

Regulation impact statement:
Prohibiting Energy Market Misconduct

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1. Background and context

On 27 March 2017, the then Treasurer directed the Australian Competition and Consumer Commission (ACCC) to hold an inquiry into the supply of retail electricity and the competitiveness of retail electricity prices in the National Electricity Market (NEM) (the *Retail Electricity Pricing Inquiry*, or REPI). This inquiry was in response to electricity affordability becoming a significant issue for households and small businesses.

The ACCC delivered the REPI Final Report to Government on 29 June 2018.¹ The ACCC found that the average residential customer bill has increased by more than 35 per cent in real terms over the past 10 years with average residential electricity prices (expressed as cents per kilowatt hour) increasing by 56 per cent in real terms over the same period. The ACCC also found that small businesses had experienced similar increases in the past decade.

The report found that there are a number of causes of higher prices, and made 56 recommendations spanning the entire electricity supply chain, focussing on the objectives of boosting competition, lowering electricity costs, and improving experiences for consumers and businesses. The ACCC reported that, when taken alongside falls in wholesale prices and flattening or declining network charges, the recommendations could achieve substantial savings for retail consumers.

Background on the electricity supply chain

The following concepts are relevant throughout this document:

- ***The electricity wholesale market (spot market):*** In the electricity wholesale market, electricity generators make capacity available for purchase by retailers and, in some cases, large end users.
- ***Electricity networks:*** Electricity networks consist of regulated infrastructure which enables the transmission and distribution of electricity from generators to consumers.
- ***The electricity contract market:*** The electricity contract market consists of financial contracts which are designed to assist generators and retailers in managing the risk of price volatility on the electricity spot market by effectively allowing them to fix electricity prices for a set period (for example, by providing for compensation to be paid where the wholesale spot price is higher than the price set in the contract).
- ***The electricity retail market:*** In the electricity retail market, electricity retailers sell electricity to residential and small business consumers. Retailers purchase electricity directly from the wholesale market, and enter into electricity contracts to manage their exposure to wholesale market price volatility. Retail consumers pay prices set by their retailer under a range of 'market offers' (competitively priced offers which often include discounts) or 'standing offers'

¹ The ACCC's Final Report is available at: <https://www.accc.gov.au/publications/restoring-electricity-affordability-australias-competitive-advantage>

(for consumers who do not actively choose a market offer). Increases and decreases in wholesale spot prices, network charges, contracting prices and other supply chain costs can ultimately flow through to retail consumers.

- ***Gentailer***: A colloquial term for a vertically-integrated entity which operates in both the wholesale market (as a generator) and in the retail market (as a retailer).

2. The problem

The problem is that electricity market participants can engage in conduct which may be harmful to consumers by detracting from the efficient and competitive operation of the electricity market, but which is not prohibited by the existing prohibitions in the *Competition and Consumer Act 2010*. The problems, as identified by the ACCC in its REPI Final Report, broadly relate to the possibility of taking advantage of confused and disengaged consumers, contract market illiquidity, and conduct which undermines the effective operation of the wholesale market.

On 20 August 2018 the Treasurer tasked the ACCC with an ongoing Electricity Price Monitoring Inquiry (EPM Inquiry), to run from 2018 to 2025.² The EPM Inquiry is intended to ensure consumers receive the benefit of any reduced supply chain costs, and ensure that electricity markets are operating competitively and efficiently, to the benefit of consumers. The terms of reference specifically require the ACCC to monitor and report on three issues the ACCC identified through its REPI in relation to electricity retail, contract and wholesale markets.

Retail electricity markets

The ACCC found that retail electricity pricing structures are confusing to consumers, and discounting practices make it difficult for consumers to compare offers across the market. The ACCC found that retailers' behaviour has led to poor consumer outcomes, in particular:

*Electricity retailers' discounting practices are a deliberate tactic to give the impression that an offer is significantly cheaper than other offers in the market when this is often not the case. This behaviour is confusing, at times misleading, and leads to poor consumer outcomes.*³

As part of this practice, consumers who shop around are rewarded with greater discounts (which in some cases operate as a form of late payment penalty for consumers unable to satisfy the attached conditions) while less active consumers are left on excessively-priced standing offers.

On electricity retail price competition, the ACCC found:

*Retailers' confusing discounting practices indicate a lack of effective competition...Discount offers are presently complex and difficult to compare, which enables retailers to compete less aggressively on price.*⁴

In the absence of effective competition, moderations in wholesale prices create an opportunity for retailers to profit at the expense of consumers by retaining supply chain cost savings rather than passing those savings on to consumers.

A hypothetical example to illustrate the problem is where:

² A joint media release by the then Prime Minister, Treasurer and Energy Minister is available at: <http://sjm.ministers.treasury.gov.au/media-release/089-2018/>

³ ACCC REPI Final Report, page 253.

⁴ ACCC REPI Final Report, page 264.

- a retailer's costs fall substantially due to a significant and sustained decrease in wholesale costs (i.e. the costs of acquiring electricity from the spot market as well as longer-term costs such as contracting to manage exposure to spot price variation); and
- the retailer fails to reduce their prices to reflect the reduced supply chain costs, leaving its consumers on higher-priced offers.

Ordinarily, in a market characterised by effective competitive constraint and price competition, a retailer would be unable to engage in such conduct. This is because one retailer cannot be certain that its competitors will not reduce their prices, and thereby win customers from the first retailer. However, in electricity retail markets, it is possible for retailers to take advantage of consumers' confusion and disengagement and their resulting difficulty in identifying and switching to better deals.

