



2 November 2001

Mr Michael Rawstron
General Manager Regulatory Affairs
Australian Competition and Consumer Commission
PO Box 1199
Dickson ACT 2602

By Email electricity.group@accc.gov.au

RE: Bidding and Rebidding Code Changes

Dear Mr Rawstron,

Thank you for the opportunity to respond to the NECA Code changes in respect of the bidding and rebidding provisions of the National Electricity Code, ("the Code"). Loy Yang Power (LYP) supports the National Generators Forum submission in relation to this proposed Code change. However because of the importance of this issue in relation to the reputation and integrity of the market we are also making a separate submission.

Loy Yang Power (LYP) supports the aim of ensuring efficient, economic and reliable operation of the national electricity market. We believe that the recent actions of NECA in pursuing changes to bidding and re-bidding are misconceived and will significantly impede the development of a competitive market, however we have welcomed its preparedness to modify its approach after consultation with the market. We trust that this will continue and dialogue will be maintained between NECA, the ACCC and participants over this important issue.

However, it does seem that the process in regard to bidding and re-bidding is starting to test everyone's patience and that NECA is keen to quickly establish a change to address a perceived problem with undue haste; one which if it exists really should be addressed at

a more fundamental level. From our perspective, it appears that NECA has lost faith in the market model and is not prepared to allow the transition of full market development to occur without some form of centralist intervention. In essence, an attempt is being made to regulate a competitive market despite the recognition that the market needs “full and unfettered competition.” LYP has urged NECA on several occasions to reconsider the issues where it has concern and re-focus the current proposals towards outcomes that will deliver sustainable competition in the marketplace. However NECA is seeking a rapid and permanent fix to a problem which is at worst transitory without providing any substantial evidence that the problem actually exists. However, if one conceded that NECA had identified a problem, it has yet to clearly articulate the objectives it is trying to achieve and has not undertaken any serious examination of alternative solutions which might include structural or incentive based options.

Our submission discusses a number of issues in relation to the proposal namely;

- The changes to the Code proposed by NECA directly contradict both the Code objectives and NECA’s objectives in proposing this change.
- The proposed Code change gives NECA the power to modify generator bidding behaviour by changing the guidelines at NECA's discretion.
- The analysis that has led NECA to conclude that a Code change is required is flawed as it is based on incomplete information and a misunderstanding of the operation of the market
- NECA has not demonstrated that the market is economically inefficient as a result of any re-bidding behaviour.
- These changes represent an abandonment of two of the principles underpinning the National Electricity Market, namely competition and light handed regulation in favour of a return to intrusive regulation and constrained competitive outcomes.
- The Code change is flawed because NECA has failed to distinguish between a “market” in its economic or competition law sense, and a market in the physical sense and the proposed Code change as drafted will have unintended consequences.

- NECA's attempt to establish itself as a competition regulator will create overlap with the existing regulator, the ACCC. This creates a real danger that there will be inconsistencies where both regulators act and gaps where neither act.
- If these guidelines are implemented without authorisation, generators will be faced with contradictory legal obligations from the Code on one hand and on the other hand, sections 45 and 45A of the Trade Practices Act. They will not be able to comply with each of these laws simultaneously

Furthermore NECA has not demonstrated that current behaviour has resulted in any anti-competitive detriment, and to the extent that any such detriment can be deduced from NECA's reports, there is no evidence that there is a countervailing public benefit. In fact any detriment that NECA seeks to eliminate through these changes and associated "guidelines" is outweighed by the decrease in public benefit brought about by the increased risk, uncertainty, and lack of investor confidence, which at the best will lead to higher long term prices and at the worst market failure due to lack of timely investment.

The proposal introduces a high degree of regulatory uncertainty for participants. In particular, the Code change allows NECA to introduce or change the guidelines at its sole discretion to address issues as perceived by NECA. In addition the guidelines as currently drafted would have significant economic impact on participants and associated market outcomes. Consequently if there are to be guidelines we believe that the guidelines should form part of the Code and therefore be subject to appropriate regulatory consultation and authorisation.

These issues are discussed below in more detail in this submission.

Yours faithfully

Ken Thompson
General Manager Marketing

Loy Yang Power Submission on Proposed Bidding Code Changes

Market Objectives

NECA's mission is to supervise and enforce, and administer the ongoing development of the Code in order to ensure that the objectives of the National Electricity Market are met. Two of the objectives of the Code which are relevant to this application are;

- The market should be competitive
- A particular energy source or technology should not be treated more favourably or less favourably than another energy source or technology.

NECA notes in its executive summary of the Code Change Panel¹ document that it has consistently made clear that for the effective operation of the market:-

1. *“rebidding in its view represents an essential flexibility to enable generators to respond to changes in physical and legitimate commercial, circumstances.”*
2. *“rebidding is imperative for the effective operation of the market. Efficient prices represent crucial signals for much-needed new investment and for demand-side responses”.*
3. *“Regulatory responses that have the effect of artificially constraining prices that properly reflect underlying dynamics of the market will distort those crucial signals and jeopardise the new investment already committed or planned, and future prospective investments, in the market. NECA has therefore been at pains to avoid such responses.”*

These statements are consistent with the Code objectives. However the changes to the Code proposed by NECA directly contradict both the Code objectives and NECA's objectives in proposing this change because

- NECA is proposing to regulate a competitive market , and
- The Code change proposed allows NECA to introduce mandatory rules that are discriminatory between energy sources or technology as is evidenced by the current draft guidelines.

