Enertrade

1 November 2001 Ref. 479/75/24

Mr Michael Rawstron
General Manager
Regulatory Affairs – Electricity
Australian Competition and
Consumer Commission
PO Box 1199
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Dear Mr Rawstron

Enertrade's submission on proposed changes to the National Electricity Code's rebidding rules
(Authorisation Numbers A90797, A90798, A90799)

I refer to the National Electricity Code Administrator's applications for authorisation of draft changes to the National Electricity Code's rebidding provisions, and the ACCC's request for submissions about them. This letter contains Enertrade's submission on the applications.

Scope of submission

Enertrade's submission is not confined only to the draft Code changes. It also includes comment upon NECA's Draft Rebidding Guidelines[1] (at Attachment A). Enertrade considers these to be so significant and inextricably linked to the draft Code changes that the ACCC cannot properly consider authorising the latter without taking the former into account. The Guidelines are much more than a mere explanatory tool describing how the new draft Code rebidding rules will be applied. They create additional rebidding rules or offences, because they effectively forbid specific rebidding conduct by threatening enforcement action in relation to it.

These rules are likely to have such major impacts upon generators and the market that Enertrade requests the ACCC either:

- take the finalised Guidelines into account when considering whether to authorise the new draft Code rebidding rules, or
- reject NECA's applications for authorisation until the contents of the Guidelines are finalised and transplanted into the Code, where they belong. If market rules reside outside the Code, they escape the established regulatory process and can be changed at will by NECA without future reference to Participants or the ACCC.

[1] *Draft Guidelines – Ensuring the efficient, economic and reliable operation of the national electricity market*

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This is clearly undesirable as it raises generators' regulatory risk. It also raises their legal risk. Complying with ex-Code guidelines could potentially expose generators to *Trade Practices Act* litigation, because it might be construed as giving effect to an arrangement between competitors to control wholesale electricity prices.[2]

Enertrade's overall position

Enertrade considers that the draft Code changes and the interrelated draft Guidelines should not be authorised because they will not produce public benefits outweighing potential anti-competitive detriment. This opinion is reinforced by the absence of evidence that:

- the proposed changes will produce any, let alone net, economic or public benefits;
- the current rebidding regime:
    - is economically inefficient
    - is operating contrary to the law or established market design principles
    - results in prices that "are wholly disproportionate to changes in actual or opportunity costs", "do not represent genuine price signals", or "have no basis in the underlying dynamics of the market".

In the absence of such proof, Enertrade can see no justification for disturbing the existing rebidding rules. It is concerned that eliminating the targeted rebids will remove prices that may form an integral part of the market's essential investment signals. This is because these prices frequently reflect a lack of interconnection or generation capacity or other structural issues that have not been addressed. Applying bandaids in the form of rebidding rules to these underlying problems will only mask them and discourage the creation of solutions.

In addition, the proposed changes are so pervasive and extreme that they contravene several central Code tenets. They offend the Code objective that Participants should be allowed the greatest possible amount of commercial freedom to decide how they will operate in the market place. They are inconsistent with the intended regime of "light handed regulation". Perhaps most significantly, they breach the public policy decision recognised in Code clause 3.1.4(b) that competition regulation would be reserved to the ACCC under the *Trade Practices Act*. Moreover, they try to regulate bidding behaviour without evidence that it is anti-competitive. In fact, they appear designed to reduce wholesale prices in a way tantamount to price capping.

More specifically, and for reasons outlined below, Enertrade considers that the proposed changes will:

- create substantial regulatory uncertainty for generators, thereby disrupting the ongoing transition to a deregulated National Electricity Market and potentially discouraging new market entry;

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[2] This is particularly possible in light of *ACCC v CC (NSW) Pty Ltd* (1999) ATPR ¶41-732 , which decided that arrangements between competitors 'control' price where they restrain a freedom that would otherwise exist regarding prices to be charged. The Guidelines certainly appear to control price as their stated purpose is to eliminate price spikes that NECA considers objectionable.

- increase risks and compliance costs for existing generators and, indirectly, electricity costs for consumers in the longer term; and
- interfere with generators' ability to conduct their affairs efficiently and independently, by constraining them from rebidding in circumstances when it is economically logical (and presently lawful under the *Trade Practices Act*) to do so.

