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South Australian Council of Social Service

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Australian Energy Markets Commission (AEMC)

Att: Mr Mark Allen, Project Leader
Submitted via www.aemc.gov.au

July 20th, 2012

AEMC reference: ERC0123

Re: Potential Generator Market Power in the NEM

Consultation on Draft Determination

Dear Sir,

Please accept this letter as the SACOSS Submission to the referenced Rule Change Proposal.

Background

SACOSS has broadly supported the Rule Change Proposal by the MEU. In particular SACOSS has supported the need to thoroughly investigate the issues raised by the Rule Change Proposal.

SACOSS made a submission[1] to the Directions Paper, sent a letter to the AEMC on February 1st, 2012 (in response to the release of an information sheet and technical paper by the AEMC) and was provided with a chance to meet with Paul Smith and Mark Allen from the AEMC in Adelaide on the 8th June 2012 immediately following the release of the draft determination.

The first SACOSS submission stated that:

> *The evidence sought relates to market (and contract pricing) and an assessment of a Long Run Marginal Cost in the market. SACOSS would argue that the high level of variability, uncertainty and subjectivity of the component parts of this assessment is likely to result in a relatively large window of 'acceptable' bidding and pricing into which both acceptable and unacceptable behaviour may fall. The 'statistical power' of the technique proposed may therefore be insufficient to resolve the behaviour associated with the definition of 'substantial market power', as defined by the Commission.*

And summarised that;

> *The MEU Rule Change Proposal is predicated on an hypothesis that "Market Power exists in the NEM". The AEMC response is to test the null hypothesis that "Significant Market Power does not exist in the NEM" and to then define the term 'substantial market power' and how it could be detected. SACOSS is of the view that there is a high risk of a Type II statistical error in this approach (ie an inability to detect a genuine rejection of the null hypothesis) and would encourage the AEMC to instead*

[1] Available at www.aemc.gov.au/Media/docs/SACOSS - 111121-40e01f6f-cabd-44f5-b6ea-33f12c6b253b-0.PDF

focus on the underlying conditions rather than relying on the ability to detect something that is extremely difficult to define let alone detect.

The second SACOSS submission followed a similar vein encouraging a different approach to investigating the issue:

> *We strongly urge you to investigate this issue from a parallel path of inquiry to the current approach.*
>
> *The parallel approach would be to test the following hypothesis: As the Dominant Generator in the SA Region of the NEM, AGL will always act as a profit maximising firm and take (at least) some advantage of its market power which may be to the detriment of consumers.*
>
> *The Null Hypothesis would be along the lines of: Can circumstances plausibly exist that would ensure market forces will nullify or seriously constrain any impact on costs to consumers?*
>
> *If the subsequent analysis was able to identify a set of market and commercial conditions that could plausibly exist where end consumers were insulated from the shorter and longer term impacts of the 'dominant generator' – and we are confident that these conditions could or should exist (and be sustained) – then it would be possible for consumers to be confident that the market functions to protect consumers from the exercise of market power in this way.*

In relation to the first SACOSS submission, the AEMC responded by ensuring that their consultant (NERA Economic Consultants) developed a range of LRMC estimates (in recognition of concern about the imprecision of LRMC estimates) and engaged Competition Economics Group (CEG) to undertake an assessment of the conditions that restrict competition and create barriers to entry.

There was no apparent acknowledgement of the second SACOSS submission (February 2012).

The Draft Rule Determination[2]

To summarise, the Draft Determination was an extremely concerning dismissal of a complex aspect of the market. Unfortunately, the work conducted by and commissioned by the AEMC has only reinforced our concerns that the SA region of the NEM is far from the 'average' and that our concerns over limited competition are entirely justified.

The Draft Determination also encourages a conclusion that the AEMC is not the appropriate body to address this issue. It is our view that the South Australian regional circumstances warrant a specific inquiry into the limitations on competitive outcomes however, it would obviously be a conflict for the AEMC, who in 2008 found that the South Australian retail energy markets were sufficiently competitive to remove retail price controls.

SACOSS previously expressed its concern over the Commission's approach and stated that it was highly unlikely to detect significant market power – whether it exists or not. To be fair, this is probably at the heart of our concerns. As consumer advocates we take the view that the market is not competitive and need to be convinced that it is. The rule change proponent no doubt has a very similar perspective. The Commission has the alternate view: that the markets do function well and, in order to countenance the proposal, needed to be convinced otherwise. An objective investigation needs to carefully articulate the hypothesis and null hypothesis if it is to reach meaningful conclusions.