Electricity retail markets have a number of somewhat unique characteristics, which result in consumers' lower levels of responsiveness to price shifts relative to that observed in other markets. These characteristics can be illustrated by comparison to the petrol market:

- *Regularity of consumer engagement:*
 - Consumers generally select a retail electricity offer no more than once a year (at best) and in some cases may only select an offer when they move house.
 - Consumers purchase petrol on a much more regular basis and can more readily identify shifts in prices.
- *Triggers for consumer engagement:*
 - Electricity consumers lack regular 'triggers' to select another offer, as retail electricity contracts are often for 12 months and consumers' electricity supply continues after the contract expires and the benefits under that contract are lost.
 - Consumers often purchase petrol on a weekly basis and are forced to purchase more petrol to continue using their vehicles.
- *Information asymmetry and comparability:*
 - Electricity prices can be difficult to understand and compare, as they consist of both a supply charge and a tariff and may include other variables (such as peak and off-peak tariffs).
 - Petrol prices are prominently displayed outside petrol stations and are expressed in a simple, readily comparable figure of dollars and cents per litre.
- *Industry transition:*
 - The electricity sector is in a period of significant structural change, with factors such as the greater prominence of intermittent generation technology, the progressive ageing and retirement of the existing generation fleet, improvements in technology

(such as smart meters) and greater access to information (such as through the consumer data right).

- The petrol sector is relatively static by comparison.

As part of the EPM Inquiry, the ACCC is undertaking ongoing monitoring of electricity prices faced by customers, including both the level and spread of price offers, analysing how wholesale prices are influencing retail prices and whether any wholesale cost savings are being passed through to retail customers.

Electricity contract markets

Electricity financial contracts are important for effective risk management, as they allow a retailer to set a fixed rate over a specified period, and thereby hedge against the risk of spot market volatility. This, in turn, is critical for confidently operating in the retail market. The ACCC found that a lack of electricity contract liquidity, in part related to vertical integration between electricity generators and retailers, has the potential to become a barrier to entry and expansion for some electricity retailers. The ACCC found that:

In certain regions of the NEM, particularly South Australia, the level of liquidity and the advantages enjoyed by vertically integrated retailers make it difficult for new entrants and smaller retailers to compete effectively in the retail market.⁵

Without sufficient competitive pressure in wholesale and retail markets, these vertically integrated players may have the ability and incentive to withhold contracts from rival retailers, or to discriminate against them regarding price.⁶

A lack of liquidity in electricity contract markets limits the ability for new electricity retailers to enter the market and compete to win customers with better deals. A hypothetical example to illustrate how contracting behaviour (or rather, a lack thereof) can be used for anti-competitive purposes is where:

- Gentaile A, an incumbent generator and retailer, typically offers contracts directly with Retailers A, B and C, standalone retailers with no generation assets of their own;
- Retailer B becomes a significant competitive threat to Gentaile A at the retail level;
- Gentaile A then refuses to contract with Retailer B, for the purpose of ensuring Retailer B is unable to manage its risk and becomes unviable, removing the competitive threat from the retail market and thereby substantially lessening competition.

As part of the EPM Inquiry, the ACCC is undertaking ongoing monitoring of contract market liquidity, including assessing whether vertically integrated electricity suppliers are restricting competition and new entry.

⁵ ACCC REPI Final Report, page ix.

⁶ ACCC REPI Final Report, page 114.

Wholesale electricity markets

The ACCC found that there is a general lack of competitive constraint in wholesale electricity markets. Where behaviour interferes with competitive processes in wholesale electricity markets, increased prices flow through the supply chain to consumers. While the ACCC considered that clear instances of manipulation are not a major feature in the market today,⁷ it also reported that:

This lack of competitive pressure is of concern to the ACCC, particularly given the critical need for a sufficient level of competition in [the wholesale] market to drive affordable electricity prices.⁸

The ACCC went on to recommend a rule against market manipulation (behaviour which has the effect of manipulating the proper functioning of the wholesale market), together with powers to prevent businesses from exploiting cross-market positions.⁹

While there is a broad scope of conduct which may have the effect of manipulating the proper functioning of the electricity wholesale market, a hypothetical example of such behaviour is where:

- a generator schedules discretionary maintenance on a large power plant to occur during a peak period, to cause a spike in wholesale prices and thereby increase the revenue the generator makes through its other plants.

As part of the EPM Inquiry, the ACCC is undertaking ongoing monitoring of wholesale market prices, including the contributing factors to these such as input costs, bidding behaviour and any other relevant factors.

Interaction with existing legislation

There are existing prohibitions and remedies in the *Competition and Consumer Act 2010* (CCA), designed to ensure competitive markets and protect consumers, such as the misuse of market power provision (section 46), a prohibition on exclusive dealing (section 47) and a prohibition on misleading or deceptive conduct (section 18 of the Australian Consumer Law).

However, the issues described above are somewhat unique to the electricity sector and may fall outside the scope of the existing broad prohibitions. For example, section 46 does not prevent a retailer failing to reasonably pass through supply chain cost savings, as this does not have the purpose, effect or likely effect of substantially lessening competition. Other existing prohibitions are similarly not adapted to the unique situation in electricity markets.

Further, there are currently no specific remedies tailored to the electricity sector that could be applied if the ACCC's ongoing monitoring identifies issues in these areas. There is a risk that, unless action is taken, the electricity market might not operate as competitively and efficiently as it could to deliver the best price outcomes for consumers.

⁷ ACCC REPI Final Report, page 96.

⁸ ACCC REPI Final Report, page 87.

⁹ ACCC REPI Final Report, page 96.

Interaction with other Government policies

The Government is progressing a number of other policies designed to address electricity affordability, secure good outcomes for consumers, and promote well-functioning electricity markets. For example:

- the default market offer, as recommended by the ACCC, is intended to reduce the highest retail electricity prices, limiting retailers' ability to exploit their most disengaged consumers;
- the reference bill, as recommended by the ACCC, is intended to establish a common benchmark against which all retail offers and discounts can be compared, providing consumers with greater transparency around retail offers and improving their ability to identify the best deal; and
- the Consumer Data Right will give consumers greater control over their own data and assist consumers to identify and negotiate better deals.

These policies are designed to improve transparency in the retail market and better inform consumers, so that they may select the best deal from amongst retail offers. However, on their own, they do not guarantee that those retail offers reflect shifts in retailers' underlying costs.

3. Case for government action / Objective of reform

Government action is necessary because, as discussed above, the current prohibitions and remedies available in the *Competition and Consumer Act 2010* are not well adapted to the somewhat unique issues that could arise in electricity retail, contract and wholesale markets.

