

Determination

Applications for Authorisation

Amendments to the National Electricity Code

Changes to bidding and rebidding rules

Date: 4 December 2002

Authorisation Nos:

A90797

A90798

A90799

Commissioners:

Fels

Bhojani

Jones

Martin

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Glossary

AFMA	Australian Financial Markets Association
AGL	AGL Energy Sales and Marketing Limited
COAG	Council of Australian Governments
code	National Electricity Code
Commission	Australian Competition and Consumer Commission
Delta	Delta Electricity
ESCoSA	Essential Services Commission of South Australia
EMEAL	Edison Mission Energy Australia Limited
Eraring	Eraring Energy
Ergon	Ergon Energy
ETEF	New South Wales Electricity Tariff Equalisation Fund
EUAA	Energy Users Association of Australia
FCAS	Frequency Control Ancillary Services
Forum	Market Review Forum
guidelines	Draft guidelines- <i>Ensuring the efficient, economic and reliable operation of the national electricity market</i>
InterGen	InterGen (Australia) Pty Ltd
Loy Yang	Loy Yang Power Management Pty Ltd
Macquarie	Macquarie Generation
MMA	McLennan Megasanik Associates Pty Ltd
MSORC	Market and System Operator Review Committee
MWh	MegaWatt hour
NECA	National Electricity Code Administrator
NECG	Network Economics Consulting Group
NEM	National Electricity Market
NEMMCO	National Electricity Market Management Company Ltd
NETA	New Electricity Trading Arrangements
NGF	National Generators Forum
NRG Flinders	NRG Flinders Operating Services Pty Ltd
NSW Government	New South Wales Ministry of Energy and Utilities
NSW Treasury	New South Wales Treasury
Origin	Origin Energy Electricity Limited
Panel	Code Change Panel
PASA	Projected Assessment of System Adequacy
PJM	Pennsylvania, New Jersey and Maryland
PPA	Power Purchase Agreement
Report	Code Change Panel- <i>Generators' bidding and rebidding strategies and their effect on prices</i> - Volume 1- Report
SA Minister	South Australian Minister for Energy
Snowy Hydro	Snowy Hydro Trading Pty Limited
SRMC	Short run marginal cost
Stanwell	Stanwell Corporation Ltd
Tarong	Tarong Energy Corporation Ltd
TPA	Trade Practices Act 1974
Tribunal	National Electricity Tribunal
TXU	TXU Electricity Ltd
VoLL	Value of Lost Load

Westpac
Yamasa
\$/MWh

Westpac Institutional Bank
Yamasa Australia Pty Ltd
dollars per MegaWatt hour

Executive Summary

The Australian Competition and Consumer Commission (Commission) assesses changes to the National Electricity Code (code) which governs the National Electricity Market (NEM). Code changes are proposed by the National Electricity Code Administrator (NECA) under Part VII of the Trade Practices Act 1974 (TPA). The TPA requires that any changes are deemed to result in a net public benefit before they can be given immunity from sections of the TPA.

With respect to the code changes proposed for bidding and rebidding, the TPA does not require the Commission to decide whether the code changes are the most effective way to address the issue of price spikes in the NEM, but rather, it requires the Commission to determine whether the changes, or parts thereof, will result in a net public benefit, where the benefits outweigh any anticompetitive detriment that may arise from the conduct to be authorised.

NECA's application for authorisation

NECA has applied for authorisation of code changes which aim to improve the reliability of pre-dispatch forecast prices in each dispatch interval and address aspects of generator's bidding and rebidding strategies that are of concern, and that are claimed to have been the cause of short-term price spikes experienced in the NEM.

Associated changes to the management of system security and ancillary services aim to improve network transfer capabilities, hence enabling additional benefits of trade to be realised and reducing opportunities for the exercise of local market power.

The proposed rebidding code changes were developed by NECA after criticism of price outcomes that arose during the summer of 2000-2001.

Commission's draft determination

The Commission released its draft determination on 3 July 2002 outlining its views on the application for authorisation.

Good faith

On the basis of the authorisation test, the Commission found that the public benefits of the good faith proposal, on balance, outweigh the detriments. Public benefits arising from reliable pre-dispatch forecasts are an important component in the NEM's design.

To address the issue of uncertainty pertaining to the definition of good faith, the Commission urged NECA to develop a definition.

Reverse onus of proof

The Commission did not support the 'reverse onus of proof' proposal, as such a clause would require generators to prove themselves innocent to the satisfaction of the National Electricity Tribunal (Tribunal) if their behaviour was questioned by NECA. The proposal has the potential to impose significant costs on participants and would not be consistent with the code objective 'to provide a regime of 'light-handed' regulation'.

Conduct prejudicial

The Commission does not consider that the proposal delivers a net public benefit and for this reason has not authorised it. There are three main reasons for this.

The first is workability of the proposal. The proposal links individual actions to market outcomes that are the culmination of actions and reactions of all market participants. Given the amount of information in the market and the number of ways in which new information can be interpreted and responded to within the market, it is not certain that the code change will be workable.

The second is compliance costs. These costs are ultimately borne by consumers. Perhaps more significantly the costs may encourage firms to bid and rebid more conservatively, leading to less flexibility in the market which may on occasions reduce competitive responses.

The third is that the guidelines seem to go beyond the bidding and rebidding mechanism. The guidelines targets market power, outlining specific behaviour in the market that NECA considers inappropriate. However, market power can manifest itself through mechanisms other than the ability to bid and rebid.

Power system security

The Commission found that the 'power system security' code change would satisfy the authorisation test after the conditions of authorisation are applied. With respect to principles for power system security, the Commission:

- accepted NECA's proposal as to the rewording of clause 3.11.3(b), on the condition that it be altered to include clarification that the National Electricity Market Management Company (NEMMCO) should only attempt to enhance the value of spot market trading when it can be done without prejudicing system security and when it is cost effective to do so; and
- accepted NECA's proposal as to the rewording of clause 4.2.6(b), on the condition the guiding principles and specific guidelines be developed to make the provisions in the clause effective.

Summary of submissions arising from the draft determination

Good faith

Table 1 below summarises the submissions on the good faith proposal.

