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Dr Kerry Schott
Independent Chair
Energy Security Board

Sent electronically: kerry.schott@esb.org.au

Dear *Kerry*

Re: National Energy Guarantee - draft design consultation paper

The ACCC refers to the Energy Security Board's Draft Design Consultation Paper of 15 February 2018 and the invitation to provide input into the design process for the National Energy Guarantee.

The ACCC's interest in the process is the interaction of the Guarantee with competition in electricity markets and, ultimately, the prices paid by electricity customers.

The ACCC notes that the ESB has identified potential competition issues arising from the National Energy Guarantee, including in the advice to COAG provided on 20 November 2017 and in the Draft Design Consultation Paper. We also note that the Consultation Paper states that competition issues cannot be given further consideration until the design is more developed. While the ACCC acknowledges the design of the mechanism is at an early stage, it is our view that competition issues should be a key consideration.

As you would be aware, the ACCC was directed by the Treasurer in March 2017 to conduct an inquiry into the competitiveness of the electricity supply chain. The ACCC released a preliminary report in October 2017 and is required to provide a final report to government by 30 June 2018.

The ACCC's inquiry is focused on affordability and our findings to date indicate serious concerns with electricity affordability in Australia. The contributing causes span the entire electricity supply chain. However, one particular area we have been exploring is the competitiveness of the wholesale contract market; that is, whether the way that electricity generators and retailers contract with one another is competitive, efficient and delivering the best outcomes for electricity users. Under the National Energy Guarantee, we understand this contracting market is likely to be the key platform through which the retailers will meet their emissions and reliability obligations.

The ACCC's preliminary report outlined some existing concerns with market structure that may be contributing to competition problems in the contracting market:

The wholesale (generation) market is highly concentrated and this is likely to be contributing to higher wholesale electricity prices.

...the 'big three' vertically integrated gentailers, AGL, Origin and EnergyAustralia, hold large retail market shares in most regions and control in excess of 60 per cent of generation capacity in NSW, South Australia and Victoria... This market dominance has led to non-vertically integrated retailers having limited access to risk management products, and outcomes for consumers and businesses are being driven by pricing practices that are not consistent with vigorous competition.¹

Submissions to the ACCC's inquiry have also raised concerns regarding the operation of the contract market. For example:

- Alinta has pointed out that where there is a lack of liquidity in contract markets it “significantly impacts non-vertically integrated retailers and creates barriers to market entry and expansion.”²
- ERM has noted that the new supply coming into the NEM in recent years has been predominantly wind and solar PV, which “are unable, on current technology, to offer hedge contracts to the market.” ERM observes that “[a]n improvement in contract market liquidity is crucial for retail electricity prices to reduce.”³
- Momentum has indicated that it is “mindful that any future energy policy should seek to dismantle rather than consolidate market power.” It “believe[s] this to be true of all markets and note[s], that policies in the retail sector which may increase the market power of Tier 1 retailers will have a flow on effect of consolidating these same player’s positions in the wholesale market.”⁴
- Sumo has indicated that “[i]n some jurisdictions, there is insufficient generation capacity to support an ‘over-the-counter’ hedging market for new entrants.”⁵
- Energy Consumers Australia has noted that “lack of contract liquidity has been identified by Finncorn (2017) as a significant barrier to entry in the retail market... A cause of the lack of liquidity is an increase in vertical integration of retailers with generators.”⁶
- The Energy & Water Ombudsman SA noted that a “particular area of concern regarding wholesale market competition is the lack of liquidity and very small volume of hedging products in the contract market in South Australia.”⁷
- Enova has noted that new entrants “find the liquidity of the contract market to be limited due to the credit requirements of the contract market participants”. It has also noted that “[v]ertical integration reduces derivative trading making the market more illiquid and hence less transparent. Gaining market knowledge (e.g. by Reuters) is an extra fixed cost that small retailers may have to forego. This puts the big trading counterparties in a strong position of market knowledge when pricing hedge contracts that is not matched by the small retail buyer of the hedge product.”⁸

The ACCC will be considering these issues in preparing its Final Report to be delivered in June 2018, but there appears to be sufficient concern among market participants about contracting and liquidity issues to justify a cautious approach to policy changes that will affect these aspects of the market.

¹ ACCC, ‘Retail Electricity Pricing Inquiry, Preliminary Report’, 22 September 2017, p. 7.

² Alinta, submission in response to ACCC inquiry into retail electricity supply and pricing Issues Paper, 30 June 2017.

³ ERM, submission in response to ACCC Preliminary Report, 17 November 2017.

⁴ Momentum, submission in response to ACCC Preliminary Report, 17 November 2017.

