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Competition Policy Review Secretariat
The Treasury
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Lodged web: http://competitionpolicyreview.gov.au/

Competition Policy Review – Draft Report

The Energy Supply Association of Australia (esaa) welcomes the opportunity to make a submission to the Competition Policy Review – Draft Report.

The esaa is the peak industry body for the stationary energy sector in Australia and represents the policy positions of the Chief Executives of 36 electricity and downstream natural gas businesses. These businesses own and operate some $120 billion in assets, employ more than 51,000 people and contribute $16.5 billion directly to the nation's Gross Domestic Product.

Whole of economy recommendations

Mergers (Recommendation 30)

The esaa supports expanding the test the Australian Competition and Consumer Commission (ACCC) can apply formally to authorise a merger to include weighing the public benefits against the anti-competitive elements. But we do not support removing the option to seek the authorisation of the Australian Competition Tribunal (ACT) in the first instance. This option provides an important alternative to the ACCC process. The ability to seek approval through the ACT can improve the timeliness of decision making. The swift resolution of a merger proposal, either way, is critical to business.

This approach is particularly relevant to the stationary energy sector for a number of reasons.

Accounting for public benefits

The sector is subject to multiple and at times conflicting demands from policymakers and the community. While it is important that competitive markets are maintained in order to deliver efficiently priced energy, reliability and environmental outcomes are also required. The latter, in particular is taking place in the context of significant oversupply in the National Electricity Market (NEM), caused, in part, by policy interventions. This in turn is a barrier to cost-effective emissions reduction in the sector.

To support emissions reduction policies, the sector will need to find a way to resolve oversupply. Given flat/falling demand, this will entail closure of plant to rebalance demand and supply. Logically, wholesale prices can be expected to rise as a result. This closure will involve significant costs (for example lost future earnings and remediation costs). One way for the sector to manage these costs is consolidation. While not the only solution available, it does highlight the importance of any merger decision to take account of the public benefits that may follow from consolidation in the energy sector.

It is well understood in the industry that the trend towards vertical integration (VI) is in part a tool to manage a range of risks imposed on the sector by policy and regulatory interventions, as governments seek to influence outcomes to meet the competing demands described earlier. To be clear, the esaa believes VI to be a legitimate business combination that is fully compatible with ongoing competition – not least since VI does not result in a perfectly hedged generation/retail load. That said, any acquisition that leads to greater vertical integration, like any in merger more generally, needs to be assessed on their individual merits.

The ACCC's analysis of what constitutes competition in the sector is flawed

The ACCC analysis presented as part of the recent acquisition of Macquarie Generation by AGL and a speech by the Chairman of the ACCC to the Energy Users Association of Australia covering the sale of Queensland generation assets, both suggest the ACCC is unlikely to take into account the current market conditions and will not come with an open mind to future acquisitions/mergers in the electricity generation sector. In doing so, it gives undue weighting to: the number of participants in a market; the existence of (partial) vertical integration –so-called "gentailers", and a supposition that competition requires a certain level of liquidity in the contract market. It also ignores the growing competitive threat posed by distributed generation (DG).

Competitive markets are important to ensure consumers receive the best outcomes. Market structure provides an indication of the level of competition, but is not determinative. How businesses behave is ultimately the relevant factor. The ACCC has expressed the view that the current trends in the NEM are undesirable, particularly the emergence of three large gentailers and the shift towards vertical integration more generally. An arbitrary theoretical view on the appropriate number and size of market participants is not helpful when considering authorisation of a merger. In the recent AGL case, the ACT was critical of the ACCC's approach to market structure. The Tribunal noted:

There is nothing inherently wrong with a market in which three large firms compete vigorously for market share where there are incentives to steal customers away from rivals. It is behaviour that matters, not structure per se. It appears to the Tribunal that it has been invited to assume that the "Big 3" will not constitute a competitive market principally on the basis of their combined market share immediately post-acquisition on an assumption that competition between them would become muted over time. In the opinion of the Tribunal, oligopolies should not be thus prejudged…

The competitive environment that is likely to exist in that situation may be hostile for small, non-integrated retailers or it may present niche opportunities. However, the Tribunal cannot conclude that a more atomistic market structure that favours a

particular class of competitors is intrinsically better for consumers in the long run. It is the competitive mindset that matters, not market structure.

Similarly, the ACCC's approach of aggregating the three large gentailers' retail and generation position and presenting them as roughly balancing is flawed. The net position of each gentailer is the relevant metric (whether they are long on generation or retail). Such a metric is more likely to reveal a company's market behaviour and competitive intent. Further, simply stating aggregate figures for generation and retail for an individual business is largely meaningless when attempting to discern a company's impact on the liquidity in the contract market.

