Lisa Rautenbach

From: Brett Woods [redacted]
Sent: Tuesday, 5 November 2024 2:21 pm
To: TaskForce
Cc: Miliana Belhout; Chris Abbott
Subject: Energy Competition Task Force - request for level playing field measures

This message responds to the request from the Energy Competition Task Force for information on level playing field measures.

We consider that the Task Force should closely consider the work undertaken by the ACCC since 2017 on vertical integration and contracting markets. Some key highlights of that work are covered below.

Retail Electricity Pricing Inquiry Preliminary Report dated 22 September 2017
https://www.accc.gov.au/system/files/Retail%20Electricity%20Inquiry%20-%20Preliminary%20report%20-%2013%20November%202017.pdf

This report looked at two structural features of the wholesale market: (Chapter 3, P79, P103):

- the level of concentration
- the extent of vertical integration.

We note a few relevant submissions and expert reports provided in submissions:

- Origin and CEG (https://www.accc.gov.au/system/files/Origin%20Energy_0.pdf?ref=0&download=y; https://www.accc.gov.au/system/files/Origin%20Energy%20%28Attachment%29.pdf
    - While each of the large retailers control substantial generation assets, **the extent of effective integration is limited, as generally there is a significant mismatch in terms of the location and profile of generation with retail load.** Vertically integrated retailers also have a strong incentive to supply or purchase hedge contracts (even in preference to using generation to back their retail load) if hedge prices diverge from expected spot prices
    - Origin considers that to the extent **vertical integration** has any impact on wholesale prices, it is likely to lower the incentive for integrated generators to offer generation at high prices, due to the integrated entity's potential exposure to high pool prices.
        - In New Zealand we refer to this as 'net pivotal'. Contact recently commissioned Concept Consulting to undertake analysis of its net pivotality from Nov 2019 – Oct 2022 as part of its application for clearance to acquire Manawa Energy. This showed that neither Contact, nor a combined Contact and Manawa was ever net pivotal in this period.
    - **Ultimately, no party is truly capable of being perfectly vertically integrated (in that the 'shape' of generation output perfectly matches the 'shape' of retail sales**). All parties will typically trade in the contracts market. Moreover, if standalone retailers win market share from vertically integrated retailers (or vice versa) then that automatically 'undoes' the level of vertical integration – creating the supply of uncontracted generation to meet the expanding standalone retailers' demand (or vice versa if standalone generation captures market share). Competition is a dynamic process and the level vertical integration is not fixed by any one set of market participants.
- AGL, Frontier Economics, and NERA (https://www.accc.gov.au/system/files/AGL_0.pdf?ref=0&download=y; https://www.accc.gov.au/system/files/AGL%20%28Frontier%20report%29.pdf;

https://www.accc.gov.au/system/files/AGL%20%28supplementary%20submission%29_0.pdf?ref=0&download=y

- **Vertical integration is an efficient competitive market response to managing risk**, which has had a moderating effect on wholesale electricity prices, rather than contributing to price increases. The **natural tendency for electricity retailers to manage their risks through vertical integration and the benefits that result from this integration have been recognised by the Federal Court and the Australian Competition Tribunal** (Australian Competition Tribunal, Determination regarding application for authorisation of Macquarie Generation by AGL Energy Limited [2014] AComp T1 at [253]; Australian Gas Light Company v Australian Competition & Consumer Commission (No 3) (2003) 137 FCR 317 at [214].)
- AGL submits that it would be incorrect and overly simplistic for the ACCC to conclude that vertical integration has limited retailers' **access to hedging contracts** or led to a **lack of liquidity in contract markets**. The current conditions in contract markets **reflect the conditions of the broader wholesale electricity market – the tightening of supply and demand and policy uncertainty discouraging investment.**
- Frontier Economics report found that vertically integrated generators behave more competitively on average than when they were operating as stand-alone generators. **The vertically integrated generators were found to be bidding 4 to 6 percentage points more capacity at competitive prices**. This statistically significant, robust, and striking result is contrary to claims that vertically integrated generators will bid at higher prices than stand-alone generators.
- NERA's report focussed on vertical integration, they find that **vertical integration per se does not diminish competition or increase market prices.**
- **Measures to promote liquidity in some jurisdictions (Ireland, Netherlands, NZ) have had little or no effect, with the volume of trade** remaining at or around the level that would have happened anyway.