Table 1: Summary of submissions from the draft determination regarding good faith.

Support	Comments
Tarong Energy	Should define 'good faith' properly to avoid risks.
Hydro Tasmania	Should be accompanied with clarification of how it will be applied in practice.
Macquarie Generation	Support definition as 'genuine intentions'. Draft does not address enforcement of 'good faith'.
Southern Hydro	Supports 'good faith' based on available information at the time.
Eraring Energy	No problem with concept, but should be defined.
SA Minister of Energy.	Definition will help but ultimately up to the National Electricity Tribunal
Energy Australia	NECA has already defined it as 'genuine intentions'.
Westpac	Support 'good faith' and interpret it as bids should be optimal price/ capacity trade-off based on the information at hand.
No Support	Comments
NSW Government	Generally opposed to behavioural rules such as 'good faith'.
NECG	Initial bids don't shape ultimate outcomes anyway. Definition is not made a condition of authorisation.
Stanwell	Effect of 'good faith' may mirror 90 min rebidding rule in QLD which was later revoked. Behavioural rules don't work and lead to higher prices.
InterGen	NECA has not demonstrated net public benefits of 'good faith'
NGF	'Good faith' has no precise meaning in Australian law. Definition should be a condition of authorisation.
Delta	'Good faith' should be defined as a condition of authorisation, as should the development of an enforcement mechanism.
Origin	Overall costs outweigh benefits of 'good faith'. Does not work without a definition.
TXU	Will not work without a reverse onus of proof. No case to have it.
Yamasa	'Good faith' is a meaningless term.

Power system security

In its submission to the draft determination, NEMMCO proposed a different wording to clause 3.11.3(b) in response to the Commission's condition of authorisation. NEMMCO sought to clarify the meaning of 'to enhance the value of spot market trading when it is cost effective to do so', and as such, provided an alternative to clause 3.11.3(b):

*'NEMMCO must develop and publish a procedure for the **dispatch** of each kind of non-market ancillary service required for NEMMCO to achieve the power system security and reliability standards to maximise network transfer capability whilst still maintaining a secure operating state when, in NEMMCO's reasonable opinion, the expected resulting increase in non-market ancillary service costs will not exceed the expected increase in the value of spot market trading.'*

In respect to condition 4 in the draft determination, NECA proposed a minor change to the wording of the condition. NECA suggested deleting the reference to ancillary services in the first dot point of the condition and deleting the words 'take into account' in the second dot point of the condition.

Differences between the draft and final determination

Good faith

The Commission considers that the net public benefit of the good faith proposal, on balance, outweighs any detriment associated with the code change. For this reason the Commission did not impose defining good faith as a condition of authorisation in the draft determination. However, considering any further uncertainty which may arise from the lack of a definition for good faith, and after taking into account further submissions, the Commission considers that providing a firm definition of good faith will alleviate any such further concerns that participants may have with the code change.

Therefore, the Commission sees it prudent to define good faith according to NECA's submission, as a participant's 'genuine intentions'.

The Commission proposes to delete subclause 3.8.22A(b) as proposed by NECA in its original application, and insert subclauses 3.8.22A(b) and 3.8.22A(c) as follows:

3.8.22A Variation of offer, bid or rebid

- (a) Market Participants must make dispatch offers, network dispatch offers, dispatch bids and rebids in good faith.
- (b) In clause 3.8.22A(a) a dispatch offer, network dispatch offer, dispatch bid or rebid is taken to be made in good faith if, at the time of making such an offer, bid or rebid, a Market Participant has a genuine intention to honour that offer, bid or rebid, if the material conditions and circumstances upon which the offer, bid or rebid were based remain unchanged until the relevant dispatch interval.

- (c) A Market Participant may be taken to have contravened clause 3.8.22A(a) notwithstanding that, after all the evidence has been considered, the intention of the Market Participant is ascertainable only by inference from the conduct of the Market Participant, or of any other person, or from relevant circumstances.

Application of the good faith provision

Significant price spikes have been observed in the spot market between May and July 2002 that appear to have been in part the result of a strategic withdrawal of capacity, increasing year average prices significantly. There is a concern about the ability of generators to affect spot prices and the relative lack of competitive generator response witnessed over this period.

The Council of Australian Governments (COAG) draft energy market review proposes that the New South Wales Electricity Tariff Equalisation Fund (EETF) be abolished. The report found that the EETF arrangements create a bias towards less bilateral contracting, which reduces liquidity in the forward market and, by potentially leaving generators more exposed to the spot market, exacerbate spot price volatility.

The Commission recognises that there is a legitimate role for Governments to protect household consumers, especially lower income households. Along with other measures, EETF was established to achieve this objective. However, the Commission considers that the experience to date shows that EETF significantly distorts the operation of the spot market and that there are less distortionary ways of achieving these consumer protection objectives. At the time EETF was established the Government anticipated that the number of households covered by the fund would decrease over time with the onset of Full Retail Contestability (FRC). FRC gives customers the option of selecting an alternative provider. In practice, relatively few households have made the switch which means that the distortionary impact of the fund has not subsided as anticipated.

Should the EETF fund accumulate to a significant level, such as occurred in May and June 2002, generators may face few restrictions on bidding behaviour in the spot market. The spot market price spikes observed during May and June 2002 may, at least in part, have occurred as a consequence of EETF deterring bilateral contracting, and the failure of the market to impose an alternative discipline on generator behaviour. In general the lower contract coverage the stronger the incentives for economic withholding.

Replacing EETF with less distortionary measures would be an important step toward increasing liquidity in the contract market and restoring the discipline that contract holdings can normally be expected to exert on generator behaviour in the spot market.

Therefore, it remains important that the market design does not unnecessarily facilitate the exercise of market power. The rebidding provisions are important to enable the market to respond efficiently to evolving conditions. However, the present provisions are also open to abuse. For example, a participant's initial offer may be intended to mislead or encourage strategic withholding by other suppliers. It is important for an informed and competitive market that a participant's current offer should at all times reflect the participants genuine expectation of what its final offer will be.

