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Australian Energy Market Commission
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National Electricity Amendment (Potential Market Power in the NEM) Rule 2011: Draft Rule Determination

The Energy Supply Association of Australia (esaa) welcomes the opportunity to make a submission to the Australian Energy Market Commission's (the Commission) Draft Rule Determination for the Potential Market Power in the National Electricity Market (NEM) Rule change proposal.

The esaa is the peak industry body for the stationary energy sector in Australia and represents the policy positions of the Chief Executives of 38 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.

esaa supports the Commission's Draft Rule Determination not to make the proposed Rule. esaa agrees with the Commission's conclusion "that any rule that seeks to constrain or limit the bidding of generators, in the manner proposed by the MEU… is likely to diminish incentives in the current investment environment [which is] likely to reduce the long term reliability of supply".

esaa considers that the Commission has generally adopted a sound framework for assessing the rule change by focusing on long term market outcomes rather than short term pricing events. Occasional price spikes are an intentional part of an energy-only market. They are essential to support sufficient generation capacity at the extreme peaks of demand and to enable more regularly dispatched generators to earn sufficient revenue to cover their fixed costs, which can be a significant proportion of their total costs.

esaa supports the Commission's conclusion that there is no evidence of substantive market power in the NEM to date.

The Commission's approach to assessing whether a generator has substantive market power

esaa welcomes the Commission's approach of not using a single dimensional test to determine whether substantive market power exists. By attempting to establish the underlying causes of price changes and also assessing market conditions, it will hopefully ensure that the state of competition in the market is not misdiagnosed.

Further, relying on a range of estimates may overcome the difficulty in accurately estimating long run marginal cost (LRMC).

The Commission has concluded that the framework set out in the Directions paper is the appropriate methodology for assessing the presence of substantive market power. The Commission noted in the Draft Rule Determination that it will apply the same framework if this issue is raised again in the future, and has encouraged market participants to take it into consideration when formulating possible rule change proposals. We reiterate our point made in our submission to the Directions paper that while this test may form a useful part of an overall assessment of market power, it should not be the only criterion. In particular there are a number of practical issues that mean caution will be required if and when it is used in the future.

It is difficult for regulators to second guess business in judging when investment should occur

In essence the Commission's proposed test requires a regulator to form an opinion on when new investment should occur; i.e. based on prices being greater than LRMC for the requisite period. However, irrespective of a regulator's judgement that new investment is viable, what matters is the opinion of the potential project proponent (and their financiers) that actually makes the investment. Before a business invests, it needs to be confident that the proposed project is viable over its life.

There are many ways to measure LRMC

There is a range of different methods for measuring LRMC. Given the range of methods, subjectivity is required in the choice of technique. Furthermore, in addition to deciding upon the general method, regulatory decisions must then be made about the data inputs to be used in the LRMC calculation. While relying on a range of estimates will improve the robustness of any estimate, caution will need to be exercised.

Electricity prices are the result of many factors

As the Commission is aware, electricity prices reflect the end result of the decentralised decision-making of multiple actors responding to a myriad of commercial, climatic, policy, regulatory and network factors through the market mechanism. Electricity prices are the end result of the workings of a complex system. Isolating the effect in practice from a single generator's conduct is difficult to do for historical prices and would be even more difficult to do prospectively. Any findings would be unavoidably contentious.

Unresolved elements of the test

The Commission left two issues unresolved: the length of time the assessment should be made over and the geographical dimensions of the market.

The Directions paper proposed a timeframe of one to three years. However, in the Draft Rule Determination the Commission notes that the "relevant period should reflect a sufficient time under which new entry would be expected to occur in the absence of significant barriers to entry."

As noted in our submission to the Directions paper, the Investment Reference Group report[1] shows that the period from conception to operation is typically four to six years for closed cycle gas turbine, three to five years for open cycle gas turbine and more than five years for coal.

In addition, the Draft Rule Determination does not specify what the appropriate geographical dimensions are for determining substantive market power. Using the small but significant and non-transitory increase in price approach, NERA concluded that the sub regions of the NEM were the appropriate geographical markets. However, the Draft Rule Determination merely notes that there is no evidence of substantive market power whether the NEM is considered as a whole or each region is considered separately.

Through-out this process, esaa has maintained that the interconnected NEM should be regarded as a single market for the purposes of this analysis. One of the rationales for physical integration of the NEM was to enable trade of energy between regions. In this regard, new entry into a NEM region can effectively be achieved not just through new generation investment but also through new transmission investment that enhances the capability of inter-regional power flows; i.e. generation and transmission infrastructure can be substitutes.

Barriers to entry should be the focus of any future examination

As the Commission determined that there was no evidence of substantive market power, no solutions were proposed. The Draft Rule Determination states that depending on the cause of substantive market power, a rule change may not be the most effective way to address the issue.

If new investment was economically viable but was being prevented due to significant barriers to entry, good regulatory practice would suggest that in the first instance those barriers to entry should be the target of any regulatory intervention. This would be preferable to introducing a new distortion into the competitive market, particularly one that is a barrier to entry in its own right.

Given the Commission has just concluded a thorough examination of the issue of market power, we do not see any basis for it reopening the issue in the near future. Recourse to the ACCC remains the primary avenue for competition concerns in this industry as in any other.

Any questions about our submission should be addressed to Kieran Donoghue, by email to kieran.donoghue@esaa.com.au or by telephone on (03) 9205 3116.

Yours sincerely

Matthew Warren
Chief Executive Officer

[1] Investment Reference Group Report: A Report to the Commonwealth Minister for Resources and Energy April 2011 (available at: http://www.ret.gov.au/energy/Documents/Energy-Security/IRG-report.pdf).