To establish whether a company has a perfect natural hedge, and therefore does not need to sell or buy contracts, can only be assessed by looking at a range of factors including generation profile (baseload and peaking capacity), load profile (spread of customers across the different market segments) and geographic spread of generation and retail (as contracts are still predominately region based). The likelihood that a gentailer's generation output will be able to perfectly match their retail load is remote.

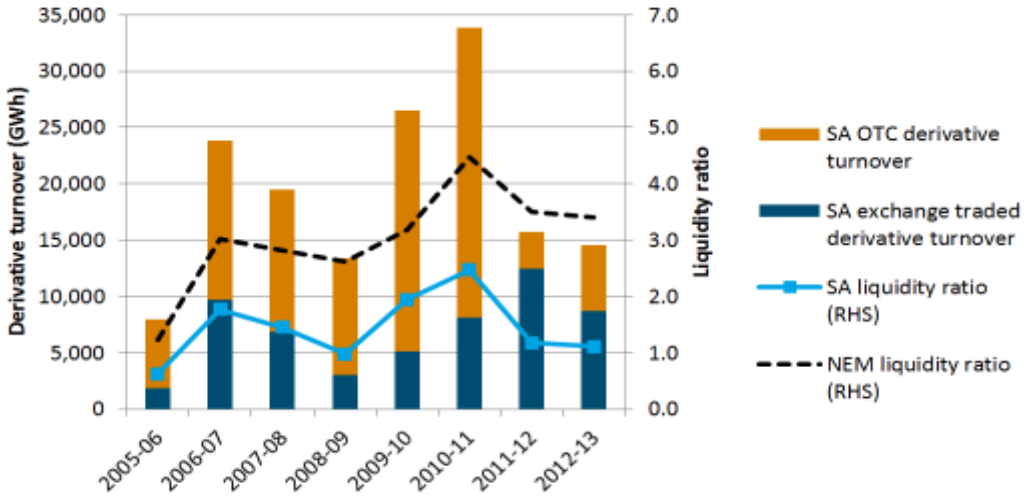
As noted above, there will need to be a reduction in the current level of supply, achieved through either closure or consolidation. Consolidation in the generation sector could in principle have an impact on the electricity retail market, as retailers manage spot market volatility through financial hedge contracts with generators and other counterparties, either directly through OTC contracts or indirectly through exchange trade contracts. If a retailer could not obtain hedge contracts, they would be exposed to the volatility of the wholesale price, a design feature of the NEM. esaa notes it is not a given that consolidation will lead to a lower level of liquidity. By reducing contingency risk through a larger portfolio, consolidation could increase liquidity.

The ACCC is concerned that consolidation in the generation sector[1], particularly by vertically integrated players, will limit the options for second tier retailers to enter the market and grow their customer base. The ACCC suggests second tier retailers are a key driver of competition in the electricity retail market, as they believe competition will become muted if the market is dominated by the big three[2]. This underpins their view that anything that reduces the liquidity in the contract market is necessarily bad for competition. We would note that the contract market will be affected as the physical market rebalances, regardless of how this occurs.

The idea that there is some ideal level of liquidity, below which competition does not work, does not appear to hold in practice. Obviously, the more liquid the contract market is the easier it is for retailers to acquire hedges. But low levels of liquidity in the South Australian contract market does not appear to have negatively affected retail competition in that state.

[1] Application for Authorisation of Acquisition of Macquarie Generation by AGL Energy Limited [2014] ACompT 1, Australian Competition and Consumer Commission Report, paras 1.32 and 7.6.
[2] Application for Authorisation of Acquisition of Macquarie Generation by AGL Energy Limited [2014] ACompT 1, Australian Competition and Consumer Commission Report, paras 1.31, 7.167 and 7.170.

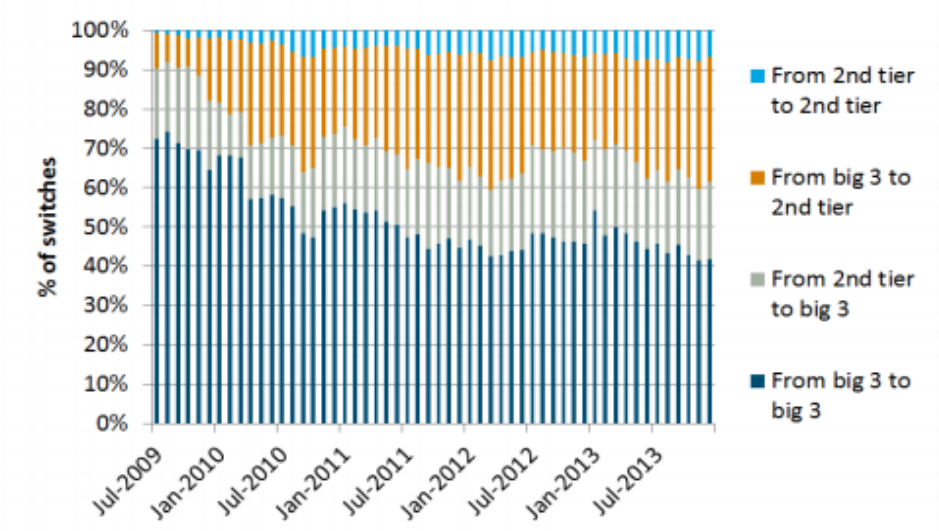
Annual electricity futures turnover and liquidity ratios[3]



