SUBMISSION ON ACCC DRAFT GUIDELINES ON THE *PROHIBITING ENERGY MARKET MISCONDUCT ACT*

Introduction

I refer to the ACCC's letter of 10 March 2020 inviting me to make a submission on the ACCC's draft guidelines on the *Prohibiting Energy Market Misconduct Act*. My submission is set out below. I would be happy to discuss it with the relevant staff of the ACCC.

My background

I am Managing Director of Craig Emerson Economics Pty Ltd, an economic advisory firm whose clients include businesses in the energy sector. In the period 2009-2010, I was Australian Minister for Competition Policy and Consumer Affairs. I was invited by the ACCC to make a submission towards the development of guidelines on the *Prohibiting Energy Market Misconduct Act*, which I did on 19 December 2009.

Overview

While the ACCC's draft guidelines constitute a genuine attempt to describe the sorts of behaviour that would clearly constitute prohibited conduct, as well as many behaviours that would not constitute prohibited conduct, substantial grey areas remain. Essentially, the ACCC has indicated these grey areas would need to be clarified by the courts. Especially in the context of the ongoing economic crisis triggered by the COVID-19 outbreak, the operation of the *Prohibiting Energy Market Misconduct Act* can only add to the risk and uncertainty faced by electricity wholesalers and retailers.

Of course, the Parliament enacted this legislation, not the ACCC, and the ACCC is required to issue guidelines on the operation of the Act. In the enforcement of those guidelines, however, where grey areas are involved, the ACCC might consider the economic environment in which the industry and electricity consumers are operating.

A form of margin control

In my submission of 19 December 2019, I raised my concern that the *Prohibiting Energy Market Misconduct Act* and the guidelines appear to constitute a form of margin control. The Act nominates prohibited conduct as including a failure to pass on sustained reductions in costs incurred by electricity retailers to small businesses and residential electricity users.

The starting point of any ACCC assessment of whether a firm has engaged in this form of prohibited conduct is when electricity prices charged to small businesses and residential electricity are high.

When prices are high, demand will tend to fall, the size of the reduction being determined by the short-run price elasticity of demand. An economically rational retailer, seeking to retain its customer base, will absorb some of the price increase and pass on the remainder to customers. This will compress the retailer's margin. It is this compressed margin that appears to constitute the benchmark for the purposes of the legislation. Generally, unless that compressed margin is maintained when prices fall, the retailer might be considered to have engaged in prohibited conduct.

The ACCC's draft guidelines confirm that: "Retail costs and margins are not included in the cost of procuring electricity" (p. 6). The draft guidelines include: **Example 5: Retail cost savings:** "A new customer billing technology that greatly improves accuracy and efficiency is developed and rapidly becomes the industry standard, resulting in a substantial, sector-wide reduction in retail operating costs. Section 153E does not require a retailer to adjust its prices to pass through such efficiency gains, as only reductions relating to wholesale costs, network costs or environmental costs need to lead to price adjustments" (p. 7).

However, the Act appears to prevent retailers from recovering reductions in their margins when input costs are high. That is, the Act appears to regulate margins when they are likely to be at their tightest; when input costs, most particularly wholesale prices, are highest. <u>The legislation is effectively a form of margin control</u>.

When input costs are high, as long as incumbent retailers are covering their variable costs (short-run marginal costs) they will continue to supply electricity. However, these tight margins would not include any allowance for new capital costs (long-run marginal costs). By failing to do so, the legislation will reduce incentives for new and replacement investment, for innovation and for new market entry. <u>In the longer term, the legislation is likely to increase electricity prices</u>.

In determining what constitute 'reasonable adjustments' to prices, and therefore what constitute contraventions of section 153E of the Act, the Explanatory Memorandum lists whether any reductions in supply-chain costs were "sustained and substantial" and whether any adjustment was "reasonable" (2.35, p. 16).

The ACCC's draft guidelines include **Example 14: Reasonable adjustments do not expect retailers to operate at a loss:** "Two retailers operate in a particular network region where a recent network determination results in a sustained and substantial reduction in network costs. Retailer A is a profitable retailer in the region. It would be reasonable for Retailer A to pass through the full network cost reduction, if all else is held constant. Retailer B is a recent market entrant. Retailer B's strategy is to operate at a loss initially to compete with Retailer A on price and establish a customer base. Retailer B plans to become profitable in the medium term by gradually unwinding its aggressive pricing and moving tariffs to a more financially sustainable level. Retailer B only partially passes through the price reduction. Despite making a smaller price reduction than Retailer A, Retailer B may have made a reasonable adjustment in the circumstances" (p. 12).

What happens if Retailer A had decided to make a temporary loss in circumstances of high input costs? Retailer A could be found to have engaged in prohibited conduct if it failed to continue making a loss when input costs fell on a sustained basis. The prohibited conduct provisions could apply, too, where Retailer A decided to accept an unsustainably low margin when input costs were high and did not maintain that unsustainably low margin when input costs fell.

To deal with this problem, the guidelines could include additional examples where an incumbent retailer, such as Retailer A in Example 14, would not be in breach of the Act if it had not fully passed on a reduction in network costs but had previously absorbed an increase in input costs.

It is recommended that the ACCC's guidelines include additional examples of retailers not being considered to be engaging in prohibited conduct in circumstances where they had previously absorbed a portion of high input costs and, when those costs have fallen on a sustained basis, have not fully passed on a reduction in costs.

Conclusion

When electricity retailers' input costs were high, the government of the day would expect retailers to squeeze their margins in order to cushion the impact on customers. Yet, under the *Prohibiting Energy Market Misconduct Act*, it appears that retailers might not be able to recoup the consequential losses or reduced profits when input costs fell on a sustained basis.

If this were correct, the Act would deter retailers from squeezing their retail margins when input costs were high, for fear of subsequently engaging in prohibited conduct. Perversely, the *Prohibiting Energy Market Conduct Act*, and the ACCC's draft guidelines, could defeat a key objective of the Act – to put downward pressure on retail electricity prices when retailers' input costs were high.

The ACCC's final guidelines could clarify this by including additional examples of retailers not being considered to be engaging in prohibited conduct in circumstances where they had previously absorbed a portion of high input costs and, when those costs had fallen on a sustained basis, have not fully passed on a reduction in costs.