognises that current market circumstances are likely to change over time and, in future,

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[1] ACCC (2018). *Restoring electricity affordability and Australia's competitive advantage: Retail Electricity Pricing Inquiry – Final Report.* Australian Competition and Consumer Commission, June 2018.
[2] ibid. p. 96.
[3] ibid.
[4] ibid. p. v
[5] ACCC (2019). *Inquiry into the National Electricity Market – August 2019 Report.* Australian Competition and Consumer Commission, August 2019.
[6] ACCC (2018). p. vii, p. 134.

there may a reduced imperative for an enforcement framework of this type. For example, in the wholesale market, new generation is expected to enter the system over the next decade, potentially reducing market concentration. Second, the timing aligns with the ACCC's ongoing inquiry, monitoring prices, profits and margins in the National Electricity Market (NEM), which is scheduled to conclude on 31 August 2025.

The Government committed to introduce the Bill ahead of the last election[7] and undertook consultation ahead of its introduction to the House of Representatives.

**Prohibitions**

The Bill sets out three new prohibitions: the retail pricing prohibition, the contract liquidity prohibition and the wholesale prohibition.

Retail pricing prohibition

A corporation will contravene this section if:

(a) the corporation offers to supply electricity, or supplies electricity, to small customers; and

(b) the corporation fails to make reasonable adjustments to the price of those offers, or to the price of those supplies, to reflect sustained and substantial reductions in its underlying costs of procuring electricity.

In essence, the purpose of the prohibition is to ensure that any 'sustained and substantial' cost savings that retailers receive through, for example, the procurement of wholesale electricity at lower prices, reduced network service fees, or reductions in environmental scheme compliance costs, are reasonably passed on to customers as lower retail prices.

The construction of the prohibition recognises that there are many short term fluctuations in the wholesale spot market in which prices can differ significantly hour-to-hour, day-to-day or month-to-month. These fluctuations may not be reflective of long-term trends in wholesale or contract prices. As such, the Bill does not require retailers to adjust their retail prices following short-term cost changes. Only if there has been a sustained and substantial reduction will retailers be required to reasonably adjust their prices.

For example, current futures prices for 2021 are between $63 and $82 a megawatt hour, which is considerably lower than current wholesale spot prices. The Government has targeted an average wholesale price of $70 a megawatt hour by the end of 2021, driven by Government programs such as the Underwriting New Generation Investment program. The existence of the prohibition will ensure that the benefits of wholesale cost reductions will be passed through to customers in the form of lower retail prices.

The Government has already taken targeted action on retail prices through the introduction of the Default Market Offer (DMO), which places a price cap on standing offer prices in New South Wales, South Australia and south-east Queensland.[8] The Victorian Government has also introduced its own price cap – the Victorian Default Offer (VDO) - in that state. Given

[7] See: https://www.liberal.org.au/our-plan-affordable-and-reliable-energy

[8] A standing offer is the default offer that a customer is likely to be on if they have never engaged in the market. A market offer is one that includes terms and conditions not included in standing offers. For example, some may offer discounts on their rates.

this existing protection, the Bill will not require retailers to adjust their standing offer prices following a sustained and substantial reduction in cost as these are already covered by relevant Commonwealth regulations, or where a state regulates prices, such as Victoria under the VDO. But these pricing protections do not ensure structural savings across the electricity market are passed on to the majority of retail customers – those on market offers.[9] Conceivably, were the Bill not passed, a retailer could increase its market offer prices following a cost reduction. This prohibition means that all customers, not just those benefiting from the DMO and VDO price caps, can benefit from a sustained and substantial reduction in costs.

<u>Contract liquidity prohibition</u>

A corporation will contravene this section if, for the purpose of substantially lessening competition in an electricity market, it:

(a) fails to offer electricity financial contracts;

(b) limits or restricts its offers to enter into electricity financial contracts; or

(c) offers to enter into electricity financial contracts in a way that has, or on terms that have, the effect or likely effect of preventing, limiting or restricting acceptance of those offer.

In the case a corporation owns both generation and retail services – a gentailer – it might be tempted to withhold contracts with the aim of increasing prices and making it harder and more expensive for competing retailers to purchase electricity contracts. Such action could give the gentailer an unfair advantage in the retail market.

The ACCC found that the advantages enjoyed by gentailers make it difficult for smaller retailers and new entrants to compete in the retail market, particularly in South Australia.[10] The ACCC stated that "without sufficient competitive pressure in wholesale and retail markets, these vertically integrated players [gentailers] may have the ability and incentive to withhold contracts from rival retailers, or to discriminate against them regarding price".[11] Thus, the intent of the prohibition is to prevent businesses acting in such a way for the purpose of substantially lessening competition.

