

# **WILL THE “BIG STICK” IMPACT WHOLESAL PRICE PASS-THROUGH IN AUSTRALIA’S RETAIL ELECTRICITY MARKETS?**

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## **Overview**

In 2017, the Australian Competition and Consumer Commission (ACCC) undertook an inquiry into the affordability of retail electricity markets within the National Electricity Market (ACCC, 2018). The ACCC (2018) concluded that the “approach to policy, regulatory design and promotion of competition in this sector has not worked well for consumers” and that energy companies have “played a major role in poor outcomes for consumers”. The ACCC (2018) recommended a number of changes to increase competition in the electricity generation and financial contracts markets, and to improve consumer outcomes in the retail electricity market. However, the ACCC (2018) did not identify any failure by retailers to pass on cost reductions as a major cause of high prices (Pan, 2020).

In response to the ACCC recommendations, the *Treasury Laws Amendment (Prohibiting Energy Market Misconduct) Act 2019* (Cth) (“the Act”) came into effect on 10 June 2020. The Act amended the *Competition and Consumer Act 2010* (Cth) to create three new energy market misconduct prohibitions in relation to electricity retail pricing, financial contract market liquidity and conduct in the wholesale electricity spot markets. The broad objective of the new provisions – commonly referred to as the “Big Stick” legislation - is to “put downward pressure on electricity prices and hold energy companies to account” (Frydenberg and Taylor, 2019).

A corporation contravenes the Big Stick electricity retail pricing provisions (s.153E) if it offers to supply electricity, or supplies electricity, to small customers, and fails to make reasonable adjustments to the price of those offers to reflect sustained and substantial reductions in its underlying cost of procuring electricity. The retail pricing prohibitions are specifically designed to ensure consumers see the benefit of supply chain cost savings, and that such savings are not retained by retailers to the detriment of their consumers (*Explanatory Memorandum Treasury Laws Amendment (Prohibiting Energy Market Misconduct) Act 2019* (Cth)). The ACCC is responsible for monitoring and enforcing compliance with the Big Stick legislation and has released guidelines on how they intend to undertake these duties (ACCC, 2020). Penalties for breach of the Big Stick retail pricing provisions include infringement notices (s.153N(1)) carrying a penalty of up to \$126,000 (*Crimes Act 1914* (Cth) s.4AA), and public warning notices (s.153M). The new retail pricing prohibited market conduct provisions are yet to be invoked or tested in the courts. However, the ACCC has reportedly approached a number of electricity retailers that it suspects may not have adequately passed on cost savings to their customers (ACCC, 2021).

The purpose of this study is to critically examine whether the Big Stick legislation will have any meaningful impact on retail electricity prices in Australia. Our contribution is a critical analysis, through the use of economic reasoning and understanding of competitive retail electricity markets, and drawing on the evidence from the study of these markets in Australia, Great Britain, the United States and other countries.

## **Methods**

This study critiques the approach to monitoring and enforcing wholesale price pass-through to retail electricity prices pursuant to the Big Stick retail pricing provisions. We draw on insights regarding wholesale price pass-through to retail electricity prices in Australia and internationally to critically assess whether the legal tests and thresholds are likely to be effective.

## **Results**

The key concepts in the retail pricing provisions (s.153E) are: ‘small customers’, ‘underlying cost of procuring electricity’, ‘sustained and substantial reductions’, ‘reasonable adjustments’ and ‘price’. However, our insights into wholesale price pass-through in competitive retail electricity markets reveals several important limitations to the construct of the Big Stick legislative provisions.

One, the ACCC intends to monitor “underlying costs” by reference to market-wide trends (ACCC, 2020). However, a retailers underlying costs cannot be known by reference to market-wide trends because retailers have heterogeneous hedging strategies. Individual retailers will also have heterogeneous hedging strategies across their different retail products. As there is no single definition of “underlying costs” and these costs cannot be known by reference to market-wide trends, assessing the magnitude and rate of wholesale price pass-through for the purposes of the Act is difficult. Several approaches have been used to estimate underlying costs based on an assumed retailer hedging strategy for the purposes of assessing wholesale price pass-through in Australia (Burns and Mountain, 2022) and internationally (see, for example, Ofgem (2011) in Great Britain, Mulder and Willems (2019) in Netherlands, and

Hartley et al. (2019) in Texas). However, the methods used to estimate underlying costs directly impacts the assessment of wholesale price pass-through to retail electricity prices (Burns and Mountain, 2022) and this creates barriers to monitoring and enforcement.

Two, the duration of time to be considered “sustained” is defined only so far as a period of time greater than a month, reflecting a downward trend that is expected to continue over time (ACCC, 2020). Without a clearly defined threshold it is unclear when the retail pricing provisions would be triggered and, as wholesale prices are highly volatile, the provisions may be easily circumvented through legal reasoning.

Three, the magnitude of the reduction in costs required to constitute “substantial” is not well defined and the ACCC will not set a threshold other than indicating the reduction in costs must be “real or of substance, relative to the overall costs of procuring electricity, but not necessarily large”. Again, without a clearly defined threshold it is unclear when the provisions would be triggered and the provisions may be circumvented through legal reasoning.

Four, what constitutes a ‘reasonable adjustment’ is vague and does not necessarily require full pass-through (ACCC, 2020). For example, an incumbent profitable retailer is expected to fully pass-through a reduction in network costs, whereas a new retailer may not be required to fully pass-through reductions in their underlying costs (ACCC, 2020). It is also unclear the point in time when a retailer must adjust prices to constitute a “reasonable adjustment”, and whether this need occur before or at the regular planned price adjustment. Further, whether it is reasonable to adjust prices pre or post discount is also vague.

Finally, the definition of retail “price” also presents some interpretation issues because retailers charge many different prices, some prices vary by time of day/day of week, and discounts may also apply. Retailers also offer many different retail tariffs, both new and historical, meaning there are potentially many thousands of prices to monitor. Several approaches have been used to estimate retail prices for the purpose of assessing wholesale price pass-through in retail electricity markets (see, for instance, Burns and Mountain, 2022; Ofgem, 2011; Hartley et al., 2019). However, the methods used to estimate retail prices directly impacts the assessment of wholesale price pass-through to retail electricity prices (Burns and Mountain, 2022) and this presents barriers to effective monitoring and enforcement.

## Conclusions

The Big Stick retail pricing provisions are ill-defined and overlook the complexity of how retail electricity prices interact with wholesale price movements over time, and the heterogeneity of retailers underlying cost structures and prices offered in the market. Although the Act has yet to be tested, it is likely that the identified issues in the retail pricing provisions will make monitoring and enforcement difficult. In conclusion, the Big Stick is unlikely to have a meaningful impact on retail electricity prices in Australia.

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