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[2] www.aemc.gov.au/Electricity/Rule-changes/Open/potential-generator-market-power-in-the-nem.html

Despite these opposing world-views, there are specific parts of the analysis that are not particularly robust. The final piece of work by NERA Economic Consultants and Oakley Greenwood is particularly disappointing in that the weight placed on their findings is inconsistent with the uncertainty that accompanies their figures.

Particular attention is drawn to the data referred to as "average region wide contract price". According to the NERA Report[3] [p39]

> *"Given the assumptions that have had to be made to develop these contract price estimates, we believe that the insights that can be drawn from the estimates are limited"* and *"… public information about historical contract prices is relatively limited, especially in South Australia where some of the strongest points of concern about price have been raised. This situation has been compounded by increasing vertical integration within the industry meaning that explicit external contracts are not needed to hedge supply costs for much of the demand."*

These significant assumptions do not stop the consultants representing the data to three significant figures. Further, comparison of these single point estimates to a range of LRMC estimates is done in a way that assumes the upper and lower LRMC bounds are equally as probable as any point in the range. Such use of a range means the upper bound is taken as a 'true' value when clearly, by definition, it is not. Even the AEMC states that[4]:

> *" … NERA considers that, in the absence of considerably more information … the conclusions that can be drawn from the comparison of LRMC with contract price estimates is limited."*

While SACOSS's concerns about the statistical limitations on the methodology have been validated, this is less relevant following the Commission's apparent concession that, as the Rule Maker, it is not the appropriate body to be involved in these matters.

Of particular relevance was the following (page 8):

> *"…if the main cause of the existence of substantial market power in a NEM region was the industry structure in the wholesale electricity market then a rule change may not be the most effective way to address the issue."*

And again (page 14):

> *"While a generator may have the ability to exercise substantial market power, it may not choose to do so. The mere ability of a generator to exercise substantial market power is not sufficient to justify regulatory intervention if that power is never exercised. Such a scenario is likely to be caused by structural factors, which may be addressed through more preferable alternatives than a change to the rules."*

In the case of South Australia, CEG

> *" … noted that there was evidence that meant that ongoing monitoring of prices against the long run efficient level may be warranted" (Summary of draft determination page ii to iii).*

However, the Commission has not indicated who should do this monitoring. When Commission staff were questioned on this matter the answer was that this should be left to "participants".

[3] www.aemc.gov.au/Media/docs/NERA-report-a1ffd670-8a15-456f-93cd-f404ba6bfa6b-0.PDF
[4] Draft Determination page 21 (on LRMC methodology)

To underline our ongoing concern, the draft determination discusses Potential barriers to entry in South Australia in section 7.3.2 (p42):

> *"CEG has provided evidence supporting elements of both structural and strategic barriers to entry in South Australia."*
>
> *"CEG also considers that another form of pre-emption by incumbent generators in South Australia may arise from the large presence of vertical integration between generators and retailers, the consequence of which may raise the costs of hedging for independent new entrants."*
>
> *"CEG refers to the recent statement by the AER that since 2007 there has been negligible investment in generation by firms that are not also present at the retail level"*
>
> *"Vertical integration acts as a natural hedge to the wholesale market and reduces the level of participation in the market for hedge contracts. South Australia persistently demonstrates a lower level of contract market liquidity than other NEM regions"*
>
> *"The overall evidence from CEG's analysis suggest that barriers to entry are unlikely to be a significant concern in New South Wales, Queensland and Victoria, but that the evidence concerning South Australia is less clear."*
>
> *"CEG propose that the impact of vertical integration and the problem of contracting for new entrants in South Australia should also be kept under review."*

SACOSS can only interpret these findings and comments as the Commission saying, " … *yes, there is something not quite right in SA but it is not for us to do anything about it and certainly not through a rule change*".