The Commission believes the proposed requirement that market participants must make offers in good faith can potentially assist in this matter. It will give NECA additional scope to investigate rebidding practises such as those which may have contributed to the spot price outcomes seen between May and June this year. The Commission will also be vigilant in monitoring outcomes to ensure compliance with the TPA.

Power system security

The Commission continues to believe there is merit in the code changes aimed at enhancing network transfer capabilities through modifying arrangements for managing power system security and non-market ancillary services. The deployment of non-market ancillary services, for the purpose of enhancing network transfer capabilities, should not be limited to dispatch time decisions. Such limitations would rule out any benefits in increased competition and market efficiency that might be achievable by tendering for extra services ahead of dispatch. Nevertheless the Commission accepts that NEMMCO should only be required to act in circumstances where action is practicable and is, in NEMMCO's reasonable opinion, justifiable.

Accordingly, the condition relating to clause 3.11.3(b) has been modified somewhat from what was proposed in the draft determination.

The proposal to use non-market ancillary services to enhance transfer capabilities might be considered a departure from accepted practices. Hence it would be appropriate to review the relevant procedures after a suitable time. As the code already requires NEMMCO to review and report on the provision of network control ancillary services, this may provide an appropriate context in which to evaluate the operation and effectiveness of the new provision for deploying non-market ancillary services to enhance network transfer capabilities.

The Commission therefore imposes conditions of authorisation to clause 3.11.3(b) and clause 4.2.6(b) to ensure that the public benefits resulting from the code changes outweigh the potential detriment that could arise from its operation. The Commission intends to impose conditions to the effect that:

C4: The wording of clause 3.11.3(b) be altered to:

NEMMCO must develop and publish a procedure for determining the quantity of each kind of non-market ancillary service required for *NEMMCO*

- (1) to achieve the power system and reliability standards; and
- (2) where practicable to enhance network transfer capability whilst still maintaining a secure operating state when, in *NEMMCO's* reasonable opinion, the resultant expected increase in non-market ancillary service costs will not exceed the resultant expected increase in benefits of trade from the spot market.

C5: The wording of clause 4.2.6(b) and other relevant parts of the code should be altered to the extent necessary to implement the following changes:

- The Reliability Panel must establish guiding principles and guidelines that determine how NEMMCO should maintain system security while taking into account the costs and benefits to the extent practicable;
- The guidelines referred to above must be developed using the appropriate consultation process and must take into account:
 - the need for transitional arrangements to allow for development and testing of an appropriate methodology by NEMMCO; and
 - the results of any decision by the Panel to revise network constraints.
- Until the Reliability Panel publishes guidelines and an appropriate testing period has been completed, the current system of preserving system security will continue to apply.
- NECA should review and report on the way NEMMCO has used its new powers and whether the more relaxed standard of system security has led to market benefits over all. This review should take place 2 years after the guidelines have come into effect.

Further issues – submissions arising from the draft determination

In addition to the formal draft determination decision, the Commission made a number of suggestions in its draft for NECA to consider. A number of these further issues, namely price volatility, interconnection, review of penalties in the code and game theory and auction design have also been reviewed, given the interest noted by submissions to the draft determination.

It was intended that the suggestions made by the Commission in the draft determination would generate debate on certain issues as identified by NECA to be problematic in the NEM. Due to the formal procedures to be followed in an authorisation process, the Commission has been unable to further any of NECA's solutions to the issues raised in the draft determination.

Increasing the transparency of the contract market

Most revenue in the NEM is earned through the contract market. There seems to be a benefit in increasing the transparency of how risk is transferred and priced in an inherently volatile spot market. This increased transparency, and any potential inefficiencies identified may contribute to a better understanding of price spikes in the NEM's energy only design. Increasing transparency is beyond the scope of this decision, but is a matter that could be discussed at the Market Review Forum if participants consider it useful.

Market Review Forum

The code changes put forward by NECA seek to address issues which are fundamentally linked to market structure. The first best solution would be to address these issues through further structural reform of the NEM. Absent this reform there will remain the ability for strategic behaviour to impact on wholesale market prices, behaviour which is deemed undesirable if it results in inefficient market outcomes. The

Commission proposes to facilitate further rigorous debate on these issues through the implementation of a Market Review Forum.

Such a forum would provide industry participants with input to a structured mechanism for discussion and analysis of a wide range of market behaviours and topical issues, in addition to providing advice to regulators and government on NEM issues. The Commission proposes to hold the first forum in the first half of 2003.

Summary of determination

The Commission therefore grants authorisation to application numbers A90797, A90798 and A90799. Authorisation is granted subject to the conditions and deletions below. The Commission proposes to limit the period of the authorisation to 31 December 2010.

Conditions of authorisation

- C1 Sub-clause 3.8.22A(b) must be deleted.**
- C2 In place of subclause 3.8.22A(b) deleted as per condition 1, the following subclauses 3.8.22A(b) and 3.8.22A(c) be inserted:**
- (b) In clause 3.8.22A(a) a dispatch offer, network dispatch offer, dispatch bid or rebid is taken to be made in good faith if, at the time of making such an offer, bid or rebid, a Market Participant has a genuine intention to honour that offer, bid or rebid, if the material conditions and circumstances upon which the offer, bid or rebid were based remain unchanged until the relevant dispatch interval.**
 - (c) A Market Participant may be taken to have contravened clause 3.8.22A(a) notwithstanding that, after all the evidence has been considered, the intention of the Market Participant is ascertainable only by inference from the conduct of the Market Participant, or of any other person, or from relevant circumstances.**
- C3 The proposed clause 3.8.22B of the code relating to ‘conduct prejudicial to the market’ must be deleted including all references to guidelines under this clause.**
- C4 The wording of clause 3.11.3(b) be altered to:**
- NEMMCO* must develop and publish a procedure for determining the quantity of each kind of non-market ancillary service required for *NEMMCO***
- (1) to achieve the power system and reliability standards; and**
 - (2) where practicable to enhance network transfer capability whilst still maintaining a secure operating state when, in *NEMMCO*'s reasonable opinion, the resultant expected increase in non-market**

ancillary service costs will not exceed the resultant expected increase in benefits of trade for the spot market.

