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Poorly considered market interventions: an inefficient path to lower power prices

Response to the Senate Economics Legislation Committee Inquiry into the Treasury Laws Amendment (Prohibiting Energy Market Misconduct) Bill 2018

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There are no restrictions on publication of this submission or requirements for anonymity. The submission contains no personal information of third party individuals.

Summary

- Australians want cheaper power, and they welcome governments taking on the big power companies to deliver that result. But hasty government intervention risks making things worse rather than better. Lowering prices ultimately requires private investment; a short-term 'company bashing' approach may well prove counter-productive.

- Such is the case with this Bill. It is designed to prohibit misconduct in the electricity market that contributes to high consumer prices. But the Bill focuses on issues that are not obviously driving high prices, or problems for which there are better solutions. As a result, the proposed legislation will not deliver significant cost savings.

- Failure by retailers to pass through cost savings to their customers is a potential market failure in several high-profile sectors. It has not been identified as a significant problem in the retail electricity market, although retail margins appear consistently higher than would be expected in a well-functioning market.

- Having only a small number of large, vertically integrated generator-retailers could mean poor liquidity in the market for financial hedge contracts, which stand-alone or smaller generators and retailers need to manage their risks. But the case for market intervention to reduce concentration has been poorly made. A targeted market-making obligation on vertically integrated retailers in South Australia only, as proposed by the Australian Competition and Consumer Commission (ACCC), may be worth a carefully calibrated trial. Unlike the proposal in the Bill for the Treasurer to issue contracting orders, it would have the advantage of being imposed through existing agencies.

- The current industry structure, ownership and bidding rules can lead to transient or ongoing market power, and opportunities for generators to distort or manipulate the wholesale market. Rule changes and greater powers for the Australian Energy Regulator (AER) to investigate and remedy such behaviour are likely to have as much, or more effect, but at lower cost than the Bill's proposal to force divestment of assets.

- In Australia, market concentration is a common feature across many sectors. If the Government is genuinely concerned about this issue, it should review the Consumer and Competition Act with a view to possibly introducing a divestiture power across a range of industries.

- The Bill targets three potential areas of electricity market misconduct with three novel solutions. The ACCC would play a key role in their implementation. Yet in 2018, the ACCC produced a comprehensive report on the causes of high power prices, with recommendations to bring them down. Rather than introducing novel proposals unlikely to work, the Government should focus on comprehensively implementing the ACCC's more practical recommendations.

1 Introduction

This submission from Tony Wood and Guy Dundas of the Grattan Institute responds to an invitation from the Senate Economics Legislation Committee on its inquiry into the Treasury Laws Amendment (Prohibiting Energy Market Misconduct) Bill 2018 (the Bill). The structure of this submission follows that of the Bill and the Explanatory Memorandum circulated by the Treasurer, the Hon Josh Frydenberg MP.

The submission focuses on those elements of the Bill where we have specific and relevant views and knowledge. Accordingly, we have not attempted to address all the matters raised in the Bill or Explanatory Memorandum.

Grattan Institute is an independent think-tank focused on Australian domestic public policy. It aims to improve policy outcomes by engaging both decision-makers and the broader community.

2 General comments

Australians want cheaper power and they welcome governments taking on the big power companies to deliver that result. But hasty government intervention risks making things worse rather than better. Lowering prices ultimately requires private investment; a short-term 'company bashing' approach may well prove counter-productive.

Such is the case with the Government's Bill designed to prohibit energy market misconduct. Under the Bill, a range of new powers, specific to the electricity market, would be introduced through amendments to the *Competition and Consumer Act 2010* (the Act). Sector-specific provisions would not be unique to electricity. For example, Part XIB of the Act covers powers for the ACCC to address anti-competitive behaviour in telecommunications.

The primary trigger for the Bill is the ACCC's June 2018 report *Restoring electricity affordability and Australia's competitive advantage.*[1] which identified causes of high prices in the electricity market and made 56 recommendations to bring them down. There is some correlation between that report and the Bill.

Schedule 1 of the Bill prohibits misconduct in three areas:

1. Electricity retailers failing to reasonably pass through to their customers sustained and substantial supply chain cost savings.
2. Energy companies withholding hedge contracts for the purpose of substantially lessening competition.
3. Generators manipulating the spot market, for example by withholding supply.

