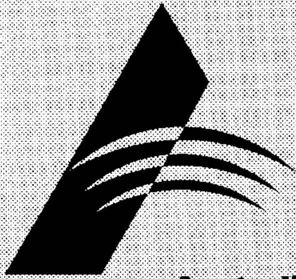

Australian
Competition &
Consumer
Commission

Determination

Applications for Authorisation

Trading limits, Funding for compensation for system security directions, Settlement by estimates and Intra-regional loss factors

Date: 2 February 2000

A90708
A90709
A90710

File no:
C1999/761

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1. Introduction

On 10 September 1999 the Australian Competition and Consumer Commission (the Commission) received applications for authorisation (Nos A90708, A90709 and A90710) of amendments to the National Electricity Code (Code). The applications were submitted under Part VII of the *Trade Practices Act 1974* (the TPA) and, together with a supporting submission, were lodged by the National Electricity Code Administrator (NECA). Amendments to the applications were received on 23 September and 15 October 1999. The proposed amendments to the Code dealt with:

- Trading credit limits for market participants;
- Funding of compensation to generators for system security directions;
- Settlement by estimates; and
- Intra-regional loss factors for new generation and transmission customers.

The applicants also requested that the Commission grant interim authorisation in respect of the settlement by estimates amendment, so that the proposed changes could be implemented prior to the Y2K transition. The Commission granted interim authorisation to the proposed change on 10 November 1999.

On 16 December 1999, the Commission issued a draft determination proposing to grant authorisation of the proposed Code changes. There was no request, pursuant to section 90A of the Act, for a pre-determination conference to be held in respect of the draft determination.

Authorisation under Part VII of the TPA provides immunity from court action for certain types of market arrangements or conduct which would otherwise be in breach of Part IV of the TPA, where the Commission concludes that the public benefits of the arrangements or conduct would outweigh the anti-competitive detriments of such arrangements or conduct.

The Commission has prepared this determination outlining its analysis and views on the key competition issues arising from the applications for authorisation of the amendments to the Code. This determination is an authorisation of the above amendments and is not an authorisation of the entire Code. Therefore the Commission's previous analysis of the Code remains relevant and can be found in the Commission's determinations of 10 December 1997, 19 October 1998 and 22 December 1999.

The following section outlines the Commission's consultation arrangements and section 2 documents the Commission's statutory assessment criteria and approach. Sections 3-6 describe the Commission's assessment of the applications for authorisation and section 7 sets out the Commission's determination.

Background information regarding competition policy, the importance of electricity industry reform and the extent of reform in the industry can be found in the 10 December 1997 determination.

1.1. Public consultation process

The Commission has a statutory obligation under the TPA to follow a public process when assessing an application for authorisation.

The Commission received the initial application for authorisation of the changes to the Code on 10 September 1999 and further variations to the applications were received on 23 September and 15 October 1999. Notification of the application and a request for submissions was advertised in *The Financial Review* on 28 September and 26 October 1999, placed on the Commission's web site and interested parties were also contacted by letter. Interested parties were asked to make submissions to the Commission regarding their views on the issues of public benefit and anti-competitive detriment arising from implementation of the proposed changes.

On the release of the draft determination on 16 December 1999, there was a further opportunity for interested parties to comment on the Code changes. The Commission received no requests for a pre-determination conference nor were there any submissions on the draft determination.

2. Statutory test

These applications were made under sub-sections 88(1) and 88(8) of the TPA. The TPA provides that the Commission shall only grant authorisation if the applicant satisfies the relevant tests in sub-sections 90(6) or 90(8) of the TPA.

Sub-section 90(6) provides that the Commission shall grant authorisation only if it is satisfied in all the circumstances that:

- the provisions of the subject arrangements or conduct would result, or be likely to result, in a benefit to the public; and
- that benefit would outweigh the detriment to the public constituted by any lessening of competition that would, or would be likely to result from the arrangements or conduct.

Sub-section 90(8) provides that the Commission shall grant authorisation only if it is satisfied in all the circumstances that the proposed provision or conduct would result (or be likely to result) in such a benefit to the public that the proposed contract, arrangement, understanding or conduct should be allowed.

In deciding whether it should grant authorisation, the Commission must examine the anti-competitive aspects of the arrangements or conduct, the public benefits arising from the arrangements or conduct and weigh the two to determine which is greater. Should the public benefit or expected public benefits outweigh the anti-competitive aspects, the Commission may grant authorisation or grant authorisation subject to conditions.