C5 The wording of clause 4.2.6(b) and other relevant parts of the code should be altered to the extent necessary to implement the following changes:

- **The Reliability Panel must establish guiding principles and guidelines that determine how NEMMCO should maintain system security while taking into account the costs and benefits to the extent practicable;**
- **The guidelines referred to above must be developed using the appropriate consultation process and must take into account:**
 - **the need for transitional arrangements to allow for development and testing of an appropriate methodology by NEMMCO; and**
 - **the results of any decision by the Panel to revise network constraints.**
- **Until the Reliability Panel publishes guidelines and an appropriate testing period has concluded, the current system of preserving system security will continue to apply.**
- **NECA should review and report on the way NEMMCO has used its new powers and whether the more relaxed standard of system security has led to overall market benefits. This review should take place two years after the guidelines have come into effect.**

1 Introduction

1.1 The applications

On 13 September 2001, the Australian Competition and Consumer Commission (the Commission) received applications for authorisation (A90797, A90798 and A90799) of changes to the code. The applications were submitted by the NECA under Part VII of the *Trade Practices Act 1974* (TPA).

NECA has applied for authorisation of code changes, which will in NECA's view:

- improve the reliability of pre-dispatch forecast prices in each dispatch interval, which would assist generator operator's to plan the operation of their plant; and
- address aspects of generator's bidding and rebidding strategies that are of concern, and that are claimed to have been the cause of short-term price spikes experienced in the NEM.

In order to improve the reliability of pre-dispatch forecast prices, NECA has proposed that generators' bids and rebids be made in good faith and therefore represent their 'genuine intentions' at the time they are made.

In order to address aspects of generator's bidding and rebidding strategies which are claimed to have been the cause of short-term price spikes experienced in the NEM, NECA has proposed to curtail bids or rebids that withhold or withdraw capacity from the pool. These bids and rebids have been identified by NECA to have successfully and artificially raised prices, exploited network constraints, or manipulated other aspects of the market design.

1.2 Statutory test

The applications were made under sub-sections 88(1) and 88(8) of the TPA.

Applications made under sub-section 88(1) of the TPA are for authorisation to make a contract or arrangement, or arrive at an understanding, a provision of which would have the purpose, or would or might have the effect, of substantially lessening competition within the meaning of section 45 of the TPA; and to give effect to a provision of a contract, arrangement or understanding where the provision is, or may be, an exclusionary provision within the meaning of section 45 of the TPA. Further sub-section 88(6) provides that an authorisation made under sub-section 88(1) has effect as if it were also an authorisation in the same terms to every other person named or referred to in the application.

Applications made under sub-section 88(8) of the TPA are for authorisation to engage in conduct that constitutes, or may constitute, the practice of exclusive dealing in accordance with the provisions of section 47 of the TPA. Further, sub-section 88(8AA) provides that where authorisation has been granted under sub-section 88(8) and this particular conduct is expressly required or permitted under a code of practice, the

authorisation applies in the same terms to all other persons named or referred to as a party or proposed party to the code. Authorisations may also apply to any corporation who becomes a party in the future.

The TPA provides that the Commission shall only grant authorisation if the applicant satisfies the relevant tests in sub-sections 90(6) and 90(8) of the TPA. While sub-section 90(6) and sub-section 90(8) relate to different types of anti-competitive behaviour, the tests are essentially the same.

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

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

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

The detriment to be considered is limited to detriment caused by a lessening of competition. However, consideration of public benefits is less restricted and public benefits recognised in the past include:

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

In considering whether or not to grant authorisation the Commission must consider what the position is likely to be in the future if authorisation is granted and what the future is likely to be if authorisation is not granted.

If the Commission determines that the public benefits do not outweigh the detriment to the public constituted by any lessening of competition, the Commission may refuse authorisation or grant authorisation subject to conditions.

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

A more expansive discussion about the Commission's authorisation process and the statutory test that the Commission applies can be found in: *Guide to authorisations and notifications*, Australian Competition and Consumer Commission, November 1995.

1.3 Public consultation process

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

The Commission received the applications for authorisation of these changes to the code on 13 September 2001. Notification of the applications and a request for submissions were advertised in *The Australian Financial Review* on 20 September 2001 and posted on the Commission's web-site at www.accc.gov.au. Interested parties were asked to make submissions to the Commission regarding their views on the issues of public benefit and anti-competitive detriment arising from implementation of the proposed changes.

The Commission received 22 submissions from interested parties in relation to the application (see Appendix A).

The Commission produced a draft determination on 3 July 2002 outlining its views on the application for authorisation. The Commission invited the applicant and other interested persons to notify it within 14 days, whether or not they wished the Commission to hold a conference in relation to the draft determination. The Hon. Patrick Conlon, Minister for Energy for South Australia, and Macquarie Generation (Macquarie) both called a pre-determination conference. The conference was held in Melbourne on 13 August 2002 with approximately 100 interested parties attending. The minutes of the conference may be obtained from the Commission's web-site.

Interested parties were given the opportunity to lodge further submissions with the Commission following the release of the draft determination. The Commission received submissions from 25 interested parties (see Appendix B). All submissions have been placed on the Commission's public register and are available on the Commission's web site.

In addition to the issues discussed in the draft determination, this determination takes into account the issues raised at the pre-determination conference, and those submissions received in response to the draft determination.

The Commission has released this final determination outlining its analysis and views on the application for authorisation according to the statutory assessment criteria set out in section 1.2. A person dissatisfied with this determination may apply to the Australian Competition Tribunal for its review.

2 History of the rebidding debate

2.1 The National Electricity Code Authorisation 1997

Rules for rebidding were authorised by the Commission as part of the original authorisation of the National Electricity Code 1997¹. In the draft determination for the original authorisation, the Commission imposed the following condition:

C8.4 Clause 3.8.22 must be revised to prohibit all rebidding of Mega Watt (MW) quantities within three trading intervals prior to dispatch.

During the public consultation process for the authorisation of the code, it became evident that most generators did not support any restriction on rebidding, insisting that the rebidding function was crucial for generators to be able to respond to physical problems such as unexpected outages. Conversely, market customers supported restrictions on rebidding, citing concerns that some generators held considerable market power and would manipulate spot market prices through their ability to rebid.

