

Wholesale electricity market performance monitoring 2022 Focus paper

Introduction

Consultation on focus areas for the 2022 performance report

We are seeking input and feedback from stakeholders on the key issues and areas of focus for the *Wholesale electricity market performance report 2022* (2022 performance report) outlined below. We invite interested parties to submit any feedback on our areas of focus, to wholesaleperformance@aer.gov.au by **16 December 2021**. We will publish any formal submissions on our website. Our general approach to the use and disclosure of information is set out in the *ACCC/AER information policy*.¹

Separately, as we move closer to the publication of the 2022 performance report, we will conduct more intensive engagement with stakeholders regarding the details of these issues. While we will contact a wide range of stakeholders for discussions, we also invite any interested parties to contact us at the above email address to discuss any issues relevant to the 2022 performance report, or our broader wholesale market performance monitoring.

AER wholesale electricity market monitoring and reporting

The AER is required under the National Electricity Law (NEL) to undertake regular comprehensive, longer-term assessments of the performance of wholesale electricity markets.² These comprehensive reports assess the performance of Australia's wholesale electricity markets over at least the previous 5 years. We will publish our next performance report in December 2022.

We will report on whether:

- there is effective competition in the wholesale markets, or there are features of the market that may be detrimental to effective competition
- there are features of the market that may compromise the efficient functioning of the market.

This *2022 Focus paper* provides an overview of the 2022 performance report, the areas we intend to focus on in our analysis, and the framework and tools we intend to apply. This *2022 Focus paper* should be read alongside our enduring *Statement of approach*, which outlines the general approach we take in monitoring the performance of the market.³ This includes:

- the framework for our analysis
- how we define effective competition and efficiency
- the way we will collect and use information

¹ ACCC & AER, [ACCC/AER information policy](#), June 2014.

² NEL, Part 3, Division 1A.

³ AER, [Wholesale electricity market performance monitoring – Statement of approach](#), March 2018.

The overall framework we use for our analysis is the structure-conduct-performance approach. In our *Statement of approach*, we identified a number of measures to provide consistent analysis between reports. In addition to the *Statement of approach*, for each performance report we prepare a focus document outlining the particular methods we intend to use and areas of the market we will examine in detail. This *2022 Focus paper* fulfills this function for the 2022 performance report. In future reports, we expect the wholesale markets will evolve and the issues we focus on will change.

In undertaking these monitoring and reporting functions, we must use publicly available information in the first instance, but can request confidential information if we identify an issue from this. We will also meet with stakeholders on a voluntary basis to discuss specific issues, as we have done for previous reports. Our *Statement of approach* identifies how we approach information gathering and confidentiality.

Separately, we have other reporting obligations across our wholesale, retail and network areas in addition to these functions. Our other wholesale reports generally focus on shorter term outcomes, compliance issues and individual price events. In contrast, this biennial report allows us to take a longer term view of the market, with a focus on competition and efficiency issues. If through our other, related reports we identify emerging issues or trends, we will incorporate that analysis in the 2022 performance report and may examine the issues further.

Context for the 2022 performance report

The ongoing market transformation

Australian electricity markets are transforming, driven by technological change and emissions reduction. As a result, the current and future competitiveness and efficiency of the wholesale electricity markets as they transition remain an important area of focus.

As dynamics shift, particularly across different times of the day, market operation is more technically challenging. The coal-fired generation fleet continues to age and exit, and find their old strategies under pressure. At the same time, the significant growth of renewable generation is driving a greater need for flexible technologies and storage. Given this, policymakers and market bodies continue to hold concerns for the reliability and security of electricity supply. As a result, governments and market participants have implemented or proposed a number of changes to address these concerns and support the transition.

This ongoing transformation of the electricity sector continues to be important context, influencing our analysis and conclusions regarding the performance of the NEM over the previous 5 years.

Introduction of 5 minute settlement

In October 2021, the market moved to 5 minute settlement. This change was designed to provide a better price signal for investment in faster, flexible technologies such as batteries and peaking generation, and demand side participation. However, as participants now receive every 5 minute price, this presents new implications for competition and efficiency.

In the 2022 performance report we will assess the impact of this change on the market in the first year following its implementation.

Demand side participation

While demand side participation remains limited, we will continue to report on the effect of recent and proposed developments on the wholesale electricity markets. One of the most significant developments to date is the introduction of the Wholesale Demand Response

Mechanism on 24 October 2021, which allows eligible energy customers to sell demand response into the market. We will assess the impact of this change on competition and efficiency across the first year following its implementation.

