

## **Draft Determination**

### **Amendment to the National Electricity Code**

### **Changes to Bidding and Rebidding Rules – 3 July 2002**

## **Macquarie Generation Public Submission Introduction**

Macquarie Generation has significant concerns with regard to the draft determination, issued by the ACCC on 3 July 2002, which proposes changes to the bidding and rebidding rules in the National Electricity Code. These concerns cover three broad areas:

- The process that has resulted in the issue of the draft determination.
- The determination itself, particularly with regard to the analysis, the recommendation, the suggestions made to NECA for further code changes and the conclusions reached with regard to market power in the National Electricity Market (NEM).
- The role being played by the ACCC in this process.

Furthermore, following the Pre-determination Conference on 13 August 2002 a new issue has emerged:

- The Code compliance of NECA's new proposals and whether such new proposals should effectively cancel the existing application and the authorisation process recommence.

Each of these areas of concern will be examined in more detail.

## **The Process**

NECA has been concerned about the issue of rebidding for some years and the current draft determination is the result of a process that began formally with a forum conducted by NECA on 14 August 2001 where proposed code changes to limit the perceived negative impact of rebidding were discussed.

As a result of this forum NECA proposed code changes, which it submitted to the ACCC on 13 September 2001 for authorisation, and are the subject of this draft determination.

Our concerns about the process that has been conducted by NECA are:

1. At no stage in the process of considering the issues with regard to bidding or rebidding has NECA conducted any analysis of the impact of bidding or rebidding that considers all of the available data. NECA's approach has been to focus on particular high priced events, which must be expected in an energy only market with a VoLL of \$10,000, and draw general conclusions with regard to the impact of bidding or rebidding from this highly selective data set. This is in our view very poor analysis and not an appropriate basis for supporting the recommended the code changes.
2. The code changes that are the basis for the current draft determination were proposed not by a market participant, but by the Managing Director of NECA. Our concern is that having been a strong and public advocate for these Code changes that the Managing Director of NECA then acted as chair of the Code Change Panel that deliberated on and subsequently recommended these Code changes to the ACCC. We do not believe that this is an appropriate process and we have written to the Chairman of the NECA Board expressing our concerns with this process.
3. At each stage of the process since 14 August 2001 fundamentally different proposals have been put forward apparently to address insurmountable problems with the previous proposals. However, the later that such proposals have been put forward, the less opportunity there is for the proposals to be appropriately developed and tested under the Code Consultation procedures and public authorisation consultation process.

Our further concern with process is that good regulatory practice would require that NECA and the ACCC in considering these code changes should:

1. Clearly identify, based on sound analysis of the data the need for the proposed regulatory intervention.
2. Consider the potential for non-regulatory approaches to resolve the issue.
3. Establish clearly that the proposed intervention will improve market outcomes, again based on sound analysis of the data, compared with allowing the current behaviour to continue. The particular challenge in this instance is to prevent what is perceived as undesirable behaviour without also preventing desirable behaviour, which delivers benefits to the market.

In our view neither NECA, or the ACCC have satisfied these requirements but yet have persisted with proposing a range of interventionist code changes. The prescriptive nature of these changes reinforce the importance of applying good regulatory practice.

## The Determination

Macquarie Generation's concerns with the determination are:

- The lack of analysis and argument within the report to support the findings and recommendations.
- The recommended “good faith” provision.
- The suggestions made to NECA for further code changes by the ACCC.
- The finding that there is a problem of market power in the NEM without any supporting evidence.

### ***Lack of Analysis***

As indicated earlier Macquarie Generation is generally concerned about the lack of supporting analysis for the draft determination and this will be dealt with in more detail in the submission being prepared by NECG on behalf of the National Generators Forum.

### ***Recommended “Good Faith” Provision***

Clearly Macquarie Generation would support the principle that bids and rebids be made in good faith and represent our genuine intentions at the time the bids are made.

However given the very dynamic nature of the NEM new information is provided to market participants continually and they need to be able to respond to this without the risk of the response being examined well after the event on the basis of subjective criteria such as good faith. This risk will result in generators being less responsive to new information and hence will result in a less efficient market, which will ultimately result in higher prices for end customers.