Furthermore, concerns were raised that the proposed rebidding rules would provide generators with a number of avenues through which to game the market, and could therefore contribute to anti-competitive market outcomes.

In light of differences in opinion, considerable debate ensued as to whether the rebidding restrictions would contribute to, rather than relieve, the occurrence of short-term high prices in the NEM.

In its final determination of the authorisation, the Commission refrained from imposing any conditions regarding the rebidding provisions. It noted that to the extent that contract levels remained high, the ability for generators to profit from strategic rebidding would be curbed and customers would be shielded from the effects of any such activity. It also cited concerns as to the likely ineffectiveness of any rebidding restrictions.

The Commission also considered other issues in 1997 that are similar to those being considered in the current debate on further bidding and rebidding code changes.

2.2 Market monitoring

In the final determination of the authorisation of the code, the Commission stressed the importance of market monitoring to the assessment of market behaviour. Consequently, a condition of the authorisation was the inclusion of a clause requiring NECA to undertake a market monitoring role with respect to price variations.

¹ National Electricity Code – 10 December 1997.

Under clause 3.13.7 of the code, NECA is obliged to monitor variations in prices, and prepare quarterly reports for the Commission and the public, identifying and reviewing any significant price variations, including occasions where spot prices are above \$100 per megawatt hour (\$/MWh), over the related period. More recently, NECA has reported market activity on a weekly basis.

2.3 Subsequent changes to the rebidding rules

On 19 October 1998 the Commission was presented with a large body of code changes designed to allow more flexibility within the rebidding rules. The Commission was not convinced that the proposed changes would add any material benefit to the market and believed that the benefits of increased flexibility through allowing the market operator to dispatch generation with different ramp rates would be realised without additional changes to the rebidding rules.

On 15 March 2000, NECA applied for authorisation of further code changes to rebidding rules. In this case the code changes required participants to provide the reasoning behind any rebid made, and also provided for these reasons to be published by NEMMCO.

The Commission authorised these code changes.

2.4 Current rebidding rules

Generators and others must submit bids for a 24 hour period to NEMMCO by 12:30pm each day for the following trading day. Bids can be made in up to ten price bands from -\$1000 per MegaWatt hour (MWh) to \$10 000/MWh (representing the Value of Lost Load, or VoLL). Prices of bids must remain firm but generators are able to rebid the amount of capacity offered in any of the price bands subject to the bidding rules contained under clause 3.8.22 of the code. Rebids are accepted up until approximately five minutes prior to dispatch.

The rebidding rules require participants to submit a brief, verifiable and specific reason to NEMMCO at the time of the rebid, and provide any other substantiating information as required by NEMMCO. NEMMCO must publish the timing and reason for each rebid. However, the rebidding rules do not specify the type of reason that is considered appropriate, simply that a reason must be supplied.

NECA produces a weekly market analysis of the market's performance, specifically price, demand and forecast differences arising during the week. For each trading interval, it compares the spot price to that week's average price, and to the average for the last quarter. In its analysis, NECA highlights any significantly high prices arising during any trading intervals - they define a high price as one that is at least three times the average weekly price.

3 Introduction to the proposed rebidding code changes

The proposed rebidding code changes were developed by NECA after criticism of price outcomes that arose during the summer of 2000-2001. Record high summer temperatures were recorded in Victoria and South Australia, which culminated in some very high price outcomes in associated regions of the NEM over sustained periods. Government intervention followed and in some instances load shedding in the southern states occurred.

NECA began consultation on the code changes in May 2001 with the release of an issues paper analysing bidding and rebidding and its effect on price outcomes in the NEM. The May issues paper was followed by draft proposals for change which were published in July, and culminated with the release of a report² by the Code Change Panel (Panel) in September that recommended code changes governing bidding and rebidding rules.

3.1 The proposed code changes

Concerns have been raised that generators are able to take advantage of rebidding to obtain financial benefits from price spikes. NECA claims that the inflationary impact of price spikes on the spot price is detrimental to the operation of the market. NECA argues that because price spikes arise suddenly and are short term in duration, competitive responses are rare.

NECA has proposed code changes in response to these concerns. The intention of the code changes is to increase the effectiveness of market monitoring by prohibiting bids and rebids that result in unjustified price spikes.

NECA draws attention to instances where it claims rebidding has led directly to higher prices. However, in their report, NECA states that the number of bids and rebids that give cause for genuine concern is currently comparatively very small. In addition, NECA points to their own analysis that demonstrates that most rebids are benign.

NECA also emphasises the importance of rebidding to the effective operation of the NEM. NECA claims that rebidding provides essential flexibility to generators to enable them to respond to changes in physical and commercial circumstances. Efficient prices arise from the efficient operation of markets, and NECA advocates that efficient prices are essential signals for much-needed new investment and demand-side response in the NEM.

Whilst articulating the importance of rebidding, NECA says that controlling the use of rebidding and thus the incidence of price spikes will benefit the public. NECA argues that inappropriate bidding and rebidding strategies have no place in the market, and

² Code Change Panel- *Generator's bidding and rebidding strategies and their effect on prices*- Volume 1- Report, September 2001.

blames the incomplete state of the market and the existence of market power for their occurrence.

NECA envisages that the proposed code changes will give the market rules more strength to contest those aspects of generators' bidding and rebidding strategies that they are concerned with, without removing the essential flexibility required for efficient bidding outcomes.

3.2 General comments from submissions

The Commission received 22 submissions on the rebidding code changes. The majority of submissions did not support the need for code changes. Of the submissions that did support the need for code changes, few agreed that the approach chosen by NECA was appropriate.

Lack of evidence

A majority of the submissions point to the lack of evidence provided by NECA, as to what public benefit would result from the implementation of the proposed code changes. They say an inefficient market would be one in which long run prices lie above new entrant prices and they argue that NECA has not provided sufficient evidence that recent price spikes have had any impact on consumer prices, pointing to the minimal effect that price spikes have had on year average contract prices. It is further claimed that price spikes only affect market participants to the extent that they are exposed to the pool.

