



Potential Generator Market Power in the NEM

AEMC Reference: ERC0123

Responses to Draft Determination July 2012

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The Problem.

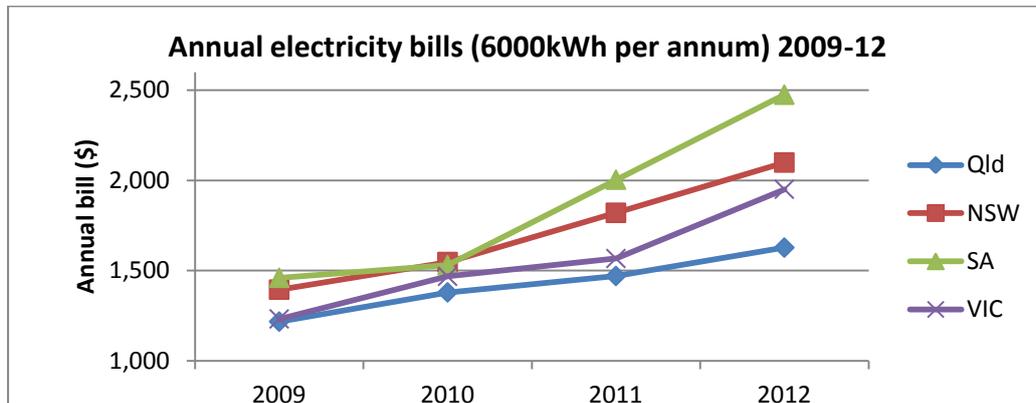
Australian households are now facing the highest electricity prices in the world –

A clear failure of the National Electricity Market!

Electricity Prices have doubled over the last 5 years in most Australian jurisdictions, (see Graph 1) exacerbating financial stress for many households in paying for this essential service, particularly lower income households, some of whom are paying over 8% of their income on energy, (see Graph 2).

This is contrary to the national electricity objective (NEO): “to promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity with respect to –price, quality, safety, reliability, and security of supply of electricity; and the reliability, safety and security of the national electricity system.”

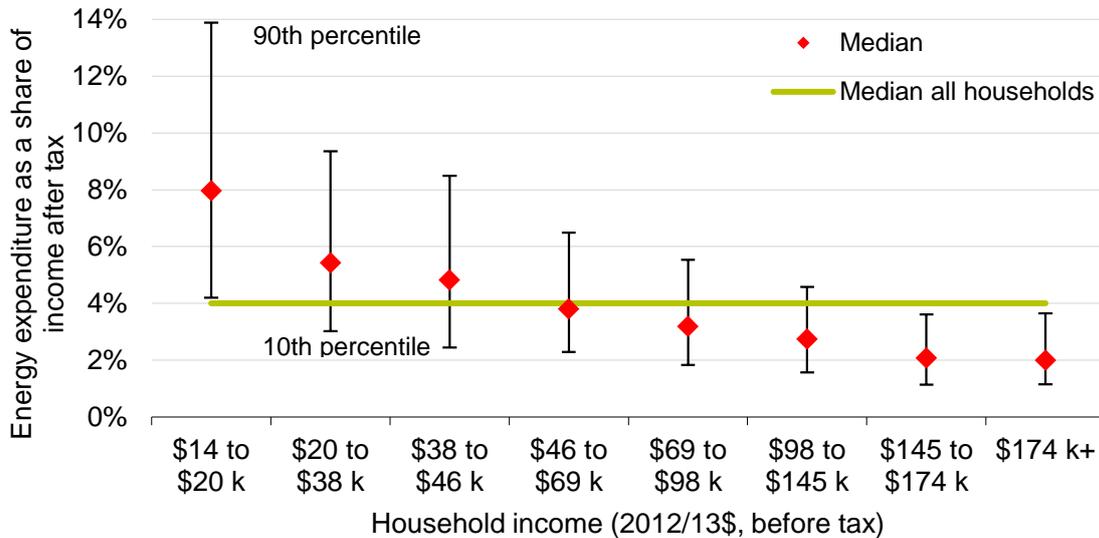
Annual Electricity Price increases, selected jurisdictions



Graph 1, source: St Vincent de Paul Society

Energy bills as a share of disposable income, by income band (Sydney and surrounds)

Energy (electricity and gas)



Graph 2, Source: IPART

Executive Summary

We surmise that the problem that this rule change proposal from the MEU seeks to address, in part, is that Australian consumers are now facing some of the highest electricity prices in the world.

In a nation that is as energy rich as Australia in renewable and non-renewable fuel sources, we think it is reasonable to ask why?

The first section of this submission deals with the Nature of Rule Making, we conclude that:

Applying the National Electricity Objective requires the AEMC, as rule maker, to place greatest emphasis on the material impacts on consumers of historical as well as likely future circumstances. This means applying a precautionary principle, to ensure the best long-term interests for consumers are achieved, with rule making also based on future potential for consumer detriment.

Concerning the draft Rule Determination, UnitingCare Australia is not convinced by the Commission's draft rule determination, observing that there is enough evidence of possible exercise of generator market power in the past, in at least one jurisdiction and that there continues to be potential for exercise of generator market power, into the future, particularly in smaller markets. Therefore a rule change is needed in order to best ensure the long-term interests of consumers.

With regard to consumer impact of generator market power risk and current high prices, we strongly encourage the AEMC to revise its draft rule determination to give particular consideration to potential adverse "price" outcomes for consumers. This should be given priority over other aspects considered by the Commission for the NEO.

We conclude by commenting briefly on Long Run Marginal Cost (LRMC) and contend that Australian consumers are currently paying something like the highest electricity prices in the world, yet there is little evidence of substantial new entrants to bid down prices for consumers. This then begs the question of "how high would electricity prices have to go in Australia before market forces would come into play and ameliorate world record high prices?" the answer would appear to be "very, very high." It appears that applying LRMC methodologies for price setting means that consumers must lose, both in the short and longer term.

Uniting Care Australia encourages the AEMC to revise this draft determination, giving greater credence to the evidence identifying the use of, or potential use of, generator market power. We also suggest that greater weight needs to be given to consumer impact.

The Commission is encouraged to apply the MEU's rule change proposal if no better rules can be identified to ameliorate the risk of the exercise of generator market power in some Australian electricity markets.

