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Market Power Mitigation Strategy

The Australian Energy Council (the "**AEC**") welcomes the opportunity to make a submission on the Market Power Mitigation Strategy consultation paper ("**Consultation Paper**") published by Energy Policy WA ("**EPWA**").[1]

The AEC is the peak industry body for electricity and downstream natural gas businesses operating in the competitive wholesale and retail energy markets. Our members collectively generate the overwhelming majority of electricity in Australia, sell gas and electricity to millions of homes and businesses, and are major investors in renewable energy generation. The AEC supports reaching net-zero by 2050 as well as a 55 percent emissions reduction target by 2035, and is part of the Australian Climate Roundtable promoting climate ambition.

The AEC makes the following comments in relation to the Consultation Paper.

Information Paper

The Consultation Paper indicates that EPWA will release an Information Paper in September 2022 outlining the final detailed design of the market power mitigation framework that will form the basis of the Amending WEM Rules. While the Amending WEM Rules will be released for consultation in late 2022, there is no mention of a consultation process for the Information Paper.

There has been an extended pause in stakeholder consultation relating to market power mitigation since the Energy Transformation Taskforce released the previous Information Paper in May 2021. In the meantime, the market has continued to evolve and EPWA launched a limited review of the Reserve Capacity Market, the State Government released new policy principles that may introduce penalties for all high carbon emission electricity generation technologies in the Wholesale Electricity Market ("**WEM**") [2], and EPWA has proposed significant changes to the civil penalties framework.[3] At the same time, the Economic Regulation Authority ("**ERA**") has released a report on the effectiveness of the WEM and stated that:

> "*…Prices in the WEM will not be high enough to support revenue sufficiency for wind, solar and battery storage facilities as more solar, wind and storage facilities enter the WEM, and coal and gas generators exit the market.*
>
> *The extent of the gap between the revenue received and the revenue required by these renewable energy facilities grows as more of them replace thermal generation. This is because as more solar*

[1] See Market Power Mitigation Strategy consultation paper
[2] See Draft Statement of Policy Principles: Penalties for high emission technologies in the Wholesale Electricity Market
[3] See Proposed Changes to the WEM, GSI and Pilbara Regulations – Civil Penalties and Reviewable Decisions: Consultation Paper

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and wind generators with negligible operational costs enter the market, they set the energy market price at or close to zero more frequently. As a result, all generators in the WEM will face lower and lower prices, which do not allow them to recover their initial investment costs.

…Importantly, ESS markets are a significant revenue source for batteries. However as more battery storage capacity enters the market, the revenue greatly diminishes."[4]

With the ERA identifying that there is already insufficient revenue for generators in the WEM, it is appropriate for EPWA to consider the combined consequences of the RCM review, the new policy principles, the proposed changes to the civil penalties framework, the recommendations that come from the ERA's review of revenue adequacy, and the proposed market power mitigation design. Equally, it is difficult for stakeholders to make informed comments on any one of these major issues in isolation without understanding the overall impacts.

The AEC recommends that:

1. Sufficient time is made available for stakeholder consultation on the Information Paper; and
2. EPWA hold further consultation with stakeholders on the market power mitigation design after the RCM review has concluded and the Coordinator of Energy has designed the proposed carbon emission penalties.

Offer Construction Guideline

The proposed changes to the market power mitigation framework removes the requirement for market participants to bid at or below the Short Run Marginal Cost ("**SRMC**") and replaces it with the Offer Construction Obligation, which requires market participants to offer prices that reflect costs that a market participant without market power would include in forming its profit-maximising offer.

The Consultation Paper notes that the ERA will be required to develop an Offer Construction Guideline which sets out its interpretation of the Offer Construction Obligation.

