



Potential Generator Market Power

Directions Paper released for public comment

The AEMC is considering a Rule change request that was submitted by an industry association, the Major Energy Users (MEU), which seeks to constrain the potential exercise of market power by generators in the National Electricity Market (NEM). As an important step in the assessment of that proposal, the AEMC has released a Directions Paper setting out its proposed approach to the definition of market power in the context of the NEM.

Public consultation

Consultation on the Rule change proposal commenced in April 2011 with submissions to the AEMC's Consultation Paper. Nineteen submissions were received from generators, retailers, users, user groups, consumer groups, government and regulators. Views varied significantly on issues raised by the MEU's proposal and submitters proposed very different approaches to defining market power.

The Commission is now seeking submissions in response to the proposed approach set out in the Directions Paper. The Commission also seeks submissions in relation to whether there is evidence of the exercise of substantial market power, as defined in the paper.

Submissions close on 17 November 2011. Following consideration of submissions, the Commission will assess whether there is evidence of the exercise or likely exercise of substantial market power.

The Commission will also hold a public forum in Adelaide in October 2011.

Proposed definitions

The Directions Paper sets out the Commission's proposed definition of 'substantial market power' in the context of the NEM, which is:

"The ability of a generator 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."

The paper also defines the 'exercise' of substantial market power. The Commission considers that regulatory intervention is only potentially justified if there is evidence that a generator has exercised, or is likely to exercise, substantial market power.

"A generator exercises substantial market power where it engages in conduct that has the effect of increasing annual average wholesale prices to a level that exceeds LRMC, and the generator is able (or is likely to be able) to sustain prices at that level due to the presence of significant barriers to entry."

The relevant cost measure for the purposes of these definitions is LRMC. LRMC estimates the cost in net present value terms of bringing forward the cost of capacity expansions to meet a sustained increase in demand. The relevant price is the annual average wholesale price, which will be determined having regard to both spot and contract prices.

Substantial market power

The Commission considers that 'substantial market power' is a more appropriate concept than 'market power' in the context of the NEM. This approach distinguishes between:

- substantial market power, which involves sustained pricing above the level that would prevail in a workably competitive market; and
- transient pricing power, which involves a transitory ability to increase prices above variable costs for short periods of time.

The Commission considers that a transient increase in wholesale electricity spot or contract prices is not, in itself, sufficient to constitute a market power problem that justifies

The AEMC invites submissions on the Directions Paper.

Submissions close on 17 November 2011

regulatory intervention. Price spikes may constitute evidence of substantial market power, but only if they occur with sufficient frequency to cause annual average wholesale spot or contract prices to exceed LPMC.

The Commission's approach has been guided by the National Electricity Objective (NEO), which relates to the promotion of efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers.

If a generator can sustain high wholesale spot or contract prices that exceed LPMC, those prices are likely to flow through to the prices that users pay for electricity. Those high prices are likely to result in inefficient investment and inefficient use of electricity services. Electricity is a vital input into most goods and services, and sustained high electricity prices can also have a significant impact on the broader economy.

In contrast, transient wholesale price spikes are not likely to have the same effect on achievement of the NEO or the economy. Indeed, occasional price spikes are an inherent feature of a market such as the NEM and provide a mechanism for generators to recover their efficient fixed costs. If price spikes were prevented, investment is likely to be deterred as generators may not be able to recover their efficient costs. That would be likely to result in higher prices and lower levels of reliability over the longer term.

Wholesale electricity market pricing and the MEU's proposal

Generators sell their electricity into the wholesale electricity market. Retailers purchase electricity in the wholesale market and sell it to consumers. Some large users also buy electricity directly from the wholesale market.

Generators compete with each other to sell their electricity into the wholesale market by submitting offers for each 30 minute trading interval. Generators are paid a wholesale spot price that is determined for every trading interval. The spot price can vary significantly depending on the level of supply and demand, from a floor of -\$1,000/MWh to a cap of \$12,500/MWh. Generators also enter into financial contracts to manage some of their exposure to future prices by locking in a price for electricity they intend to sell in the future.

Higher spot and/or contract prices can provide an important incentive for new generation investment. Generators in the NEM earn almost all of their revenue from spot or contract wholesale energy prices. To encourage investment, generators must have a reasonable expectation that wholesale prices will cover the fixed costs of building a generating unit as well as ongoing fuel and maintenance costs.

The MEU's Rule change request seeks to amend aspects of how wholesale prices are currently set. The MEU is concerned that some generators have market power that they are able to use to cause the wholesale spot price to rise to high levels during periods when demand is very high.

To address this perceived problem, the MEU proposes that the Australian Energy Regulator should assess which generators have market power and declare them to be 'dominant generators'. When demand exceeds a pre-determined level, each dominant generator would be required to offer all of its available capacity for dispatch at a price that does not exceed \$300/MWh. All other generators would remain free to offer any price up to the current market price cap of \$12,500/MWh.

Other matters addressed in the Directions Paper

In addition to explaining the Commission's proposed definitions, the paper also explains:

- the Commission's views on the definition of the relevant 'market' to be used when assessing whether a generator possesses substantial market power;
- why the Commission considers that it is not appropriate to address 'tacit collusion' as part of this Rule change process; and
- the Commission's response to submissions regarding its power to make the MEU's proposed Rule and whether it is the appropriate body to consider these issues.

The Commission has also published a report that it commissioned from NERA Economic Consulting, and a peer review of that report by Professors Joshua Gans and Stephen King.

For information contact:

AEMC Chairman, **John Pierce** (02) 8296 7800

AEMC Project Leader, **Richard Owens** (02) 8296 7800

Media: Communication Manager, Prudence Anderson 0404 821 935 or (02) 8296 7817

22 September 2011