New South Wales
TREASURY

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Dear Mr Rawstron

PROPOSED REBIDDING CODE CHANGES

The New South Wales Treasury (Treasury) appreciates this opportunity to make a submission to the Australian Competition and Consumer Commission (Commission) in relation to the NECA Code Change Panel's proposed Code changes for generator rebidding (rebidding Code changes).

Treasury understands that there may be a legitimate purpose in attempting to constrain the ability of generators to rebid. However, Treasury observes that NECA's proposed rebidding Code changes have the effect of transforming NECA into a competition and pricing regulator of the National Electricity Market (NEM), thus extending NECA's role beyond that of Code administrator. This is highlighted by NECA's recently published draft guidelines for "Ensuring the efficient, economic and reliable operation of the national electricity market" (Guidelines).

In Treasury's view, NECA's apparent appropriation of economic regulation is undesirable from both a market design and a governance perspective. Treasury urges the Commission to consider, in its determination, the serious public detriment risks of arbitrary and *ad hoc* rule making that the rebidding Code changes and Guidelines may create for the market. Treasury is also concerned by the possible overlap of roles between NECA and the ACCC, and believes that a clear allocation of roles consistent with their expertise and functions is warranted.

Background

NECA published an Issues Paper on generator rebidding in June 2001. Treasury made a submission on that Issues Paper, stating that NECA had not made a reasoned case for changing the market rules. In summary, Treasury took the view that for Code changes to be supported, NECA would have to demonstrate:

- 'Non-genuine' rebidding accounts for a significant portion of rebids;
- Technological limitations prevent demand or supply-side response to rebids within a certain period of time prior to the relevant dispatch interval; and
- Benefits of proposed rule changes outweigh the costs.

Our submission concluded by saying that, "In light of the fact that the Issues Paper does not contain such analysis, we suggest that much more work needs to be done before a change to the market rules can be supported." A copy of this submission is attached.

The purpose of the Treasury submission to NECA was not to deny the importance of the rebidding issue but to place NECA on notice, at an early stage in the rebidding review process, of the analytical steps that would be required to make a cogent case for Code changes.

Subsequent to its consultation process, NECA made some changes to its proposed Code changes. However, at no stage has NECA addressed the key issues outlined above. In the absence of this basic analysis, Treasury cannot support the adoption of *any* measures designed to limit or discourage rebidding. With this in mind, the remainder of this submission assesses NECA's proposals on their own merits, assuming that a robust case for limiting or discouraging rebidding can be made.

Bids to be made in good faith

Onus of proof

NECA has proposed that market participants must bid and rebid in good faith and that in any proceedings in relation to this rule, a market participant is deemed to not have bid or rebid in good faith unless the participant can satisfy the National Electricity Tribunal otherwise.

This proposal is designed to overcome the informational difficulties that NECA perceives arise when attempting to prove that a participant has not bid or rebid in good faith. However, it also constitutes a reversal of the ordinary onus of proof, which increases the risk of penalising market participants for behaviour that has not been shown to be harmful or could have been for good reason. It is for this reason that reversing the onus of proof should only be considered as a last resort, and must be based on clear and compelling reasons.

It might be argued that in the regulatory context that the difficulties for a regulator of establishing the motivation of rebidding form the basis for the reversal of the onus of proof. That is, it is difficult for the regulator to establish guilt for a subset of events among many that cause no concern. Under these circumstances it is easier to assert guilt and pass the burden of proof to the party under review. However, this argument cuts both ways. NECA has acknowledged that the vast majority of rebidding behaviour is efficiency enhancing. Restrictions on rebidding is designed to capture the small number of times where rebidding is opportunistic and exploitative of temporary market power. However, the reversal of proof now means that the regulatory reach extends, at least in theory, to all rebidding activity. To manage this regulatory risk, generators must be able to account for all possible instances of rebidding – even if only a handful of events are called into question by the regulator. In the absence of demonstrable evidence of the magnitude of the problem the regulatory proposal by NECA appears as a regulatory 'sledgehammer' to crack a competitive 'nut'.

NECA did refer to section 51A(2) of the *Trade Practices Act* 1974 (Cth) as a precedent for reversing the onus of proof. However, section 51A(2) refers to proceedings concerning representations made by a corporation with respect to a future matter. According to Miller's *Annotated Trade Practices Act*, section 51A(2) does not apply to a representation as to a

person's present state of mind. It only applies to a representation as to an event or conduct in the future, such as a prediction. Therefore, a statement by a generator that the market price is likely to be $x at a certain time in the future may be a prediction that the generator could be expected to have reasonable grounds for making. However, a 'statement' in the form of a bid for the supply of a certain quantity of electricity at a certain price at a certain time in the future is likely to not be a representation as to a future matter – it may simply be a representation as to a present state of mind for which no grounds should need to be provided. It is not appear appropriate to require a corporation to have reasonable grounds for an intention, other than, presumably, profit maximisation.

Good faith

The risks inherent in reversing the onus of proof are even more profound when applied to a concept as intangible as good faith. Good faith in the context of contract refers to parties engaging in fair dealing in bilateral or direct relations with other parties. However, in the context of a market with many buyers and sellers, a bid or rebid is not directed to any particular party or parties. Indeed, an initial bid by a generator could be characterised an offer that is not capable of acceptance until a certain time (dispatch).