The ACCC's role would be to identify prohibited misconduct, and the first line of remedy would be warning and infringement notices for all three areas. Beyond that, the proposed remedies are, first, civil penalties, then forcing companies to offer contracts, and finally, Divestiture Orders.

The Government should act on market misconduct where existing market constraints are ineffective and where the misconduct leads to poor outcomes for consumers. The problem with the current Bill is that the first of the identified forms of misconduct has not been identified as a problem and the other two could be remedied using existing structures and agencies; that is, without new legislation. Furthermore, none of the identified forms of misconduct is a major contributor to high consumer prices.

Consumers should not expect significant cost savings from this Bill. The ACCC's analysis of the impact of its suite of recommendations indicates annual savings of 20-25 per cent could be achieved by 2020-21. But some of these savings are projected to arise regardless of the ACCC's recommendations, and others from recommendations not covered by the Bill. Based

[1] ACCC: *Restoring electricity affordability and Australia's competitive advantage*, Canberra 2018. https://www.accc.gov.au/publications/restoring-electricity-affordability-australias-competitive-advantage

on the ACCC's analysis, the annual savings attributable to the Bill would be in the range of $33 to $58 per year, or 2.3 to 3.4 per cent per residential consumer.

Schedule 2 of the Bill confers new compulsory information-gathering powers on the AER and facilitates conferral on the AER of functions related to the regulation of retail prices. The rationale for such regulation and the design of the proposed mechanisms are beyond the scope of this submission.

3 Prohibited conduct in the electricity industry

3.1 Prohibited conduct in the retail electricity market

The ACCC identified complex and confusing market offers as a problem. The Government is taking action, including the introduction of a default or 'safety net' price. The Bill seeks to facilitate the introduction of the default offer by conferring appropriate powers on the AER.

The ACCC did not identify failure to pass on cost reductions to small customers as a major cause of high prices. Nonetheless, the Bill's main target is failure to pass through cost reductions. In an effective market, retailers would pass through decreases in their common supply costs or lose market share. In the case of electricity, a market failure could exist where there is an effective oligopoly or consumers find the market simply too confusing or complex.

Electricity retailers generally make annual changes to prices for customers on standing offers, while price changes for customers on market offers are made within the terms of their market contracts. In both cases, retailers' actions will be determined by a combination of backward-looking and forward-looking analysis of cost movements and expectations of the actions of competitors.

If a default offer is introduced and set by the AER, it would seem to cover any concern regarding the pricing of standing offers.

As for the pricing of competitive offers, if the government has evidence of market failure that justifies intervention, it has not made that evidence public. The wide range of examples cited in the Explanatory Memorandum demonstrates that exercising this power will not be straightforward or cost-free.

Over the past several years, retailers have announced price changes in response to both increases and decreases in their supply costs. Frustratingly, the former have outweighed the latter. These announcements have not been criticised as market misconduct.
In summary, the Government has not made a case for giving powers to the ACCC in this area. Nor has it explained why, if the concern is justified, it would not apply more broadly to sectors such as banking, petrol and supermarkets.

3.2 Prohibited conduct in the electricity financial contract market

The ACCC raised concern about the degree of liquidity in hedging contracts, particularly in South Australia. This concern arises from the emergence of dominant, vertically integrated generator-retailers. Integration can be efficient for the vertically integrated business. But competition will suffer if the result is too few counterparties willing to provide hedging contracts for new entrants or stand-alone retailers. In principle there could be a

similar issue for new-entrant generators, but the ACCC's report and the Bill focus on improving competition in the retail sector.

The ACCC recommended that the Australian Energy Market Commission (AEMC) impose a "market making obligation" on large, vertically integrated retailers to buy and sell hedge contracts.

Recognising that there would be risks and costs associated with this recommendation, the ACCC said it should apply at first only to the relatively small and concentrated South Australian market. After two years, it should be reviewed and considered for extension to other regions of the National Electricity Market (NEM).

There are strong reasons for proceeding with caution. First, the ACCC's recommendation for South Australia is based on a mechanism implemented by Ofgem in the UK. Recent evidence suggests the benefits of this market intervention may not outweigh the costs. Indeed, Ofgem has moved to suspend the market making obligation.[2]

Separately to the ACCC, the Energy Security Board has included in the final design of the Retailer Reliability Obligation (RRO) a market liquidity obligation on large vertically integrated retailers, but only on the triggering of the Obligation. The ACCC emphasised that the two mechanisms should be interoperable, without recommending how this should be achieved. Further work is required on this matter.