In relation to **retail electricity markets**, there is a risk that electricity retailers retain the savings from any reduced-supply chain costs as profits, rather than pass those on to consumers. In other markets where there is effective retail competition, retailers place competitive pressure on each other to pass on cost savings to consumers, because consumers are engaged and dissatisfied consumers will likely move to a competitor which is offering a lower price. In those markets, there is no need to prohibit a failure to reasonably pass on cost savings. However, in electricity retail markets, retailers may be able to take advantage of consumers' confusion and disengagement. In the absence of government action, retailers may not have a strong enough incentive to offer consumers better deals in response to supply chain cost savings.

In relation to **electricity contract markets**, behaviour which limits contract liquidity can act as a barrier to entry in retail electricity markets. This is because, without sufficient access to electricity financial contracts (such as caps, swaps or power purchase agreements), standalone retailers without generation assets are over-exposed to wholesale spot market volatility. This barrier to entry can undermine effective competition at the retail level, as new retailers may face difficulty entering, or not be on a level playing field with incumbents. Ultimately, ineffective competition at the retail level is detrimental to consumers.

In relation to **wholesale electricity markets**, generators may engage in certain bidding and non-bidding conduct which can undermine effective competition in the wholesale market and distort or manipulate prices, which increases supply chain costs at the expense of consumers.

This measure therefore has a twofold objective:

- Firstly, to ensure that electricity retail, contract and wholesale markets are operating competitively, efficiently and to the benefit of consumers; and
- Secondly, to ensure that consumers realise the benefits of reduced supply chain costs, resulting from more effective competition, policy reform and other factors.

4. Policy options

Three options were considered to ensure well-functioning and competitive electricity retail, contract and wholesale markets and to ensure electricity consumers see the benefits of reduced supply chain costs.

Option 1: Status quo, implementing REPI recommendations

The first option is no action (i.e. maintain the status quo). This option, like options 2 and 3, would involve the implementation of some or all of the REPI recommendations. REPI recommendations which have been agreed by the Government include:

- implementing a cap on the market share of generators, which would prevent further acquisition beyond the cap but permit investment in new capacity (recommendation 1);
- a default market offer, regulated by the Australian Energy Regulator (AER), to replace standing offers (recommendation 30);
- using the default market offer as a reference point for all advertised discounts (recommendation 32);
- placing limits on the size of conditional discounts (recommendation 33); and
- establishing a mandatory code of conduct for energy comparator websites (recommendation 34).

However, under this option there would be no ongoing monitoring of whether electricity retail, contract and wholesale markets are operating competitively and efficiently and no ability to quickly respond to any issues identified. Therefore, this option would not ensure that consumers receive the benefits of any reductions in electricity supply chain costs.

Option 2: Electricity Price Monitoring Inquiry without remedies and sanctions

The second option is that the ACCC undertake an EPM Inquiry without remedies or sanctions to address any misconduct identified by the ACCC. This is in addition to the implementation of some or all of the REPI recommendations (option 1).

Under this option, the ACCC would undertake ongoing monitoring of electricity retail, contract and wholesale markets, and would provide regular reports on its findings.

Where the ACCC identifies unacceptable behaviour, such as a failure to pass through substantial supply chain savings to consumers or behaviour designed to hinder effective competition, the ACCC could publicly report on this conduct and make recommendations for government consideration.

However, under this option there would be no mechanism available to immediately take action against unacceptable conduct. This means that identified harm to consumers or to the competitive process may be able to persist (and potentially worsen) while the Government considers and implements any recommendations made by the ACCC.

Option 3: Electricity price monitoring with remedies and sanctions

The third option is to make available a graduated range of remedies and sanctions to address any misconduct identified by the ACCC. This is in addition to the implementation of some or all of the REPI recommendations (option 1) and the ACCC undertaking an ongoing EPM Inquiry (option 2).

Unlike option 2, this option includes a legislative framework prescribing prohibited conduct, setting out the applicable remedies and sanctions, and providing processes for applying the remedies and sanctions. The legislation would sunset in 2025, unless a review determines that it should continue to operate beyond 2025.

Under this option, at any point during the ongoing electricity price monitoring inquiry, the ACCC or the Government would be able to take action when it identifies a corporation engaging in prohibited conduct.

Prohibited conduct:

Under this option, the legislation will prescribe prohibited conduct in a three-limb provision corresponding to the three limbs of the ACCC's ongoing EPM Inquiry. The prohibition is intended to target behaviour by electricity corporations which is detrimental to competition and/or to consumers.

- The retail pricing limb is targeted toward conduct by retailers that take unfair advantage of consumers' confusion around retail electricity offers and their difficulty in identifying and switching to better deals, by failing to reasonably pass through supply chain cost savings to consumers. This limb would attract the ACCC-imposed remedies (public warning notice, infringement notice) or an ACCC application to the Court for civil penalties. Contracting orders (Treasurer-ordered) and divestiture orders (Court-ordered) would not be available for a breach of this limb.
- The contract liquidity limb is targeted toward conduct whereby a generator refuses to offer electricity financial contracts to a rival at the retail level for anti-competitive purposes. This limb would attract the ACCC-imposed remedies, Court-ordered civil penalties, or a Treasurer-issued contracting order. Court-ordered divestiture would not be available for this limb.
- The wholesale bids and conduct limb is targeted toward bidding and non-bidding conduct by generators, which is anti-competitive or manipulative and can lead to an increase in prices which flows through to consumers. This limb would attract the full suite of remedies detailed below. Contracting orders and divestiture orders would only be available for a breach of the aggravated case of this limb, not for the basic case.

Remedies and sanctions:

Where the ACCC identifies prohibited conduct, the following remedies and sanctions would be available, where appropriate with reference to applicable legislated criteria (which are detailed below).

1) *A public warning notice issued by the ACCC.*

Upon identifying prohibited conduct, the ACCC will be able to issue a public warning notice.

2) An infringement notice issued by the ACCC.

Upon identifying prohibited conduct, the ACCC will be able to issue an immediate infringement notice which includes a penalty amount. Infringement notices are used by the ACCC as an enforcement tool in a number of other contexts.

3) Court-ordered civil penalties on application to the Court by the ACCC.