The South Australian contract market is considered to be a serially illiquid market. Despite this, the 2014 Competition Report[4] produced by the Australian Energy market Commission (AEMC) noted that:

- there are thirteen energy retailers currently competing in the small customer market in South Australia;
- there has been entry by retailers without generation interests and non-vertically integrated retailers continue to operate in the market;
- retailers other than the big three collectively have a market share of approximately 20 per cent; and
- rivalry between retailers appears relatively strong.

Electricity switching rates by tier in South Australia[5]



[3] AEMC, 2014 Retail Competition Review, 22 August 2014. ASX Energy and AEMO data; AEMC analysis.
[4] AEMC, 2014 Retail Competition Review, 22 August 2014.
[5] AEMC, 2014 Retail Competition Review, 22 August 2014. AEMO data; AEMC analysis.

During the period where the three large gentailers have increased their share of the generation market, there has also been a significant increase in the level of activity from second tier retailers. While second tier retailers play an important role, the benefits of competition amongst the larger players should not be dismissed.

While the ability to obtain hedges is important to retailers, generators also have an interest in selling hedges, as hedges are an important risk management tool. In the current market, with an oversupply of generation, the supply/demand balance is in favour of retailers looking to acquire hedges, rather than generators looking to sell hedges. This is reflected in the low price of hedge contracts. Also the desirability of price and relative availability of contracts can be inferred from the decisions of businesses long on retail choosing to withdraw generation assets from operation[6].

In addition to the prevailing market conditions of high availability of generation capacity and low demand in the physical wholesale market, there is increasing competition to both retailers and generators from DG. Even if the thesis held that the gentailers could limit competition from other traditional retailers, their offerings would still need to be competitive against solar and other DG solutions. This is highlighted by the emergence of a solar leasing business model, which from a customer perspective is structured similarly to a traditional retail offering, removing any upfront capital constraint to customer take-up. As the price of DG continues to fall and more retail products are developed, this will place even greater competitive pressure on traditional retailers.

While the concerns with the current structure and future trends of the generation sector may only be indicative of the current attitude of the ACCC, rather than being predicated on the legislative structure of competition oversight, they highlight the importance of the ACT providing an alternative basis for assessing M&A activity.

Misuse of market power (Recommendation 25)

esaa does not support the introduction of an effects test, as it could adversely impact legitimate business conduct, and therefore dampen competition. An effects test could capture behaviour that impacts competitors, but does not necessarily affect competition.

Unilateral commercial actions and decisions in the NEM are taken constantly, as the wholesale price is set every five minutes. Generator bids are made dynamically responding to a plethora of continually changing information. An effects test would require businesses to factor in the outcome of each decision on the level of competition, which is likely to be highly subjective and relevant only to very short timeframes.

In an energy-only market such as the NEM, spot price volatility is an inherent and necessary feature of a market. Flexibility is essential for maintaining a reliable system given the range of factors that impact on the dynamics of both demand and supply of

[6] For example, EnergyAustralia's decision to close one unit at Wallerawang and place the other on restricted operation.

electricity. In a recent report[7], in which the AEMC concluded that market power is not an issue in the wholesale market, it identified two forms of market power:

- 'substantial market power', which involves sustained pricing above the level that would prevail in a workably competitive market; and
- transient pricing power', which involves a transient ability to increase prices for short periods of time.

The AEMC concluded that transient pricing power is an inherent feature of a workably competitive wholesale market, and is only a concern if it leads to average annual wholesale prices consistently being above the long-run marginal cost.

Enforcement (Recommendations 36 and 37)

The esaa supports lifting penalty for not complying with a section 155 notice, on the basis that it is implemented as a package with updating the search requirements to reflect the digital age. Compulsory evidence gather powers are an important element of the regulatory system, but the costs to business complying need to be minimised. Accordingly, the esaa support the proposal to require the ACCC to frame section 155 notices in the narrowest form possible, consistent with the scope of the matter being investigated, and to require the recipient to undertake a "reasonable" search.

The Panel is recommending aligning the treatment of a finding of fact and an admission of fact. The esaa notes that this change to section 83 is likely to impact co-operation with the ACCC.