The Bill seeks to address the same concern as the ACCC's recommendation. But it does so in a way that is less targeted and likely to prove ineffective.

It is less targeted because it covers the entire NEM rather than focusing on South Australia (where the ACCC had most concern). The ACCC found 'cautious comfort' among retailers regarding liquidity in other markets.

The Bill is likely to prove ineffective because it does not affect generator-retailers who do not offer contracts to other retailers because they need their generation capacity to manage their own risks as a retailer. The ACCC's analysis indicates that, if anything, the 'big three' retailers (AGL, Origin and Energy Australia) are 'short' of generation capacity in South Australia. Any failure of these retailers to offer contracts to potential competitors can hardly be deemed to be for the purpose of substantially lessening competition, because all their generation capacity is likely needed to manage their own retail positions. It follows that the big three would not be affected by the Bill's contracting requirements, at least with respect to their South Australian operations.

If retailers are engaging in restrictive trading as described in the examples in the Explanatory Memorandum, these would seem to be prohibited by the existing Act.

In general, the Bill and Explanatory Memorandum provide no rationale for the implicit rejection of the ACCC's assessment or approach. While there are risks in the ACCC's proposed market making obligation, it is worth exploring further before reverting to the approach in this Bill.

[2] https://www.ofgem.gov.uk/system/files/docs/2018/08/ofgem_open_letter_-_secure_and_promote_update.pdf

The ACCC also considered functional separation of the retail and generation businesses of vertically integrated retailers, as a way to address low levels of contract liquidity. On balance, it rejected this approach on the basis that the market benefits of vertical integration outweighed the costs. It recommended monitoring for any further deterioration in the market dynamics. We support that conclusion and note that the increasing proliferation of new-entrant renewable generators, combined with dispatchable generation, may provide greater liquidity in the contract market.

3.3 Prohibited conduct in the wholesale electricity market

The ACCC concluded that concentration in the wholesale market is contributing to current high prices. Its report focused on Queensland and the bidding activity of Stanwell Corporation. Grattan Institute's 2018 report *Mostly working: Australia's wholesale electricity market* identified gaming behaviour by generators as a contributor to higher prices, albeit a far smaller contributor than high gas and coal prices and the closure of ageing coal generators.[3]

We recommended introducing rules to constrain generators' bidding practices in specific circumstances. The ACCC recommended giving powers to the AER to investigate and remedy market behaviour that manipulates the proper functioning of the wholesale market.

The Bill provides for more extreme action where a power generator has bid or failed to bid electricity into the wholesale market either fraudulently or with the purpose of distorting or manipulating prices. The Bill provides for the Treasurer, on the advice of the ACCC, to recommend a divestiture order to the Federal Court. The Court could then order a corporation "to dispose of interests in securities or assets that are part of its electricity business".

The ACCC considered a divestiture mechanism for the wholesale market. But it concluded this would be extreme and that its other recommendations "will, if implemented, be a better means to restore competition to a level which serves competition well". Again, having identified a genuine market problem, the Government has without justification ignored the recommendations of the ACCC and the use of existing agencies and processes.

It is unclear if the ACCC considered whether the Commonwealth has the constitutional powers to order asset divestiture as proposed in the Bill. The Bill does not address this question. It provides that if a prohibited conduct notice as described by the Bill would be inconsistent with Section 51(xxxi) of the Constitution,[4] then that provision of the Act will not apply. The burden of proof would lie with the affected corporation. Application of a court-ordered divestiture seems likely to trigger a legal challenge on this basis.

Even if the Commonwealth can impose such an order on a private corporation, there are separate grounds for questioning whether

[3] Wood, T., Blowers, D., and Percival, L. Mostly working: Australia's wholesale electricity market. https://grattan.edu.au/wp-content/uploads/2018/06/905-Mostly-working.pdf

[4] Provision of powers for the Commonwealth to make laws on the acquisition of property on just terms.

the Commonwealth has the power to impose divestiture on a corporation owned by a state government.[5]

The Bill's court-ordered divestiture proposal raises a wider consideration. In contrast to some other countries, the Australian body responsible for addressing market competition and anti-trust activity does not have the power to break up companies when market concentration is preventing or substantially lessening competition.