SACOSS does not necessarily accept that the AEMC can so readily dismiss the issues raised in the rule change. In particular, it is our view that the focus on generation only is inappropriate for South Australia. The AEMC accepted NERA's conclusions that[5]:

> • *the relevant functional dimension is electricity generation only, <u>and does not include electricity retailing</u>;*

Both NERA and CEG repeatedly emphasised the importance of vertical integration in South Australia yet the relationship between generator market power and retail markets has been ignored. This may be appropriate in other regions but clearly not in SA where the generator-retailer (gentailer) model is the almost entirely dominant industry structure. The Commission's attention is drawn to the Peer Review of NERA's approach provided by CoRE research in July 2011 and the specific comments regarding the *functional dimension*[6]:

> *We agree with this standard approach and agree with the NERA's conclusion that there is clearly a separate generation market. However, two caveats need to be noted:*
>
> 1. *The existence of a separate generation market does not mean that the issues of generator market power can be analysed in isolation of the retail market structure. For example, if a generator is vertically integrated into retailing then its incentives to exercise market power might change.*

[5] Draft determination Section 5.1.1 Dimensions of the relevant market (page 17)
[6] www.aemc.gov.au/Media/docs/Peer review report-ded09b2b-0aa5-45e1-8b10-74ceceb5b114-0.pdf

SACOSS is particularly concerned with the impact on South Australian residential consumers and following the activation of the National Energy Customer Framework and the National Energy Retail Rules on July 1st, 2012, so should the AEMC.

The point being made in the Peer Review is that Vertical Integration provides different incentives than would otherwise be the case. In South Australia there is clearly the structural opportunity to exercise market power, the incentives to limit retail market entry are present and the findings of CEG, the AER, MEU and others suggest there is some observable market evidence of behaviour consistent with the exercise of market power. Yet, despite this, the AEMC is not prepared to take any further action.

Vertical Integration

The following is intended to paint a picture of vertical integration in the SA region of the NEM through a focus on the five main downstream entities in South Australia. These five players are:

- AGL Energy
- Origin Energy
- International Power – GDF Suez and their retail arm Simply Energy
- TRUenergy
- Alinta Energy

Noting that:

- Alinta Energy Retail Sales (AERS) is a recent entrant to the retail energy market having been granted a retail license by ESCOSA in 2011, the four main players occupy 94% of the residential electricity retail sector;

- The same four players occupy the entire market in the residential Gas sector; and

- in the generation market the five own or control the entire dispatchable generation fleet, 56% of the state's wind capacity (MW) and 92% of all generation sales (MWh).

These market shares are shown in the following table (Table1 data has been sourced from ESCOSA, AER and AEMO). The table also calculates a Herfindahl-Hirschman Index (HHI) for each sector. CEG[7] describes the HHI as:

> *" … calculated by adding the sum of the squares of the market shares of each firm within the market. Markets with higher HHIs are considered to be more likely to suffer from weaker competition, although whether this is the case will depend on a wide range of other factors impacting competition. The ACCC's Merger Guidelines state that the ACCC will be less likely to identify competition concerns when the HHI is less than 2000."*

[7] www.aemc.gov.au/Media/docs/CEG-Report-ece57d9c-399c-4724-b5f0-a6ba319dca83-0.PDF [page30]. ACCC's merger guidelines are available here: www.accc.gov.au/content/index.phtml/itemId/809866 [page 37]: " ... As part of its overall assessment of a merger, the ACCC will take into account the HHI, as a preliminary indicator of the likelihood that the merger will raise competition concerns requiring more extensive analysis."

	Small Customer Market Share (2010-11)	Dispatchable MW	Wind MW	Total GWh Generated
AGL	55%	36%	36%	24%
Origin Energy	19%	13%	0%	11%
TRUenergy	12%	6%	15%	3%
Simply	8%	23%	4%	22%
Alinta Energy	0%	21%	0%	32%
HHI	3555	2509	1567	2241

Table 1: Electricity Market Concentrations, SA Region 2010-11

As can be seen the vertically integrated generator-retailer (or 'gentailer' model) is the dominant form of market participant and exists in concentrations that, in other markets, would trigger concerns over the level of competition present.

The CEG report discusses Market Shares and the HHI and presents the results of their own analysis in this regard. However, their interpretation of the results is not, in our view, correct. The AEMC should take note of the difference in HHI in the sub-markets for dispatchable vs wind generation in Table 1 (above). The five vertically integrated gen-tailers own or control the **entire** fleet of dispatchable generation. There is more diversity in the Wind Generation fleet. However, at the times of peak demand – and hence the times where the market can be considered most susceptible to the exercise of market power [which we acknowledge is transient in terms of each incident but, in our view, 'sustained' in the sense that the transient opportunities arise often] – the firm wind capacity is considered by AEMO[8] to be available less than 5% for planning purposes. Even if a value of 10% is used, the HHI for total generation sits just below 2500.