¹ NECA - Code Change Panel - Generators bidding and rebidding strategies and their effect on prices, Volume 1 Report, September 2001

NECA's Proposal

In proposing this Code change NECA's² intentions are to:

- *address inefficiencies that have led to very short-term price spikes experienced in the market that have no basis in underlying dynamics;*
- *ensure that generators' bids and rebids are made in good faith; and*
- *impose a prohibition on bids or rebids that materially prejudice the efficient, competitive or reliable operation of the market. Interpretation on whether a bid meets the criteria for prohibition will be based on Guidelines currently being developed by NECA. “*

The objective appears to be to eliminate some high prices, so called non genuine short term price spikes that in NECA's view have no place in the market. According to NECA these price spikes arise from,

1. inefficiencies in the market rules or the way these rules are applied in practice, and
2. the impact of “*a tiny minority of generators bids and re-bids*”³ that lead to price spikes that NECA considers to be “non genuine”.

Market Inefficiencies

In relation to point 1 above the NECA submission seeks no specific Code changes.

NECA acknowledges that the market is working towards addressing these issues. The area of concern to NECA is primarily in relation to the impact of the transmission network and the constraints imposed on the energy market by interconnector transfer limits, short term loading constraints and lack of integration of the energy market with network services. LYP is fully supportive of moves to closely integrate network services and the energy market.

In relation to this issue LYP notes the ACCC is aware that the costs and risks to the market as a result of this lack of integration manifest themselves in areas other than just in infrequent short duration price spikes. (eg Transmission FM risk, no firm transmission access, no property rights, etc). These inefficiencies are far greater than a few infrequent price spikes.

LYP is also of the view that even if all the market issues addressed by NECA are resolved that over time the energy market will still be constrained periodically by the network and

² NECA letter to the ACCC dated 12 september 2001 Generators bidding and rebidding strategies and their effect on prices

³ NECA - Code Change Panel - Generators bidding and rebidding strategies and their effect on prices, Volume 1 Report, September 2001 – Page 7

inter-regional transfer limits due to growth in demand and supply. That price spikes occur when these constraints are met demonstrates that the market is working. High prices are indicators to investors that an opportunity exists for increased investment in new interconnector or new generating capacity, or improved operation of existing assets, or demand management. Exposing the market participants to these high prices provides an incentive to improve their operations or reliability and availability. The market already has processes to address these market issues.

These price spikes have identified the location and nature of the constraints in the market and their potential value, and have signalled to investors where additional capacity is required, e.g. new interconnection to SA and peaking plant in Victoria. These needs are consistent with the views of NEMMCO expressed in its recent review of the Statement of Opportunities, and there are a number of developments proposed to overcome these constraints.

NECA appears to be suggesting that the market should have no inefficiencies and network investment should proceed so that price spikes do not occur. Clearly this view is totally unrealistic and not in accordance with the market design.

NECA acknowledges that these market inefficiencies are best addressed by the ongoing market development. However the proposed Code change gives NECA the power to modify generator bidding behaviour by changing the guidelines. This means that in the future the guidelines could be amended at NECA's discretion to address further so called market inefficiencies as and when perceived by NECA for whatever reason.

In LYP 's view the risk of NECA's potential intervention in the market would negatively impact future investments by promoting a regime of regulatory uncertainty and distortion of pricing signals in the spot market.

Non-genuine Price Signals

NECA further asserts that there are price signals (other than those caused by market inefficiencies) that have no basis in the underlying dynamics of the market and are only made possible by the current incomplete state of development of the market which prevents a fully competitive outcome. This is a second category of non genuine prices. This assertion appears to be based on a particular theoretical view of the characteristics

of a competitive market, and of the behaviour of participants in this market, (which unfortunately can only be inferred from the NECA documents). NECA's view that some prices are non genuine appears to be derived from the observation that some generators are not bidding as NECA would have expected.

NECA has determined from their analysis that in relation to these bids, *"The number of bids and rebids that give cause for genuine concern is currently comparatively very small"* As the analysis in NECA's issues paper also demonstrated, *"most rebids are benign"* and *"The impact of that tiny minority of bids and rebids that does give cause for concern is, however, wholly disproportionate"*.⁴

What NECA is describing is the impact on price of a market with needle peak demands, (SA and Vic in summer with high air conditioning load). The market design, (energy only, no capacity payments) recognises that all generators must be compensated for capacity through energy payments and the level of VoLL has been established in recognition of this. This means that for short periods of time the market will be subject to very high prices which will have an impact on long term average pool prices which will allow generators to be compensated for capacity held to cover these peaks. Therefore high prices are expected when

- network constraints or limits are reached, and, or
- there is a mismatch between generating capacity and demand, or
- a mismatch between contract cover and demand

If a generator has a low level of contract cover it is entitled to bid its uncontracted capacity at high prices to recover the costs of maintaining this capacity.

The market does not prescribe which generators must be responsible for maintaining the capacity required to meet peak demand. All generators can be compensated for capacity held as all receive the high pool prices. What this means is that generators who are highly contracted do not receive large (defacto) capacity payments but accept an average price over all periods, (because of the difference payments they make to retailers), while generators who are not highly contracted do retain the high pool prices and are compensated for holding capacity available.