Proposed draft Code changes

"Good faith"

The first major change to the existing Code rebidding rules:

- requires generators to make offers and rebids in "good faith", and
- reverses the usual burden of proof by deeming a generator to breach the good faith requirement (and therefore the Code) unless it satisfies the National Electricity Tribunal in any subsequent hearing that its offer or rebid was so made.

Enertrade considers it poor regulatory practice to import an indeterminate common law concept like "good faith" into the Code without explaining its meaning. "Good faith" is capable of being construed in multiple ways as it applies in a wide variety of contexts (from bankruptcy law through to consumer protection law). It is therefore difficult for generators to discern the intended meaning of this term and the kind of bidding conduct likely to fall foul of it. Such uncertainty will unnecessarily raise generators regulatory risks, thereby potentially deterring new market entry and disadvantaging existing generators. It can also be expected to deter generators from taking a chance on bids that are otherwise economically efficient and commercially sensible.

Enertrade also questions the practical sense of importing a subjective standard of conduct with moral connotations[3] into commercial transactions between large corporations. The "good faith" requirement has been inserted more commonly in laws regulating transactions in which one party is not able to adequately protect itself. For example, it was inserted into section 51AC of the *Trade Practices Act* to remedy the distinct disparity in bargaining power between small businesses transacting with much larger ones. Enertrade questions whether such a requirement is necessary in a wholesale market. It is generally understood that players in such markets are equally capable of assessing the terms and risks of their transactions. Participants in the wholesale electricity market arguably share these attributes. It was always intended that Participants would manage their risks by the use of appropriate derivative contracts. These contracts themselves acknowledge the capacity of Participants to assess associated terms and risks.[4]

Reversed burden of proof

The reversal of the usual burden of proof is improper, unwarranted and unlikely to benefit the public. It is improper because it conflicts with the basic legal principle that

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[3] The Federal Court of Australia described good faith as a "moral conception involving a moral duty" in *Brownley v State of Western Australia* [1999] FCA 1139 at para 22.

[4] It is standard practice for parties to International Swaps and Derivatives contracts to include a clause describing each party as capable of assessing the terms and risks associated with derivative transactions.

one is innocent until proven guilty. It is unwarranted because there is no justification for it. NECA has not shown that:

(a) it will have difficulty proving that bids have not been made in good faith, and
(b) that this difficulty can be overcome only by presuming a generator to have bid without good faith unless it can prove otherwise.

Unless NECA demonstrates these matters, it is not valid for it to rely on section 51A of the *Trade Practices Act*[5] as a precedent justifying a reversal of the burden of proof in the NEM. While section 51A does reverse at least part of the burden of proof in relation to representations about "future matters", it was introduced only to overcome the type of evidentiary problems described above.[6] Without evidence of similar problems in relation to rebidding that might be fixed by reversing the burden of proof, there is no basis for or obvious benefit to the public in doing so.

The reversal of the burden of proof will also significantly increase generators' legal risks and administrative costs, which ultimately may affect end-use prices. A generator may well have grounds for believing its offer or rebid is made in what it considers to be "good faith", but these grounds may be comprised of a number of relatively intangible factors (such as the beliefs of a trader at the time a rebid was made). Proving that these grounds existed therefore will be difficult. The creation and maintenance of a paper trail to justify every offer and rebid is an impracticable task, but it is conceptually the only means of providing a defence if the burden of proof is reversed.

"Central prohibition"

The second major change proposed to the Code's rebidding rules is a prohibition upon offers or rebids that have the purpose, effect or likely effect of materially prejudicing the efficient, competitive or reliable operation of the market, unless there is reasonable cause for such offers or rebids ("central prohibition"). This prohibition will be underpinned by the Draft Rebidding Guidelines that provide "general examples of conduct that may be investigated."

Enertrade objects to the regulatory uncertainty created by this prohibition. The prohibition does not explain the meaning of the many subjective words it incorporates. For instance, it does not define the behaviours that would "materially prejudice" the market or the sort of "reasonable cause" that would legitimise otherwise suspect bidding behaviour. It is also not clear from whose perspective a cause for bidding must be "reasonable". To be justifiable, must the cause for a bid be reasonable from the perspective of the generator in question, a hypothetical "reasonable generator", NECA, NEMMCO, or consumers? This vagueness creates legal risks that generators trading actively in the real-time spot market will find very difficult to manage. Generators may not make valid rebids out of fear of investigation. This can be expected to affect their revenues and, as a consequence, the prices they charge for electricity.