Areas of focus for 2022 performance monitoring

How participants behave

Our analysis in the 2018 and 2020 performance report examined participant behaviour in aggregate, often grouped by fuel type or region. But many participants hold varied types of generation across multiple regions. Those participants typically optimise their production across the portfolio as a whole, rather than in individual regions.

In 2022 we intend to extend our analysis of how individual participants offer their portfolio of assets across and within different NEM regions. While we continue to assess trends in the same way as previous years, this additional focus on offers across different generation types within a portfolio will provide greater insight into individual participant behaviour. In addition, we intend to explore new methods to consider whether there is evidence of economic withholding that may suggest the sustained exercise of market power. However, without detailed access to participants' contract positions our analysis will be limited, as this is a significant input to their behaviour.

Additionally, our analysis in the 2020 performance report found that new dynamics are emerging across different times of the day. In 2022, we will further analyse the impacts of increased intermittent generation during the day, how flexible generators respond during morning and evening peaks, and the impact this has on competition and efficiency.

Contract market dynamics

Our analysis in the 2020 performance report examined contract markets in more detail than in 2018. However, while the products traded on the Australian Securities Exchange (ASX) are public information, there is still limited visibility regarding the parties to these trades, and little to no information about bilateral over-the-counter (OTC) transactions. This limits our ability to assess contract market dynamics and it is hard to state how these markets have performed over time. In its *Retail electricity pricing inquiry*, the Australian Competition and Consumer Commission (ACCC) recommended that the AER's wholesale market monitoring role should be expanded to include monitoring, analysing and reporting on the contract market.⁴ Following this, Energy Ministers agreed to expand the AER's powers and are currently considering relevant change to the NEL. We will continue to advocate for changes to allow us greater visibility over contract market outcomes.

In the meantime, over the next year, we will conduct qualitative analysis through engaging with a range of stakeholders including standalone retailers, to determine whether the existing range of risk management products are working to support competitive and efficient markets. We will also seek to understand how these, and related, products impact commercial investment drivers. We expect that our analysis will provide some insight into how the market is currently functioning, but will be limited without broader powers to access quantitative contract information on a systematic basis. Access to quantitative contract information would allow us to test participant's impressions of the contract markets more thoroughly and draw firmer conclusions on the functioning of those markets. .

⁴ ACCC, *Retail electricity pricing inquiry – Final report*, July 2018, recommendation 41.

Barriers to entry

The 2020 performance report identified a range of potential barriers to entry, and impediments to efficient price signalling in the NEM. Understanding these factors helps us to assess the likelihood of new entry in response to market price signals. New entry is an important feature of effectively competitive markets because it may constrain incumbents' ability to exercise sustained market power.

For 2022, we will continue to examine incentives and trends for investment in the NEM, informed by our own assessment and discussions with market participants and stakeholders. We will also engage with stakeholders to specifically understand how the accessibility and range of risk management products impact market entry.

Methods and analytical issues

Estimating underlying costs

Our *Statement of approach* identifies possible approaches for estimating costs when assessing whether prices are determined by underlying costs in the long run. In the 2018 and 2020 performance reports, we use levelised cost of energy and storage estimates. In the 2022 performance report we intend to continue using these estimates, but are considering if there is value in using alternative approaches. In our *Statement of approach*, we discuss some potential approaches, including estimates of long run marginal costs.⁵ We are interested in stakeholders' views on the merits of any alternative approaches.

Additionally, in 2020 we modelled the costs, revenues and operating earnings for generators in the mainland NEM. As this assessment was based on publicly available information, we considered undertaking more formal information requests of generators to better understand their revenues and costs. We did not conduct these requests in 2021, but we are regularly reviewing the need for more formal information requests and will consider how this analysis may fit in the 2022 performance report.

Frequency Control Ancillary Service (FCAS) markets

In the 2020 performance report we analysed competition in FCAS markets in detail for the first time. This assessment used basic metrics such as market shares, a high-level examination of participant behaviour. Given the increasing importance of FCAS markets, we intend to build on this assessment for the 2022 performance report and use a broader range of tools in our analysis. We will also seek to develop our understanding of how participants determine the cost of providing FCAS, and how that influences their behaviour.

Questions for stakeholder input

We would appreciate stakeholder views in response to the following questions.

Question 1: Are there any additional issues or areas of focus we should consider for the 2022 performance report?

Question 2: Have there been changes in the main drivers of outcomes in the wholesale electricity markets since 2020 that we should consider?

Question 3: Are there new factors influencing market entry and exit that we should incorporate in our assessment?

⁵ AER, [Wholesale electricity market performance monitoring – Statement of approach](#), March 2018, pp. 15-16.