A real issue is raised by what constitutes bidding and rebidding in good faith. For example, a generator could honestly believe at 7am that bidding at price $Y would maximise profits, but at 7:05am may believe that changing its bid to $(y+1) would maximise profits. The 7am bid could have been made on the basis of a certain load forecast, a certain temperature forecast, a certain structure of other generators' bids, certain transmission line capacities, a certain appetite for risk, a certain contract position, or even a certain trader's 'gut feel', any of which may change at any time. If the circumstances that affect generators' decisions to bid and rebid can change at any time, it is unclear what it really means to bid or rebid in good faith. This ambiguity may be acceptable if the onus of proving bad faith is on the party asserting it. But if the onus is on the bidding party, it is iniquitous to expect participants to *prove* that the bid was made in 'good faith'. As a procedural matter, there may be a substantial burden on businesses to establish they acted in good faith, given the number of factors that could contribute to the making of a bid or rebid.

NECA has not provided any evidence of the need to make this fundamental change. The Code Change Panel has merely asserted that it is satisfied that the shift in the onus is appropriate and reasonable. This is a completely inappropriate approach to a serious policy question. Furthermore, if a change as significant as a reversal of the onus of proof is deemed necessary, Treasury believes that it ought to be implemented through a change to the National Electricity Law, not to the Code.

Conduct prejudicial to the market

NECA's Code changes prohibit bids or rebids that have the purpose, or have or are likely to have the effect of materially prejudicing the efficient, competitive or reliable operation of the market unless the participant has reasonable cause to do so. The Code changes allow NECA to develop non-binding Guidelines as to how it will exercise its power to enforce this prohibition. In the draft Guidelines, NECA rejected the targeted approach of Ofgem in the UK by avoiding defining unlawful conduct. Rather, NECA outlined several types of conduct that it might investigate:

- Withholding capacity to artificially increase prices;
- High-priced sleeper bids;
- Exploiting network constraints, reductions in capacity or increases in demand; and
- Manipulating dynamic capability.

Taken together, the application of these Guidelines would effectively transform NECA into a competition and pricing regulator for the NEM.

Prima facie, the focus on withholding capacity and exploiting constraints would appear to prohibit bids that push prices above the bidder's short run marginal cost, unless there is some reason that NECA considers appropriate. NECA attempts to distinguish between high prices reflecting underlying demand and supply conditions or resulting from the normal operation of a competitive market and high prices resulting from capacity withholding or other deemed undesirable causes.

Treasury submits that this distinction is almost impossible to maintain both in theory and in practice. The competitiveness of a market depends on the degree to which free interactions (ie competition) between profit-maximising agents prevent the withholding of supply to increase price. The creation of this environment is the rationale for implementing a market. As discussed in Treasury's submission on NECA's Issues Paper, if it can clearly be shown that the NEM is not working in this respect, then the preferred solution is to change the design or structure of the market. The solution to inadequacies in market design or market structure is generally *not* to try to deter or prevent participants from behaving in a profit-maximising manner. It is one thing to have a market objective that the market should be competitive. It is quite another to place an obligation on individual participants to not bid in a way in certain ways. Rather, it is the market, as an institution, that is meant to impose discipline on participants' conduct. Attempting to address design or structural problems through behavioural rules or 'guidelines' risks creating serious uncertainties and inefficiencies and in effect, defeats the purpose of implementing a market.

The Code changes and Guidelines together give NECA and the Tribunal extremely broad discretion to make a judgement about what behaviour is 'legitimate' and what is not. For example, it is completely unclear whether a 'reasonable cause' for bidding or rebidding is profit-maximisation. By and large, in a market-based economy, firms are free to set prices as they wish, provided this does not involve any form of collusion or predatory behaviour. We understand this is one of the reasons why the ACCC does not have the power to prosecute businesses for setting high prices *per se*. NECA's approach is contrary to the principle of implementing a (relatively) free wholesale electricity market.

It is notable that on the one hand, NECA has championed an increase in the number of NEM regions and claimed in that context that, subject to a certain minimum size, market power is either not a concern or will be addressed by new entry or demand-side response.[1] Yet on the other hand, NECA has drafted ambiguous and arbitrary guidelines to deter profit-maximising behaviour. This reflects a schizophrenic attitude towards the market – in favour of an ever more refined and disaggregated market, but against market participants attempting to maximise profits within that market.

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[1] See NECA, *The Scope for Integrating the Energy Market and Network Services*, Draft Report, Volume 1, October 2000, page 16.

If the difference in NECA's approach is purely a function of a belief that rebidding close to dispatch does not allow sufficient time for a competitive response, then, as Treasury pointed out in our earlier submission, we are yet to see clear evidence supporting this assertion. Yet even if this evidence were provided, it would not justify the extremely broad-ranging powers and discretion that the rebidding Code changes and Guidelines confer on NECA.

Finally, as a matter of good governance, Treasury is opposed to Code changes that give NECA broad discretion as to how they plan to enforce parts of the Code. Good governance requires that the body administering rules should not be the same body that develops those rules. Such concentration of power risks arbitrary rule-making and rule administration. These risks are unacceptable to Treasury and would presumably be unacceptable to many other NEM stakeholders.

Conclusion

Treasury does not, at this stage, support any changes to the Code in relation to limiting or discouraging rebidding. We understand that there are concerns among some industry participants and jurisdictions regarding this rebidding issue. However, the questions and concerns we raised in our submission on NECA's Issues Paper, which are fundamental to establishing the basis for proposals for Code changes, have not been addressed. Even assuming that good reasons for such restrictions could be found, NECA's proposed changes are highly ambiguous, poorly conceived and give NECA an unparalleled level of discretion to administer rules of its own making. Taken together, NECA's proposals fundamentally change its role from the Code administrator to a competition and pricing regulator, a role that is in Treasury's view completely inappropriate and *ultra vires*.

Please contact me if you wish to discuss the matters raised in this submission.

Yours sincerely,

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New South Wales Treasury