

By email: energymarkets@dmirs.wa.gov.au

Dear Energy Policy WA

Thank you for the opportunity to comment on the Market Power Mitigation Strategy Consultation Paper (Paper).

The energy sector in Western Australia exists to provide electricity and gas to consumers. It is central to energy production and delivery that the long-term interests of energy consumers are served. The Expert Consumer Panel (ECP) was established by the Western Australian Government to provide input on policy, rules and other processes across all elements of the energy supply chain.

The ECP is represented on the Market Advisory Committee (MAC) and engaged in the range of technical and other matters currently being considered by the MAC, including the market power mitigation review, the Reserve Capacity Mechanism review and the cost allocation review. Consumers' interests are being promoted by the ECP representatives in these reviews.

The ECP supports the introduction of the market power mitigation arrangements outlined in the consultation paper and makes suggestions around implementation to ensure the scheme has teeth and can increase public trust and confidence in the Western Australian Wholesale Energy Market (WEM).

Consumer context

Understanding the consumer context for the market power mitigation framework is critical. Western Australian households and businesses are facing acute cost increases and supply chain challenges as the state emerges from the disruption of the COVID-19 pandemic and while we have been shielded from the worst of energy bill increases seen in the eastern states, we are not immune.

The challenge of maintaining affordability and security of supply for Western Australians as the grid decarbonises means we have to ensure we implement robust arrangements to deliver competitive outcomes now and into the future. An open and competitive wholesale energy market is critical for investor confidence and attracting the billions of dollars of private capital needed to replace retiring fossil fuel generation.

The market power mitigation framework is also critical for public trust in the market. Energy Consumers Australia's Energy Consumer Sentiment Survey results indicate that Australians do not necessarily have trust and confidence that energy markets are working in their interests, with only 40 per cent providing a positive rating in its latest publication.¹ Recent events in the

1

<https://ecss.energyconsumersaustralia.com.au/sentiment-survey-june-2022/western-australia-sentiment-june-2022/>

National Electricity Market highlight the damage that the perception of anti-competitive behaviour by energy companies can do to the public trust and confidence in the market.

The conduct of market participants upstream also influences how consumers engage with the market downstream. Western Australian households and businesses with rooftop solar PV, batteries and other forms of distributed energy resources are being subject to new requirements around how they manage their assets and trust and confidence that the wider market is working in their interests is critical for social licence and these changes to be supported.

Market power frameworks in the WEM

The problem of market power in electricity markets is well established - even in markets that are less concentrated than the WEM - and can impact consumer outcomes. According to respected electricity market experts Daryl Biggar and Mohammad Reza Hesamzadeh:

“In the short run, market power reduces allocative efficiency and productive efficiency. In the long run, market power distorts investment decisions by generators (over-incentivising entry or discouraging timely exit). Most importantly, market power can also deter sunk investment by customers in assets that rely on a reliable supply of electricity at a reasonable price.

Importantly, while the consultation paper focuses on preventing the extraction of ‘abnormal profits’:

“These consequences arise whether or not the firms exercising market power are earning above-normal profits or ‘monopoly rents’.”²

The absence of a fit-for-purpose market mitigation arrangement in the highly concentrated WEM is a major concern for consumers. The protracted process to resolve the action brought by the ERA against Synergy (for pricing it contends exceeded its reasonable expectation of the short run marginal cost of generation in the trading period between March 2016 and July 2017 is still to be resolved in August 2022) - still going five years later - is unacceptable and continues to highlight the urgent need for reform.³

This delay is indicative of a wider set of deficiencies identified by the Energy Transformation Taskforce, which are worth restating:

- “Current market power mitigation mechanisms are largely reactive (ex-post) rather than pro-active (ex-ante)
- The nature of the ex-post regime leads to regulatory uncertainty
- Ex-post investigations are complex, resource intensive and time-consuming

² *The economics of electricity markets*, Darryl R Biggar, Mohammad Reza Hesamzadeh, IEEE Press and John Wiley & Sons Ltd, 2014.

³ <https://www.wa.gov.au/government/document-collections/application-no-1-of-2019>

- There are lengthy delays between the regulator detecting inappropriate behaviours and remedies being delivered
- The adverse outcomes for other market participants and consumers may persist for extended periods before the behaviour is remedied
- The requirement for the ERA to refer findings to the Electricity Review Board has restricted the ERA's ability to be transparent about the content and progress of market power investigations
- Limited transparency and availability of timely information make compliance with the regime challenging
- Market participants lack clarity regarding their trading conduct obligations
- There are no direct obligations on market participants to ensure compliance and report breaches.”⁴

The ECP supports the model outlined in the consultation paper to address these deficiencies.