Upon identifying prohibited conduct, the ACCC will be able to apply to the Court for a civil penalty order. Civil penalties would be in line with those available for other breaches of the competition law, and significantly higher than the penalties available under an infringement notice.

4) Treasurer-issued price cap orders.

The Government has announced that it would implement a default market offer, set by the AER. When this has been implemented, the Government's intention is to provide an additional remedy, whereby the Treasurer could make an order that a corporation's retail electricity offers are capped for a specified period at the level of the default market offer.

5) Treasurer-issued contracting orders.

Upon identifying prohibited conduct in relation to either the contract liquidity limb or the wholesale bids and conduct limb, the ACCC will be able to initiate a notice and response process with the corporation. Following this process, the ACCC could make a recommendation to the Treasurer that would allow the Treasurer to make an order that the corporation offer electricity financial contracts to unrelated parties.

The order will need to specify details such as:

- the amount of generation capacity the offers must relate to;
- a requirement that offers be made on commercial terms (to prevent corporations seeking to circumvent the order by making offers on terms that are unlikely to be accepted);
- the period(s) over which offers must be made; and
- any other details necessary to give effect to the order.

This remedy is essentially a form of structural separation, as it aims to ensure vertically integrated entities are making contracts available to third parties rather than solely (or primarily) using them internally.

6) Court-ordered divestiture on an application by the Treasurer.

Upon identifying an aggravated case of misconduct in the wholesale market, the ACCC will be able to initiate a notice and response process with the corporation. Following this process, the ACCC could make a recommendation to the Treasurer that would allow the Treasurer to apply to the Court for an order that a corporation divest some or all of its assets. In determining whether to accept the

ACCC's recommendation and make an application to the Court, the Treasurer would need to consider not only that the remedy is proportionate and targeted, but also that the public benefit of the order would outweigh any public detriment.

In its REPI Final Report, the ACCC considered divestiture as a mechanism for reducing market concentration (rather than in response to particular prohibited conduct) and did not support it, arguing that its other recommendations would sufficiently address the conduct it identified.

However, the Government considers that divestiture is needed as an additional remedy, to deter corporations from engaging in particularly egregious prohibited conduct. It is intended that divestiture orders would only be sought as a last resort, and subject to a court finding a corporation has breached the aggravated wholesale conduct prohibition. The divestiture order power is a significant deterrent, and it may never become necessary to seek such an order.

Contracting orders and divestiture orders – legislative criteria

Treasurer-issued contracting orders and Court-ordered divestiture orders are subject to a requirement that the chosen remedy must be a proportional means of preventing the corporation from engaging in that conduct in future. This is designed to ensure that the remedies cannot be applied where this would be disproportionate and a lesser remedy would be as effective in preventing the conduct from re-occurring.

In relation to divestiture orders, there is an additional legislative test to be met by the ACCC (in making a recommendation to the Treasurer) and the Treasurer (in determining whether to make an application to the Court), whereby the actual or likely public benefit of a divestiture must outweigh any actual or likely detriment.

Public benefit is a broad concept, encompassing benefits to the market (e.g. increased competition, for example where an asset can be sold to assist a new market entrant), and to consumers (e.g. lower prices which may flow from increased competition), among other potential benefits.

Similarly, public detriment is also a broad concept, encompassing detriment to the market (e.g. any investor uncertainty) as well as any detriment to consumers (e.g. where a divestiture would be detrimental to system reliability, or might lead to increased prices in the longer term) among other potential detriments.

The public benefit and detriment of a particular divestiture would need to be weighed on a case-by-case basis with reference to the specific circumstances. These concepts are further explored in section 4.

In determining whether to make a divestiture order, the Court is also subject to the test of proportionality.

Notice and response process for Treasurer-issued remedies

For more serious conduct, where the ACCC considers a contracting or divestiture order is warranted, this option provides for the ACCC to engage with the corporation to resolve the issue before making a recommendation to the Treasurer.

This would involve the ACCC issuing a notice to the corporation, stating that the ACCC considers the corporation has engaged in prohibited conduct, and giving the corporation an opportunity to provide a response explaining its conduct or detailing how it will remedy its conduct, as well as an opportunity for the corporation to comment on the recommendation under consideration.

The ACCC will then have a period to consider the corporation's response, and will give a notice to the Treasurer either recommending the Treasurer take action (either that the Treasurer make a contracting order, or apply to the Court for a divestiture order), or stating that no action is recommended.

The Treasurer will then have a period to consider the ACCC's notice. Where the ACCC recommends that no action be taken, the Treasurer will take no action. Where the ACCC recommends a remedy, the Treasurer will be required to consider whether the relevant tests are met (including proportionality, and an additional public benefit test for divestiture) before determining whether or not to accept the ACCC's recommendation.

If the ACCC recommends that the Treasurer seek a Court-ordered divestiture order, and the Treasurer considers all relevant tests are met, the Treasurer will then apply to the Federal Court seeking that a divestiture order be made.

5. Cost benefit analysis of each option / Impact analysis

This section discusses the expected impact of each policy option. Each of the three policy options is likely to have some impact on electricity corporations (retailers and generators, some of which are vertically integrated as 'gentailers') and electricity consumers.

Option 1: Maintain the Status Quo, implementing REPI recommendations

Option 1 is the implementation of some or all of the REPI recommendations with no additional action. REPI recommendations which have been accepted by the Government are detailed in section 3.

The REPI made a number of recommendations related to electricity retail, contract and wholesale markets, which are expected to be beneficial in terms of promoting more effective competition and reducing supply chain costs. The ACCC reported that electricity consumers, in particular residential consumers and small businesses, could see substantial savings as a result of the implementation of its recommendations.

Each of options 1, 2 and 3 *should* carry these benefits to electricity consumers in the form of lower prices, and to electricity markets in the form of increased competition. In their submissions to the consultation paper, some stakeholders suggested the Government should focus on progressing the ACCC recommendations as these would do more to promote competition and address the causes of high prices.