⁴ NECA - Code Change Panel - Generators bidding and rebidding strategies and their effect on prices, Volume 1 Report, September 2001 – Page 7

NECA has overlooked the impact on generator bidding activities in the wholesale market and has concluded in relation to particular types of bids or bids by particular generator types (namely baseload generators with steep supply curves or large amounts of capacity bid at high prices), that,

“They do not represent genuine price signals to either the supply side, in terms of the need for new investment, or the demand side of the market.”⁵

NECA has not considered that the high prices may be due to an imbalance between contract cover and capacity within a region or that there are no market rules to say retailers must contract with particular generators. NECA has therefore come to an inappropriate conclusion, ie

“They reflect, eg through the absence of counter-bids to reduce inappropriately high prices, the current lack of a fully competitive market. Taken together, however, they have a significant effect on prices. They also add significantly and inappropriately to trading risks. Moreover, inappropriate bids and rebids affect the reputation of the market and risk bringing it into disrepute.”⁶

NECA asserts without evidence that the market is not fully competitive and the high prices therefore do not represent genuine price signals to the demand side or the supply side in terms of the need for new investment.

An alternative interpretation is that the market is providing price signals to retailers that their contracting strategy is less than optimum, or that retailers have decided to take pool exposure instead of contracting.

In the competitive electricity market these prices are signals to generators, retailers or investors who are sophisticated businesses and who are aware of the limits and the constraints in the market and the basis for the price signals. Separation into genuine or non-genuine price signals on the basis of some preconceived market view by NECA is at best unnecessary and an artificial contrivance.

NECA’s analysis is flawed in that it is based on a theoretical view and has ignored the impact of the contract market. These price spikes are a normal part of the operation of the market and will be addressed in any case by the market dynamics based on the

⁵, ⁶ NECA - Code Change Panel - Generators bidding and rebidding strategies and their effect on prices, Volume 1 Report, September 2001 – Page 7

current market design. They provide an essential driver on generators to ensure reliable operation and part of the revenue base for generators. They also send the signals necessary for retailers and others to purchase appropriate risk management products to guard against the risks inherent in the spikes. In our view no market is ever perfect nor will a market always behave in a manner predicted by the theory.

The fact that commercial outcomes through ownership and long term contracts have caused generators to behave in ways different from that anticipated at the inception of the market is immaterial. Experience of the market operation and the factors mentioned above have blurred the distinction between base load and peak load generation and it is not appropriate for NECA to intervene to seek to compel generators to behave in the way NECA thinks they should behave based on a particular theoretical model of the market. This aspect was discussed by LYP in previous correspondence to Mr R Shogren (ACCC) on 28th June, 2001.

This aspect is further highlighted in a recent paper⁷ by Stephen Littlechild⁸ where the author addresses the difficulty for a regulator with the economic analysis of competition relating to, *“the proposition that, in a competitive market, price should equal marginal cost. If price is systematically above marginal cost this indicates market power⁹. This proposition derives from theoretical models in which the market and all firms within it are assumed to be in equilibrium. Typically there is perfect knowledge, and the firms have made optimal decisions about technology, scale of output, and so on.”*

Is this really the world we live in? Is it not more realistic to assume that we live in a world of constant and moreorless unexpected change? Neither the generation market nor any other is ever actually in equilibrium. Certainly there may be equilibrating tendencies – an increase in price will stimulate existing generators to try to produce more, and (depending on their estimates of future prices) generators will be more inclined to enter the market, including by building plant. But equally there are disequilibrating tendencies – an explosion at a plant, unexpected movements in gas prices, levels of rainfall affecting

⁷ The Beesley Lectures on Regulation Series XI, Electricity: Regulatory Developments Around the World, dated London 9 October 2001

⁸ Honorary Professor, University of Birmingham Business School, and Principle Research Fellow, Judge Institute of Management Studies, University of Cambridge. Consultant to various governments, regulators and companies in the UK and overseas. Member of Ofgem’s Panel of Economic Advisers

hydro capacity, changes in the growth of consumer demand, events in the macro-economy (no small factor after September 11) and not least intervention and changes in policy by regulatory and government authorities.

In such a world, it would be commercial suicide for a generator to assume that the market will always be in equilibrium and that it should price at marginal cost. The world is too risky for that. Investment in new plant is very expensive and typically takes a long time to recover. The entrant must reduce its risks and plan to get its investment back as soon as possible. It will do this by a variety of long term and short term contracts to allocate risk to those parties best able to control them – which will typically include fuel suppliers and equipment manufacturers as well as retailers and customers. In the absence of regulatory or other constraints, there is a continual process of trading and re-trading such contracts in the face of ever-changing market conditions. The bid that a generator makes in the spot market, if indeed it chooses or is forced to be in the spot market, is thus just a small part of its whole strategy for coping with the substantial risks of a generation business.

This is not to argue that the generation market is different from other markets. I am arguing that, in the real world, competitive markets generally are not characterised by price equal to marginal cost. That is the wrong benchmark for judging possibly anti-competitive behaviour. Life is more complex and in particular more risky than the marginal cost criterion recognises. In a competitive market each participant will seek to reduce its risks and cover its investment whenever and wherever it can. It cannot price at any time on the basis that each of its assets will earn an equilibrium return for the rest of its life.”