The guiding principles that have informed the design of the mechanism are sound and the systematic and transparent three-part test developed by Energy Policy WA - drawing on tried and tested international models - should provide consumers and market participants alike with greater clarity and confidence in the WEM.

We have a specific comment in relation to the design of the three-stage test. We are concerned that the use of the words ‘profit maximising offer’ in the Offer Construction Guideline, could be misinterpreted by market participants as validating just the kind of uncompetitive conduct in a concentrated market that we are trying to mitigate. While we acknowledge these words are qualified by the terms “by a Participant without market power”, we think it would be better to use words which convey the outcome we are seeking to achieve. That is, offers which reflect the participants’ legitimate right to recover their efficient short run marginal costs and make a reasonable profit, rather than profit-maximise, even with the proposed framework.

The proposed Offer Construction Obligation; “That a Market Participant who has market power offers prices in Submissions (made for STEM, RTM or the FCESS market) that reflect the costs that a Market Participant without market power would include in forming its profit-maximising offer”, could be reworded to say:

“That a Market Participant who has market power offers prices in Submissions (made for STEM, RTM or the FCESS market) that reflect the costs that a Market Participant without market power would include in forming its offer, including a reasonable profit that reflects the interests of consumers.”

4

<https://www.wa.gov.au/system/files/2021-03/Proposal%20for%20changes%20to%20Market%20Power%20Mitigation%20Mechanisms.pdf>

Beyond the design of the three stage test itself, the ECP's major concern is that the ERA is not adequately resourced to administer the new framework, and that the penalties for misconduct are not an effective deterrent.

The history of these kinds of actions in Western Australia and other jurisdictions highlights the challenges regulators face because of information and resourcing asymmetries between them and market participants. Unlike fines motorists receive for speeding (and even with the introduction of an ex ante framework) penalties for breaching the market power mitigation rules will not be mechanistically applied as a consequence of failing all three stages of the framework. Rather the new framework will act as a trigger for the ERA to consider whether it should commence compliance investigation and enforcement action for breach of the Offer Construction Obligation in respect of the Market Participant's relevant offers.

The ECP's strong view is that the scheme should be designed to maximise transparency at each stage in the process to ensure that there are strong reputational and financial incentives against misconduct. Public reporting and disclosure around the commencement of investigations - not just the outcomes of a completed process - is therefore necessary to ensure the scheme has teeth. We note that as part of the Small Use Customer Code, the Electricity Code Consultative Committee undertakes a review of the effectiveness of the code every two years and publishes a report - a practice which could be incorporated into the market power mitigation framework.

The Small Use Customer Code also requires retailers to arrange for regular independent audits to identify any non-compliance with the Code. These audits are submitted to the ERA and eventually made public. The transparency of this approach is a significant driver of retailer behaviour to avoid reputational damage. A regime similar in nature could be considered to introduce independent audits and provide transparency of audit outcomes.

We are also concerned that the financial penalties for misconduct are not commensurate with the consumer impact of the exercise of market power in the WEM, nor to act as a strong deterrent for this behaviour. We note for instance that the civil penalty for the breach of the rules around balancing submissions which is the subject of the Synergy matter is \$50,000 for the first breach and \$100,000 for subsequent breaches. In what we understand is the only other example of enforcement action under the existing market power mitigation arrangements, Vinalco Energy Pty Ltd was fined only \$2,500 for two breaches of the market rules in 2014.⁵ These penalties do not appear to be at an adequate level in a market which includes market participants with revenues in the billions of dollars.

The civil penalty provisions in the NEM have recently been increased to ensure they are commensurate with the harm by a business who breaches the law - with the penalty for a

5

<https://www.wa.gov.au/system/files/2021-06/Application%20No%201%20of%202016%20-%20Decision%20-Independent%20Market%20Operator%20and%20Vinalco%20Energy%20Pty%20Ltd.pdf>

top-tier breach lifted to \$10 million.⁶ The ECP's strong view therefore is that the development of the market power mitigation arrangements should be supported by a review of the civil penalty regime to ensure it is fit-for-purpose.

Please do not hesitate to contact the ECP secretariat if you would like to discuss our submission further.

Kind regards

Expert Consumer Panel

6

<https://www.aer.gov.au/news-release/stronger-penalties-demand-energy-businesses-prioritise-compliance-with-the-law>