Uncertainty

Submissions point to a decrease in public benefit arising from the increased risk, uncertainty and resulting lack of investor confidence that would arise from implementation of the code changes. Submissions argue that the type of market regulation proposed by NECA will create uncertainty and risk for market participants in bidding and rebidding, saying that the changes lack clarity and are ill defined, and will be subject to arbitrary changes by NECA.

Structural reform

Submissions argue that rebidding code changes are not an effective solution to the problem of price spikes. They say that the problem of price spikes has arisen as a result of inadequate ownership structures within the NEM, and some submissions say that limiting generators' ownership of total capacity would reduce the ability of generators to exercise market power.

Signals for investment

Some submissions claim that focussing on eliminating the bidding and rebidding behaviour that is targeted by the proposed changes would also have the consequence of eliminating price outcomes from the market that form an integral part of the market's essential investment signals. This price signalling is especially important when there is a lack of interconnection, generation capacity, or other structural issues. Some submissions believe that concern about the potential for high pool prices could be

addressed through reducing the level of VoLL, which as of April 2002 is \$10 000/MWh (increased from \$5 000/MWh).

Higher average prices and less flexibility

Submissions contend that the new rules would lead to more conservative rebidding strategies by generators, translating into fewer offerings of financial contracts, or offerings of contracts at higher prices. They argue that this would ultimately result in higher costs for end users and even a significant drop in retail competition. It is also argued that the proposed changes would not serve to promote the NEM as a competitive, transparent and clearly codified market.

Hydro-electric generation

Submissions say that the proposed code changes are discriminatory and would place an additional burden on renewable energy generators who make greater use of rebidding due to the unpredictable nature of their fuel resources. The short-run marginal cost of hydro-electric generation is the opportunity cost of water and is dependent on the state of any storage, and the forecasts and uncertainties regarding market opportunities. With the opportunity cost of water constantly changing, rebidding is essential for effective water management. Due to the volume of rebidding by hydro-generators, their behaviour may be falsely perceived as taking advantage of market conditions, whereas it is argued that in reality this behaviour is simply aimed at optimising the use of a scarce water resource, which would be expected in a competitive market.

Responsibility for system reliability

Submissions say that the ‘conduct prejudicial’ clause shifts the responsibility for some technical aspects of the NEM, which are currently administered by NEMMCO, to market participants. This added responsibility may potentially and inappropriately require participants to contact their competitors and NEMMCO to discuss and agree upon the consequences of their bids to system reliability.

Draft determination

Many submissions believe that the analysis of the proposed code changes undertaken by the Commission has been inadequate³. Some also believe that insufficient analysis was conducted to justify a net public benefit arising from implementation of the proposed changes⁴.

Many of the submissions are critical of the Commission’s suggestions in the draft determination⁵. Edison Mission Energy Australia Limited (EMEAL) believes the draft determination to be an inappropriate forum for the Commission to suggest possibilities

³ Macquarie, New South Wales Ministry of Energy and Utilities (NSW Government) and Yamasa Australia Pty Ltd (Yamasa) submissions.

⁴ Delta Electricity (Delta), InterGen Australia Pty Ltd (InterGen) and Loy Yang Power Management Pty Ltd (Loy Yang) submissions.

⁵ Delta, InterGen, NSW Government and Snowy Hydro Trading Pty Limited (Snowy Hydro) submissions.

for future proposals, while others⁶ contend that the suggestions put forward by the Commission in the draft actually go beyond the powers granted to the Commission by the TPA. Should the Commission take any of these suggestions further, Loy Yang argues that it will create significant legal uncertainty. Others also consider that the issue of suggestions to NECA may place the Commission in an untenable position should it be required to authorise any future code changes that may result⁷.

⁶ Delta, Loy Yang, Macquarie, Origin Energy Electricity Limited (Origin) and Tarong Energy Corporations Ltd (Tarong) submissions.

⁷ Delta, Macquarie and Network Economics Consulting Group (NECG) submissions.

4 Variation of offer, bid or rebid

Scheduled generators in the NEM are required to indicate to the market the volume of electricity they are prepared to produce for specified prices. The code currently stipulates that initial bids must be ‘firm’, and that price cannot be varied. Apart from daily bids which must be received before 12.30pm the day before supply is required, generators can rebid quantities of supply into fixed price bands up until approximately five minutes prior to dispatch, subject to code requirements.

4.1 What the applicant says

4.1.1 Good faith

NECA says that the requirement for generators’ bids to be ‘firm’ is rendered meaningless by the flexibility allowed by the rebidding function. Whilst NECA’s analysis demonstrates that most rebids are benign, they argue that a minority of rebids create price spikes that have a significant impact. NECA has identified some rebidding strategies that it says result in unfavourable market outcomes, and which it believes may be alleviated by changes to the code:

- instances where rebids are made too close to dispatch for competitive demand side response – specifically those cases where rebids are made in response to information or events about which the relevant parties have significant prior knowledge; and
- instances where great price volatility has arisen in response to relatively small changes in demand, which NECA says have led directly to significant price spikes.

NECA believes that the current arrangements regarding flexibility and rebidding can be reinforced by an addition to the code specifying that bids and rebids are to be made in good faith. Thus, the proposed addition to the code of clause 3.8.22A(a) states:

Market participants must make dispatch offers, network dispatch offers, dispatch bids and rebids in good faith.⁸

NECA’s intention is that generators must be able to prove that their bids and rebids represent their genuine intentions at the time they are made:

It represents no more or less than fair and honest dealing. It is essential to accurate and reliable pre-dispatch. This is central to the market design and is in turn essential to informed competitive and demand-side response.⁹

The Panel does not consider that the term good faith needs to be defined in the code. The Panel believes that it is a commonly used term in legislation and contractual

⁸ NECA Code Change Panel Report, Volume 1, page 8, September 2001

⁹ NECA Code Change Panel Report, Volume 1, page 8, September 2001

arrangements, and therefore claims that there is a significant body of precedent as to its meaning.