Energy sector recommendations

Retail price deregulation (Recommendation 16)

The Association has long supported the removal of retail price regulation where retail markets are contestable and welcomes the Panel's draft recommendation. Open, competitive energy markets free from distortions such as retail price regulation naturally encourage prices to be efficient through the development of competitive market offers, just as in other markets. Victoria, South Australia and New South Wales (at least in part) have since deregulated their retail markets. Queensland is set to follow suit on 1 July 2015.

National Energy Customer Framework (Recommendation 16)

esaa supports the implementation, with limited derogations of the National Energy Customer Framework (NECF). The effective implementation of NECF means retailers only have to comply with a single set of energy laws administered by the Australian Energy Regulator (AER), rather than a different set of laws for each state they operate in. This increase in regulatory consistency reduces barriers to market entry by making it easier to operate across national energy market borders, the key benefits of which are more competition and improved services for customers.

Providing a level playing field

[7] AEMC, Potential Generator Market Power in the NEM, 26 April 2013.

Over the coming years there will be a range of new retail products offered by incumbents and new entrants. These new choices will provide consumers with better services and lower prices. But the current approach of exempting the emerging class of businesses know as energy service companies (ESCOs) from certain regulatory requirements, while continuing to fund government policies through grid-supplied electricity, is unsustainable and an impediment to competition.

Customers face a legitimate choice whether to invest in solar panels (and in due course other technologies to assist self-supply) to meet part of their supply needs. But a portion of customers, including households who are not able to install solar (e.g. renters and apartment dwellers) and heavy industrial/commercial users, will continue to be reliant on centrally produced electricity. Under current arrangements, these customers are poised to bear an increasing share of the cost of government policies that continue to be funded through energy bills rather than on budget. Recent regulatory exemptions provided to ESCOs offering solar leasing arrangements have added to this distortion.

The AER recently considered how ESCOs offering solar leasing should be regulated. The AER argued ESCOs should be exempt from having a retail licence and some of the requirements placed on retailers, as consumers could rely on existing businesses to provide consumer protections. Unfortunately this overlooks the fact that such services are not free and that ESCOs are competing directly with the incumbents. This approach could result in an outcome where a customer sources the majority of their energy from a solar leasing company, but the regulatory burden is principally borne by the grid supplier.

Regulatory costs are borne by businesses and ultimately passed on to consumers through higher prices. This becomes problematic when businesses providing the same service face different regulatory burdens. The challenge for regulators is to strike the balance between allowing competition from new providers while also ensuring a level playing field. Given the transition towards self-supply is already well under way, the onus is on governments and regulators to consider whether the current regulatory burden and mechanism for funding government policy initiatives is appropriate.

Privatisation of government owned infrastructure

Government involvement in the electricity sector beyond that of policy maker and regulator can create a conflicting set of interests, the outworking of which may be inefficient policy decisions and diminished stakeholder returns.

Various state governments continue to play multiple roles in the electricity sector, including policy, price regulation, asset ownership and consumer protections. This inevitably brings tensions that do not appear to have been well-balanced over recent years, with network businesses being subject to abrupt changes in rates of investment in Queensland and New South Wales.

Over the long term, consumers will be best served if governments consolidate their roles and focus efforts on: joint oversight of electricity sector developments with other governments via the COAG Energy Council; and addressing jurisdictional specific issues through direct policy instruments.

Recommendations being examined by other processes

The Panel has proposed a number of changes to areas already being examined in other reviews. While the Panel's comments are useful stimuli for a wider debate on these areas, given the high level nature of the review and the detail involved in some of these recommendations, the esaa believes they are better dealt with through the other processes.

Access and pricing regulator functions (Recommendation 46) - A governance review of energy market bodies is expected to commence shortly. A multi-utility regulator could have a range of benefits including better utilisation and retention of expert staff. A multi-industry body is also less likely to suffer from industry capture, real or perceived. While a body of this sort is not likely to form part of the terms of reference of the review, it will be important to fully explore the benefits and challenges of such arrangements before determining whether such a significant reorganisation of the regulatory architecture would be worthwhile.

NT and WA adopting the NEM governance arrangements (Recommendation 16) – the relevant jurisdictions are currently examining their policy settings for the energy sector. In general, there is merit in harmonising governance arrangements to the extent that doing so minimises barriers to entry; this results in an efficient allocation of capital and contributes to the process of disentangling jurisdictional governments from the sector. But these must be weighed against issues relating to the size and structure of theses energy systems, which are quite different from the NEM at the time of its inception.

Reform of the gas market – this is being dealt with through the Government's Energy White Paper process and relevant Ministerial Council on Energy processes.

If you have any questions relating to this submission, please contact Fergus Pope on 03 9205 3107 or by email to fergus.pope@esaa.com.au.

Yours sincerely

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