The prohibition goes much farther than the proposed UK licence provisions upon which it is based. The UK provisions will only be contravened if a generator "knowingly or

[5] This section effectively deems representations about "future matters" to be misleading if the representor does not have reasonable grounds for making them.
[6] This is stated in Paragraph 72 of Explanatory Memorandum to *Trade Practices Revision Act* 1986 (Cth) (Act No 17 of 1986).

recklessly" acts in a manner likely to materially prejudice the safe, economic and efficient operation of the market. In other words, a breach will only occur in the UK where a generator has some sort of *intention* to negatively affect the operation of the market. In contrast, a breach of the proposed Australian prohibition can occur inadvertently, even where a generator never intended its bids to cause the proscribed market effect. So long as a generator's bids are "likely" to have the proscribed effect on market operations, *and regardless of whether the generator could have foreseen that likelihood*, it will breach the Australian prohibition.

This is impracticable and unfair. A generator in the NEM is seldom able to accurately assess whether its particular bidding conduct is "likely" to effect market operations because market operations depend on a wide variety of factors beyond any one generator's control.[7] Obliging generators to predict the likely market-wide outcome of their bidding even though they lack the information to accurately do so creates a major new regulatory risk which may ultimately be priced into energy sales to the public.

The prohibition is also objectionable because it passes partial responsibility for system reliability on to generators. Generators should not have to consider the impact of their offers or rebids on system reliability, as the prohibition dictates, given that NEMMCO already has responsibility for system reliability and explicit power to direct generation to ensure it. In any event, generators will rarely be in a position to assess the likely impact of their bidding conduct on market reliability, because generators (unlike NEMMCO) are not privy to all the information about factors affecting it. Holding generators responsible for outcomes beyond their control is likely to discourage future investment in generation.

In short, the central prohibition and the "good faith" requirement create substantial uncertainties, risks and compliance costs for generators that may financially damage them and deter future entry into the generation market. These fundamental changes to the existing rebidding regime are also unnecessary because there is no evidence of a market failure necessitating it. Enertrade therefore maintains that generators should not be required to consider anything beyond existing competition laws and rebidding rules when submitting offers and rebids.

In closing, Enertrade would also like to comment on the propriety of adopting the untested market regulations of a foreign jurisdiction. The fact that the United Kingdom is considering implementing similar rebidding changes to those proposed by NECA is no reason to justify implementing them here. Unless there is analysis proving that:

- the UK market mirrors the Australian one in all important respects, *and*
- the UK regime has been tried, tested and proven to generate net public benefits

it is ill-considered to simply copy the UK rules into the local setting.

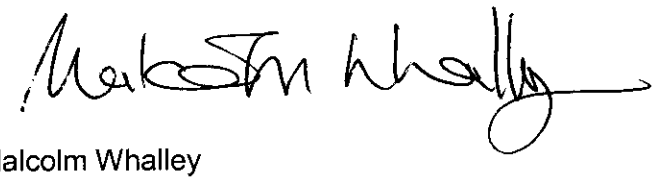
No such analysis has been provided. NECA has therefore completely overlooked at least one radical difference between the UK and Australian markets. UK energy policy explicitly aims to promote social objectives such as the alleviation of fuel poverty (in a

[7] Plant failures, interconnector outages, and activities of competitors and the market operator all affect whether or not a particular generator's offer or rebid will set the price. In view of this, it is hard to see how a generator can accurately predict if its bids are likely to have the proscribed effect on the market.

climate where such poverty is life threatening) and the enjoyment by the poor of low energy prices.[8] There is no equivalent objective underpinning the Australian market. The Australian market was designed to be competitive[9] and for prices to reflect the efficiencies produced by competition. The governments that introduced it intended social policy objectives to be met through subsidies to end users or their retailers. This protects vulnerable members of the community without diluting the economic efficiencies delivered by the wholesale market. This difference alone renders the UK regime unsuitable for transplantation into Australia.

Should the ACCC wish to further discuss any aspect of this submission, Enertrade would be happy to assist.

Yours sincerely



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[8] http://www.dti.gov.uk/energy/index.htm, "DTI Initial Contribution to the PIU Energy Policy Review", at i-ii.
[9] Code clause 1.3(b)(i)

ATTACHMENT A

Comments on the Draft Rebidding Guidelines

Enertrade opposes the Guidelines in their entirety because it believes they create de facto rebidding rules that are deeply flawed. For reasons outlined below, they may harm generators, the market and ultimately the public, without demonstrably producing countervailing public benefits.

