

# **SUBMISSION ON SCHEDULE 1 OF TREASURY LAWS AMENDMENT (PROHIBITING ENERGY MARKET MISCONDUCT) ACT 2019**

## **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.

## **Prohibited conduct**

The Act prescribes various forms of prohibited conduct. These include 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 would 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 Act regulates margins when they are likely to be at their tightest; that is, when input costs, most particularly wholesale prices, are highest. The legislation is effectively a form of margin control.

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. In the longer term, the legislation is likely to increase electricity prices.

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 are "sustained and substantial" and whether any adjustment was "reasonable" (2.35, p. 16). It is noted that the purpose of the ACCC calling for submissions is to assist it in determining how to operationalise

these notions objectively, but they do not lend themselves to objective determination, especially the notion of reasonableness.

These concerns are amplified by the guidance given in the Explanatory Memorandum as to what constitute sustained and substantial reductions in supply-chain costs: that assessments should consider “both broad electricity market trends and the specifics of the case” (2.36, p. 16). Operationalising these notions would seem extremely challenging.

The Explanatory Memorandum provides 12 examples of what does and does not constitute prohibited conduct. Consider Example 2.9:

**Example 2.9**

*“Over a three year period, wholesale prices trend upward for the first two years, and begin to fall in the third year to the point where there has been a sustained and substantial reduction.*

*In the first two years, a retailer does not increase its prices and absorbs the higher prices which would otherwise flow through to its consumers. All else held constant, when considering the retailer’s pricing over the longer term, it may be considered reasonable for that retailer to make only small adjustment, or no adjustment, to its prices in the third year.” [Emphasis added]*

A retailer will not know whether it is engaging in prohibited conduct if it makes only a small adjustment or no adjustment to its prices. If the ACCC were to be bound by this example in the Explanatory Memorandum, it could not provide meaningful guidance as to what constitutes prohibited conduct.

## **Conclusions**

The ACCC will have difficulty trying to operationalise in guidelines what are nebulous and subjective notions in the Treasury Laws Amendment (*Prohibiting Energy Market Misconduct*) Act 2019 and the Explanatory Memorandum. These include but are not limited to: reasonable; sustained and substantial; real or of substance though not necessarily large; broad electricity market trends; and specifics of the case. This problem is not the fault of the ACCC but of the use of these and other terms by the Parliament.

To the extent that ambiguity and subjectivity remain following the finalisation of the ACCC’s guidelines, perceptions of sovereign risk will be elevated and retailers will not be confident they are complying with the law even when they are diligently seeking to do so. Conversely, if retailers were to seek to take advantage of such ambiguities, the ACCC would be placed in the unenviable position of having to decide whether prohibited conduct has occurred and whether it could win a court case based on the circumstances of the case.

In any event, the legislation is a form of margin control, allowing only the tightest of margins to be achieved, when wholesale prices and other input costs are at their highest. The effect will be to discourage market entry by new retailers and innovation. Ultimately, electricity prices are likely to be higher as a consequence of the legislation. It is suggested that the ACCC be mindful of these restrictions on competition in developing its guidelines.