The current market in NECA’s view has some anti-competitive detriments. The LYP view is that the apparent imperfections in the electricity market have clearly not been understood and the materiality has not been demonstrated by NECA.

Economic Efficiency

Based on NECA’s own market analysis re-bidding has on average tended to reduce prices rather than raise them. NECA however appears to be concerned that in a comparatively small number of cases, price spikes in the market that are based on so called market inefficiencies or generators’ exercise of market power through bidding or re-

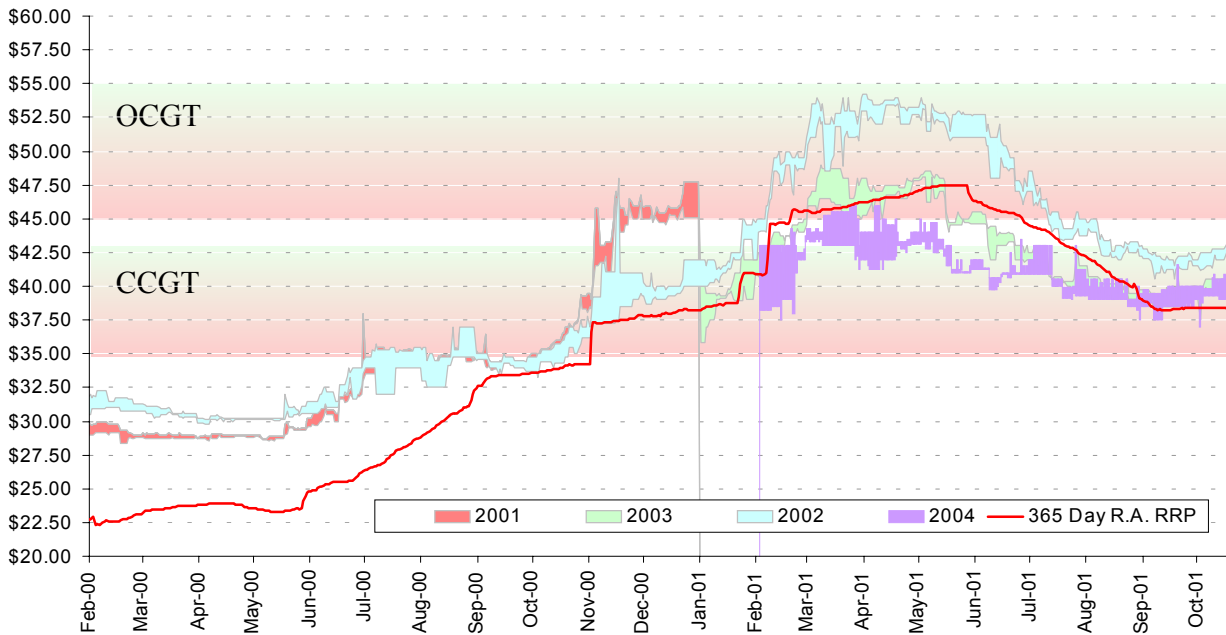
bidding has led to unnecessarily higher prices and these prices have led to an inefficient market.

NECA recognises that “efficient prices represent crucial signals for much needed new investment “. This means that NECA would expect that in an,

- efficient market the long run prices would be at a level required by a new entrant, and in an
- inefficient market it would be expected that long run prices would exceed new entrant price for sustained periods of time,

In this analysis contract prices for the Victorian region are compared to the long run prices required for new investment to assess whether long run contract prices on average are consistently in excess of new entrant price. The following chart plots the 365 day average rolling Victorian pool price and the bid ask spread for flat forward contracts in Victoria for the calendar years 2001 to 2004 (long run contract prices) and compares these to the prices required to attract new entrant.

New entrants in the market in the short term, particularly in SA and Vic are expected to be gas fired generators, either as Open Cycle Gas Turbines (OCGT) or Combined Cycle Gas Turbines (CCGT), The new entrant prices have been prepared for LYP by Intelligent Energy Systems and are presented as a price range for each new entrant type. The price range is due to uncertainty in the installed capital costs (which can vary due to country of manufacture, exchange rate and site location), gas costs and financing costs.



Due to the shape of the Victorian load profile (peak demands for short periods of time in summer), OCGT plant is the most likely new entrant in Victoria.

It can be seen from the graph that for the period up to Nov 2000 contract prices have been well below that required by an efficient market. From the period Feb 2001 to Jun 2001 contract prices moved into the range required to sustain a new entrant OCGT plant in Victoria and subsequently are trading at a level below that required to sustain a new entrant.

In an inefficient market it would be expected that long run prices would exceed new entrant price for sustained periods of time, and the graph clearly demonstrates that this is not the case. In fact on an average in Victoria for the period covered by the analysis, contract prices are well below the level required to support a new entrant. This suggests that any action taken by NECA to reduce price volatility will have an adverse impact on long term and new investment in the market.

Our analysis shows that NECA's claim that price spikes are creating market inefficiencies is inaccurate.

The analysis presented here only covers Victorian pool price. NECA as the proponent of this change should provide a similar analysis for all the other regions.