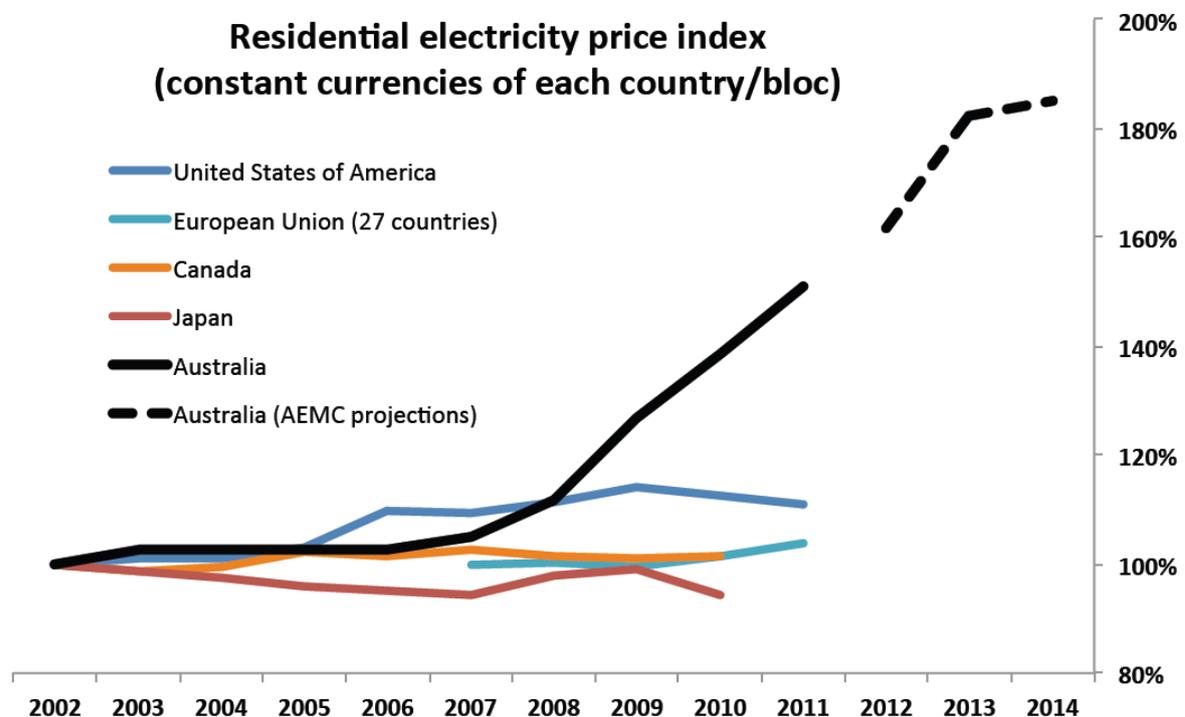
Context of this Rule Change

In commencing this submission with our statement of the current problem that needs to be addressed, we are not seeking to be overly melodramatic, we are simply stating the current reality as we understand it. After a 5 year period in which electricity bills approximately doubled for Australian households, increases in most states on July the 1st 2012 have been in the order of 14-18%. (NSW average increase 18.1%, SA increase 18%, Victoria, with no standing contract, has increases in the range 12-18% and the Queensland government has halted previously announced price increases.)

Based on the trends presented in Graph 3, and the price rises that came into effect in most Australian jurisdictions in July 2012, **there is a high probability that Australian households have the highest electricity prices in the world.**

In a nation that is as energy rich as Australia in renewable and non-renewable fuel sources, we think it is reasonable to ask why?

We suggest that aspects of Australian energy markets must be failing, in order to produce this perverse outcome. This is the issue that sets the context for our response to the Generator Market Power rule change Draft Determination.



Graph 3, Source: Carbon Market Economics

We recognise that this rule change proposal is but one of a range of current policy and regulatory processes, at national and jurisdictional level, that are dealing with aspects of Australian energy markets and impacts on consumers.

Background

About Uniting Care Australia

UnitingCare Australia is an agency of the National Assembly of the Uniting Church in Australia. We represent the Uniting Church's network of community services of which there are over 1,300 service delivery sites nationwide.

The UnitingCare network is one of the largest providers of community services in Australia, providing services and supports to more than 2 million Australians each year, employing 35,000 staff and 24,000 volunteers. We provide services to older Australians, children, young people and families, Indigenous Australians, people with disabilities, the poor and disadvantaged, people from culturally diverse backgrounds and older Australians in urban, rural and remote communities.

UnitingCare Australia works with and on behalf of the UnitingCare network to advocate for policies and programs that will improve people's quality of life. UnitingCare Australia is committed to speaking with and on behalf of those who are the most vulnerable and disadvantaged for the common good.

UnitingCare Australia believes that all people have the right to access a decent standard of living. This includes access to:

- appropriate food, clothing, housing and health care;
- meaningful work, education, rest and recreation;
- the opportunity to meaningfully express and explore spiritual needs; and
- the opportunity to participate in and contribute to communities.

