



## Final determination on potential generator market power

**The Commission recommends that energy ministers consider giving new functions to the Australian Energy Regulator to regularly report on whether the wholesale electricity market is operating efficiently. The Commission today released its final determination on potential generator market power in the National Electricity Market.**

### The Commission's final determination

The Australian Energy Market Commission (AEMC) has determined to make no rule on the rule change request proposed by the Major Energy Users Inc. (MEU) relating to the potential exercise of market power by generators in the National Electricity Market (NEM).

The Commission considers there is insufficient evidence to support the proposition that substantial market power will be exercised in the current market environment.

The Commission accepts that there are some circumstances in which substantial market power could exist and be exercised in the NEM. This view is particularly informed by the Commission's analysis of outcomes in South Australia.

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

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

### Reasons for the Commission's final determination

#### Defining market power

In order to ensure that the assessment of the likely impact of the proposed rule is robust, the Commission considered it important to establish a clear definition of 'market power' and to consider how this concept should be applied in the context of the NEM.

In doing so, the Commission has taken into consideration that spot price volatility is an inherent and necessary feature of a market with the characteristics of the NEM.<sup>1</sup> Pricing flexibility is essential for maintaining a reliable system given the range of factors that impact on the dynamics of both demand and supply of electricity. A generator's transient ability to increase wholesale prices should not be considered an issue unless that power is exercised to such an extent or with sufficient frequency that it causes long term average prices to be above the efficient level for a sustained period of time.

Efficient long term wholesale prices should, averaged over time, be expected to be at the level required to recover the cost of building new generation or transmission capacity to satisfy consumer demand.<sup>2</sup>

#### Assessing the existence or exercise of substantial market power

The Commission undertook analysis of wholesale prices compared to efficient long term wholesale costs and the potential presence of barriers to entry for the period from 2005 to 2012. This included all the periods of time highlighted by the MEU as periods in which it considered market power had been exercised by generators in the NEM.

<sup>1</sup> The NEM is an energy only market where generators receive payment from the market for energy produced. This is in contrast to so called capacity 'markets' where customers bear the risk of decisions by a central planning agency as to how much capacity should be purchased to achieve an efficient outcome.

<sup>2</sup> To determine the efficient long term prices the AEMC has used the economic long run marginal cost.

**The AEMC recommends the Standing Council on Energy and Resources provides the AER with a specific function to monitor the efficient operation of the National Electricity Market.**

The Commission engaged the Competition Economists Group (CEG) and NERA Economic Consulting (NERA) to assess, respectively, to what extent barriers to entry can be said to exist in the NEM and to what extent prices have been maintained above efficient long term wholesale prices in various regions of the NEM.

For New South Wales, Queensland and Victoria this analysis shows results which are consistent with a wholesale electricity market that responds to the supply demand position broadly in the way that would be expected of a workably competitive market.

The Commission considers NERA's results for South Australia to be less clear. Annual average wholesale spot prices for the most recent two year period from 2010-2011 to 2011-2012 are significantly below the efficient long term wholesale prices.

However, there is a three year period in the analysis, from 2007-2008 to 2009-2010, where for two years the wholesale electricity prices could be observed to be near the top of the long run efficient cost range and one year where prices have exceeded the market modelled long run efficient cost.

In the case of South Australia, the Commission therefore considers that, to the extent that any substantial market power may possibly have been exercised by generators in South Australia in the period from 2007-2008 to 2009-2010, the following years have demonstrated the response to these price outcomes that is consistent with what would be expected of a well-functioning market.

In more recent years there have been developments in the wholesale market that make the exercise of substantial market power unlikely, in particular falling demand and a greater uptake of wind generation.

### **MEU's rule change request**

In the MEU's rule change request, the Commission was asked to consider making a rule which would impose restrictions on dispatch offers that may be submitted by a 'dominant generator' (to be determined by the AER for each NEM region). The offer restrictions would come into play when regional demand exceeds the level at which the generator has been declared to be a dominant generator.

A rule as proposed by the MEU, or similar, which seeks to limit occasional price spikes by capping generator dispatch offers, is difficult to reconcile with the fundamental features of the NEM. A rule that limits the ability of generators to bid during particular periods in a manner that seeks to recover their efficient costs over time is likely to be detrimental to the NEM investment environment.

### **Market monitoring**

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

The monitoring would allow identified constraints to be addressed in the long term interests of consumers based on an understanding of the underlying cause(s) such as industry structure or the presence of barriers to entry.

The AER would report periodically on the outcomes of its monitoring. The Commission considers that the AER is the energy market institution best placed to have the responsibility for such a monitoring function, given the AER's existing functions and scope of activities.

Conferring a new monitoring function on the AER requires a broad consideration of the necessary changes to the existing governance framework.

For this reason, the Commission recommends that SCER makes the necessary changes in order to confer on the AER a specific function to monitor the efficient operation of the wholesale electricity market.

The introduction of a monitoring regime was supported by a number of stakeholders including the South Australian Minister for Mineral Resources and Energy.

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