The Code Changes

In NECA's view the market has failed and it is therefore proposing as a solution, "new and more effective rules to control participants behaviour". NECA is proposing a two stage process. Firstly it is seeking that the ACCC authorise a simple change to the rebidding rules in the Code, by introducing the concepts of "good faith" and "conduct which has the purpose, or has or is likely to have the effect, of materially prejudicing the efficient, competitive or reliable operation of the market..." Behind the introduction of the concept of "conduct prejudicial" NECA is proposing to issue "guidelines", which although mandated by the Code, will be outside the Code, containing NECA's view of what is "conduct prejudicial" These "guidelines" will effectively compel generators to bid according to NECA's view of how they should do so. They will be subject to prosecution if they do not follow the guidelines, and it is likely that any Tribunal will accept the "guidelines" as a definition of "conduct prejudicial". This will subject the bidding and rebidding behaviour of power generators to unprecedented legal constraint and intrusive regulation beyond those normally encountered by other commercial businesses. By placing these restrictions on generator behaviour in so-called "guidelines" outside the Code, NECA will be able to avoid the scrutiny and consultation and ACCC authorisation required for Code changes. It is our strong view that if these "guidelines" are to be implemented they should either be incorporated in the Code or be made the subject of a separate application for authorisation under the Trade Practices Act..

NECA is effectively endeavouring to implement additional rules to regulate prices in a competitive market according to NECA's view of what prices should be and how they should be determined. This is contrary to the functioning of a free market in which prices are determined by competitive bids and offers. NECA's solution to their perceived failure of a competitive market of arbitrarily regulating the market is surely not a path that will allow the market to deliver genuinely efficient prices. The solution proposed will only lead to regulatory uncertainty and discourage the investment that NECA acknowledges is required for the market to develop.

The proposed Code changes are counter to

- the first key objective of the National Electricity Code, which is "to provide a regime of 'light-handed' regulation of the market to achieve the market objectives", (cl 1.4(b(1))), and

- one of the key market design principles:- “These market rules are not intended to regulate anti-competitive behaviour by Market Participants which, as in all other markets, is subject to the relevant provisions of the Trade Practices Act, 1974 and the Competition Codes of participating jurisdictions” (cl 3.1.4(b)).

Both of these are protected and fundamental principles underpinning the Code and are being disregarded in these proposals.

NECA’s attempt to establish itself as a competition regulator will create overlap with the existing regulator, the ACCC. This creates a real danger that there will be inconsistencies where both regulators act and gaps where neither act.

Furthermore NECA has not demonstrated that current behaviour has resulted in any anti-competitive detriments, and to the extent that any such detriments can be deduced from NECA’s reports, there is no evidence that there is a countervailing public benefit. In fact any detriment that NECA seeks to eliminate through these changes and associated “guidelines” is outweighed by the decrease in public benefit brought about by the increased risk, uncertainty, and lack of investor confidence, which at the best will lead to higher long term prices and at the worst market failure due to lack of timely investment.

Despite the fact that NECA recognises that a regulated solution will artificially constrain and will distort crucial signals, NECA has chosen a regulated solution. The type of regulation proposed will create uncertainty because,

- it lacks clarity and is ill defined, and
- is subject to arbitrary change by NECA,

and will therefore create a high degree of uncertainty and risk in bidding and re- bidding. In fact, the proposed change will impinge on all bidding and re-bidding activity given the lack of clear delineation provided.

Furthermore the regulation propose has not been developed in accordance with good regulation practice as agreed by Australian States and Territories Federally, and as are found in:

- the Council of Australian Governments’ Principles and Guidelines for National Standard Setting and Regulatory Action by Ministerial Councils and Standard Setting Bodies (1997);

- the Office of Regulation Review's A Guide to Regulation (1997);
- the OECD's Regulatory Reform, Privatisation and Competition Policy (1992); and
- clause 5 of the Competition Principles Agreement between the Commonwealth and all States and Territories (1994).

The process by which this Code change has been proposed has already increased the sovereign risk of competing in the electricity market which will be to the long term detriment of end consumers of electricity.

These changes represent an abandonment of two of the principles underpinning the National Electricity Market, namely competition and light handed regulation in favour of a return to intrusive regulation and constrained competitive outcomes. To the extent that such changes are being imposed less than three years after the establishment of the market, they are likely to have an adverse effect on perceptions of Australia as an investment destination.

Good Faith

One of the key features of the proposed changes being pursued by NECA is to rely on good faith as a criterion for evaluating behaviour of participants.

The term "Good Faith" has not been defined as it applies to bidding and re-bidding. It appears to be an attempt to restrict bidding behaviour that is controlled by the rules in the Code and the TPA and therefore implies some moral standard which is highly subjective, and has not been defined by the proposed Code change. This in turn will increase participant uncertainty and risk and reduce the efficient operation of the market.

While the existence of an implied term of good faith has been recognised by the courts, and has been 'allowed into' commercial transactions by the courts, this tends to be accepted only in decisions relating to consumer or similar transactions.

Some considerable degree of uncertainty remains about the utility of such a concept in Australian law especially in non-consumer transactions. In these circumstances if the expression is to be used as part of a 'Code' in what are quite complex commercial transactions, it should be defined with some precision to avoid unnecessary uncertainty.

Reversing the Onus of Proof

NECA also recommends that the onus of proof in proceedings in which an allegation of not acting in good faith should be reversed. As a result, in any proceeding, a generator would be required to satisfy the National Electricity Tribunal that its bid or rebid was genuinely made in good faith without the accuser having to adduce any evidence whatever in support of its contention.