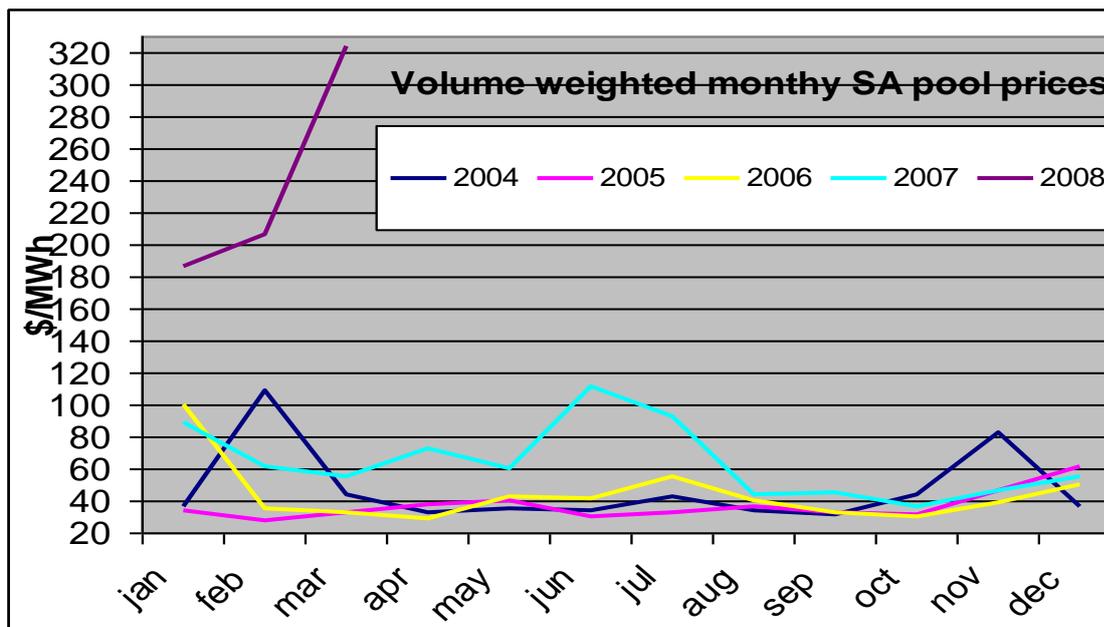
UnitingCare Australia believes that belonging in community is fundamental to people's well being. UnitingCare Australia values an inclusive community that strives to remove all barriers that prevent people from belonging and participating as fully as they wish and are able. The values that Uniting Care agencies hold as important and that play a role in informing our responses to this public policy set of questions include:

1. commitment to the common good and indeed our belief that government policy and community programs and citizen engagement need to put a commitment to the community or the common good and head of individual gain
2. equity matters, the more unequal our society is, the more citizens who are excluded from participating in society, the more quickly that society experiences problems.
3. Stewardship of our environment is a fundamental responsibility of societies both in the short-term and for the benefit of future generations. We strongly support the notion of the triple bottom line for government community and business organisations whereby economic stewardship, environmental stewardship and the nurture of citizens (social stewardship) are equally valued and reported on publicly.

UnitingCare Engagement with this Rule Change

In 2008, UnitingCare Australia member, UnitingCare Wesley Adelaide (now Uniting Communities) presented submissions to the AEMC's review of effectiveness of completion in SA, submitting in response to both the issues paper and the draft decision. The following is an extract from their April 2008 response to the issues paper:

"That a single generator has the ability to set the SA spot price creates a major (even insurmountable) risk for SA retailers (other than AGL Retail). During Q1 of 2008, it is apparent that TIPS (Torrens Island Power Station) used its market power aggressively to increase the quarterly average volume weighted price dramatically above historical levels to nearly \$200/MWh. The following graph shows the monthly average volume weighted spot prices in SA for the last 4 years, indicating the outcome of the use of the market power held by TIPS.



Source: NEMMCo data

With outcomes possible such as seen in the first quarter of 2008, retailers would be extremely loath to expose themselves to the spot market.

In fact, the only retailer that could take such spot risk would be AGL, Retail as it has the ability to offset its risk through the revenue it raises through generation at TIPS.

6.7 Conclusions

It is apparent that there is a structural problem in the SA region of the NEM which has caused a significant lack of competition in the supply of wholesale electricity.

- 1. There is barely sufficient indigenous firm generation in SA to match the peak demand in the region.*
- 2. Taking the risk on interconnection and wind generation exposes retailers to the spot market*
- 3. The spot market has shown extreme volatility in summer of 2008, directly related to the sale of TIPS to AGL*
- 4. The dominant generator in SA has the market power to set the spot price every summer.*
- 5. Retailers must have firm generation offers to avoid the risks inherent in relying on interconnection and wind generation, and must avoid being exposed to the spot market*
- 6. In order to make offers, retailers must include in their portfolios of generation, an element of power supply from TIPS, which is owned by a competing retailer.*

This assessment indicates that competition in the wholesale market for generation is heavily impacted by the ownership of the largest generator in the region, and not to include that generator in the portfolio mix, means that the retailer must take some spot market risk.

This risk of spot market exposure is very high as AGL/TIPS has the market power to set the spot market price every summer. In turn, this drives the price level of hedge and other contracts in SA. The merged AGL/TIPS, a vertically integrated business with dominant generation and retail reduces the liquidity in the market place, thereby limiting competition at the retail level, including deterring new entrants at both the generation and retail sectors.”

So the issues of potential generator market power, particularly with reference to the South Australian market, have been of concern to the UnitingCare network for some time now – at least 5 years.

UnitingCare Australia has also been engaged with this particular rule change proposal, presenting at the 12th October 2012 forum in Adelaide and submitting in response to the Directions paper, late in 2011.

The remainder of this submission deals with three separate, but related issues:

1. The Nature of Rule Making
2. Generator Market Power Draft Determination
3. The usefulness of Long Run Marginal Cost as a basis for Rule making

1. The Nature of Rule Making

In section 3.2.2 of the Draft Rule Determination, the AEMC says

“In consideration of the lack of evidence from NERA’s analysis supporting the existence of substantial generator market power and the lack of firm evidence from CEG’s analysis supporting the existence of significant barriers to entry, the Commission considers that there are insufficient grounds to conclude the existence of substantial market power and to assume the likely future exercise of substantial market power by generators in the NEM”

UnitingCare Australia believes that this paragraph includes a very important perspective, that we believe needs to be challenged, regarding the perspective from which rule making occurs, in the NEM. In summary, we understand the AEMC is saying that unless there is demonstrated past evidence of a problem within the NEM, then no rule change action is needed, in other words of rule making is an ‘ex post’ process.

We however believe that the application of the national electricity objective (NEO) means that rule making needs to be primarily an ‘ex ante’ process where the potential of future consumer outcomes are considered along with any historical evidence, to develop rules that are most likely to act towards consumer benefit into the future.

In other words, rule making needs to be proactive more than reactive.

We suggest that this issue is broader than this particular rule change proposal and so needs to be considered by the AEMC, with appropriate stakeholder input, in a process separate to this specific rule change consideration.

The fact that this issue has been presented in this rule change process means that it also needs to be taken into account in considering this draft determination.

UnitingCare Australia strongly suggests that the NEO requires the AEMC, as rule maker, to place greatest perspective on the material impacts on consumers of historical as well as likely future circumstances. This means applying a precautionary principle, to ensure the best long-term interests for consumers are achieved.