However, the ACCC's estimated savings and other benefits will only eventuate if electricity corporations' behaviour supports effective competition, and if retailers choose to pass through those savings. Under this option, there is no ongoing monitoring of conduct and no guarantee of

retailers passing through any supply chain cost savings, resulting from increased competition, policy reforms and other factors, to consumers.

This option would impose no additional regulatory costs on electricity corporations, other than those being considered and dealt with separately as part of the implementation of individual REPI recommendations.

Option 2: Electricity price monitoring without remedies and sanctions

Option 2 is the implementation of some or all of the REPI recommendations (option 1), with an ongoing EPM Inquiry, but without remedies or sanctions available to address any misconduct identified by the ACCC.

The option has the added benefit of shining a light on the behaviour of participants in electricity retail, contract and wholesale markets. Electricity corporations would know that their behaviour is under constant monitoring between 2018 and 2025, with the prospect of the ACCC publicly reporting on any behaviour which is not in the interests of effective competition or which contributes to poor outcomes for electricity consumers. In and of itself, this monitoring and reporting may prompt a positive behavioural change by electricity corporations.

Similarly, where the ACCC publishes reports identifying unacceptable behaviour by particular corporations or data about the relative prices offered by retailers, this could theoretically prompt consumers to seek and switch to a better deal. Over time, this could provide sufficient competitive pressure for electricity companies to behave in a way that is pro-competitive and in the interests of their consumers. However, as discussed in section 1, the electricity market faces a somewhat unique problem in that there is a sub-set of consumers who are disengaged from the market and are not responsive to changes in price. It is likely that these consumers would continue to stay on an unfavourable offer, even if the ACCC makes a publication that the particular offer is excessively high relative to other offers in the market. This option therefore has the potential to exacerbate the problem of ‘winners and losers’ amongst retail electricity customers.

Further, where the ACCC identifies unacceptable behaviour, it would have no immediate enforcement tools available to address the conduct beyond ‘naming and shaming’ in its reports and making recommendations for Government consideration. Such recommendations may take months, or even years, to implement depending on their nature. As electricity companies would be aware of the ACCC’s lack of enforcement tools, they would have little incentive to take immediate steps to remedy their conduct, and are likely to wait for the Government to action recommendations made in the ACCC’s six-monthly reports. This may mean that behaviour which hinders effective competition, or is detrimental to electricity consumers, could persist or even worsen over time. The lack of enforcement tools is therefore considered a significant hindrance to the effectiveness of the EPM Inquiry.

Option 2: Regulatory burden costings:

This option is expected to carry regulatory compliance costs, insofar as the ACCC issues information-gathering notices under section 95ZK of the *Competition and Consumer Act 2010* to electricity corporations. It is expected that compliance with such notices will cost businesses

approximately \$420,000 per year over ten years. This figure is based on the following assumptions, based on the REPI:

- The ACCC is assumed to issue approximately 80 information-gathering notices per year, primarily to electricity retail and electricity businesses. Over the course of the REPI, the ACCC issued over 110 notices over 15 months.¹⁰
- It is assumed that it will take an average of approximately 110 hours to comply with each notice, noting that it may take more or less time to comply depending on the precise requirements of the notice.

The REPI was a very recent and comprehensive examination of the electricity supply chain, and it is expected that the EPM Inquiry may not need to cover precisely the same ground. These estimated regulatory costs therefore represent an upper estimate.

Regulatory burden estimate table – Option 2

Average annual regulatory costs (from business as usual)				
Change in costs (\$ million)	Business	Community organisations	Individuals	Total change in costs
Total, by sector	\$0.42m	\$0	\$0	\$0.42m

Option 3: Electricity price monitoring with remedies and sanctions

Option 3 is the implementation of some or all of the REPI recommendations (option 1), with an ongoing EPM Inquiry (option 2), **with** remedies or sanctions available to address any misconduct identified by the ACCC.

In addition to the benefits detailed under options 1 and 2, this option has the added benefit of providing the ACCC and the Government with a graduated range of enforcement tools and a procedure for taking more immediate action against conduct which breaches a new set of prohibitions tailored to the electricity retail, contract and wholesale markets.

Two elements of the legislative framework, the prohibitions and the remedies, are expected to carry significant non-regulatory costs and benefits. These costs and benefits are expected to occur across electricity markets, with few geographical differences, except as detailed below.

The prohibitions

While there is a degree of overlap with existing prohibitions, the prohibitions considered are new and specific to the regulatory framework for the electricity sector.

In their submissions to the consultation paper, many stakeholders noted the importance of ensuring the prohibitions recognise the somewhat unique design and operation of electricity markets. They

¹⁰ ACCC REPI Final Report, page 357.

noted that improperly designed prohibitions could have unintended consequences, such as interfering with retailers' risk management strategies and risking their viability, or exposing consumers to price volatility which retailers would otherwise seek to smooth out.

Noting these stakeholder concerns, the prohibitions have been carefully designed to strike an appropriate balance between capturing unacceptable conduct and not over-capturing legitimate conduct. The explanatory memorandum provides detailed guidance on the intended scope of the prohibitions.

The **retail price limb** has been designed to require that sustained and substantial supply chain cost savings are *reasonably* passed through to consumers. Retailers' submissions questioned this limb, and suggested that this prohibition would amount to price regulation and cause risks to their viability. However, this limb does not require retailers to immediately pass through savings in response to small or short-term price fluctuations, as this would expose consumers to price volatility.

Similarly, it does not presume a 'one size fits all' approach, noting that different retailers will be in different positions and therefore it will not necessarily be reasonable to require all retailers to reduce their prices by the same amount in response to a particular change in conditions. For example, it would be open to a retailer to argue that it is not reasonable to pass through wholesale cost savings if their overall costs of supply had remained the same, or had increased (for example due to contracting to manage risk).

The main point is that retailers are required to *reasonably* pass through any supply chain savings, and this allows a case-by-case, holistic assessment by the ACCC of what is reasonable in the given circumstances. To the extent that retailers reduce their prices, consumers will benefit.