"The WEM Rules will require the ERA to develop and publish the Offer Construction Guideline setting out how the ERA expects to consider the following matters as part of its assessment:

- *All start-up and shutdown costs of a Facility, including the costs of fuel, water, internal power, additional labour and lost asset value directly attributable to the startup or shutdown;*
- *Variable costs of production, including:*
    - *Fuel costs;*
    - *Operational and maintenance costs that are attributable to the production of output;*
    - *Unplanned outages costs;*
    - *The value of water;*
    - *Any relevant regulatory costs or allowances; and*
    - *Reasonable amortisation of costs across Trading and Dispatch Intervals."*[5]

[4] See p13 and 18, Triennial review of the effectiveness of the Wholesale Electricity Market 2022: Discussion paper
[5] See p55, Market Power Mitigation Strategy consultation paper

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The AEC raised this issue in our submission on the market power mitigation information paper released in 2021 and expressed concern about the prescriptive approach.[6] Such an approach contradicts the sentiments put forward by the Brattle Group in their report on how the WEM Rules can be improved for using SRMC in market power mitigation.[7] Energy Policy WA also released the *Directions Report: Clarifying Short Run Marginal Cost and market offer requirements in the Wholesale Electricity Market* (the "Directions Report") in 2020 and noted the difficulty of including a list of specific cost components in the rules given a participant's circumstances in the market will change over time.[8]

Any offer construction guideline will be unable to capture all the circumstances and costs that must be recovered in offers. This is especially the case as the market evolves, new technologies enter and some generation types, such as wind, solar and battery storage, may need to recover their Long Run Marginal Cost given the lack of revenue sufficiency outlined by the ERA. A prescriptive guideline will result in uncertainty and could force market participants into lower offers than optimal and contribute to the revenue sufficiency problem.

This guideline approach would also put the ERA in a conflicted position. Under the proposed changes, the ERA is required to develop the guideline, assess performance against their own interpretation of the guideline, and then also penalise participants under the civil penalties framework. The AEC recommends that there is extensive consultation on the proposed guidelines via a separate body to ensure that the process is independent, and views that do not align with the ERA's interpretations are fairly considered and able to be challenged.

It is challenging for the AEC to endorse a guideline approach without seeing the details of the guidelines. Nonetheless, the AEC suggests that:

1. Any guideline should not be prescriptive given the increasing amount of wind, solar and battery storage entering the market and the challenges they face in earning sufficient revenue; and

2. EPWA's proposed approach puts the ERA in a conflicted position where it must produce a guideline and then regulate and enforce submissions. For this reason, there should be thorough consultation on the guideline through an independent body.

Gateway Test

In the Consultation Paper, EPWA reviewed options for a Gateway Test based on market power tests currently used in other markets. EPWA concluded that:

> *"…using a Static Concentration Ratio method for the Gateway Test is likely to provide the most certainty and associated competition benefits to the WEM, while ensuring that offers most likely to result in adverse market outcomes are subjected to further assessment by the ERA.*
>
> *…It is proposed that … a 10% share of total generation is a suitable threshold to trigger the Static CR Gateway Test when it is first implemented. It is EPWA's view that the most appropriate implementation of the 10% Static CR is based on sent out MW, as it provides a simple, stable and proportionate ex-ante calculation methodology to determine a Portfolio's overall market share at a given point in time."*[9]

[6] See AEC submission on Proposals for changes to Market Power Mitigation Mechanisms
[7] See Implementing recommended improvements to market power mitigation in the WEM
[8] See page 4, Directions Report: Clarifying Short Run Marginal Cost and market offer requirements in the Wholesale Electricity Market
[9] See p14, Market Power Mitigation Strategy consultation paper

The AEC is concerned that the Static CR Gateway Test has two drawbacks:

1. The Static CR Gateway Test may fail to capture portfolios that have less than 10% of market share but can still influence prices due to their generation technology. This creates an uneven playing field where these portfolios avoid investigation and have the potential to alter prices while larger portfolios will be captured under the Gateway Test and may not be exercising market power; and

2. On the other hand, the Static CR Gateway Test could capture large portfolios that have little influence on prices. For example, as more renewables enter the market the Static CR Gateway Test could potentially capture large solar and wind portfolios that exceed 10% of market share but cannot meaningfully adjust prices because bidding artificially high is not a viable strategy for them and withholding generation would not inflate prices during these daytime periods with typically low prices.