We observe that there is enough evidence of possible exercise of generator market power, in the past, in at least one jurisdiction and that there continues to be potential for exercise of generator market power, into the future, particularly in smaller markets (eg South Australia, Tasmania), so a rule change is needed in order to best ensure the long-term interests of consumers.

2. Generator Market Power Draft Determination

The Commission's Draft Rule Determination

"The Commission has determined not to make the proposed rule.

In light of the Commission's analysis and the lack of evidence supporting the existence of substantial generator market power in the NEM, the Commission considers that any rule that seeks to constrain or limit the bidding of generators in a manner proposed by the MEU, a similar manner, is likely to diminish incentives for efficient investment, thereby potentially reducing the long-term reliability of supply to consumers"

UnitingCare Australia Response - Summary

UnitingCare Australia is not convinced by the Commission's draft rule determination and presents the following arguments in support of our proposition that there has been the exercise of generator market power in at least one Australian jurisdiction (South Australia) and that there remains potential for the exercise of generator market power in the future.

We accept that there may be a better solution to deal with generator market power than the MEU has proposed, and would welcome proposals from the AEMC, or other stakeholders with more technical expertise than we are able to contribute, but consider the MEU rule change proposal to be the best suggestion 'on the table' at the moment, and worthy of implementing.

Specific Issues

The following comments respond to the Draft Rule Determination under 3 headings

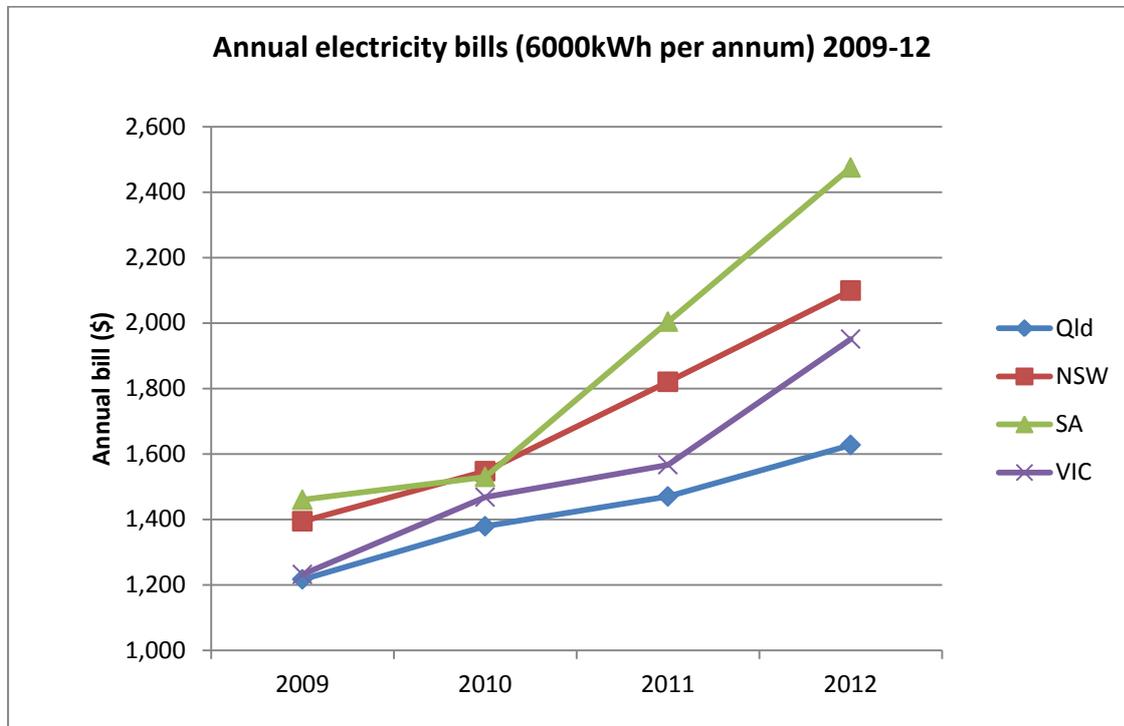
1. Evidence
2. Consumer Best Interest
3. "Plus Margin"

1. Evidence

The Commission states that insufficient evidence has been presented to establish a case for the exercise of generator market power in Australia. We believe that the case has been presented strongly for the exercise of market power in SA

The first graph that we present, graph 1, the increase in 6Mw annual household usage costs are presented from 2009 – 2012. South Australia clearly has seen the highest price increases over the past 4 years.

An important question is why SA prices, which were high at the start of the period graphed, continue to rise at a greater rate than other jurisdictions, particularly when network costs in NSW, for example, are rising faster than in SA?



Graph 1.(Re-presented)