To the contrary, CEG state [page 32]:

> 114. *In South Australia … The fall in HHI in 2008-2011 has reflected both rearrangements of assets via asset sales and relatively modest expansions in capacity (mostly) by existing players.*
>
> 115. *The significant falls in HHIs in New South Wales and South Australia in itself is indicative of significant competition among incumbents and/or entry by independent generators. In either case, this suggests that even if SMP were present in those States, it is weakening over time.*

These two statements are not accurate. Firstly, the fall in the SA generation HHI from 2008 has been largely due to the expansion of Wind capacity and, when accounted for in terms of firm capacity (which seems entirely reasonable if we are talking about control of outcomes) has hardly fallen at all. Secondly, to say that the fall in SA is indicative of significant competition, is a misrepresentation of the market. The incentives for entry by wind capacity are not the same as

[8] AEMO SASDO 2011 [page 7]: "Firm capacity refers to the level of generation that can be considered to be statistically reliable during 85% of peak demand periods". For 2010-11 planning was based on a firm availability of 40.8MW out of a nameplate capacity of 1150MW

for dispatchable generation (despite the semi-scheduled status of these new entrants) and can also be seen as the complete opposite – as being encouraged by the higher revenue potential of the regional market.

CEG's conclusion that " … *this suggests that even if SMP were present in those states, it is weakening over time*" is not supported by the realities behind the numbers.

Market Observations

SACOSS remains unconvinced that the South Australian market, particularly for small consumers, is at all that competitive. The concentration of the main players in a relatively small market with interconnection that is often constrained at peak times, results in an environment where market power has the potential to be exercised. The 'economic withholding' of capacity in the region by Torrens Island Power Station (TIPS) and more recently by Northern/Playford has been well documented as has their pivotal positions in the regional generation market.

To validate the structural potential for the exercise of market power, the AER's State of The Energy Market 2011[9] makes a number of relevant observations regarding AGL's "strategic" behaviour at both the high and low ends of the pool price range:

> [Market Overview p13]: "*Periods of sustained high demand and strategic withholding of generation capacity by AGL Energy contributed to three years of very high average spot prices in South Australia, from 2007 – 08 to 2009 – 10.*"
>
> [Market focus – SA p36] "*At $42 per MWh, the average spot price in South Australia for 2010 – 11 was almost 50 per cent lower than in 2009 – 10. The price exceeded $5000 per MWh in nine trading intervals, down significantly on the previous year (figure 1.9). A mild summer, with only a few days above 40 degrees, affected this outcome. Another contributing factor was South Australia's 177 trading intervals with negative prices in 2010 – 11, up from 86 in the previous year and the highest annual number ever recorded for any region. Wind generators sometimes bid negative prices to ensure dispatch, relying on the value of the renewable energy certificates they earn to cover their costs. But several instances of prices near the – $1000 market floor were driven by AGL Energy rebidding large amounts of capacity at times of high wind generation and low demand. The negative prices caused other generators, including wind farms, to shut down.*"
>
> [Market Overview p14] " … *repeated instances of negative prices increase volatility, which may discourage entry by competing independent generators and retailers.*"

Further, SACOSS recently commissioned work by energy consultants Carbon Market Economics that makes some important observations about the spot and contract markets in South Australia (copy available on request). In summary CME has found that South Australia's higher than average volume-weighted spot prices can be attributed to a small number of high priced events and, in turn, these high priced events can be traced to periods not of scarcity of supply but of the economic withholding of capacity of un-hedged pivotal generators. The implication being that both spot and contract prices for the Jan-Mar quarter (referred to as Q1) are the principal determinants of the wholesale energy costs of retailers in SA. And, further, that the South Australian market structure (a concentration of vertically integrated generator-retailers) allows these prices to sit above what a more competitive supply-demand balance might provide.

[9] www.aer.gov.au/sites/www.aer.gov.au/files/State of the energy market 2011 - complete report.pdf

SACOSS has also reflected on the Commission's perspective in the Review of the Effectiveness of Competition in Electricity and Gas Retail Markets in South Australia – First Final Report. Appendix E discusses Vertical Integration in general at Section E.1.1.3 and AGL and Torrens Island in particular in E.1.1.4 where the commission examines the argument that wholesale market power was being leveraged into retailing. The commission dismissed the argument[10]:

> *" … the argument is not supported by actual market outcomes as AGL's discounts off the standing contract price are not as high as the discounts available under its competitors' market offers. In addition, AGL's customer share has been decreasing since the start of FRC thereby reducing the number of customers from which it can recoup its losses."*

And;

> *"The assumption also rests on the ability to create and sustain barriers to entry or expansion by other, potentially competing retailers."*

Noting that this was written in 2008, it is now possible to revisit these market outcomes.