The Panel considers that any attempt to define ‘good faith’ would significantly detract from the effectiveness and scope of the proposal.¹⁰

4.1.2 Reverse onus of proof

To enforce the requirement for market participants to act in good faith, a change to clause 3.8.22A(b) proposes to shift the onus of proof to generators. Accordingly, in the case of a possible code breach, a generator would be required to satisfy the National Electricity Tribunal (Tribunal) that its bid or rebid was indeed its genuine intention at the time it was made, and not contrary to the rules in the code. This contrasts with the current situation where the onus is on NECA to establish that a bid or rebid has breached the code.

The Panel argues that there is precedence in section 51A(2) of the TPA that shifts the onus of proof in relation to misleading and deceptive conduct. NECA argues that it is not seeking a direct equivalence between section 51A and its proposal. Rather, it is simply claiming that section 51A provides a precedent for shifting the onus of proof.

4.2 Submissions to the Commission

Only a few submissions support the changes in principle, however a majority of the submissions received are from generators, none of which support the changes.

4.2.1 Good faith

As a general consensus, the submissions express concern that the good faith term will impose substantial risks and increased compliance costs on market participants. Subsequently, they claim that any increase in uncertainty and risk will be detrimental to the market, as it is likely to adversely affect investment.

Many of the submissions criticise the proposal on the grounds that the requirement that offers, bids and rebids are to be made in good faith is imprecisely defined.¹¹ An insufficient explanation of the term will fail to provide market participants with adequate guidance as to its application for day-to-day use, and compliance would be difficult, if not impossible, given the subjective meaning of the term good faith as it relates to bidding behaviour.¹²

Submissions consider that given the number of factors that could contribute to the making of a bid or rebid, requiring generators to show that they acted in good faith

¹⁰ NECA Code Change Panel Report, Volume 1, page 9, September 2001.

¹¹ Opponents include AGL Energy Sales and Marketing Limited (AGL), Delta, Eraring Energy (Eraring), Enertrade, InterGen, Loy Yang, Macquarie, NRG Flinders Operating Services Pty Ltd (NRG Flinders) and Snowy Hydro.

¹² AGL submission.

would place a substantial burden on them. Without further clarification of the intended applications of the clause, it may be subject to different interpretations by market participants, as well as NEMMCO and NECA.¹³

Submissions also argue that the use of the term is inappropriate for transactions between competitors, as it is thought to have only ever been used in the legal system in relation to consumer transactions. It is assumed under vigorous competition that one person's gain will be another person's loss, and the opportunity for profits, and fear of losses, will drive efficient market outcomes.¹⁴

4.2.2 Reverse onus of proof

Submissions contend that the code does not afford NECA the power to make laws with respect to anti-competitive behaviour, and argue that NECA does not have the authority to propose a reverse onus of proof. Submissions perceive Clause 3.8.22A(b) of the proposed changes as an attempt by NECA to regulate anti-competitive behaviour which submissions consider is contrary to the intention of clause 3.1.4(b) of the code.¹⁵

These market rules are not intended to regulate anti-competitive behaviour by the 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.¹⁶

Furthermore, submissions state that the proposed reverse onus of proof is contrary to the code objectives in clause 1.4(b)(1), which are:

to provide a regime of 'light-handed' regulation of the market to achieve the market objectives;¹⁷

Regarding precedent, submissions argue that the use of section 51A of the TPA is inappropriate, as section 51A shifts only the procedural or evidentiary burden of proof, not the legal burden of proof as the code changes intend. They contend that under section 51A, if the defendant can provide evidence clearing itself of the charge, it is then up to the complainant or prosecutor to satisfy the legal burden of proof. Furthermore, submissions contend that a business has only to provide evidence that it had reasonable grounds for making a representation, but under the proposed changes, the complainant or prosecutor is not required to make a case and it is up to the accused to prove its innocence.¹⁸

Submissions state that section 51A(2) refers to proceedings concerning representations made by a corporation in respect to future matters. It is contended that section 51A(2)

¹³ Delta, Eraring and New South Wales Treasury (NSW Treasury) submissions.

¹⁴ Loy Yang, the National Generators Forum (NGF) and Tarong submissions.

¹⁵ Delta, NGF and Snowy Hydro submissions.

¹⁶ National Electricity Code, clause 3.1.4(b).

¹⁷ National Electricity Code, clause 1.4(b)(1).

¹⁸ Macquarie and NGF submissions.

does not apply to a representation as to a person's present state of mind, and that it is not appropriate to require a corporation to have reasonable grounds for an intention other than profit maximisation.¹⁹

Submissions raise concerns that the reversal of the onus of proof is a denial of natural justice, and is contrary to the general philosophy of the market and the Australian Legal System. Submissions ask that the onus of proof remain with NECA to ensure that the reversal does not conflict with the basic legal principle that one is innocent until proven guilty. Submissions contend that the code should not place a harsher burden on a participant than a court would. Some contend that with a reverse onus of proof, participants would shy away from competitive behaviour for fear that after the event they may be accused of acting inappropriately, and be unable to defend their actions.²⁰

Submissions contend that the reverse onus of proof clause would effectively make bids and rebids illegal unless the participants can prove their innocence, thus placing an undue burden on participants. Similarly, submissions say that the code changes would treat every transaction as if it were performed in a prohibited manner, or for a prohibited purpose. They argue that the changes have been proposed without any justification, denoting them to be draconian. Furthermore, submissions believe that NECA would themselves have difficulty proving that bids have not been made in good faith.²¹

The workability of the reverse onus of proof proposal is also queried in the submissions. In particular, submissions say that the effectiveness of the proposal depends on the extent to which the resulting market outcome could be linked to the exclusive actions of one individual. Submissions assert that participants simply may not be able to prove after the event that the resulting effect was not intended, as they say that it is often more difficult to prove something than disprove it. Submissions also question what degree of proof would be required to prove a generator's innocence, whether it is proof beyond reasonable doubt, or if the balance of probabilities would suffice, or whether the decision would rest with the discretion of the arbitrator.²²

Submissions also refer to the added administrative and legal costs that would be incurred by market participants when seeking advice for bidding and rebidding actions. They argue that such costs may ultimately affect end-user prices. It is thought that a greater need for Frequency Control Ancillary Services (FCAS) would arise due to greater inflexibility in rebidding, ultimately leading to a rise in retailers' operating costs that consumers would have to bear in the end.