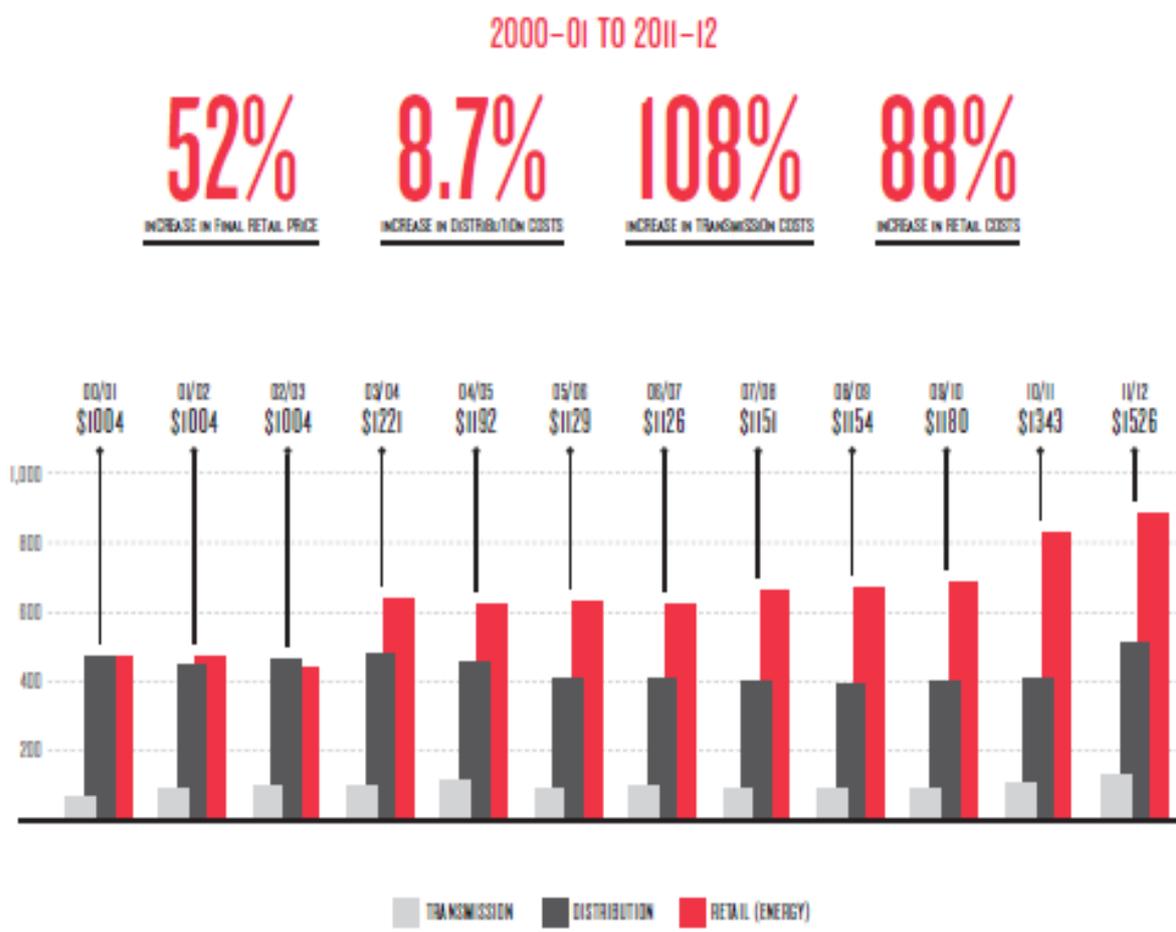
Graph 6 is taken directly from ETSA Utilities 2011 annual report. The graph shows the SA distribution business view that over the period 2000/01 – 2011/12; transmission costs have increased by 108%, distribution costs have increased by 8.7% while retail (including wholesale) costs have increased by 88%. We note that since this data was compiled, SA standing contract prices (upon which market prices are also determined), have increased by a further 18%, effective from 1st July 2012, 4.6% of this increase is explained by carbon price pass through.

We suggest that it is difficult to accept that prices being paid by South Australian customers are based on efficient costs of supply, including efficient wholesale costs.

Indeed, the SA regulator (ESCoSA) has recently instigated a review of Wholesale Energy Costs for South Australia, perhaps indicating some concerns they may have about generation costs being paid by SA consumers, although they do not state this.

Potential Generator Market Power in the NEM Response to Draft Determination

July, 2012



Graph 4, Source: ETSA Utilities (now SA Power Networks) Annual Report 2011

We also consider that the MEU submissions¹ to this rule change process do provide significant evidence of market power, at least in South Australia.

The MEU commissioned report by Poyry Management Consulting, from the UK, includes that following conclusion

“The CEG evidence provided for the South Australian market indicates that there may be a situation of substantial market power in that region - the behavioural indices do not provide conclusive evidence that the market is operating competitively or that entry barriers do not exist.”

The same report also includes:

“The evidence presented by CEG in its report to the AEMC is not sufficient to conclude that the markets do not exhibit entry barriers and therefore that what may be considered transitory pricing power would not be sustained in the long-run.”

¹ <http://www.aemc.gov.au/Electricity/Rule-changes/Open/potential-generator-market-power-in-the-nem.html>

The CEG report, commissioned by the AEMC includes the following conclusions:

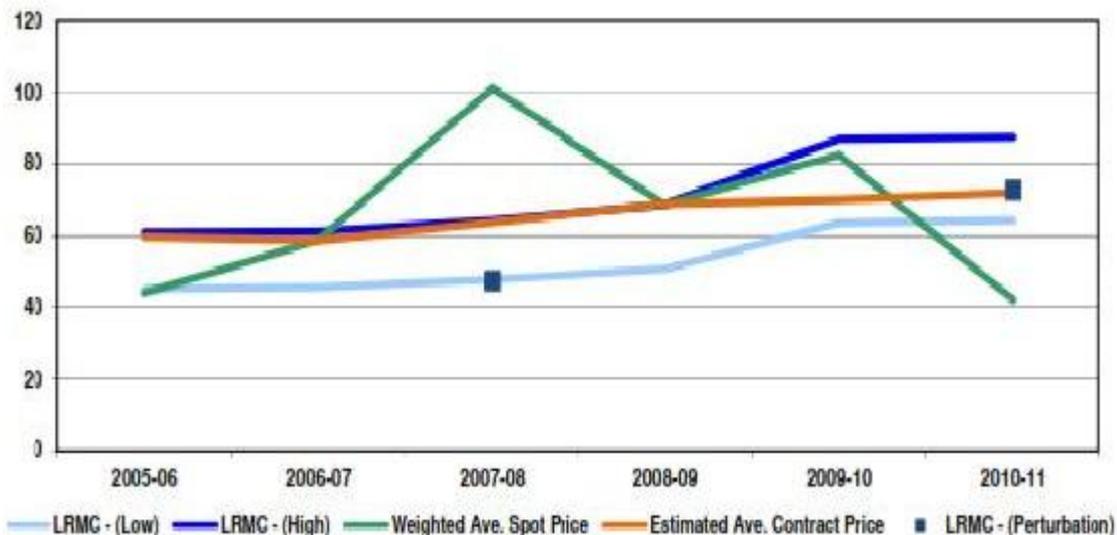
“219. The Tasmanian market raises more serious concerns. This reflects the dominant position of Hydro Tasmania and evidence potentially consistent with capacity being withheld to drive up prices. This conclusion is in line with the report of the independent review of Tasmanian electricity supply industry of March 2012 which found evidence of high degree of latent market power (albeit that Hydro Tasmania has generally chosen not to exercise its market power to date) and recommended significant restructuring of the market.

220. The evidence in relation to South Australia is mixed. AGL has a significant market share in South Australia. We found evidence potentially consistent with materially more capacity being withheld to drive up the market prices in South Australia than any other mainland state.”