The purpose test built into the prohibition – that the behaviour is 'for the purpose of substantially lessening competition' – recognises that there are good reasons why a gentailer may not be able to enter into contracts with rival retailers. For example, where a generator is being mothballed or closed as a result of economic or safety reasons, the generator would be unable to provide contracts to market. Failure to offer a financial contract because of the plant being unavailable due to mothballing or closure would not be considered prohibited behaviour.

[9] AER (2018). *Annual report on compliance and performance of the retail energy market 2017-18.* Australian Energy Regulator, December 2018.
[10] ACCC (2018). p. ix.
[11] ibid. p. 114.

Wholesale prohibition (basic and aggravated)

There are two separate, but related, wholesale prohibitions: a basic case and an aggravated case. Under the basic case, a corporation contravenes the prohibition if:

(a) the corporation:

    (i) bids or offers to supply electricity in relation to an electricity spot market; or

    (ii) fails to bid or offer to supply electricity in relation to an electricity spot market; and

(b) the corporation does so:

    (i) fraudulently, dishonestly or in bad faith; **or**

    (ii) for the purpose of distorting or manipulating prices in that electricity spot market.

Under the aggravated case, a corporation contravenes the prohibition if:

(a) the corporation:

    (i) bids or offers to supply electricity in relation to an electricity spot market; or

    (j) fails to bid or offer to supply electricity in relation to an electricity spot market; and

(b) the corporation does so fraudulently, dishonestly or in bad faith, for the purpose of distorting or manipulating prices in that electricity spot market.

Bidding among rival generators is critical to delivering efficient prices in wholesale electricity spot markets. Generators will bid and rebid into the market to maximise their income. This is normal practice and taking advantage of high prices is not prohibited.

In the basic case, a breach will only result if a generator behaves dishonestly **or** seeks to artificially manipulate prices. In the aggravated case, which is subject to more significant remedies, the corporation would have to both act fraudulently, dishonestly or in bad faith **and** for the purpose of distorting or manipulating prices in the electricity spot market.

Market manipulation rules like the contract liquidity and wholesale prohibitions are not unusual in energy markets. The ACCC highlighted that the AER already had broad powers to address market manipulation in relation to its enforcement of gas supply hubs.[12] The report also highlighted similar market manipulation powers in place in Canada, Spain and the United States.

An important element of the contract liquidity and wholesale prohibitions is the purpose test – that the conduct either be the purpose of substantially lessening competition in any electricity market, or for the purpose of distorting or manipulating prices. Whether a corporation's behaviour reflects such a purpose is a critical threshold question which is necessarily balanced by provisions in the Bill allowing enforceability of the prohibitions.

While evidence may clearly establish that a corporation has engaged in the proscribed activity for the purpose of substantially lessening competition, or to distort or manipulate spot market prices, the Bill follows precedent in the *Competition and Consumer Act 2010* (CCA) to allow the purpose of the corporation to be ascertained by inference from the conduct of

[12] ibid. p. 96

the corporation, the conduct of other people, or the circumstances relevant to the conduct. Provisions of this type already exist in the CCA in relation to hindering access to declared services, exclusive dealing, and hindering a standard access obligation.

The drafting of this provision reflects the existing law and the long-held understanding of the provision at law by all parties to provide clarity and certainty.

**Remedies**

It is vital that the prohibitions have appropriate remedies in place. First, to ensure that appropriate and proportionate action can be taken against malfeasance. And second, to provide a deterrent to electricity businesses from engaging in misconduct.

A 2017 paper from the UK's Competition and Markets Authority (CMA) undertook a review to determine the existence and extent of the deterrent effect as a result of their activities.[13] The literature reviewed by the CMA suggested that the "deterrent effect of competition law enforcement is significant and can be larger than its direct impact".[14] While the existence of the remedy should act as an effective deterrent to businesses engaging in market misconduct, it nevertheless remains a significant enforcement tool to aid in the protection of consumers and the market more generally.

The ACCC will be responsible for the enforcement of the new framework and will rely on its existing investigation powers to obtain information directly from electricity businesses regarding market conduct. On the basis of such information, and in the first instance, it will be for the ACCC to determine whether it reasonably believes there has been a breach of any of the prohibitions and what, if any, remedy it considers proportionate and targeted to recommend for that potential breach.

If the ACCC identifies a potential breach of the prohibitions it may pursue a range of graduated remedies. Such action will be taken in line with the ACCC's compliance and enforcement policy and priorities.[15] Not all of the remedies are available to all of the prohibitions.

There are three remedies available to the ACCC for all of the prohibitions. These are:

a) A public warning notice that will name the retailer, and put it on notice that its actions are under scrutiny.
   (i) The ACCC gives the company a draft public warning notice.
   (ii) The company has 21 days to respond to the notice.
   (iii) If the ACCC still reasonably believes the company has engaged in prohibited conduct, which has caused actual or likely detriment, and it is in the public interest, the ACCC has 90 days to publish the notice.

b) An infringement notice, which represents a $126,000 fine for the retailer for the breach.