⁵ Sumo, submission in response to ACCC Preliminary Report, 17 November 2017.

⁶ Energy Consumers Australia, submission in response to ACCC Preliminary Report, December 2017.

⁷ Energy & Water Ombudsman SA, submission in response to ACCC Preliminary Report, 17 November 2017.

⁸ Enova, submission in response to ACCC Issues Paper, 3 July 2017.

In this context, the ACCC's interest in the design of the National Energy Guarantee is that the mechanism should not exacerbate existing issues or create new issues in the contract market.

The ACCC considers it important to identify ways in which the National Energy Guarantee design can ensure that the burden and impact of the mechanism does not disproportionately fall on non-vertically integrated and smaller retailers. The ACCC considers that these entities, who already face significant challenges in remaining viable and competing effectively in the market, have the potential to play an increasingly important role in retail competition.

The following are some issues we believe are critical to consider in designing the National Energy Guarantee.

- Is there a way to ensure that generators will be incentivised to contract with retailers rather than creating or exacerbating scarcity? Depending on the design of the mechanism, it may create incentives for generators to take advantage of trigger events to exercise market power in the supply of contracts to those retailers that are exposed to the event. 'Gentailers' are likely to prioritise ensuring their own retail arm is not exposed to a trigger event over entering into contracts with other retailers. The closer the design comes to requiring physically-backed reliability contracts, the greater the likely disadvantage for non-vertically integrated retailers.
- Can the mechanism be designed in such a way as to limit the creation of additional complexity and fragmentation in the contract market? The ACCC shares the ESB's desire to see increased liquidity in the contract market as this will benefit competition and, ultimately, affordability. If the current contracting instruments in the market need to be re-designed to incorporate emissions and reliability metrics then there is a risk that a series of smaller, less liquid markets develop in place of existing arrangements. Such an outcome would expose both retailers and generators to more risk and result in higher prices. One way to minimise the impact on contracting markets would be to allow existing contracting instruments—in particular, financial 'cap' and 'swap' contracts—to operate much as they do now and be capable of addressing the reliability component of the Guarantee. These contracts, while financial in nature, are typically backed by physical generation that has a strong incentive to bid capacity to 'defend' their contracts. However, it may be more difficult for the emissions component of the Guarantee to be satisfied through existing contracting instruments as there is no link between the financial nature of the contract and the emissions metric.
- How will smaller retailers that take completely unhedged positions in the wholesale market, or that only hedge a short period in advance of their energy usage, be affected by the National Energy Guarantee? While these hedging strategies are, on balance, more risky than long-term hedging, they are at times a viable option for smaller retailers new to the retail market and building scale or industrial users seeking to balance self-supply. Will the National Energy Guarantee create additional costs for these retailers and industrial users? For retailers, will this further increase barriers to entry resulting in less new entry in the market? How can any such risks be mitigated in the design of the mechanism?
- It will be important for the Guarantee to be designed to mitigate the potential for unintended responses from retailers. For example, if a reliability trigger event required a retailer to meet a gap in generation or contracting that turned out to be prohibitively expensive, that retailer may rationally respond by ceasing to serve customers (or certain types of customers) in the region where the reliability gap was identified, or exit the market entirely.

- How can the National Energy Guarantee be designed in such a way that it does not impose significant regulatory costs and burden on retailers (for example through additional reporting requirements)? Additional regulatory costs ultimately result in higher prices for consumers. Minimising the burden of any new requirements on retailers, and preferably reducing retailers' overall regulatory burden, is important in improving electricity affordability.
- Will the mechanism result in alignment of incentives between generation investors and the market as a whole in terms of promoting the types of capital investment that will benefit the market in the long-run? That is, given the limited periods in which the mechanism is likely to be triggered and, potentially, fragmented obligations across retailers to procure new capacity, will investors be incentivised to undertake the kind of capital investments that the market may need.
- How will the trade-off between reliability and affordability be determined to ensure that end-users pay no more than the value to them of increased reliability? AEMO's role in forecasting will have heightened importance under the Guarantee so it is critical that these forecasts are undertaken in a way that takes account of the value that electricity customers place on reliability.

The ACCC inquiry's findings on the electricity contracting market, and other issues such as barriers to entry or expansion faced by small retailers, will shed further light on these issues and should assist in the design of the National Energy Guarantee. The ACCC inquiry may also identify complementary actions that could support the Guarantee's arrangements.

However, the ACCC urges the ESB to pursue design solutions that deal with these issues directly in a manner that promotes competition. Competition in these markets is critical to the long-term affordability of electricity in Australia.

The ACCC is willing and able to provide further information and to work with the ESB on the issues outlined above.

Yours sincerely



Rod Sims
Chairman