The Government cites the USA's Sherman anti-trust legislation as precedent. This legislation has been in place since 1890 and was famously used to break up Standard Oil and AT&T.

In Australia, debate on market concentration and regulatory powers often focuses on the relatively small size of our markets. To date, powers of divestment have been resisted. If the Government is genuinely concerned about the issue, it should review the Trade Practices Act with a view to possibly including such a power more generally.

This approach has had some support, notably from Alan Fels, a previous Chair of the ACCC.[6] He argues that a divestment power should apply across the board and include sectors such as banking, considering the findings of the Royal Commission. Professor Ian Harper, who led the government's 2015 competition review, was less convinced a divestiture power is needed. But he agreed that if divestiture powers were introduced, they should apply broadly.[7]

3.4 Other concerns with market misconduct in the Bill

According to the regulation impact statement in the Explanatory Memorandum, the Bill is intended to address the problem of conduct by electricity market participants that is not prohibited by the current Act but may be harmful to consumers. The definition is based on the ACCC's Retail Electricity Pricing Report and relates to conduct that takes advantage of contract illiquidity or "confused and disengaged" consumers or conduct that "undermines the effective operation of the wholesale market".

The ACCC made recommendations to address issues associated with the practices of retailers in a market for an essential service which consumers find complex and confusing. The Government is adopting some of these recommendations, such as the default offer. But the Bill assumes there is and will continue to be ineffective competition such that supply chain cost savings are retained by the retailers. The ACCC did not make this finding.

In the case of contract illiquidity, the Bill seems to align with the ACCC's problem definition but ignores the ACCC's proposed solution.

Similarly, in the case of wholesale market conduct, the Bill implicitly rejects the ACCC's recommendation in favour of a

[5] The Melbourne Corporation principle is an implied constitutional prohibition against Commonwealth laws that purport to "restrict or burden one or more of the States in the exercise of their constitutional powers". See Austin Commonwealth (2003) 215 CLR 185

[6] https://www.abc.net.au/radio/programs/am/former-accc-boss-says-divestiture-powers-should-include-banks/10146416

[7] https://www.theaustralian.com.au/national-affairs/competition-tsar-pans-new-power/news-story/54858f3a11fe4ef4499977aed2924e5f

draconian intervention that could face constitutional challenges if ever applied.

The issues the Bill seeks to address do justify serious consideration. Australia's electricity prices are high by global standards. But it is not clear that the Bill targets the largest problems with electricity prices or intervenes in a way that clearly offers net benefits.

4 AER information gathering

Schedule 2 of the Bill confers new information gathering and sharing powers on the AER to facilitate retail price regulation. The ACCC recommended two new pricing mechanisms. First, standing offers set by retailers should be replaced with a default market offer at or below a price set by the AER. Second, advertised discounts must be calculated from a reference bill amount published by the AER.

The case for these mechanisms, the design of the default offer and reference bill, and other related recommendations by the ACCC regarding the retail market are not the subject of the Bill. The Bill proposes that these recommendations could be implemented through a mandatory industry code. The Bill simply suggests how the recommendations could be implemented. We have nothing to add to that assessment.

5 The case for intervention

The Government's associated media release[8] shows that the motivation for the legislation is lower power prices. But the three areas targeted by the legislation have not been identified as major causes of high electricity prices.

The ACCC calculated that if its full suite of recommendations were adopted, average annual residential bills would fall by 20-25 per cent or $291-$419 over the next three years. But it said most of the fall in wholesale prices would happen regardless of the recommendations. And the Government is not acting to deliver the substantial cost savings that the ACCC identified as available through lower network prices and the phasing out of environmental subsidies that had run their course.

Based on the ACCC's analysis, the annual savings attributable to the Bill would be $33-$58, or 2.3-3.4 per cent over the next three years.

The ACCC produced a comprehensive report on the causes of high electricity prices and remedies to bring them down. Rather than introducing highly contentious legislation when other remedies are available, the Government should implementation the ACCC's recommendations.

For queries, please contact:

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[8] http://jaf.ministers.treasury.gov.au/media-release/060-2018/