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Energy Policy WA  
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### Proposals for changes to Market Power Mitigation Mechanisms

The Australian Energy Council (the “AEC”) welcomes the opportunity to make a submission to Energy Policy WA on the *Proposals for changes to Market Power Mitigation Mechanisms* consultation paper (the “**Consultation Paper**”).

The AEC is the industry body representing 22 electricity and downstream natural gas businesses operating in the competitive wholesale and retail energy markets. These businesses collectively generate the overwhelming majority of electricity in Australia and sell gas and electricity to over 10 million homes and businesses.

#### Ex-ante regulations

##### *Pivotal supplier test*

The AEC appreciates Energy Policy WA consulting with stakeholders about the proposed changes to market power mitigation mechanisms. This is an important issue that is regularly considered in the Wholesale Electricity Market (the “WEM”) in an effort to find the most optimum arrangements. In October 2016, the Public Utilities Office engaged the Brattle Group to provide a review of market power mitigation measures, which concluded that an “an ex post mitigation approach satisfies all the evaluation criteria for the WEM”.<sup>1</sup> Then, in April 2020, the Brattle Group was commissioned to consider how the WEM Rules can be improved for using Short Run Marginal Cost (“SRMC”) in market power mitigation.<sup>2</sup> Now, in March 2021, a report from Sapere Research Group and Robinson Bowmaker Paul (the “**Sapere Report**”) offers a different perspective on market power mitigation and one that will have significant implications for market participants.<sup>3</sup>

The Sapere Report suggests re-weighting market power mechanisms towards ex-ante regulation. The Consultation Paper appears to have endorsed this suggestion in arguing that the existing market power mitigation regime is deficient because it is ex-post rather than ex-ante. .<sup>4</sup> The Sapere Report seeks to address this by, among other things, proposing a three-part market power test that involves:

- a) Identifying market power through a pivotal supplier test (ex-ante);
- b) Considering whether the participant is operating within the safe trading envelope (ex-post); and

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<sup>1</sup> See page 42, [Market Power Mitigation Mechanisms for the Wholesale Electricity Market: Information Paper](#)

<sup>2</sup> See [Implementing recommended improvements to market power mitigation in the WEM](#)

<sup>3</sup> See [Market Power Mitigation in the WEM](#)

<sup>4</sup> See page 4, [Proposals for changes to Market Power Mitigation Mechanisms: Consultation Paper](#)

c) Assessing how the market power exercise has affected market outcomes (ex-post).

The Sapere Report considered various pivotal supplier tests and concluded that a “three pivotal supplier test in the WEM would be overly stringent and could identify every participant as having market power” and so, for simplicity, it proposed a single pivotal supplier test.<sup>5</sup> This approach means that Synergy, and perhaps some other participants, will exceed the threshold to be considered a pivotal supplier and therefore be required to provide reporting and other ex-post activities, even without evidence of an actual exercise of market power.

This new approach risks creating inefficiencies by inhibiting conduct that does not constitute a harmful exercise of market power. The AEC strongly encourages Energy Policy WA to adopt consider a more balanced regulatory framework that does not unnecessarily restrict commercial behaviour and disproportionately impact specific participants in the process.

#### *Offer construction guideline*

The Consultation Paper explains that an objective of the proposed changes is to remove uncertain concepts from the WEM Rules, such as how to define the SRMC, and instead proposes that the ERA be required to provide offer construction guidelines that set out how the ERA expects a participant to construct its offers.<sup>6</sup>

This prescriptive approach contradicts the sentiments put forward by the Brattle Group and Energy Policy WA as part of the *Directions Report: Clarifying Short Run Marginal Cost and market offer requirements in the Wholesale Electricity Market* (the “**Directions Report**”). For instance, the Brattle Group stated that “we do not consider that it would be possible to specify in the Rules any form of required mechanical relationship between gas prices and offers, except that a generator with market power should not exploit that market power to raise prices above competitive levels”<sup>7</sup>. Similarly, the Directions Report noted the difficulty of including a list of specific cost components in the rules given a participant’s circumstances in the market will change over time.<sup>8</sup>

Because an offer construction guideline is unable to capture all the circumstances and costs that must be recovered in offers, especially as the market evolves and new technologies enter, adopting such a prescriptive guideline will only result in uncertainty and inefficient prices. This will make the guideline counterproductive.

The Sapere Report notes the guideline can be “reviewed, consulted on, and amended from time to time”. This will result in more uncertainty, and there will likely be as much focus and discussion on this guideline as there was about the composition of SRMC.<sup>9</sup> It further puts the ERA in a conflicted position of producing a guideline and then regulating and enforcing submissions.

#### *Safe trading envelope*

Another ex-ante mechanism that the Consultation Paper proposes is the introduction of a safe trading envelope. It seems the intention of the safe trading envelope is to give participants confidence to adjust their market submissions and, on the basis they are still operating within the defined safe trading envelope, participants can assume they are compliant with their trading conduct obligations.