Firstly, it is apparent that AGL and its wholly owned Powerdirect are able to offer market contracts at significant discounts to the standing contract that are highly competitive with other retailers. As an example, Figure 1 plots market transfer data that shows that AGL has been able to be competitive enough to ensure that over 25% of all small customers market transfers have been back to them (AEMO only published disaggregated data from 2009)

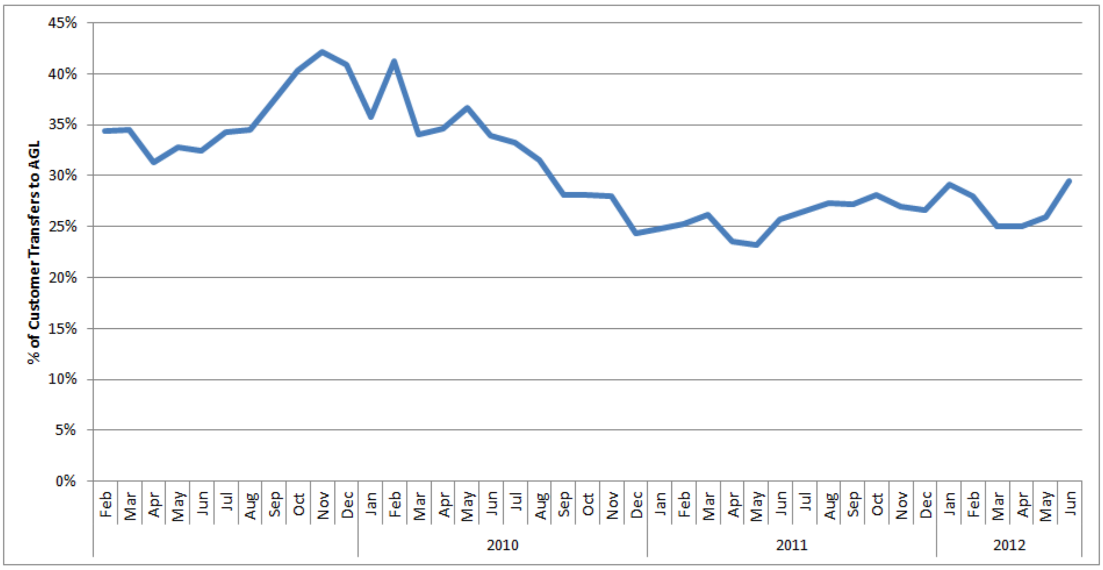

Figure 1: Percentage of small customer transfers to AGL (source: AEMO statistics for Tier 1 retailer in SA)

Secondly, the combined AGL/Powerdirect market share has held virtually constant since 2008 at just over 55% of the small customer market as shown in the following chart derived from ESCOSA data:

[10] www.aemc.gov.au/Media/docs/First Final Report - Appendices-f166c14f-d1da-4307-b738-31706b886415-0.pdf page 147

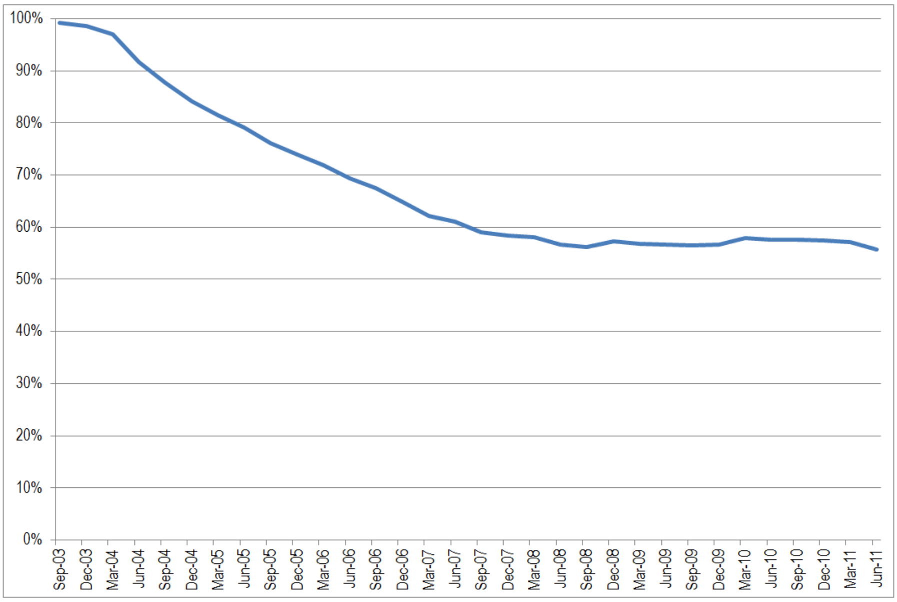

Figure 2 – AGL/Powerdirect combined retail market share (small customers, SA Region)