The AEC encourages EPWA to give further consideration to the Gateway Test and how these scenarios will be addressed.

Review period for energy and FCESS price limits

The Consultation Paper states that the energy and FCESS price limits will be reviewed every three years and that the ERA has discretion to make an in-cycle determination of the price caps in exceptional circumstances. This process would be initiated by the ERA unilaterally, or on participant request.[10]

The energy sector is transitioning at a rapid pace and there may be merit in reducing the review period to two years to ensure that the limits continue to align with market conditions. At the least, the AEC suggests that there needs to be a prescribed process for participants to request an in-cycle review and determination. This process should:

- Outline the circumstances that would warrant an in-cycle review so participants are clear when a review would be considered and, equally, avoid the ERA conducting regular and unnecessary reviews; and

- Include an independent body, perhaps the Coordinator, so that requests for a review are thoroughly considered, not rejected without merit and any rejection can be challenged.

Energy and FCESS price limit indexation

In referring to the price caps, the Consultation Paper states that "the ERA would have discretion to nominate additional indexation according to average fuel prices where relevant and practicable."[11]

The increase in east coast gas prices over the last few months highlights the importance of this issue. Quarterly average gas prices jumped by over 200% in the east coast markets between Q1 2022 and Q2 2022, pushing gas prices to record levels and contributing to the spike in wholesale electricity prices.[12] This period shows how fast the market can change and the impact fuel prices have on wholesale electricity pricing.

In light of this, the AEC considers that rather than the ERA having 'discretion' to index price caps to fuel prices, the WEM Rules should make clear that the ERA is required to index price caps to fuel prices.

[10] See p48, Market Power Mitigation Strategy consultation paper
[11] See p48, Market Power Mitigation Strategy consultation paper
[12] See p40, Quarterly Energy Dynamics Q2 2022 July 2022

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FCESS Price Cap

The Consultation Paper considers three options to address FCESS Price Caps and notes that EPWA undertook a series of case studies to assess the feasibility of these options. One of the observations is that:

> "*It is expected that participants may incur a small loss during the period of ramping a generator to its minimum generation level, and potentially while ramping down, under Option 1 [EPWA's preferred option]. This occurs because a participant that has been forecast to be needed for FCESS will likely need to price its energy offers at a very low level in order to ensure that it is dispatched on, and to the level at which it can provide the necessary FCESS.*
>
> *However, EPWA considers the materiality of this is likely to be small, lasting for only one or two dispatch intervals while a gas turbine is ramped from 0 MW to the minimum generation level.*
>
> *EPWA considers that any such loss should be able to be recovered through FCESS offer prices, as a start-up cost, noting that the price cap under Option 1 would include a margin and be rounded up.*"[13]

The AEC is concerned that:

1. Generators will be forced to incur a loss in some circumstances during the ramp up and ramp down periods and the extent of these losses may be larger than acknowledged in the Consultation Paper. This is because the energy price for the ramp up/ramp down intervals could be low, or even negative, and outweigh the revenue from the FCESS.

2. Generators may not be able to fully recover their ride through costs in circumstances where it would be more efficient for a facility to ride through and recover losses rather than incurring the shut down and start-up costs.

The AEC seeks further information about whether a generator can decline to offer into the market and how they can recover their full ride through costs.

Conclusion

The AEC appreciates this opportunity to provide feedback on the Consultation Paper and encourages EPWA to consider the issues raised above.

Please do not hesitate to contact Graham Pearson, Western Australia Policy Manager by email on graham.pearson@energycouncil.com.au or by telephone on 0466 631 776 should you wish to discuss this further.

Yours sincerely,

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[13] See p39, Market Power Mitigation Strategy consultation paper