We suggest that these two reports, from highly regarded consulting firms, present clear evidence of, at least, a problem of potential generator market power in two Australian jurisdictions.

The NERA report includes the following graph:

Figure 4.23
South Australia Weighted Average Prices Compared with Long Run Marginal Cost



Source: NERA report

It shows that the difference between the high and low ranges for LRM is 36%, so the high LRM is 18% above average cost. This 18% sensitivity range is derived from Table 4.5 in the NERA report, which follows:

Table 4.5
Long Run Marginal Cost, Spot and Contract Prices for South Australia (\$/MWh)

	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11
LRMC (perturbation)			47.4			72.7
LRMC (average incremental cost)						
- upper bound	60.9	61.2	64.3	68.7	87.0	87.5
- lower bound	45.1	45.5	47.8	50.7	63.6	64.2
Volume weighted spot price	44.0	58.8	101.2	68.6	82.5	42.0
Average region wide contract price	59.7	58.6	63.7	68.8	70.1	72.0

Source: NERA report

We deduce from this data and from the draft determination that wholesale prices could exceed costs by about 20% for four years or more as a result of market power being exercised before the AEMC would consider there was a problem. Using indicative numbers to derive an order of magnitude consumer impact: with network costs being 50% of the total electricity bill, the draft determination implies that electricity bills could exceed costs by 10% for 4-5 years, before the AEMC would consider there to be a definitive basis for taking action.

While the Poyry report is new to the AEMC, the CEG report is not, nor is significant other evidence, so we are surprised by the draft rule determination's claims of lack of evidence. The NERA report also contains data supporting the use of generator market power, despite their conclusions. We certainly believe that the available evidence, over at least 5 years, coupled with taking a precautionary approach with regard to consumer best interests, can only lead to a conclusion that there is at least a risk of generator market power, and consequently an imperative for the AEMC to actively consider rule change options to mitigate future risk for consumers.

2. Consumer best interests

We also suggest that the draft rule determination should have given greater consideration to impacts on small consumers of both very high electricity prices, and the welfare (in an economics sense) risk for consumers from the potential of the exercise of market power.

The most recent ABS Household Expenditure² Survey (HES) reports that average household expenditure on 'domestic fuel and power' has remained unchanged from 2003-4 to 2009-10, at 2.6% of household expenditure, prompting some to observe

² ABS; Cat no 6530.0 - Household Expenditure Survey, Australia: Summary of Results, 2009-10

that energy is a minor part of household expenditure and consequently affordable for all.

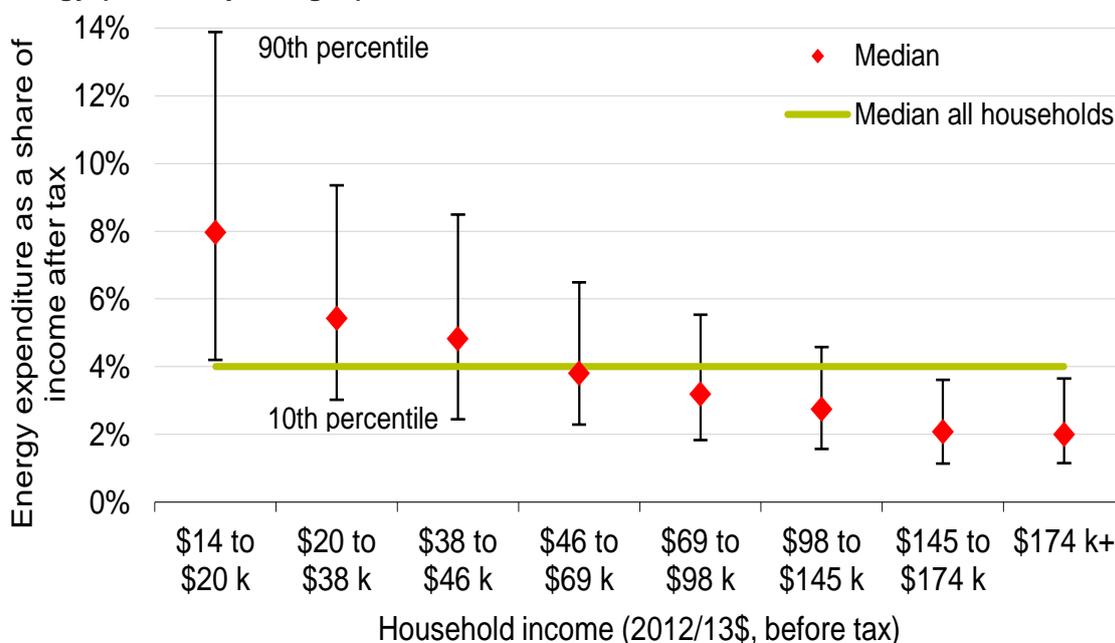
This however is not the reality, because distribution measures of affordability are much more useful than statistical measures of “central tendency” (eg mean and median).

Graph 2, (re-presented below), indicates the spread in relative household energy costs for the Sydney region. We expect that similar distribution impacts for various income classes would apply across Australia.

This graph is consistent with the experience of financial counsellors across the UnitingCare network, who identify significantly growing numbers of clients presenting with major concerns about the capacity to pay rising energy costs. Graph 2 shows that for some very low income households, nearly 14% of the household pre-tax income is spent on energy, while there are households in each of the three lowest income bands who spend over 8% of their household income on energy. Generally lower income households are lower energy use households, so a high proportion of income being spent on energy is more a function of income than energy use.

These lower income households are heavily affected by energy price rises above CPI, by price shocks in general and therefore are the households at greatest risk of adverse impacts as a result of any use of market power, including in energy markets.