Determining just what is a benefit to the public is therefore a key issue. Public benefits recognised in the past include:

- fostering business efficiency;

- industry rationalisation;
- expansion of employment;
- promotion of industry cost savings;
- promotion of competition in industry;
- promotion of equitable dealings in the market;
- development of import replacements;
- growth in export markets; and
- arrangements which facilitate the smooth transition to deregulation.

If the Commission determines that the public benefits do not outweigh the anti-competitive detriment, the Commission may refuse authorisation or alternatively, in refusing authorisation, indicate to the applicant how the applications could be constructed to change the balance of detriment and public benefit so that authorisation may be granted.

The value of authorisation for the applicant is that it provides protection from action by the Commission or any other party for potential breaches of certain restrictive trade provisions of the TPA. It should be noted, however, that authorisation provides exemption only for the particular conduct specified. Authorisation does not provide blanket exemption from all provisions of the TPA. Further, authorisation is not available for misuse of market power (section 46).

3. Trading limits

The applicants propose to change clause 3.3.10(a) to redefine the trading limit for market participants to represent the product of the prudential factor and the greater of:

(i) the market participant's maximum credit limit; or

(ii) the credit support provided by the market participant.

Issues for the Commission

Whether the proposed change could lead to discrimination between market participants or barriers to entry based on the relative ease and cost with which they can obtain credit support.

What the applicants say

The applicants state that the objective of these changes is to enhance market efficiency in electricity trading by allowing participants to trade up to the level of their credit support. The proposed change provides market participants with recognition, in the calculated trading limit, of the discretionary excess credit support held.

The applicants maintain that the change will lower barriers to entry for new retailers as they will not have to prove a trading amount but just have a line of credit to allow a trading limit to be defined. The change will reduce the trading costs for retailers as it allows them full access to their credits and simplifies their administrative procedures by removing the need to constantly watch their trading limit to ensure they have matched their credit backing to their trading. The applicants claim that the combination of these two aspects will mean that the cost of retail overheads is reduced which will lead to cheaper energy to customers.

The applicants contend that the change will result in a public benefit by lowering barriers to entry and reducing market cost to participants and thus customers.

What the interested parties say

In their submission Synergen state that the change results in a commercially acceptable practice and support its inclusion in the Code.

It should also be noted that the proposed change was requested by the National Retailers Forum and jointly supported by fourteen retailers.

Commissions considerations

The Commission expressed concern in its 10 December 1997 determination regarding the number of prudential requirements contained in the Code and whether the demands they placed on market participants could act as barriers to entry for new participants. The importance that the prudential requirements played in ensuring confidence and security in the market was recognised, however, and the majority of the prudential requirements were authorised.

By allowing market participants the discretion to use any excess credit support held, the proposed change is likely to result in a decrease in the barriers to entry created by the prudential requirements. The Commission also understands that NEMMCO already, in practice, interprets the existing provisions of the Code in this way without any adverse effects, including on prudential risk.

The Commission agrees that the proposed change is a more commercially acceptable practice. It should also be noted that a financial institution would often in a better position to assess the credit worthiness of their client (ie the market participant) than NEMMCO, due to a greater familiarity with the financial standing of the participant. This could allow a market participant the benefit of a greater credit limit than would otherwise be determined by NEMMCO.

Giving participants the ability to increase their credit limits will invariably lead to more frequent or higher levels of trading. This increased participation is likely to improve liquidity and therefore efficiency in the market.

4. Funding of compensation for system security directions

In its 19 October 1998 determination, the Commission required NEMMCO to develop a methodology for compensating generators who are given directions under section 76 of the National Electricity Law or clause 4.8.9 if the Code.

The Commission's determination of 20 October 1999 also granted the applicants a derogation from clause 4.8.9 to postpone payment of compensation until NEMMCO had developed an appropriate funding mechanism.

The proposed addition of clause 3.15.10A to the Code will allow NEMMCO to recover compensation paid to generators for system security direction from market customers in proportion to their energy usage in the relevant trading intervals.

Issues for the Commission

Whether the proposed changes will have a beneficial or detrimental effect on the competitive efficiency of the national market.