The concern is that in the proposed standard “good faith” is undefined and open to a multiplicity of interpretations. This is clear even from the statements made by NECA and the ACCC which seem to indicate quite different views on what the term “good faith” means:

1. NECA appears to consider that “good faith” is a wholly subjective concept which the Tribunal or upon review a Court would apply by reference to the state of mind of Market Participants. The Code Change Panel's Report stated that in its view “good faith” amounted to “conduct in accordance with the genuine intentions of the Market Participant at the time of the conduct and which constitutes honest dealing.”

2. By contrast, the ACCC seems to take the view that “good faith” is concerned with the provision of accurate information which would lead the Tribunal or upon review a Court to examine the factual circumstances in which the bid was made rather than the state of mind of the Market Participant. “the design of the market auction relies on accurate information”<sup>1</sup>

As a minimum if the concept of “good faith” is adopted at all, in its final decision the ACCC should set out how the term should be defined and interpreted to ensure that other possible meanings are not adopted by the Tribunal or Courts in their efforts to give meaning to this subjective term.

Also importantly the draft decision does not address the content of regulations under the National Electricity Law for the enforcement of the proposed clause 3.8.22A. Such regulations would specify the penalty limit and which enforcement mechanism is to apply. Given the highly subjective nature of the proposed standard and the pejorative language in which it is expressed, it would seem appropriate for NECA to be required to prove to the National Electricity Tribunal that a contravention has occurred and the maximum penalty be a modest one.

If the objective of the “good faith” provision is to ensure the Tribunal has accurate information, in our view no action is required. The Code already requires in clause 3.8.22 for Market Participants to provide to NEMMCO a “verifiable and specific reason for the rebid” and to NECA “additional information to substantiate and verify the reason for a rebid as NECA may require from time to time”. Consequently there seems to be little value in adding the “good faith” requirement given the risk of reduction in market efficiency that will result.

### ***Suggestions for Further Code Changes***

The suggestions made to NECA in the draft determination are of particular concern. This concern is reinforced given that the ACCC has indicated that they would be predisposed to authorise code changes based on the suggestions.

The suggestions would constitute a significant step towards the re-regulation of the electricity market. These suggestions are quite contrary to the stated view of the ACCC’s preference<sup>2</sup> for structural solutions to market problems rather than behavioural rules. We support the ACCC’s view and therefore we consider that the regulators of the NEM should allow these structural solutions to take effect by encouraging:

1. Higher levels of interconnection
2. A meaningful demand side response by allowing price signals to flow through to end customers

---

<sup>1</sup> Page 56 of ACCC Draft Determination

<sup>2</sup> “Reforming Australia’s Electricity Market”, Professor Allan Fels, The Utility Congress, September 2002

3. A stable regulatory environment that will facilitate new investment. Our concern is that the regulatory uncertainty created by the suggestions in this draft determination will only deter future investment and hence limit the prospects for the preferred structural solutions to be effective.

It should be noted that re-regulation of an electricity market has been undertaken with poor outcomes in California. Based on data that we have reviewed the outcomes have not been good. In particular the introduction of a range of price caps has not succeeded in limiting prices.

We have noted with interest that Frank Wolak, Chairman of the Market Surveillance Committee, Californian ISO at a recent conference hosted by IPART is proposing:

- “Guardrails” for pricing outcomes based on SRMC pricing benchmarks.
- That in the event that intervention is required that generators be required to offer “cost based bids” and in the event that these generators “earning insufficient revenue to cover total costs ... must cost justify its annual costs to the regulator”<sup>3</sup>

We are concerned that the suggestions made are beginning a process similar to that being advocated by Frank Wolak, which is in effect price regulation of the electricity market. This is clearly not the policy objective that Governments had when introducing the NEM.

Also we are concerned that the suggestions are based on taking ideas from overseas markets without due consideration of the relevance of these to the Australian market. For example the concept of “economic withholding” may have some relevance in a market where there are capacity payments but in an energy only market it is difficult to understand how this concept could be applied.