Rule against withholding capacity

The Guidelines threaten investigation wherever generators offer *"materially less than their registered capacity"* when market forecasts have predicted potential capacity shortfalls *"sufficiently far in advance for the generator reasonably to have increased the amount of capacity offered."* Potential capacity shortfalls are defined as "*conditions which prompt NEMMCO to issue a low reserve notice*". This effectively creates a rule obliging generators to offer or rebid their units available to levels close to registered capacity whenever it appears a low reserve notice may be issued.

This rule potentially exposes generators such as Enertrade to costly contractual breaches, which may well be passed on to the ultimate detriment of the public. For instance, exempt generation agreements between Enertrade and its third party power stations[10] pre-agree a firm schedule of maintenance. If Enertrade is forced to delay scheduled maintenance to comply with this rule (by "bidding available" units that would otherwise be unavailable to allow maintenance work to occur), it might:

- breach its contractual obligations, or
- become liable to pay costs that the power stations incur by having to delay the scheduled maintenance.

Additional concerns relate to this rule's vagueness and subjectivity. Precisely how much extra capacity must generators make available to "reasonably" increase capacity in response to predicted shortfalls? Just how many megawatts below registered capacity would be "materially" less than registered capacity? By posing but not answering these questions, this rule adds to regulatory uncertainty.

The justification for imposing the rule is also weak. For reasons outlined on page 5, Enertrade disagrees that the rule is necessary to ensure reliability and security of supply. Even if withholding capacity does prejudice market security or reliability, the Code already allows NEMMCO to direct generation to overcome this problem.

Rule against sleeper bids

Investigation will occur where *"significant proportions of high capacity factor plant (is offered or rebid) at very high levels, whilst ensuring that the capacity is available to the market and therefore that reserve levels remain appropriate."* This effectively creates a rule deterring baseload generators from bidding themselves available but expensive.

This rule is objectionable on two grounds. Firstly, it is discriminatory. It creates a rule that applies to baseload offers and rebids but not to the offers and rebids of peak

[10] These power stations are third parties, quite separate from Enertrade. Enertrade does not own them but instead owns the right to bid their output into the NEM.

generators. This contravenes the market objective that forbids discrimination between one source of generation and another. Secondly, there is no economic justification for this rule. The Guidelines make an unsubstantiated assertion that the rule is necessary because sleeper bids produce "inefficient and uneconomic outcomes". Enertrade considers this assertion questionable. It is equally arguable that sleeper bids are efficient and desirable because they allow some generators to recover long run costs that they otherwise could not. Preventing such cost recovery could encourage generators to exit the market inefficiently, or discourage new ones from entering.

Rule against exploiting network constraints etc

The Guidelines effectively create a rule forbidding rebids following:

- interconnector constraints
- unplanned reductions in generating or network capacity, or
- increases in demand

if these rebids result in prices that do not represent "a genuine, efficient and competitive market response".

This rule is objectionable because it imposes a very vague standard for generators to comply with. It will be very hard for a time-pressured trader to determine if a rebid price complies with this unclear definition.

Furthermore, the rule is flawed because it assumes that all generators are in fact operating in a competitive market. In regions suffering a lack of capacity, for instance, they arguably are not. Generators in these regions should not be forced to bid artificially low, as though constrained by competition, because this will dampen the signals for new investment or structural reform. Such a restriction is tantamount to wholesale price capping, which (aside from VoLL) the market was not designed to include. It also offends the fundamental principle that generators be permitted to *choose* the prices and quantities of energy offered, and then compete with one another on the basis of those choices, subject only to the *Trade Practices Act.*

Enertrade also objects to the expressed intention to investigate when baseload generators set high prices and peak plant is not dispatched. Discouraging baseload generators from bidding prices higher than peakers will do nothing to stimulate baseload investment. It is also arguably discriminatory, particularly as peakers are permitted to run like baseload generators (ie at prolonged periods for relatively low prices).

Rule against manipulating dynamic capability

The Guidelines effectively prohibit:

- ramp rate rebidding that results in *"inefficient and uneconomic increased or decreased responsiveness"*, and
- bidding ramp rates at levels *"demonstrably below good industry practice for the type of unit".*

The lack of clarity to this rule again creates excessive regulatory uncertainty. Whether responsiveness is efficient or economic and whether ramp rates accord with "good industry practice" will be matters of interpretation, about which there may be many diverging yet still legitimate views.