



Fact sheet: South Australia

Potential Generator Market Power in the National Electricity Market

The assessment framework

The Australian Energy Market Commission (AEMC or Commission) has examined the extent to which substantial market power and barriers to efficient investment exist in the various regions of the National Electricity Market (NEM). The Commission considers that, taking account of all the evidence, it is not clear as to whether substantial market power has existed in the South Australian region to date. However, the Commission's analysis has demonstrated that South Australia may have some characteristics that may make it different from other NEM regions and potentially more prone to inhibiting efficient investment and promoting the likelihood of substantial market power.

To assess the rule change request the AEMC developed a definition of market power in the context of the energy only market and taking account of precedents used by competition authorities and other regulators. The AEMC defines substantial market power in the context of the NEM as the ability of a generator or group of generators to increase annual average wholesale prices to a level that exceeds long run marginal cost (LRMC), and sustain prices at that level due to the presence of significant barriers to entry. LRMC is a baseline against which to measure efficient wholesale prices that would be expected in the long term. If significant barriers to entry are absent then it can be expected that if prices are expected to be above LRMC for a significant period, there will be a competitive response through new entry.

The Commission engaged the Competition Economists Group (CEG) to determine the existence of barriers to efficient investment and NERA Economic Consulting (NERA) to undertake analysis to identify evidence of the existence of substantial market power in South Australia.

Evidence of substantial market power

In the case of South Australia, the Commission considers that the findings from the investigation into the presence of barriers to entry, and the results of the comparison of annual average wholesale prices and LRMC, mean that there is the possibility of the exercise of substantial market power over the period 2007-08 to 2009-10. The Commission considers there to be insufficient grounds however to support the proposition that substantial market power will be exercised in the current market environment.

Variations in the wholesale price of electricity are to be expected due to variations in the underlying conditions of supply and demand. Wholesale prices that are higher than in previous years should not be considered a cause for concern unless those prices are significantly above LRMC and are sustained at that level for an undue period of time.

The results of the analysis show wholesale prices to be at the high end or above LRMC over the three years from 2007/08 to 2009/10. In more recent years, annual average wholesale electricity prices have been significantly below LRMC.

The Commission recognises that supply and demand conditions have existed in South Australia in previous years that, for short periods, may have supported some generators' ability to increase prices significantly above their costs. This transient ability to increase prices for short periods has contributed to annual average prices rising above the efficient level over the 3-year period.

In more recent years there have been developments in the wholesale market in South Australia that make the exercise of substantial market power unlikely, in particular falling demand relative to generation capacity.

The Commission notes that the renewable energy target has driven a considerable increase in the capacity of generation in South Australia through the uptake of wind generation in the period under review. The installed wind generation capacity increased from 389 megawatts (MW) to 1,205 MW between January 2006 and June 2012. The Commission also notes the planned upgrade of the Heywood interconnector with Victoria which is envisaged to increase its capability by about 40% in both directions. When available, the increased capacity on the interconnector will reduce the extent of price variation between South Australia and Victoria.

However, the Commission notes that, should industry structure or conditions substantially change, the possibility of the future exercise of substantial market power cannot be ruled out.

Evidence of barriers to efficient investment

The overall evidence from CEG's analysis suggests 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 provided evidence supporting elements of both structural and strategic barriers to entry in South Australia. CEG concluded that:

- a principal structural concern for South Australia is the large minimum investment size relative to the size of the market and that a new entrant of sufficient size may expect a material reduction in prices post-entry;
- incumbent generators may strategically and deliberately install excess capacity to promote the expectation that the entry of a minimum efficient scale new entrant would alter the pricing strategies of the incumbents and lower prices; and
- there is a relatively large presence of vertical integration between generators and retailers, the consequence of which may raise the costs of hedging for independent new entrants.

CEG highlighted a number of concerns regarding potential barriers to entry in South Australia which may have been a contributing factor to the price outcomes, but the report was not able to reach definitive conclusions on this issue in the presence of alternative explanations. CEG recommended ongoing monitoring with regard to South Australia.

Conclusions and future considerations for South Australia

Recognising the potential for substantial market power to exist or be exercised in the future, the AEMC has explored the possibility of making a rule which would confer on the Australian Energy Regulator (AER) a specific function to monitor the wholesale electricity market, but considers there is material doubt as to whether this function is compatible with the existing functions of the AER.

Therefore, the Commission recommends that the Standing Council on Energy and Resources (SCER) consider conferring on the AER such a monitoring function, and add accountability mechanisms to the AER's current information gathering powers in relation to this monitoring function.

An appropriately developed monitoring regime is a pre-requisite for identifying at an early stage any evidence that the efficient operation of the wholesale electricity market is constrained by the presence of significant barriers to entry or other features of the industry structure.

The monitoring would allow identified constraints to be addressed in the long term interests of consumers based on an understanding of the underlying cause(s).

This approach was supported by a number of stakeholders including the SA Minister for Mineral Resources and Energy.

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