Inquiry into the National Electricity Market – Final Report 2018
https://www.accc.gov.au/system/files/Retail+Electricity+Pricing+Inquiry%E2%80%94Final+Report+June+2018_0.pdf

- **Key finding on transfer price practices:** ACCC analysis of internal documents from vertically integrated businesses suggest that these businesses set their transfer prices on an 'opportunity cost' basis. This means that the retail arms of these businesses are receiving wholesale electricity at a price comparable to a standalone retailer. ACCC analysis of transfer price data from vertically integrated businesses broadly supports the opportunity cost approach, with most transfer prices set at a premium above ASX contract markets that is comparable to the premium on 'all-in-one' hedging products such as load-following hedges.
- 2 possible interventions considered for Vertical integration:
  1. Market making obligations on vertically integrated businesses (NZ, UK used as examples)
  2. Requiring vertically integrated retailers to operate at 'arm's length' from their wholesale arm (essentially, a 'functional separation' of the generation and retail businesses).
- **Recommendations**
  1. introduce market making obligations in South Australia, which require large, vertically integrated retailers to make offers to buy and sell specified hedge contracts each day, in order to boost hedge market activity.
  2. **Do not require vertically integrated players to operate on an arm's length basis**. Should competitive outcomes for consumers not improve, further direct intervention regarding vertical integration may need to be revisited particularly by considering extending market making obligations.
     - **Argument against:** by negating many of the benefits of vertical integration, arms-length intervention may increase overall costs in the industry and raise prices. Restricting the ability of vertically integrated businesses to manage risk internally would likely increase their exposure

to wholesale price risk, which may also inhibit investment in new generation, or increase the cost of any investments. The goal of any intervention must be to improve outcomes for end consumers. While there are potential benefits to requiring vertically integrated players to functionally separate, we must also have regard to potential costs. The ACCC accepts that the market trend towards vertical integration likely reflects competitive advantages of such a business structure, and that vertical integration therefore has the potential to be pro-competitive. Indeed, a number of small and medium sized retailers are vertically integrated, or are pursuing vertical integration.

Inquiry into the National Electricity Market – December 2023
https://www.accc.gov.au/system/files/accc-inquiry-national-electricity-market-december-2023-report_0.pdf
Supporting Report**: Frontier Economics (2023):**
https://www.accc.gov.au/system/files/accc-inquiry-national-electricity-market-december-2023-report_0.pdf

- Second time the **ACCC reviewed retail competition taking into account the impact of a changing generation mix on the hedging contract market and the ability of standalone retailers to manage their risks.**
- **Vertical integration and the need for arm's length contracts are no longer considered as solutions in the 2023 report,** and most solutions are expected to come from:
    - further vertical integration for the largest retailers with the financial capacity and customer base to support the development of generation assets
    - government-backed renewable and storage projects providing smaller retailers with preferential access to new hedging products (key recommendation from Frontier Economics)
    - supporting the development of new products on the ASX until sufficient liquidity emerges.
- The **energy market transition**, driven by government policy for a low carbon economy, is **affecting electricity prices in complex ways**. It is expected to reduce dispatchable capacity, such as thermal generation, which until now has underpinned the bulk of contracts that are traded in the NEM. Conversely, there will be an increase in renewable generation. Output from most renewable generation is dependent on weather conditions and so is unsuited to providing the firm base load swap contracts traditionally sold by baseload coal-fired generators, or the cap contracts that have been sold by gas peaking plants. It may be that the **demand for base load swap contracts may decline somewhat, but it is expected that there will still be a demand for this currently dominate form of hedge.**
- **Managing risk will become increasingly complex for standalone retailers** as the supply of financially firm contracts declines, the types of contracts available change (e.g. flat swaps to weather derivatives), and retailers are required to trade with a wider variety of counterparties (i.e with many types of renewable and storage assets vs. a few coal generators today). This could **be aggravated in circumstances where physical supply can barely meet demand.**
- **Managing risk will become most costly** as margin and prudential requirements add additional pressure in volatile markets, and this too is more challenging for smaller companies which typically struggle to access the ASX market to execute their hedging strategy and have to resort to OTC contracts which are more opaque, time consuming and expensive.
- **Historically, vertical integration has been typically confined to the larger players** in the market because of the scale of generation assets. However, the **decreasing economies of scale with newer generation technologies could provide the opportunity for smaller players to become vertically integrated**. Examples of vertical integration solutions for small participants could include small-scale solar farms and community batteries.

Regards.

Brett Woods
Head of Regulatory and Government Relations

[redacted]

PO Box 10742, Wellington 6143
Level 2, Harbour City Tower
29 Brandon Street
Wellington, New Zealand
contact.co.nz