### ***Market Power in the NEM***

The draft determination finds that “The Commission has collected a significant amount of evidence about the NEM’s operation, particularly in terms of spot prices, and concludes that it points to a presence of significant market power.”<sup>4</sup>

In our view this assertion is not supported in any way by the analysis conducted by either NECA in preparation of the code change or the ACCC in preparing the Draft Determination. In fact the only substantive analysis on the issue of market power that has been conducted is that completed by NECG. The Draft Determination does not deal with this analysis in any substantive manner.

As previously indicated a further report is being prepared by NECG on behalf of the National Generators Forum and this will be included as part of Macquarie

---

<sup>3</sup> Measurement and Mitigation of Market Power in Wholesale Electricity Markets; Frank A Wolak; Presentation to ACCC Regulation and Competition Conference; July 2002

<sup>4</sup> Page 52 ACCC Draft Determination

Generation's submission. It is not proposed to deal with any of the arguments discussed by NECG but in our view it is instructive to examine the issue of market power within the NEM by reference to three simple indicators:

- Concentration levels
- Long run price outcomes compared to a relevant benchmark
- Levels of returns being earned by participants in the market

## **Concentration Levels**

A simple measure of market power is concentration levels. Two tests that use this approach are the CR4 test used in the ACCC's Merger Guidelines and the Herfindahl-Hirschman Index (HHI).

Under the ACCC's Merger Guidelines, the CR4 test is triggered if the four largest competitors in a market have a total market share of more than 75% of the market with the largest participant having a share greater than 15%.

If these measures are applied to the NEM, based on the installed capacity of generators the following results:

- Four largest generators comprise 42% of the market
- The largest generator has a share of 12%

Clearly based on this criterion there is no indication of a market power problem based on concentration levels. It is worth noting that in the UK the largest generator has a market share of 17% and that this is viewed by OFGEM as being a competitive market.<sup>5</sup>

Under the US Department of Justice and the US Federal Trade Commission's Horizontal Merger Guidelines the HHI is used in a similar fashion to the use of the CR4 by the ACCC. Also, the ACCC informally uses the HHI in its assessment of potential mergers in addition to the CR4.

The HHI is calculated by summing the squares of the individual market shares of all the participants. The Horizontal Merger Guidelines regard markets with an HHI of:

- less than 1000 as being un-concentrated;
- 1000-1800 as being moderately concentrated; and
- more than 1800 as being highly concentrated.

The HHI for the NEM is 685 and, on that basis, it is an un-concentrated market.

The measures quoted above are based on the relevant market being the entire NEM. This will be the case if the level of constraints on interconnectors is such that they do

---

<sup>5</sup> Presentation by Callum Mc Carthy, OFGEM, IPART 2002 Conference

not have a material impact, in particular at times of high prices when the potential for exercise of market power is the greatest.

Macquarie Generation has conducted an analysis of the percentage of time that constraints actually occurred on the network during the financial year 2001/02. The results of this analysis are summarised in the following table.

Table 1

Interconnector	% time constrained
Vic to SA	5.1%
SA to Vic	0.9%
Qld to NSW	4.5%
NSW to Qld	2.3%
NSW/Snowy to Vic	0.5%
Vic to NSW/Snowy	4.5%
Snowy to NSW	0.0%
NSW to Snowy	0.0%

There were no constraints at all in the NEM for 85% of the time and the amount of time that regions were separated from the NEM is summarised in Table 2

Table 2

Region	% time separated
NSW & Snowy	0.21% - ½ a day
Victoria	0.01% - 53 minutes
South Australia	5.1%
Queensland	2.25%

The price differences across interconnectors at times of constraint are as shown in Figure 1.