The effect of such provisions is to deem a person or corporation guilty of an offence unless they can prove their innocence. NECA cites the precedent of section 51A of the Trade Practices Act as justification for the proposal. However in that case there was a particular problem concerning proof of a person's belief about future matters, the burden of proof has been shifted to the defendant if prima facie evidence of certain facts is adduced. The change proposed here goes far beyond this by requiring the accuser to prove absolutely nothing and placing the entire burden of proof on the accused. This is a dramatic shift away from one of the most basic principles of the law. The analogy with section 51A of the Trade Practices Act is mistaken, and this draconian change is proposed without any justification.

NECA has not provided any reasonable evidence in support of this extraordinary proposal in the amendment. Indeed, the proposal, if accepted, could open the 'floodgates' for a similar approach to other provisions. The NECA amendment, as it is currently drafted, asserts that every bid or rebid by a generator is not in good faith, unless proven by the generator that it is. Whilst the issue only becomes relevant when a proceeding is instituted, the fact that the mere act of the transaction involving a bid or rebid is itself being deemed not to be done in good faith, is quite an extraordinary approach to such commercial transactions. Every transaction is assumed to be performed in a prohibited manner or for a prohibited purpose. It is difficult to see how any generator can bid at all when faced by an legal presumption that its behaviour is not in "good faith" and illegal. At best generators will lose all speed and flexibility due to the need to undertake complex analysis and consultation to determine whether they are acting in good faith and to whether they have evidence of sufficient probative value to prove their case if NECA makes an allegation against them. The behavioural impact of these proposals may be to impede bidding and re-bidding activity to such an extent that market efficiency and reliability of supply will be severely compromised.

Indeed, at least two additional questions need to be considered in evaluating the proposal further:

- Are generator bids and rebids frequently associated with the exercise of arbitrary power?; and
- Are there intrinsic and almost insurmountable problems with NECA proving a generator bid or rebid has not been conducted in good faith?

The answer to both of these questions is quite emphatically - NO. As we understand the position, there has in fact been no flood of complaints to the ACCC nor to other regulators in relation to these issues. There are therefore strong grounds to argue a reversal of onus of proof, as proposed by NECA, is inappropriate.

Conduct prejudicial to the market

Clause 3.1.2 (“Purpose of market rules”) of the Code says, *“The purpose of these market rules is to create a regulatory environment which promotes an efficient, competitive and reliable market for the wholesale sale and purchase of electricity. The purpose is not to mandate competitive behaviour but to create an environment that will promote it.”*

A reliable market is defined as “ a recognised degree of confidence in the certainty of an event or action occurring when expected in any of the markets or exchanges described in this code, for so long as the market or exchange is conducted by NEMMCO.

The words efficient and competitive are not defined in the Code however one of the market design principles Clause 3.1.4 (b) is that *“These market rules are not intended to regulate ant-competitive behaviour by Market Participants which, as in all other markets, is subject to the relevant provisions of the trade practices Act, 1974 and the Competition Codes of participating jurisdictions.*

It is therefore reasonable to assume that the words “competition” and “efficiency” in the Code relate to the market system operated by NEMMCO, rather than the economic market regulated by the Trade Practices Act.

It appears from the documentation submitted by NECA that it wishes to regulate behaviour in the market in the economic or competition law sense, ie eliminate “conduct prejudicial to the market”, and change the “competition” and economic outcomes in this

market because NECA believes that they are “inefficient” and that some behaviour impacts the “reliability” of the market.

The NEC’s function is to regulate the market in the sense of the system of processing buyers offers, (and ultimately sellers bids), and turning these offers into prices, and is administered by NEMMCO. It is not appropriate for NECA to regulate outcomes in the competition law market through rules (the NEC) which govern the technical operation of the electricity market administered by NEMMCO.

It is clear under the Code from the definitions of “reliable” and “reliable operating state” that operation of the NEC “market” is NEMMCO’s responsibility. This change would shift part of this responsibility to the multiplicity of Market Participants and potentially require Market Participants to contact their competitors and NEMMCO to discuss and agree upon the consequences for the system reliability of their bids.

Presumably NEMMCO is also responsible for operating the market in an efficient manner (ie without waste) however it is not clear under the Code how the nature of the bid ie “genuine” or “non genuine” would impact the efficiency of the technical process of establishing a price.

Furthermore the meaning of the following expressions needs to be clarified,

- “has the purpose, or has or is likely to have the effect”, and
- “reasonable cause”

In relation to the former it is unreasonable in a “blind” auction system to require participants to foresee whether their conduct will result in “substantial lessening of competition”. In the context of the National Electricity Market the consequences of a Market Participant’s actions are complicated by the actions and interactions of other NEM regions, other Market Participants, plant outages, weather and non-Market Participants (such as the actions of end consumers).

Consequently, it would be quite possible for a Market Participant to accidentally or inadvertently fall foul of the prohibition as currently drafted. Therefore, if this provision is introduced, the risk for Market Participants of engaging in the supply of electricity will be increased, investment will be discouraged and the costs of increased risk-adjusted costs of capital will be borne by end consumers of electricity

NECA's use of the Code to control behaviour in the competitive electricity market is therefore misguided. The introduction of this clause in the Code only creates confusion and uncertainty. These are clearly not the outcomes that NECA is attempting to achieve.

