

24 January 2019

Economics Legislation Committee
Submission via web form

Submission to the Inquiry into Treasury Laws Amendment (Prohibiting Energy Market Misconduct)

We appreciate the opportunity to make a submission to the Senate inquiry into the Treasury Laws Amendment relating to Energy Market Misconduct. We made a similar submission to the one below to the Treasurer during the brief consultation period late last year.

We are investors in Australian equities, investing ~\$6 billion on behalf of Australian households who are mainly saving for retirement. We invest for the long-term in a broad range of Australian companies, from industrial companies and others impacted by higher electricity and gas prices, as well as one of the electricity retailers. As a result, our interest is in the long-term, sustainable health of these markets.

We have serious reservations about the legislation contemplated, which we believe is unnecessary (particularly as it applies to the retailers) and could actually make things worse for consumers and taxpayers in the long-term. In the rest of this submission, we detail the issues with the assumptions and evidence that are relied upon to arrive at these policies, and we outline particular problems with the current Bill.

Implicit assumptions and evidence relied upon

It would be fair to say that the ACCC report on electricity pricing has informed much of the debate around electricity pricing. In that report, the ACCC states that retail margin increases have contributed to higher costs. We make the following points on their data and analysis:

- The data uses EBITDA (earnings before interest, tax, depreciation and amortisation) margins. This is not an appropriate metric as it ignores a very real cost – the cost associated with the capital required to run the retail business which are reflected in the depreciation and amortisation expense over time. For an equal return to providers of capital, a capital intensive company or industry would need to attract a much higher EBITDA margin than for a capital-light company or industry. The capital intensity of the energy retailers has increased over time and it is therefore reasonable to expect EBITDA margins to have increased too. It is more appropriate to focus on EBIT margins given the real capital costs associated with being an energy retailer.
- The data appears not to be consistent with the ACCC's own analysis in its Preliminary Report (p75 in particular). Reported EBITDA margins have changed from that report without explanation. In fact, the Preliminary Report says that "the data ... did not provide a clear trend in retail margins over time", but, in the Final Report, the ACCC says there is a trend after the addition of just one year's worth of additional data. Not providing a right of reply for electricity retailers given such a drastic shift in their findings, we believe, is a failure of process.
- Recent announcements in August 2018 by Origin Energy show that reported costs in the electricity business have been dramatically understated in its accounts as a result of hedge accounting practices. These costs are recurring cash costs and should play a part in any analysis of the economics of retailers. They amount to \$160m per annum, and were lower in previous years. It is unclear whether other retailers have had similar costs, but it is doubtful that any of these costs are taken into account in the ACCC's analysis given they do not form part of the reported EBITDA numbers in the first instance and they were only brought to light subsequent to their report. In Origin's case, these costs specifically relate to NSW, where the ACCC data shows the most prominent increase in retail margins. Including these costs would

certainly flatten out the apparent increases. These hedge costs are an important and ongoing part of an energy retailer's business and are specifically designed to protect them from significant spikes in energy costs which they are unable to pass on to their customers.

- Other sense checks suggest that the margins ascribed to retailing are inflated. If we assume that the ACCC is correct about retail margins, then the generation arms of Origin and AGL are not making enough money to justify new investment even in this period of high wholesale energy costs. If that is true, then why would these companies invest in any new capacity if margins are fixed at these levels, as this legislation contemplates?

We do not believe the data and analysis that the ACCC report presents would stand up to independent scrutiny given the above and we worry that important policy prescriptions and interventions are being crafted on the back of a flawed assumption: that energy retailers are making too much money. In fact, there is no credible evidence that this is the case. The end result is if, as we expect, retail margins are actually a lot lower, then the companies required to invest in the future will be the very ones that are starved of the capital to do so. This is not in the interests of consumers or taxpayers.

Specific comments on Prohibited Conduct

The Bill says prohibited conduct, as it relates to retail pricing, would occur if a company 'fails to make reasonable adjustments to the price ... to reflect sustained and substantial reductions in its underlying cost of procuring electricity'. The Explanatory Memorandum expands on that definition with a number of examples.

We see several issues with the definition of prohibited conduct:

- This is a market with several players, different strategies and a number of different cost bases. The 11 examples provided relating to the retail market do not cover the different possible scenarios, which means that regulator discretion and court cases will likely decide what may be considered prohibited conduct. That is not a recipe for a healthy market – uncertainty will be priced in by retailers one way or another, to the detriment of consumers.
- For example, if a retailer comes up with a way to procure energy more efficiently than others, through hedge contracts and PPAs, and this is sustainable, then must that retailer pass on their sustained decrease? None of the examples deal with this scenario explicitly. In our reading of this Bill, there has been a sustained and substantial decrease in their costs, so the retailer would have to pass on that decrease. If that is the case, then there would be no incentive for a retailer to innovate in this manner, and consumers would be worse off.
- The intent of this Bill is to fix retail margins, in the absence of operating cost reductions. Any changes to offers essentially need to pass the regulator's test of reasonableness. We question why the regulator is best-placed to do this and not the customer. A smaller audience will undoubtedly lead to lower levels of innovation, and worse outcomes for consumers in the end.
- Prohibited conduct is vaguely defined in other ways. For example, in 2.35 of the Explanatory Memorandum, for a reduction to be considered 'substantial', it must be 'real or of substance, relative to the overall costs of procuring electricity, though not necessarily large'. It should not be a surprise if that definition results in confusion.
- The Explanatory Memorandum states (2.20) that the 'prohibition does not deal with overall *increases* in supply chain costs'. Given the likelihood that retail margins in general are too low at the moment, and that wholesale costs are cyclical, it would be a reasonable strategy for retailers to over-recover on margins on the way up and then pass on cost decreases as required on the way down. A few cycles of this and it is not clear what this legislation would have achieved. It is quite possible that other games could be played, by both retailers and (independent) generators.

ALLAN GRAY

LONG-TERM INVESTING

As long-term investors in Australian companies, we despair. If these are the right policies (which we doubt), then we await the roll-out of similar policies across banking (term deposits, savings accounts, mortgages), insurance, telecommunications and other consumer services. There are surely examples of similar prohibited conduct in those industries. If government were to intervene, then we should also plan for lower competition and less innovation (the likely future for electricity markets) in these sectors, which would not be in consumer, taxpayer or long-term investor interests.

We believe pricing transparency and time are sufficient to fix most of the issues in electricity markets. The cycle will fix high prices, as it always has. This legislation, which we believe could actually make things worse, is being pushed forward without any evidence of a lack of competition, or even evidence of companies that are over-earning. The only evidence is that prices are high. But the most plausible reasons that account for most of the price rises have nothing to do with nefarious conduct by electricity retailers. Using this hammer of more heavy-handed intervention would only make it harder for investors and companies to fund the capital investment required in the sector. And this is the very investment that is required to fix the prevailing high prices.

Yours sincerely,

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