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[13] CMA (2017). *The deterrent effect of competition authorities' work: Literature review.* Competition and Markets Authority, September 2017.
[14] ibid. p. 4
[15] See: https://www.accc.gov.au/about-us/australian-competition-consumer-commission/compliance-enforcement-policy-priorities#compliance-and-enforcement-strategy

(i) The ACCC issues the company an infringement notice, amounting to a 600 penalty unit fine ($126,000).

(ii) If the company pays the fine, the ACCC cannot take the matter to Court seeking a higher civil penalty in relation to the conduct.

(iii) The company is not obliged to pay the fine, but failure to pay risks the ACCC taking the matter to Court to seek much higher civil penalties.

(c) Apply to the Federal Court for civil penalties which could result in the retailer paying up to whichever is the highest out of $10 million, three times the benefit gained from breaking the law or 10 per cent of the company's annual turnover in the previous year.

(i) This requires the ACCC to prosecute a full civil case before the Federal Court, and for the Court to make a finding that there has been a breach of the legislation.

Contracting order and divestiture order

The Bill also introduces two new remedies that are only available in relation to specific prohibitions:

(a) In relation to the financial contract liquidity and aggravated spot market prohibitions - A ministerial contracting order, which forces a generator or gentailer to offer electricity financial contracts to third parties for up to three years; and

(b) In relation to the aggravated spot market prohibitions - A divestiture order issued by the Federal Court, which forces a generation company or gentailer to sell an asset or assets to an unrelated third party.

The appropriateness of seeking a divestiture order or contracting order will be assessed on a case by case basis. But divestiture will be considered a last resort response, reserved for the most egregious breaches, and for which other remedies are not be sufficient to address the conduct.

While divestiture is a significant enforcement response, divestiture powers are not unique in the global context. Both the United States and the European Union have divestiture powers, which are also typically reserved for the most serious cases of anti-competitive conduct. For example, in the USA, divestiture is available as a remedy for violations of Section 2 of the Sherman Act (the anti-monopolisation provision). And in the EU, Article 7 of Regulation No 1/2003 on the implementation of Articles 101 and 102 of the Treaty on the Functioning of the European Union (TFEU) allows the European Commission to impose behavioural or structural remedies to bring anti-competitive infringements effectively to an end. Such structural commitments or remedies include the divestiture of assets.

The Government is confident, particularly given the international experience, that divesture orders – as a measure of last resort – will not act as a deterrent to investment in Australia.

*Process*

Given the significance of the divestiture and contracting order remedies, and consistent with competition law frameworks more broadly, the Bill provides for a range of checks and balances to ensure that they are only used in appropriate circumstances.

The contracting order and divestiture order can only be recommended to the Treasurer following the notice, response and recommendation procedure, which is as follows:

- The ACCC sends the relevant company a **prohibited conduct notice**, setting out the alleged prohibited conduct and potential remedies.
- The company has 45 days to **respond** to the prohibited conduct notice. It can explain or rectify the conduct (including by offering an enforceable undertaking) and comment on the potential remedies.
- The ACCC has 45 days to consider the company's response, and must give the Treasurer a **no Treasurer action notice** or a **prohibited conduct recommendation** (that the Treasurer make a contracting order or apply to the Federal Court for a divestiture order).
- If the ACCC gives the Treasurer a **prohibited conduct recommendation**, the Treasurer has 45 days to consider whether the legislative tests are met and either accept (and action) or reject the recommendation.

Following this process, the Treasurer may only make a **contracting order** if:

- The ACCC has recommended the Treasurer make a contracting order in a prohibited conduct recommendation, following the notice, response and recommendation procedure.
- The ACCC and Treasurer reasonably believe:
  - The company has engaged in conduct in breach of the contract liquidity prohibition or the aggravated wholesale conduct prohibition; and
  - A contracting order is a proportionate means of preventing the company from engaging in similar conduct in future.

The Treasurer's decision to make a contracting order is subject to review under the *Administrative Decision (Judicial Review) Act* 1977.

The Treasurer cannot make a **divestiture order**, but can apply to the Federal Court for an order that a company divest an asset or assets. The Treasurer may only apply for a divestiture order if the ACCC and the Treasurer reasonably believe:

- The company has engaged in conduct in breach of the aggravated wholesale conduct prohibition;
- The contracting order is a proportionate means of preventing the company from engaging in similar conduct in future; and
- A divestiture order will result in a net public benefit.

The court will then hear the full case and will make a divestiture order only if it finds that the company has breached the aggravated wholesale prohibition and is satisfied that a divestiture order is a proportionate means of preventing the company from engaging in similar conduct in future.