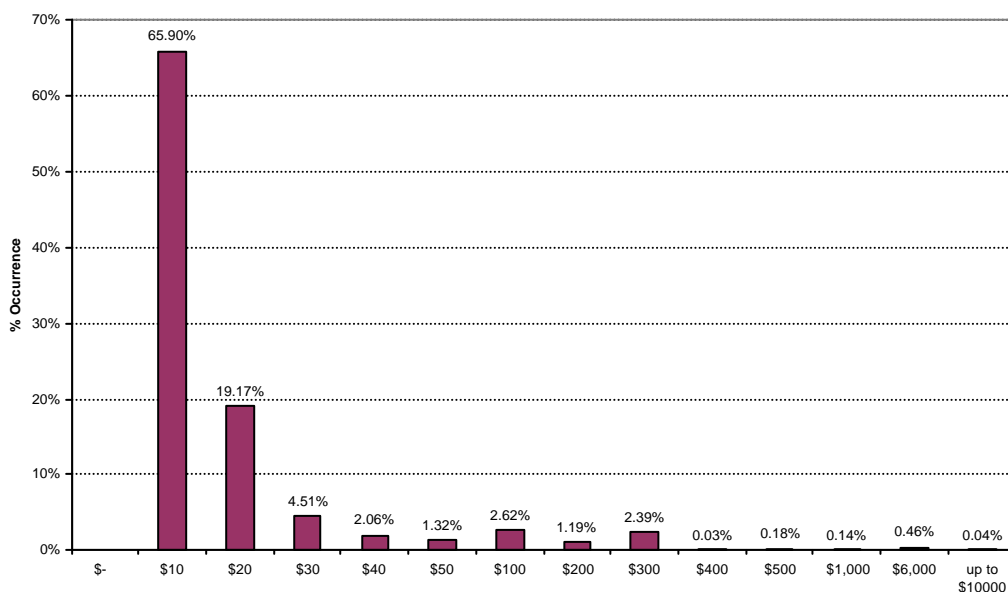


Figure 1

From this graph it is clear that 85 % of constraints occur at times when price differences are below \$20/MWh.

In conclusion given that the level of constraints that occur in the NEM are not high and that when they do occur it is at times of low price differences it is reasonable to conclude that in effect the NEM operates as a single market and that the concentration levels should be determined across the NEM and not region by region.

Therefore the conclusions reached by application of the CR4 and HHI tests are valid when applied to the entire NEM and on this basis there is no indication of an issue with market power.

### Long Run Prices Compared to Benchmark

It is generally accepted that in an industry such as electricity, with high fixed costs that the presence of sustained market power would be evidenced by long run prices in excess of Long Run Average Costs or alternatively average New Entrant Costs. A range of estimates of these costs have been provided:

- IPART in NSW in determining appropriate prices for generators to receive under the Electricity Tariff Equalisation Fund arrangements applied a figure of \$43/MWh.
- Sinclair Knight Mertz have indicated a new entrant price of \$39/MWh in a report they have provided to the NGF <sup>6</sup>
- IES have indicated a price of \$45/MWh to \$55/MWh for new entrants.

When the NSW 12 month rolling average price is compared to these benchmark prices as shown in Figure 2 there is clearly no indication of sustained market power.

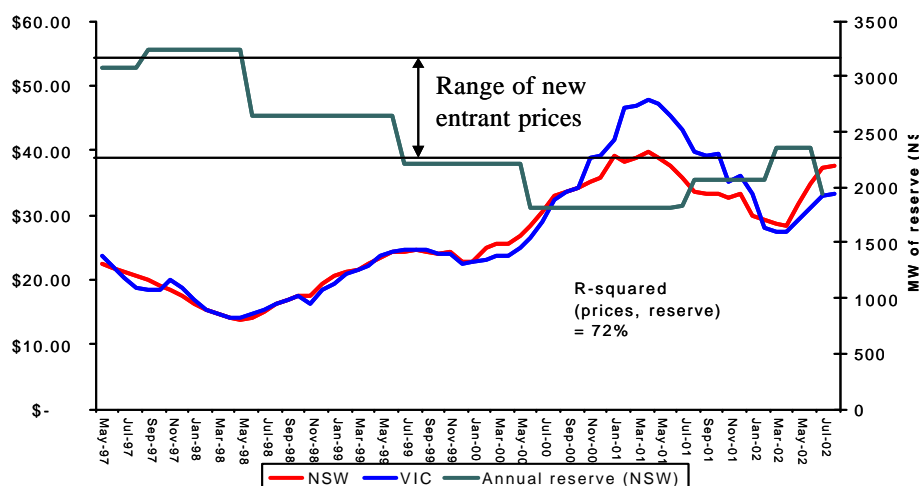


Figure 2

<sup>6</sup> “New Entrant Cost Parameter Estimates”; Sinclair Knight Mertz; October 2001



It is important to also note in Figure 2 that there is a strong inverse correlation between long run prices and the average level of reserve in NSW with a  $R^2$  of 72%. This clearly indicates that a dominant driver of increasing prices is reducing levels of reserve. This is strong evidence of the market working effectively and not evidence of an issue with market power in the market.