The **contract liquidity limb** has been designed to capture unreasonable refusals to contract, where this is done with the purpose of substantially lessening competition. It is not intended to interfere with efficient risk management strategies by electricity corporations (including gentailers). It does not require the cancellation of any contracts which are on foot, nor does it require electricity corporations to fundamentally change their contracting behaviour, unless their current contracting behaviour has the purpose of substantially lessening competition. The limb has a narrow focus on contracting behaviour which has the purpose of substantially lessening competition, which acknowledges that while there may be broader structural issues affecting contract liquidity, they should be addressed outside of this legislative framework. Contracting which is a part of a genuine risk management strategy will not breach the prohibition.

As part of its REPI Final Report, the ACCC recommended introducing a market-making obligation in South Australia (i.e. a requirement that large, vertically-integrated retailers make offers to buy and sell specified hedge market contracts each day, to boost hedge market activity). The Energy Security Board recently undertook consultation on the proposal, and is expected to provide advice to the COAG Energy Council in due course. If implemented, the proposal goes as far, if not further than, the contract liquidity limb of the prohibition, as it would actively require electricity corporations to make offers.

Similarly, the Retailer Reliability Obligation (for intended introduction in July 2019), also contains a form of contracting obligation (the Market Liquidity Obligation) which can be imposed on retailers in the event that reliability obligations are triggered. As businesses adjust for the Retailer Reliability Obligation, contract liquidity in these States is likely to improve.

Finally, the **wholesale bids and conduct limb** has been designed to use terms which are familiar to wholesale corporations, and again has been designed with the operation of the wholesale market in mind. For example, the NEM wholesale spot market operates in such a way that transitory market power is acceptable (indeed, it is considered an efficient signal for new investment). The NEM spot market also allows generators to bid and rebid at a range of prices to reflect the prevailing market conditions of supply and demand at a given time. The prohibition does not seek to prevent these outcomes. Rather, the prohibition seeks to target conduct which is not a part of genuine commercial operation in the market, and seeks to distort or manipulate prices. This limb is split into a basic case, for which contracting orders and divestiture orders are not available, and an aggravated case, which captures more serious conduct for which contracting orders and divestiture orders may be a proportionate response.

The ACCC is expected to release guidance about its approach to enforcing the prohibitions, to increase market participant certainty.

The Government expects that electricity corporations will be able to comply with the new prohibitions, as these should reflect the features of a well-functioning electricity market.

The remedies

The remedies, as detailed in section 2, range from a public warning notice issued by the ACCC up to contracting orders and divestiture. The legislative criteria ensure that the appropriate remedy is selected, through a series of tests, including that the chosen remedy must be proportionate (i.e. no more severe than is necessary to address the prohibited conduct in question). In particular, it is intended that the Treasurer would apply to the Court for a divestiture order only as a last resort, and where the public benefit of such action would outweigh any detriment.

The remedies are expected to have broader costs and benefits in two ways. Firstly, through their existence, independently of whether they are used, and secondly in the event they are used.

Existence of the remedies

The prospect of tough remedies, such as the contracting order and in particular the divestiture order, provides a very strong incentive for electricity corporations to avoid breaching the new prohibitions (i.e. to behave in a way that does not hinder effective competition, and is not detrimental to electricity consumers). Given the nature of the remedies, it is possible that their mere introduction to the electricity sector's regulatory framework imposes some non-regulatory costs and benefits.

While some of the remedies available are broadly consistent with existing enforcement mechanisms available to the ACCC, such as infringement notices and civil penalties, others are relatively new in their application as remedies rather than voluntary undertakings. For example, Court-ordered divestiture orders are available under the CCA as a remedy for mergers or acquisitions which breach

the CCA, and act to unwind the offending transaction. Outside of the CCA and foreign investment framework, divestiture is generally not available as a remedy.

The submissions to the consultation paper generally expressed concerns that the prospect of contracting orders and divestiture orders as remedies could be expected to negatively impact investor confidence. Submissions argued the prospect of remedies of this nature might either:

- add a risk premium to investment, as financiers judge that investing in the electricity sector carries greater risks than in the past; or
- deter future investment, as potential investors may judge that investment in the electricity sector carries greater risks than in the past and that returns on investment may be reduced.

Each of the above would increase costs to consumers.

It is difficult to quantify the impacts on investment, given much depends on the nature of the investment (for instance, new build or refurbishment), its location and prevailing market conditions around that investment such as price volatility. In some exercises, it is possible to model the impact on investment through a risk premium which would be imposed on the weighted average cost of capital for generation investment.

It is not possible to reliably estimate or quantify policy uncertainty for this legislation using such an approach, as there are many factors at play and significant uncertainty as to how they may play out. It is possible to assess with that the likely impact of introducing contracting orders and particularly divestiture orders to the regulatory framework would increase the cost of capital, particularly during the initial transitional period under the legislation, but this cannot be quantified with confidence.

However, with the possibility of introducing additional investor uncertainty in mind the legislative framework has been designed to put sufficiently clear criteria around when and how the remedies can be used. In particular, divestiture orders may only be made by the Court on the application of the Treasurer.

In light of this design, potential investors in the electricity sector should not be deterred by the legislative framework, unless their intention is to engage in conduct which is detrimental to competition or consumer welfare.

Further, as discussed above, over time corporations will become more familiar with the legislation and the ACCC's approach to enforcement.

Use of the remedies

In the event the remedies are used, they could be expected to have effects not just on the business which is subject to the order, but on the broader market. As such, the benefits and costs of sanctions will need to be carefully considered as part of the decision-making framework.

In the case of a Court-ordered divestiture order, for example, it is possible that both the divested and remaining parts of a business could become less efficient as a result. This is particularly so for vertically integrated gentailers, which rely on significant internal efficiencies. At worst, a divestiture order could result in the relevant business becoming unviable. This would not be in the interests of

the market, as it could result in fewer competitors, a possible resulting increase in market concentration, and a lessening of competition. Less efficient businesses, or fewer businesses in the market, could in turn result in higher prices for consumers.

On the other hand, a divestiture order could promote competition, as it may allow for new market entry or for smaller market players to expand and promote competitive pressure for all corporations.

Before the Treasurer may apply to the Court for a divestiture order, the legislation requires a consideration of the public benefits and detriments of a divestiture order, such that both the ACCC and the Treasurer must be satisfied there would be a net public benefit.