Thirdly, the assumption about the barriers to entry or expansion by others is of course discussed at length in the CEG report but also illustrated in the following time series of small customer market shares:

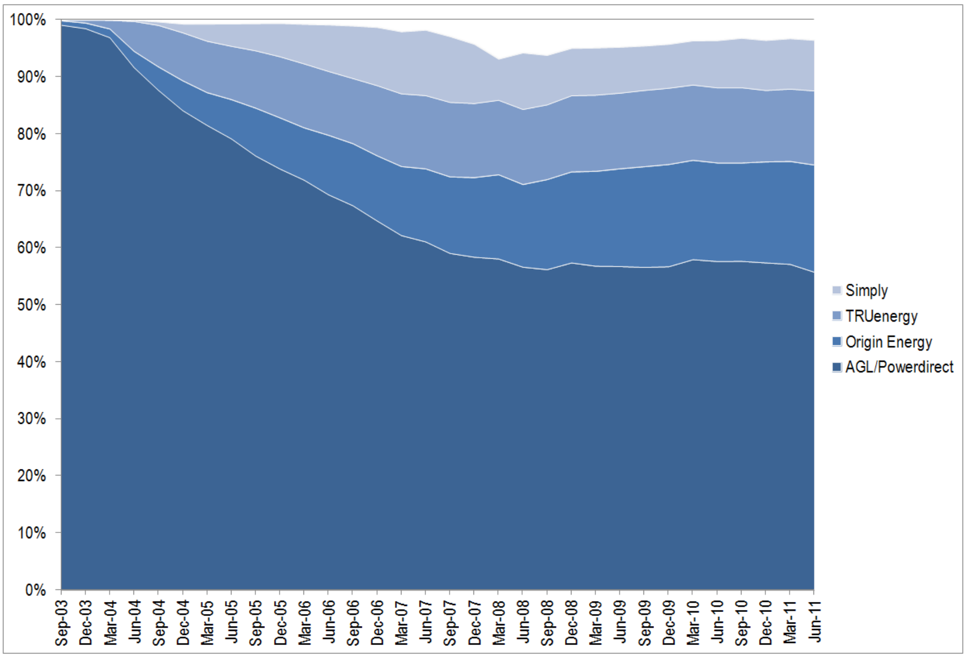

Figure 3: Small Customer Market Shares, SA region 2003-11

It is clear in Figure 3 that the four gentailers dominate the market and that, since 2008, the combined market share of the other, smaller retailers is in fact shrinking.

Conclusions

SACOSS is extremely disappointed by the AEMC's treatment of this Rule Change Proposal. It is clear to us that the South Australian region operates as an oligopoly that warrants and requires a more thorough and consumer-focussed inquiry into its structure and the implications for competition and market power than the AEMC currently feels it is obliged to perform.

The Commission has stated in the Draft Decision that it intends to use the same analytical framework and approach in any future allegations of market power. SACOSS does not believe this is at all advisable or appropriate.

It is our view that failing to consider the relationship to the retail market in South Australia fundamentally undermines the ability for AEMC to draw the conclusions that it has. Further the use of LRMC estimates and forward contract estimates has been shown to contain significant uncertainties and is not robust enough for the AEMC to draw the conclusions that it has.

The Commission appears to have the view that the perceived threat to investment outweighs the potential for economic harm to consumers. SACOSS would not support such a view and does not agree with this position.

Despite the AEMC's lack of enthusiasm, SACOSS is prepared to pursue the advice of the CEG that " … *there was evidence that meant that ongoing monitoring of prices against the long run efficient level may be warranted*," and that "… *the impact of vertical integration and the problem of contracting for new entrants in South Australia should also be kept under review*".

SACOSS respectfully asks the Commission to seriously reconsider the draft decision and contemplate a more preferable rule. If the Commission continues to find itself unable to support a rule change then it would be of great help in restoring the confidence of South Australian consumers if it was able to recommend a constructive way forward given the issues raised in the Draft Determination.

Please direct any questions in relation to this submission to Jo De Silva, SACOSS Senior Policy Officer on 0406 950 726 or via jo@sacoss.org.au.

Sincerely,

ROSS WOMERSLEY
Executive Director