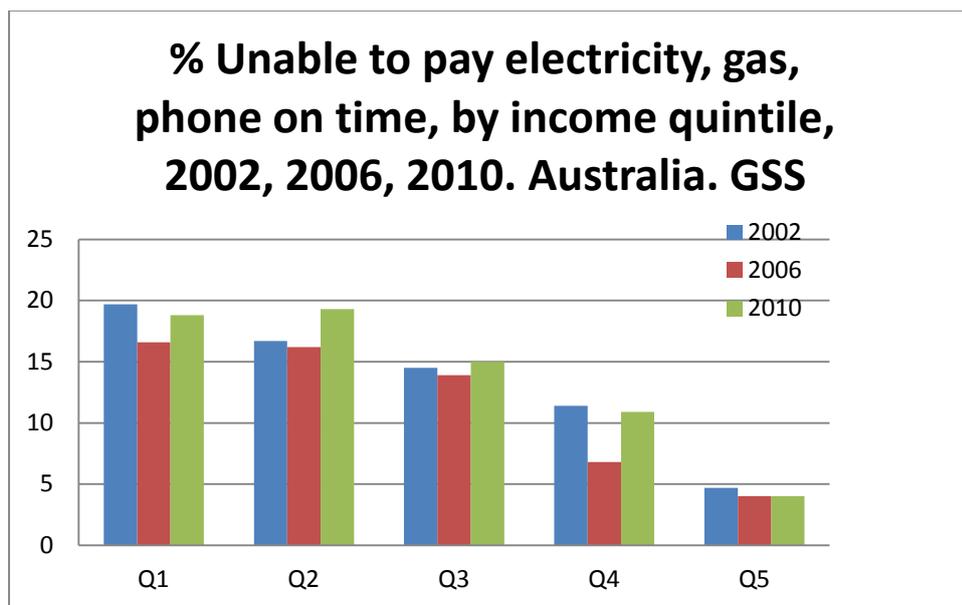
Energy (electricity and gas)



Graph 2 (Re-presented)

The following provides some further brief discussion about the growing numbers of households are who are experiencing difficulty in paying energy bills and therefore

that there are a growing number of households likely to be adversely impacted by short-term as well as sustained application of market power. A more detailed discussion about difficulty in paying energy bills was provided in our response to the network rule change (ERC0134) issues paper.



Graph 5: Source ABS, General Social Survey

Graph 5 shows data from the ABS, General Social Survey (GSS), for the years 2002, 2006 and 2010, for ability to pay utility bills on time, by income quintile. We highlight that the level of inability to pay these bills rose for all quintiles, except highest income, between 2006 and 2010. The percentage increase in inability to pay bills, over the 4 years 2006-2010 for each quintile is”

Income Quintile	% change in Households unable to pay on time, 2006-10
Q1	13%
Q2	19%
Q3	8%
Q4	60%
Q5	No change

Table 1: Source ABS, General Social Survey

For Uniting Care Australia the alarming reality of utility price increases is the move from affordability being a predominantly low income household issue, to it also being a problem for middle and higher income households. The 19% increase for households in the second quintile, along with the 13% increase in the first quintile

shows the pressure that lower and modest income households experience in paying their bills. That there has been a 60% increase in inability to pay bills on time for fourth quintile households shows how deeply utility prices are biting into budgets of all but the most affluent households.

In an attempt to better understand energy payment and affordability issues, we have conducted 3 short omnibus surveys of well over 1000 households over the last couple of years. One question we have asked is “ if electricity prices doubled over the next 5 years, then what will be the impact on spending on various other parts of your household budget?” Results are given in Graph 5 and are given for 3 income levels, households with less than \$40,000 per year (low), \$40, 000 - \$80,000 per year (medium) and over \$80,000 per year (high).

Note that we believe that the proposition that electricity prices could double over the next 5-6 years to be reasonable, it is a notion that has had recent media coverage, for example: “The recent media hype about moves by the Australian Energy Regulator to 'slash power bills' is at odds with new analysis suggesting that electricity prices may double between 2011 and 2017, ” was written by Keith Orchison in the Business Spectator , October 3rd 2011³. On May 22nd last year, the Herald Sun reported similar projections from TRU Energy⁴.

UnitingCare agencies report that many clients are reliant on casual work, with declining hours of work and wage rates that barely keep up with inflation, so nominal price increases are likely to be very close to real increases for lower and modest income households.

Of considerable concern is that about half of households with incomes of less than \$80k per year, a majority of Australian households, have indicated that they would struggle to pay other bills if electricity prices increased, while nearly 40% of lower income households and about half of middle income households (our definition of \$40-80k per year household income as middle income) would reduce their spending on fresh food. Another major concern is that about 30% of households across the entire survey of about 1300 sample size, said they would go without medicines or visits to the doctor with major electricity price increases, so there are adverse health impacts of rising energy costs.

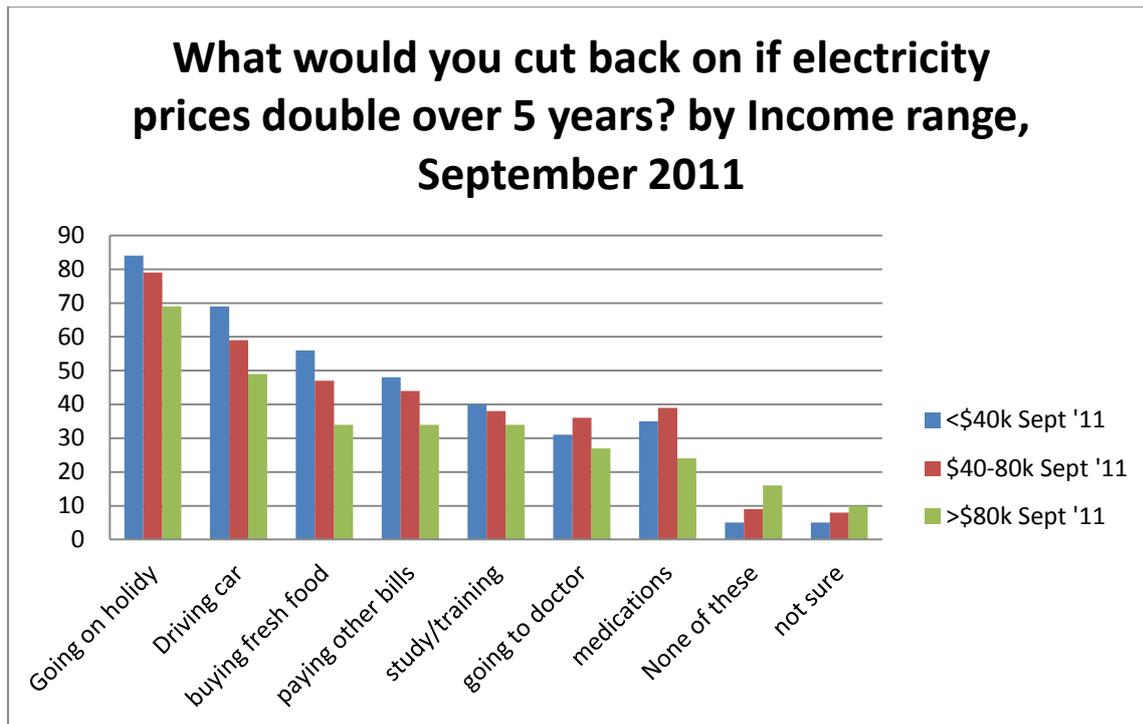
Nearly a third of people surveyed, across all incomes also indicated that they would reduce spending on study and training. This has substantial economic implications. If rising living costs, including energy costs, are reducing spending on skills then the productivity and indeed employment growth, so central to overall economic growth, are hindered. Another implication is that if lower income households are less able to gain skills for employment, then they are further excluded from economic opportunity, extending divisions in our two speed economy.