Similarly, a contracting order could have both costs and benefits, depending on the specific circumstances of the case. For example, it might be possible for prices to increase if vertically integrated generators enter into enough hedging contracts that they lose some of the efficiencies of vertical integration. On the other hand prices could decrease if sufficient contract liquidity allows more efficient hedging of risk for a wide set of market participants.

With this in mind, one factor which must be considered in making a contracting order is the amount of generation capacity the relevant corporation holds, and the nature of that capacity. This is designed to safeguard against requiring a generator to contract to the point where its own viability becomes questionable. Another factor to be considered is the generator's commitments to its load of retail customers (if any). This is to ensure that a contracting order does not undermine a generator's ability to supply its retail customers, or expose those customers to risk.

The exact impact on electricity prices in each market segment will depend on a number of factors, including but not limited to: the concentration of generation market share in each State, the volume of hedge contracts sought by retailers and the extent of spot price volatility over a given period.

To the extent that a contracting order promotes improved contract liquidity, it would be expected that States with poorer contract liquidity would benefit most.

Conclusion

Except as described above, it is expected that States and Territories will equally experience the costs and benefits detailed in this section.

With these costs and benefits in mind, the legislative framework has been designed so as to:

- carefully prescribe prohibited conduct, so that electricity companies can operate in the market with certainty as to when their conduct will or will not attract the remedies;
- provide a notice and response process for the tougher remedies, giving the corporation an opportunity to resolve the issue with the ACCC and avoid the application of those remedies; and
- explicitly link the tougher remedies to the types of breaches they are best adapted to address;

- subject the tougher remedies to a series of criteria to ensure they are only available where appropriate, for the most egregious conduct.

Option 3: Regulatory burden costings

Under option 3, electricity corporations will face three sources of regulatory costs.

Firstly, electricity retailers and generators will incur the regulatory costs associated with the EPM Inquiry, as detailed above.

Secondly, it is expected that electricity retailers and generators will incur additional legal costs during the initial transitional period, to educate themselves about the new regime and ensure their business practices are compliant. Some businesses may also need to make adjustments to their internal processes, to ensure compliance with the new legislation. These adjustment costs are not expected to be substantial, as the legislation is not intended to interfere with ordinary business practices by electricity businesses (such as good faith bidding behaviour by electricity generators, and contracting as part of genuine risk management strategies). The legislation is targeted toward behaviour which is harmful to competition and detrimental to electricity consumers.

Once electricity businesses have factored the new regime into their existing practices, it is expected that on average the additional regulatory costs will be minimal. Corporations operating outside of electricity retail, contract and wholesale markets will not need to seek legal advice or adjust their business practices, as the regime is limited to the electricity sector.

It is estimated that this initial legal advice and once-off adjustments to internal processes will cost businesses approximately \$290,000 per year over ten years. This figure is based on the following assumptions, based on the advice and experience of the ACCC:

- The regime will apply to approximately 90 electricity retail and generation businesses.
- Of these 90 businesses, 50 are considered larger active retailers and scheduled generators, to which the legislation is primarily directed. These businesses are expected to bear the majority of the regulatory costs associated with the legislation.
 - The costings assume that each of these 50 businesses will seek an average of 75 hours of legal advice and spend an average of 225 hours of internal staff time to adjust their internal practices.
- Of these 90 businesses, 40 are considered smaller entities (such as smaller wind or solar farm operators) and those operating outside the National Electricity Market, which fall within the scope of the legislation, but are not the entities to which the legislation is primarily directed. These businesses are expected to bear limited compliance costs.
 - The costings assume that each of these 40 businesses will seek an average of 10 hours of legal advice and spend an average of 20 hours of internal staff time to adjust their internal practices, substantially less than those firms to which the legislation is primarily directed.

- In the above figures, vertically integrated businesses (gentailers) and other corporate groups are counted once, and generators and retailers operating in multiple States are counted once.

Finally, where the ACCC identifies potential prohibited conduct through its EPM Inquiry, it may issue one or more notices under section 155 of the *Competition and Consumer Act 2010* to investigate the potential contravention. A section 155 notice may require electricity corporations to provide information, documents or evidence relevant to the potential contravention. It is expected that, each year, only a small number of electricity corporations would be issued with such notices.

It is estimated that responding to section 155 notices will cost businesses approximately \$79,000 per year over ten years. This figure is based on the following assumptions, based on the advice and experience of the ACCC:

- The ACCC is assumed to issue section 155 notices in relation to two matters each year, issuing 5-10 notices per matter (an average of 15 notices per year). In practice, the ACCC may undertake more or less than two investigations per year, depending on the extent of electricity businesses' compliance.
- It is assumed that it will take an average of approximately 110 hours to comply with each section 155 notice, noting that it may take more or less time to comply depending on the precise requirements of the notice.

A number of costs fall outside the scope of the Regulatory Burden Measurement Framework, and have been excluded from the regulatory burden costings below:

- Any compliance costs associated with the REPI recommendations¹¹ are excluded as those recommendations and any associated compliance costs exist independently of the legislative framework and those compliance costs are not imposed by the legislative framework.
- Any compliance costs related to, or flowing from, a contravention of the prohibitions, such as the costs of penalties or the costs of seeking judicial or merits review. These are considered costs of non-compliance.

Similarly, the broader economic costs and benefits associated with the legislation have not been quantified. However a detailed qualitative analysis is provided above in place of costings.

As the average annual regulatory burden is estimated at less than \$2 million per year, Treasury has self-assessed the costs in the table below.

A regulatory offset has not been identified. However, Treasury is seeking to pursue net reductions in compliance costs and will work with affected stakeholders and across government to identify regulatory burden reductions where appropriate.

Regulatory burden estimate table – Option 3

¹¹ In relation to the REPI recommendations, the ACCC's Final Report was certified in place of a RIS.

Average annual regulatory costs (from business as usual)				
Change in costs (\$ million)	Business	Community organisations	Individuals	Total change in costs
Total, by sector	\$0.79m	\$0	\$0	\$0.79m

6. Consultation

The three issues in relation to electricity retail, contract and wholesale markets, which form the basis of the ACCC's electricity price monitoring inquiry and the prohibitions in this legislative framework, went through consultation processes.