It also should be noted that the AFMA forward curve for flat load for years 2003/04 to 2006/07 is in the range of \$31.00/MWh to \$36.50/MWh. This reinforces the view that market expectations for the next few years do not indicate any concerns with market power.

## Returns to Generators

It has been claimed that that generators in this market are making “super profits”<sup>7</sup> however a review recently published by the Productivity Commission reveals that over the period from 1997-98 to 2000-01 that the return on assets for generators did not exceed even the levels of returns that the ACCC would expect regulated businesses operating in the NEM to achieve.

The levels achieved are shown in Figure 3 below

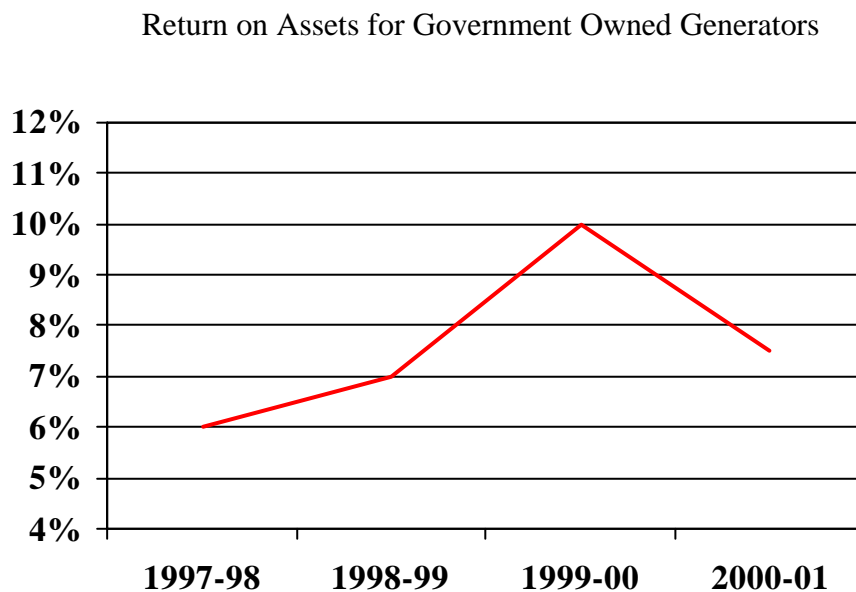


Figure 3 – Productivity Commission Report: - Financial Performance of GTEs  
Median of returns earned by Government owned generators.

Again the conclusion must be that there is no evidence of any effective use of market power since the commencement of the NEM.

<sup>7</sup> Communiqué ; NEM Ministers Forum; July 2002

## Unsafe Inferences for the Commission to draw in respect of Recent High Prices

During the period from May to July this year a period of higher prices occurred and it has been suggested that this supports a view that these higher prices are evidence of market power<sup>8</sup>.

It would be unsafe to draw the inference that high prices over such a short period are an indication of market power. Other causes and determinants exist and therefore it does not follow that market power exists.

High levels of system demand have been the primary determinant of high prices as illustrated in Figure 4 below. [*Confidential material excluded*]

The relationship between price and demand is essential if the market is to produce the incentives necessary for efficient long term new investment.