NECA has failed to distinguish between a "market" in its economic or competition law sense, and a market in the physical sense, ie whether it be a place or a system of communication and rules for creating prices or for contracts between buyers and sellers. This rule change is an attempt to take responsibility for creating a competitive environment from the economic regulator to the participants in the market and to do so with rules intended to regulate the operation of the market system.

All the problems with the current drafting of the proposed clause 3.8.22B lead to substantial uncertainties, risks and compliance costs for *Market Participants* which would contribute to substantial public detriment through discouraging investment in the electricity sector and increased costs to consumers.

This issue of regulation of a competitive market is discussed in a recent paper¹⁰ presented by Stephen Littlechild¹¹. In this paper on the section headed "Competition in Generation: Conduct and Structure," the issue of actual or potential market power is discussed. The paper refers to the recent activities of NECA in relation to this proposed Code change and makes the point that the actual or potential issue of market power is best addressed by a **focus on structure and incentives rather than conduct.**

On page 11 of this paper the author states that regulatory policy needs to,

"consider the long-run as well as the short-run consequences of any policy. If there is a substantial penalty for alleged withholding of output, an existing generator may well be more inclined not to do this. But a potential new generator might also be less inclined to enter the market. Ameliorating today's problem may thus be at the expense of exacerbating tomorrow's.

¹⁰ The Beesley Lectures on Regulation Series XI, Electricity: Regulatory Developments Around the World, dated London 9 October 2001

¹¹ Honorary Professor, University of Birmingham Business School, and Principle Research Fellow, Judge Institute of Management Studies, University of Cambridge. Consultant to various governments, regulators and companies in the UK and overseas. Member of Ofgem's Panel of Economic Advisers.

This is obviously not an easy balance to strike. Given the difficulties of satisfactorily defining and proving anti-competitive conduct, my own inclination would be to focus where possible on structure and incentives rather than conduct.”

The author also notes on page 11 that: -

“Protection for customers can be provided in a number of ways. These include promoting new entry, and enforcing divestment where necessary and practicable, taking into account local as well as market-wide monopoly positions. Wholesale trading should allow suppliers to contract ahead rather than force them to trade only in the spot market. Retail competition should give suppliers incentive to protect themselves and customers. The system operator should have flexibility to contract ahead so as to avoid or minimise market power, and there should be incentives to remove network bottlenecks where it is economic to do so.”

Authorisation of the Guidelines

The proposed “guidelines” amount to a set of rules under which wholesale electricity prices will be determined. They affectively abandon the current system of bidding and could in themselves be seen to be an arrangement between competitors to fix prices and hence infringe section 45 and 45A (price fixing) and 45 (4D) (exclusionary provisions) of the Trade Practices Act. These sections are “per se” provisions and are infringed whether or not they have the required detrimental effect on competition. It is therefore likely that Code participants will be exposed to an action under the TPA in complying with any guidelines established by NECA, unless the ACCC expressly authorises the guidelines.

It is understood that NECA has not requested that the ACCC authorise the guidelines. It is our submission that these guidelines are an integral part of the proposed changes and they should be the subject of the same consultation as would occur if they were proposed as a Code change and that this should occur before any consideration is given to the proposed Code changes themselves. In addition the guidelines should then be submitted to the ACCC for authorisation as a part of the Code change or alternatively as requiring authorisation in their own right as potential infringements of section 45 of the Act.

If these guidelines are implemented without authorisation, generators will be faced with contradictory legal obligations. They will be bound, on the one hand, as Code participants, to observe rules which impose harsh restrictions on their commercial behaviour and deem their actions to be illegal unless they can prove otherwise, and on the other hand, sections 45 and 45A of the Trade Practices Act. They will not be able to comply with each of these laws simultaneously.

Price Fixing

Section 45A provides that a provision of a proposed *contract, arrangement or understanding* will be deemed to contravene section 45 if it has the purpose of fixing, controlling or maintaining the price of goods to be supplied by parties which are in competition with each other. Just as the Code itself constitutes a deemed contract between the generators, the mandatory nature of the guidelines through their link with Rule 3.8.22B of the Code renders them also a deemed contract between them.

The very purpose of the guidelines is to control the price of electricity sold by the competing generators into the National Electricity Market. The courts have held that a contract has the effect of controlling price if it restrains a freedom that would otherwise exist as to a price to be charged. The guidelines clearly satisfy these criteria. For the purposes of section 45 it is not necessary for the contract to fix the precise price; it is sufficient if it invokes a formula that produces a price within limits imposed by the contract. In this case, the restrictions on generator bidding will significantly impact the operation of the NEMMCO algorithm and constrain prices within limits that would not apply if the parties were able to act freely in accordance with their commercial interests.

Exclusionary Provisions

So far as is relevant, an exclusionary provision is a provision of a *contract* that has the *purpose of preventing, restricting or limiting* the supply of electricity to particular persons or classes of persons, or in particular circumstances or on particular conditions by competitors.