What the applicants say

Essentially, the methodology proposed for the recovery of compensation for system security directions is the same as that currently used for the recovery of ancillary service directions. This methodology was chosen to provide consistency with ancillary service directions, which are found to have similar reasons for direction, as both types of directions are aimed at maintaining power system security. The applicants state that any difference in the funding arrangements between the two categories may have the effect of introducing an incentive for participants to prefer one category over the other.

The applicants hold that direct variable charges are more economically efficient than fixed smeared charges where the beneficiary can be identified and where that party can act to resolve the situation. The applicants claim that by levying the charge on the beneficiaries rather than smearing it across the market as a whole, the change will produce public benefits by creating a more economically efficient market.

What the interested parties say

Synergen supported the proposed methodology for the collection of money from market customers. They held that as net beneficiaries of the service, market customers are best placed to pay for the provision of such a service.

Commissions considerations

In its 19 October 1998 determination, the Commission agreed that, *in principle*, the transparency of market arrangements would be improved, and the risk of disadvantage to particular generators reduced, if there was broad consistency between the methods of compensation provided in relation to the different types of directions. However, the Commission was not prepared to conclude that the compensation methods should be uniform.

As system security directions and ancillary services directions have the similar goal of maintaining power system security, it would not be unreasonable to use a similar method for determining compensation. However, this does not imply that such a method would always be the most accurate.

While in some instances it may not be possible to identify the particular parties who should pay, wherever possible, costs should be attributed to the beneficiaries of the service. Ensuring that the beneficiary pays rather than smearing the cost across the entire market will result in more efficient market. In addition to this, basing participants' compensation payments on energy usage will also encourage those who can reduce load to do so.

As part of the applicants' derogation contained in the Commissions' 20 October 1999 determination, NECA and NEMMCO will conduct a *Joint Market Direction Review* to examine power system security and reliability direction, including how compensation payments for directions should be funded. It is possible that this review may result in more specialised methods of compensation. However, given that there is now a backlog in excess of fifteen directions, the Commission understands the importance of providing a reasonable method of compensation prior to the completion of the review.

5. Settlement by estimates

The applicants propose changes to clause 3.15 which will allow NEMMCO to facilitate settlement using estimated data where, for example, there has been a major failures of metering data processing, communications or the settlement processing systems. NEMMCO is also required by clause 3.15.12(c) to develop the principles and process to be applied in calculating the estimated settlement amount.

What the applicants say

The immediate focus for the proposed change is for Y2K contingency planning, but it is expected the change will also be relevant to any other major system failures. The applicants hold that the change is essential for confidence during the Y2K transition and will be a useful backup in case of other major problems in the market.

The applicants claim that there are no anti-competitive detriments arising from the code change. The applicants hold that there is a significant public benefit in ensuring cash flows are maintained in the rare event of system failure as it will reduce the risk and cost to participants.

The applicant also notes that the proposed change, including the process for determining estimates, arose out of discussions with the industry-based Y2K working group and the Y2K contingency planning steering committee. NECA holds that these groups, which are made up of industry participants, essentially developed the changes to meet their own needs and the estimation process was accepted by all.

What the interested parties say

Synergen were supportive of the proposed change and hold that there are clear public benefits to be gained from the change. In their submission they state:

> In the absence of any process for settling without this information, it is likely that generators would withdraw plant during these times because there is no economic reason for generation, as they would not be paid. This would impact on the public, because they would not longer have certainty of supply. Clearly this is not a desirable market. Therefore, any process that encourages full participation by both sides of the market should be encouraged.

Commissions considerations

The Commission agrees that there are definite public benefits to be gained from reducing risk for market participants by providing increased certainty of cash flows during market failures.

The only potential problems that may arise could be through the method in which estimates are determined. However, while this process could possibly produce an inaccurate estimate or result in a dispute over the process in individual circumstances, it is unlikely to result in an anti-competitive outcome. The potential for these problems may also be alleviated through consultation with market participants. It is understood that the proposed process used for determining estimates will be subject to consultation and NEMMCO will also be required to consult participants on any changes to the estimating process in accordance with the Code consultation procedures.

6. Intra-regional loss factors

The applicant proposes changes to schedule 3.2 to include:

- an appropriate process for the calculation of intra-regional loss factors for new generator and transmission customers, where no historical data exists (section 6);
- the replacement of the term 'twelve months' with 'financial year' when describing the time period for data used in the calculation of intra-regional loss factors; and
- correction of some typographical errors.