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<sup>5</sup> See page 42, [Market Power Mitigation in the WEM](#)

<sup>6</sup> See page 10, [Proposals for changes to Market Power Mitigation Mechanisms: Consultation Paper](#)

<sup>7</sup> See page 13, [Implementing recommended improvements to market power mitigation in the WEM](#)

<sup>8</sup> See page 4, [Directions Report: Clarifying Short Run Marginal Cost and market offer requirements in the Wholesale Electricity Market](#)

<sup>9</sup> See page 34, [Market Power Mitigation in the WEM](#)

Notwithstanding the concerns the AEC raised earlier about the guidelines used to form the safe trading envelope, it is critical that this safe trading envelope is reflective of the true efficient costs of the facility. If a safe trading envelope is going to be imposed on participants with market power then the safe trading envelope should let them fully recover their costs and not force them to operate at a loss.

#### *Position on ex-ante regulation*

It's the AEC's view that the WEM has become increasingly competitive – and will continue to do so if the right signals are made to investors – and this has meant a greater in-built incentive for generators not to bid too high or too low, and for the market to self-correct.

The re-weighting of market power mitigation mechanisms to put a greater emphasis on ex-ante regulation (through the pivotal supplier test, offer construction guidelines and the safe trading envelope) is, from the AEC's perspective, overly prescriptive, unnecessary and likely to lead to adverse outcomes for market participants and consumers. The cost of this approach – particularly with “false positives” (i.e. imposing market power mitigation when abuse does not exist) – needs to be carefully considered. The Brattle Group addressed this by saying:

*“While it is well recognized that consumer harm resulting from inadvertently unmitigated market power abuse can be extensive, the long-term cost of over-mitigation must not be underestimated. Mitigation actions, if they are erroneous or unnecessary, can promote both short-term and long-term inefficiency. This can lead to costly changes in the operations of generating plants and distorted prices that adversely affect investment incentives, contracting behavior, demand response, innovation, and dynamic (i.e., long run) efficiency. Even if over-mitigation does not have significant short-term price impacts, it may create a perception of having the potential for such price impacts, which may undermine the confidence of those investing in new generation and result in higher long-term costs for consumers.”<sup>10</sup>*

Rather than pursuing prescriptive and complex ex-ante obligations that have the potential to introduce inefficiency through overly restricting behaviour, the AEC encourages Energy Policy WA to consider triggers that promote ex-post reviews and inspections.

Indeed, the AEC supports the position Energy Policy WA made in its Directions Report that “EPWA agrees that the ERA's focus should be on ex-post enforcement on generators who have market power and have used that market power to raise prices above competitive levels. This is a more objective approach focusing on the effect of behaviour, rather than possibly requiring proving the intent of the market participant in relation to the behaviour”.<sup>11</sup>

#### **Essential System Service price controls**

The Consultation Paper has endorsed the proposal in the Sapere Report to introduce an Essential System Service (“**ESS**”) price limit. This would be a backstop to other market power mitigation measures and is in addition to the SESSM.<sup>12</sup>

The AEC supports Sapere's Report acknowledgement that “ESS market clearing prices may need to be higher than the energy price limits to ensure participants can recoup costs of providing services”.<sup>13</sup> However, the AEC is concerned about the merits of an ESS price limit and the ERA's trigger for the SESSM, and the impact these controls will have on the market.

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<sup>10</sup> See page 3, [Review of PJM's Market Power Mitigation Practices in Comparison to Other Organized Electricity Markets](#)

<sup>11</sup> See [Directions Report: Clarifying Short Run Marginal Cost and market offer requirements in the Wholesale Electricity Market](#)

<sup>12</sup> See page 48, [Market Power Mitigation in the WEM](#)

<sup>13</sup> See page 48, [Market Power Mitigation in the WEM](#)

Interventions based on arbitrary price limits could lead to services being undervalued and prices being below cost, which risks disincentivising investment in the energy sector. The three-year reviews will also create uncertainty and make investment decisions even more challenging.

Also, as noted in the TDOWG on 19 April 2021, there is no capacity mechanism to support investment in ESS, particularly for technologies like battery storage. As a result, there may be no avenue for ESS providers to recover their fixed costs and putting a price cap on ESS prices may prevent these more efficient technologies from entering and disadvantage them compared to the conventional incumbents. In some ways, the WEM's ESS market therefore has similar characteristics to an energy-only energy market, where high prices are essential to justify sufficient investment to meet future power system needs.

There is an increasing need for ESS as the industry transforms and traditional providers retire. The re-balancing between energy and capacity revenue means that energy and ESS prices are important signals for investment. The market should be allowed to function, incentivising ESS and encouraging new entrants when required and avoiding the barriers of an artificial pricing regime.

In a situation where Energy Policy WA does introduce an ESS price limit and retains the SESSM price controls, the AEC suggests that the ERA should not be providing guidance on pricing given their market monitoring functions.

### **Low pricing**

The Sapere Report rightly notes that there are various ways of exercising market power, including "decreasing offer prices below reasonable cost to decrease the market price with the effect of crowding out competitors, and then recovering losses through high prices later, or through inflated prices for other services."<sup>14</sup>

This issue was not further addressed in the Sapere Report or by Energy Policy WA, however the AEC encourages this matter be considered in more detail.

### **Conclusion**

The AEC appreciates this opportunity to provide feedback on the Consultation Paper and encourages Energy Policy WA to consider the issues raised above.

Please do not hesitate to contact Graham Pearson, Western Australia Policy Manager by email on [graham.pearson@energycouncil.com.au](mailto:graham.pearson@energycouncil.com.au) or by telephone on 0466 631 776 should you wish to discuss this further.

Yours sincerely,

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<sup>14</sup> See page 23, [Market Power Mitigation in the WEM](#)