The circumstances in which the guidelines will operate in a situation analogous to that which prevailed in the South Sydney Rugby League case. In that case, the Federal Court held that a scheme to improve the competitiveness of the national rugby league

competition was an exclusionary provision because it had the additional effect of excluding South Sydney from the competition. In the same way, while the guidelines may have the “ultimate purpose” of ensuring the efficient, economic and reliable operation of the NEM, they also have an “immediate purpose” of preventing supply on particular conditions (for example where price increases are significantly in excess of changes in actual or opportunity costs). On the basis of the present law, this would be sufficient to render them an exclusionary provision.

The guidelines proposed by NECA are not included in this authorisation. Because of the issues raised above the any guidelines must be included as part of the Code change and the authorisation.

Conclusion

NECA recognises that the market needs “full and unfettered competition” but has put forward a proposal to constrain competition in the market.

In LYP’s view if generators are bidding within the rules and constraints in the market and are not exercising market power to damage their competitors then all price signals in the market must by definition be genuine. NECA appears to have completely ignored the impact of the financial market on both retailers and generators in considering this issue. NECA has not demonstrated that a change to the Code is required or that the anti-competitive aspects of the change are outweighed by any increased public benefit

So that the issue can be addressed in a rational manner LYP request ACCC to not authorise the Code change until proper consideration of the economic impacts of the proposal on participants has been undertaken, including provision by NECA of the following through a consultation process:

- information in relation to the economic rationale which demonstrates the need for the proposed Code changes,
- an analysis that demonstrates that the increase in anti-competitive detriment is more than outweighed by the public benefits of the proposal,
- a demonstration that its proposal to constrain bidding behaviour, or regulate the market will not discourage needed investment in the market and or create a need to adjust the level of VoLL to compensate for the reduced price spike frequency,

and if the need for a change is demonstrated then

- propose a Code change that is consistent with competition principles.

If this is not achievable then

- a regulatory approach could be proposed through a process that is consistent with “good regulatory practice”,

where

- the proposal does not reverse the ordinary burden of proof and is consistent with established legal principles and existing laws, or if this is demonstrated to not be satisfactory only the evidentiary burden is shifted and the change does not have the effect of introducing a presumption of guilt or wrong doing, and where if necessary
- the meaning of “good faith “ and “genuine intentions” are defined as they relate to an operating auction system,

In addition guidelines that are developed as a result of the outworkings of any process must be submitted to the ACCC for authorisation under the Trade Practices Act and must be clear, unambiguous ,and capable of being applied using objective criteria.

Attachment 1 – Comments on Proposed Guidelines

Comments on the proposed guidelines are listed below. In general the guidelines create a high degree of uncertainty as to their meaning and application due to their highly subjective nature.

- **Actions that may prejudice....of the market**

NECA states that legitimate very high prices for the final increment of capacity would not breach this provision. What is the final increment of capacity? what are 'legitimate very high prices'?, It would be in contravention of cl 1.3(b) 5 if some generators (i.e. those deemed to be 'peaking') were allowed to have higher priced offers than other so called 'base-load ' generators.

- **Withholding capacity**

This does not artificially increase prices in an unfettered market, as any associated increase in price is a result of the supply and demand at the time. Restricting the level or type of bid as proposed by the NECA changes will cause artificial prices and outcomes as the market prices would not reflect supply and demand at the time.

- **Sleeper bids**

The practice described is neither inefficient nor uneconomic. The market will clear at the settled price as determined by NEMMCO. These so-called sleeper bids are simply a generator indicating the price at which it is prepared to offer its generation at a point in time. Should the market not deliver this return the generator may then revise its position to offer the MW at lower prices. This practice is simply an outworking of simple supply and demand and will only lower the RRP, not increase it. Again, NECA does not give any credence to hedging contract positions and the market risks associated with the adoption of high priced bids.

- **Exploiting network constraints increases in demand.**

NECA indicates that it would investigate instances where high capacity resources set prices where peak plant was not dispatched. It is suggested that this would not occur because of the high prices, but to determine whether the responses were proportionate or significantly out of line with what might be expected in a competitive market.

This is an extremely naive and worrying statement from an organisation that is meant to be administering the Code in a **competitive** market. Surely in a competitive market the

notion of base and peak generators in a commercial sense disappears. Whilst all generators are constrained by respective physical plant limitations, which from a technical point of view may enable classification as peak or base load, how this plant is operated in a commercial environment is surely the decision of respective participants and not that of NECA. The market has seen so called 'peak plant' running for prolonged periods at relatively low prices, (even bidding large negative values at times), just as we have seen 'base load' plant setting higher priced periods. In the energy only market that we have without provision for capacity payments, this behaviour is to be expected and welcomed. It reflects the true efficiency of the market and that competition is driving outcomes where one particular source of energy may be unavailable to the market at large. If the proposed changes were accepted, this would provide segments of the market with unfair advantages over others and distort competition and market outcomes. The strategy of some retailers would be almost protected by such regulation to the detriment of other retailer competitors and electricity consumers in the long run.

- **Manipulating dynamic capability.**

Again, NECA seems to be suggesting how participants in a competitive market should run their plant. What is '*good industry practice*' ramp rate for any particular type of unit? Ramp rates may change due to a myriad of technical, commercial or weather related issues and will be taken into account in the dispatch process, which then allows the market to clear in an efficient and economical manner.

Again, LYP believe that NECA is running the risk of contravening cl. 1.3(b) 5 of the NEC in seeking to define how different types of plant should bid or operate.