³ <http://www.businessspectator.com.au/bs.nsf/Article/energy-costs-power-bill-Australian-Energy-Regulatorpd20111003-M9URP?OpenDocument&src=rot>

⁴ <http://www.heraldsun.com.au/archives/old-news-pages/power-bills-to-double-in-six-years-on-carbon-price-truenergy/story-e6frf7ko-1226060533782>

Uniting Care Australia was surprised by the relative similarity of responses across income groups, confirming that energy affordability is a concern that is community wide.

Likely Impact on spending of a doubling in electricity prices, over 5 years
Australia, September 2011, n = 1300



Graph 6. Source: Survey conducted for UnitingCare Australia, by The Australia Institute.

The Commission considers consumer impacts in the context of the rule change proposal, against the national energy objective. The Commission wrote:

“for the rule change request, the Commission considers that the relevant aspects of the NEO are the contribution to the efficient operation and use of electricity services and the impact on efficient investment as it relates to the long term costs and reliability of supply consumers.”

“Price” is the first listed criteria that the NEO states must be given regard to in the provision of “electricity services for the long-term interests of consumers”.

We are consequently surprised that “price” was not regarded as a relevant aspect of the NEO, for the rule change consideration, particularly at the time of protracted and substantial electricity price rises and bearing in mind that the most direct impact of any use of market power is for even further price burdens on consumers.

We strongly encourage the AEMC to revise its draft rule determination to give particular consideration to potential adverse “price” outcomes for consumers, in particular from the potential exercise of market power.

3. Plus Margin

The Commission argues that wholesale prices will be set at Long Run Marginal Cost (LRMC) plus an additional margin; *“In order to be useful in a real world setting, particularly in the context of a sector like electricity that requires ‘lumpy’ non-divisible capital investments, a time dimension needs to be recognised.”*

The argument, as we understand it, is that if there is a large enough margin being recouped by incumbent businesses then new entrants will see an opportunity to move into the market, able to make a profit while competing on price with incumbents, resulting in end consumers being better off.

In other words, generators, in this instance, are able to price somewhere between an efficient operating level and a higher price that is just below a price that would attract new entrants and consequent competition and therefore lower returns to the incumbent. Where “lumpy, non-divisible capital investment” is involved, particularly in a smaller market, then a significant margin can be added above efficient pricing, before new entrants are likely to invest.

This margin represents loss for consumers and is a reason for price regulation for sectors where there is such ‘lumpy’ investment, particularly in the provision of essential services.

A public policy question then becomes: “what is an acceptable, modest margin above long run efficient costs, that doesn’t cause too much consumer detriment?”

We contend that Australian consumers are currently paying something like the highest electricity prices in the world (refer graph 3), yet there is little evidence of substantial new entrants to bid down prices for consumers. This then begs the question of “how high would electricity prices have to go in Australia before market forces would come into play and ameliorate world record high prices?” the answer would appear to be “very, very high.”

We suggest that a more realistic option than ‘the unfettered market’, is for robust public debate about acceptable price margins, over and above efficient long run costs, implemented by firm regulation, supported by rules which enable effective regulator action.

3. Long Run Marginal Cost

Allied to the issue raised above is the related question about applicability of Long Run Marginal Cost (LRMC) theoretical constructs to real world essential service policy and regulation.

“The long run is a misleading guide to current affairs.

In the long run we are all dead. Economists set themselves too easy, too useless a task if in tempestuous seasons they can only tell us that when the storm is past the ocean is flat again. - JM Keynes”

This famous quote from Keynes eloquently summarises the practical dilemmas of applying a Long Run Marginal Cost approach to real world energy regulation. In dynamic markets consumers need market functions and regulation that operate in “real time”, not considerable time after the event.

LRMC can only be accurately measured after the event, and indeed, quite sometime after the event, depending on how ‘long run’ long run is.

So in applying LRMC to prices to be paid by consumers in the future using a methodology that includes LRMC, the determination of values for LRMC can, at best be an estimate. Given that price setters are highly unlikely to accept LRMC estimates that allow prices to be below efficient costs, plus an uncertainty premium, Long Run Marginal Costs will invariably be set higher than likely real costs. When real costs are known, in hindsight, there is virtually no scope for excess prices paid by consumers to be recovered by consumers.

LRMC based methodologies are consequently unlikely to deliver efficient costs for consumers, nor capacity for compensation for higher than necessary prices paid by consumers.

In summary, applying LRMC methodologies for price setting means that consumers must lose, both in the short and longer terms.

The methodologies for estimating long run marginal costs are relatively ineffective at providing a reasonable benchmark for shorter term considerations. This includes the inability to effectively deal with the potential or actual exercise of generator market power in the market for the following reasons:

- Long timelines for determining long-run marginal costs;
- Long run marginal costs do not compare readily with spot price averages in the shorter term. These prices also impact on what consumers end up having to pay
- Abuse of market power under this approach is only observed after the event and, indeed, some time after the event, and so does not afford consumer protection;
- Fails to identify market power in the short run.

Another issue at stake with this rule change proposal is that in specific (smaller) markets a single generator must be despatched to meet the demand in that market, thereby affording the effectively monopolistic generator the opportunity to “game the market.” It is this type of circumstance that provides the opportunity for the exercise of market power in wholesale energy markets to the detriment consumers.