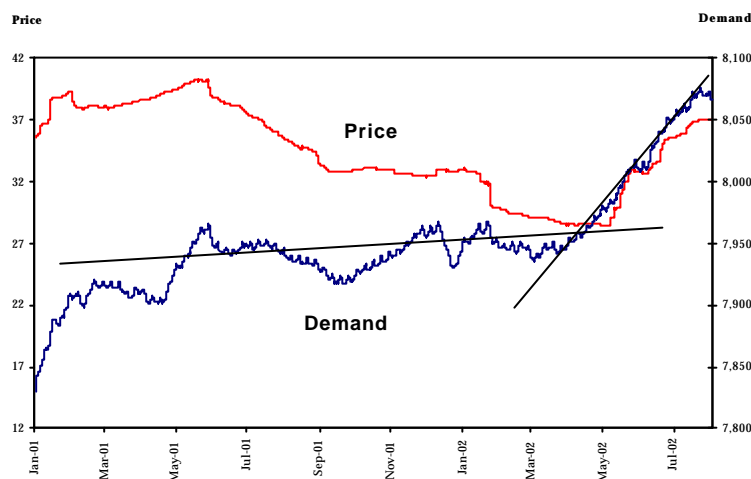


Figure 4 – Price and demand – NSW 365 day rolling average

## Conclusion on Market Power

It should be noted that in all markets periodically there is evidence of transitory market power. However as observed by Gary Banks, Chairman, Productivity Commission “The point to emphasise is that the prospect of market power is what motivates firms to innovate and new firms to enter markets. Such transitory market power is not inimical to competition. Rather, it invites it”<sup>9</sup>

<sup>8</sup> Letter to ACCC from NECA – “The Events of 18 May 2001” 24 May 2002

<sup>9</sup> “The ‘baby and the bath water’: avoiding efficiency mishaps in regulating monopoly infrastructure”; Gary Banks; IPART Conference; July 2002

Based on the evidence presented, therefore in our view the case that there is a problem with market power in the NEM simply has not been made based on the available data and therefore this conclusion must be deleted from the final determination.

### **Role of the ACCC**

The role of the ACCC under the Trade Practices Act is to authorise changes to the National Electricity Code if the public benefit created by such a change outweighs the public detriment.

In our view it is clearly not the role of the ACCC to make suggestions for further code changes, particularly changes that will fundamentally alter the operation of the NEM. The suggestions made in the Draft Determination are clearly of this type.

The suggestions made are effectively policy suggestions and changes in policy for the NEM is a role for Governments who can be appropriately held accountable for policy settings and not regulators such as the ACCC.

### **NECA's revised proposal**

Macquarie Generation notes that during the course of the conference held on Tuesday 13 August 2002, NECA's Managing Director presented a paper titled "*Changes to bidding and rebidding rules: some ideas on a way forward*". The proposals are substantively different to those set out in NECA's applications for authorisation dated 13 September 2001, upon which Macquarie Generation and other interested parties have been consulting for a period of nearly 12 months. There is now inadequate time for Macquarie Generation to meaningfully be consulted on those proposals as part of the current application for authorisation.

Further, few if any details of key elements of the proposals are provided and without adequate details, interested parties are unable to provide meaningful comments. For example, the proposed "competitive envelope" which would be key to the operation of clause 3.8.22B would be developed subsequent to the authorisation and substantially in NECA's discretion.

Macquarie Generation seriously questions whether these new proposals are Code compliant. The NGF has written to both the ACCC and NECA detailing these concerns and the implications for the current authorisation process.

### **Conclusion**

The Draft Determination proposing changes to bidding and rebidding rules in the National Electricity Code is in our view fundamentally flawed.

The conclusions reached are based on internally contradictory and unsound analysis. Without proper identification of a policy problem in need of remedy, it is inappropriate and potentially damaging for the Draft Determination to propose

suggestions. In substance, the suggestions for further code changes would involve a significant step towards reregulation of the electricity industry. There is also a tension between making suggestions in the Draft Determination and, if the suggestions are adopted, the ACCC's role if further applications for code changes are made assessing and adjudicating between submissions as to whether those suggestions are of public benefit.

In summary, our recommendation is that in the Final Determination:

- The proposed Code change requiring bids and rebids to be made in “good faith” be deleted or as a minimum that the term “good faith” be clearly defined by the Commission; and
- The Draft Determination's conclusions as to generator market power and suggested further code changes be deleted.