Issues for the Commission

The setting of intra-regional loss factors may be considered to be:

- Price fixing arrangements, to the extent that participants are employing formulae which may have the effect of fixing or controlling the price of electricity in a region; or
- Barriers to entry, whether or not the complexity of the proposed process may affect a new generators or network service providers ability to connect to the network.

What the applicants say

The applicants state that this change is necessary in order to provide an appropriate process for establishing intra-regional loss factors for new connection points where no historical data exists. They further argue that the absence of an appropriate process in these circumstances represents a manifest error in the Code which needs to be corrected immediately.

The introduction of section 6 also includes a sunset clause (31 December 2000) designed to put beyond doubt that the changes are not intended in any way to pre-empt the outcome of NECA's review into the scope for integrating the energy market and network services.

The applicants consider that in order for the market to function correctly a loss factor is required for each connection point. Therefore, to gain the benefits of the market there must be an administrative process to define a new loss factor when a new connection point is established. The applicants claim that by ensuring that a new connection point is correctly described in the market dispatch and settlement process, competition will be enhanced resulting in public benefit.

The applicants hold that proposed change to replace the term 'twelve months' with 'financial year' as the time period upon which intra-regional loss factors are calculated, is necessary in order to remove a potential inconsistency with other clauses in the Code. This potential inconsistency arises as sections 4 and 5 refers to data from the preceding twelve months rather than the previous financial year as required by clause 3.6.2.

What the interested parties say

No submissions were received regarding the proposed change.

Commissions considerations

Intra-regional loss factors for new generator and transmission customers

The Commission agrees that the absence of an appropriate process for determining loss factors for new connection points is a considerable omission from the Code. Without these loss factors it becomes difficult for the market to function properly and is also likely to cause difficulties for new entrants. In the Commission's 10 December 1997 determination the calculation of loss factors were viewed as only an approximation, but with the advantage of reducing certainty and sending meaningful locational signals. The proposed change therefore gives rise to a public benefit by increasing market certainty and allowing the market to function effectively.

While the proposed process may not be the most precise method, the Commission recognises the need to have a method in place until NECA's review is completed and its findings incorporated into the Code. The Commission therefore supports the inclusion of a sunset clause in order to ensure that the process will be refined and replaced with a more efficient method by 31 December 2000.

Time periods for data collection

Clause 3.6.2(f) requires that intra regional loss factors to apply for the next financial year must be formulated and published by 1 April in each year. Under the amended schedule 3.2, intra regional losses will be calculated based on the previous financial year's data. In effect, the combination of these two requirements implies that the data used will be anywhere between 9 – 21 months old. For example, the loss factors for the 2000/2001 financial year will be set in April 2000, based on data from the 1998/1999 financial year.

The Commission's 10 December 1998 determination recognised that losses are very unpredictable as they can vary with the season and time of day. It was further noted that depending on the systems physical characteristics and operating circumstances an increase in

delivered energy can cause either a positive or negative change in losses. This would imply that loss factors are unlikely to be static over time and the use of old data in setting loss factors may not lead to an optimal result. There is a need, however, to match the time frames used (ie matching financial year to financial year) in order to incorporate seasonal changes and peak load periods. Setting loss factors in April for the next financial year therefore necessitates that the previous financial year's data be used.

While the Commission proposes to authorise this change, it strongly recommends that NECA consider these issues in its review into the scope for integrating the energy market and network services.

Correction of formulae

The proposed correction is to remove a duplicate reference in the formulae contained in section 2 of schedule 3.2, which was identified in the Commissions draft determination of 8 October 1999. The Commission is satisfied that the proposed change clarifies the intention of the Code and does not raise any issues.

7. Determination

After consideration of the issues raised in sections 3-6 the Commission concludes that in all circumstances, the proposed amendments to the Code:

- are likely to result in a benefit to the public which outweighs the potential detriment from any lessening of competition that would result if the proposed conduct or arrangements were made, or engaged in; and
- are likely to result in such a benefit to the public that the proposed conduct or arrangements should be allowed to take place or be arrived at,

as the case may be.

The Commission therefore grants authorisation to applications A90708, A90709 and A90710 until 31 December 2010, the time set down by the Commission in the 10 December 1997 determination for authorisation of the Code.

This determination is made on 2 February 2000. A person dissatisfied with this determination may apply to the Australian Competition Tribunal for its review.