As part of the REPI, stakeholders had opportunities to make submissions to both an Issues Paper (31 May 2017) and Preliminary Report (13 July 2017), as well as provide comments at public forums. Non-confidential written submissions are available on the ACCC's website.

The Government announced the electricity price monitoring and response regime on 20 August 2018, and the ACCC was formally tasked with undertaking the EPM Inquiry by the former Treasurer on the same day.

In developing the policy underlying the legislative framework, the following objectives were considered crucial:

- providing a mechanism to ensure effective competition in electricity retail, contract and wholesale markets;
- providing a mechanism to ensure reduced electricity supply chain costs, resulting from more effective competition, policy reforms and other factors are passed on to consumers;
- ensuring the framework does not capture legitimate and appropriate behaviour by electricity corporations;
- ensuring the availability of effective remedies for prohibited conduct; and
- allowing for effective compliance monitoring and enforcement by the ACCC.

With this in mind, the policy was developed through targeted consultation with electricity market participants, ACCC, AER, AEMC, Energy Security Board and others.

On 23 October 2018, the Government released a Consultation Paper containing policy proposals for framing the prohibited conduct, the graduated range of remedies and enforcement, ACCC engagement with corporations and recommendations to the Treasurer, and review processes.

As part of this process, the Government actively sought submissions from stakeholders representing a wide range of interested parties, including (in addition to those mentioned above):

- Electricity corporations (both directly and via the Australian Energy Council);
- The Business Council of Australia; and
- The Law Council of Australia.

Submissions closed on 7 November 2018. During the consultation period, 14 submissions were received.

Submissions generally focused on the merits of the policy, rather than on the design and workability of the legislation. However, the submissions raised some important considerations which were taken into account in finalising the drafting. These related in particular to the framing of the prohibitions to ensure they provide corporations sufficient certainty to continue with genuine pricing behaviour, wholesale market conduct and risk management strategies. Specific comments are discussed above in section 4.

The Government announced its objective to introduce the legislation before the end of 2018. Given this objective, and the fact consultation has already occurred on the REPI and on the policy design underlying the legislative framework, the Government conducted a short and targeted consultation with stakeholders on draft legislation following the public consultation process. This allowed the Government to identify remaining issues and refine the final drafting of the legislation.

A key concern raised by stakeholders was around the proposal that the Treasurer would be able to make a divestiture order. The Government has responded to this concern by providing that a divestiture order can be made by the Court, on the application of the Treasurer, and upon the Court both making a finding that there has been a breach of a prohibition and considering that a divestiture order is a proportionate response.

A further concern raised by stakeholders was that some of the potential remedies may not be appropriate for particular breaches of the legislation. For example, a divestiture order would likely not be considered 'proportionate' or 'targeted' to a breach of the retail pricing prohibition, and would therefore be unlikely to satisfy the proposed tests for making an order, but divestiture orders were not explicitly excluded for such a breach. In response to this concern, the contracting order and divestiture order were more explicitly linked to particular breaches. The legislation allows a contracting order for a breach of the contract liquidity limb or the aggravated wholesale limb, but not for the retail pricing limb or basic wholesale limb. Similarly, a divestiture order may only be made for a breach of the aggravated wholesale limb, but not for any other limb.

7. Preferred option

Of the three options considered, the Government considers that the strongest means for achieving its policy objective (as detailed in section 2) is establishing a legislative framework which reflects the Government's and community's expectations about acceptable conduct in electricity retail, contract and wholesale markets. A legislative framework provides a clear mechanism to address the identified issues in electricity retail, contract and wholesale markets.

While options 1 and 2 should theoretically promote more effective competition in electricity retail, contract and wholesale markets, and lead to lower prices for consumers, those outcomes may not eventuate under options which lack strong incentives for compliance.

Option 2 carries lower regulatory costs than option 3. However, while the ACCC's public reporting of any unacceptable behaviour in electricity markets may prompt *some* consumers to move to better deals, disengaged consumers are unlikely to do so and will be disadvantaged under this approach. As discussed in other sections of this document, the electricity market has a number of somewhat unique characteristics, and many consumers do not respond to pricing changes the way they do in other sectors. Option 2 does not guarantee that electricity firms will behave in the interests of their consumers, as it lacks strong incentives for compliance.

Option 3 carries the highest regulatory costs, as well as the most significant non-regulatory costs. However, option 3 also carries the greatest non-regulatory benefits. Further, the non-regulatory costs under option 3 are expected to be mitigated through the careful design of the legislation, and are also expected to be largely transitional. Once the market gains an understanding of the new legislative framework and adjusts, it is expected that any fear and uncertainty on the part of electricity corporations will be significantly reduced, while the benefits to electricity consumers will be enduring.

The Government therefore considers that option 3 carries the greatest net benefit to the community. While it represents the strongest approach, the level of consumer protection is considered proportionate to the risks of electricity firms engaging in conduct which is harmful to competition and detrimental to consumer welfare (i.e. failing to address electricity affordability, which creates an impediment to accessing an essential consumer good and disproportionately affects consumers in financial hardship).

8. Implementation and evaluation

Once the legislation is in place, implementation will be undertaken by the ACCC. It is expected that the ACCC will, in accordance with its usual practice, issue guidelines on its approach to enforcing the legislation.

The ACCC's EPM inquiry is due to run for seven years, from 2018 to 2025. The legislation will sunset in 2025, at the conclusion of the monitoring inquiry. However, The Government's intention is that a review will be conducted in 2024 to determine whether the inquiry and legislative framework should be extended beyond 2025.

The effectiveness of the legislative framework will be measured with reference to the three problems identified in section 1. The legislative framework will be considered successful if:

- price outcomes for consumers, both individually and on average reflect underlying wholesale electricity costs;
- electricity contract markets are sufficiently liquid to allow for competition among retailers; and
- wholesale electricity markets are characterised by effective competition and competitive constraint.

The ACCC's ongoing inquiry is well-suited to monitor these outcomes over time.