¹⁹ NSW Treasury submission.

²⁰ AGL, Delta, Enertrade, InterGen, Loy Yang, NRG Flinders and Snowy Hydro submissions.

²¹ Enertrade and Loy Yang submissions.

²² Origin and Enertrade submissions.

Some submissions also contend that the proposal would increase regulatory risks and would pose a potential deterrent to new market entry.²³

Finally, submissions believe that good faith and the reverse onus of proof are intertwined, as the purpose of clause 3.8.22A(b) relies on clause 3.8.22A(a). As such, it is disputed that should one of the clauses be rejected, this would necessitate the rejection of the other, as the remaining clause would be meaningless of its own accord.

4.3 Further submissions arising from the draft determination

4.3.1 Good Faith

A number of submissions declare their support for the provision of the good faith clause.²⁴

It is EnergyAustralia's view that NECA *has* defined what it means by good faith, and they believe that at present there is nothing in the code that requires generators to submit bids that represent their real intentions. Even though EnergyAustralia and Eraring admit that the term may be difficult to enforce, they support its inclusion.

EnergyAustralia argues that its presence in the code removes the ability of participants to claim that certain types of behaviour are legitimate just because such behaviour falls within code rules- regardless of the damage such behaviour might cause to the market.

Similarly, Hydro Tasmania considers the rule important for restoring confidence in the industry regarding ethical standards.

However, most submissions cite some concern at not only the uncertainty surrounding the definition of the term good faith,²⁵ but also its application in general.

Macquarie challenges a need for the term, given that the code already requires 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'.

If the requirement is adopted, a number of submissions say that the Commission should set out how the term should be defined and interpreted.²⁶ This would ensure that the

²³ EMEAL, Enertrade, Pareto Associates (not a formal submission) and the Energy Users Association of Australia (EUAA) submissions.

²⁴ EnergyAustralia, Hydro Tasmania, the South Australian Minister for Energy (SA Minister) and Southern Hydro submissions.

²⁵ Delta, EMEAL, Hydro Tasmania, NECG, Origin, SA Minister and Tarong submissions.

²⁶ CS Energy, Delta, Macquarie and NSW Government submissions.

Tribunal or Courts, in their efforts to give meaning to what is described as a subjective term²⁷, do not adopt non-intended meanings.

Eraring is concerned that problems may arise if it is left open for interpretation by individual market participants. It is suggested that an explanatory memorandum, or guidelines, accompany its use,²⁸ whereas the SA Minister understands that it will be the National Electricity Tribunal that will have to consider each case separately.

In general, the NSW Government is opposed to the application of behavioural rules in the wholesale market such as the good faith proposal.

Submissions argue that the requirement for bids and rebids to be made in good faith is unworkable even with the specification that bids and rebids are to reflect the submitter's 'honest intentions'. A party's intention is difficult to define in advance or in hindsight. Hence it is impracticable to determine whether the party was 'honest' or otherwise.²⁹ Similarly, Delta postulates that the definitions applicable in legislation and contract law are not readily adaptable to the electricity market.

It is also argued that any regulation in this area must also apply to the demand side of the market, not just to generators.³⁰

A few submissions question the Commission's proposal for bids and rebids to be made only in the context of a 'meaningful change in information'³¹. They ask what defines a meaningful change in information or circumstance that would cause a generator to run the risk of breaching the good faith clause.

Stanwell Corporation Ltd (Stanwell) compares the good faith rule to the 90-minute rebidding rule introduced, and subsequently abandoned, in the Queensland market. Stanwell says that although the two rules are different, they believe the intent is absolutely identical- to reduce the frequency and extent of price spikes. Stanwell points out that although the 90-minute rule was directed to highlight and penalise generators who lifted bids and subsequently caused price spikes, it eventuated that price spikes became more prevalent.

TXU Electricity Ltd (TXU) perceived the good faith proposal as a vehicle for the reversal of the onus of proof. Therefore they challenge the practical purpose of the good faith provision, in light of rejection of the reversal of the onus of proof.

Westpac Institutional Bank (Westpac) suggests the provision should be interpreted as follows:

²⁷ Delta and Macquarie submissions.

²⁸ Eraring and Hydro Tasmania submissions.

²⁹ CS Energy and InterGen submissions.

³⁰ EMEAL submission.

³¹ Delta and Macquarie submissions.

Each bid should represent a generator's optimal price/ capacity trade off based on the information it has to hand.³²

Submission from NECA

In its response to the draft titled '*Bidding and rebidding- some ideas for a way forward*', NECA admits that the good faith obligation involves testing the subjective intent of the market participant, which they say would be difficult to ascertain without some form of rule governing its application. NECA states that in absence of the reverse onus of proof provision as originally proposed, the inclusion of a provision to ascertain the subjective intentions of a market participant (by means of inference from their conduct) would be critical for its successful application.

In its report, NECA proposes an 'effects test' - to be modelled on section 46(7) of the TPA- to facilitate enforcement of the clause. NECA states that the reason for the provision of subsection (7) in section 46 was to address the evidentiary difficulties involved with establishing the subjective purpose required to constitute a breach of the section. Without some form of effects test, NECA state that they would be unable to obtain direct evidence to establish that a generator has made a bid or rebid which was not a genuine representation of its intended bid at the time that bid/rebid was made.

4.3.2 Reverse onus of proof

None of the submissions received were critical of the Commission's conditions of authorisation in the draft, which specified that reference to clause 3.8.22A(b) be deleted.

4.4 Commission's consideration

4.4.1 Good faith

The Commission thinks it prudent to introduce a requirement that bids and rebids be made in good faith and therefore represent the true intentions of generators. The requirement to submit bids and rebids that represent a generator's true intention is intended to give generators the incentive to submit initial bids that are meaningful and accurate, rather than bids that are generic and that rely on the ability to rebid.

Each bid should represent a generator's optimal price/capacity trade-off based on the information it has to hand. This is consistent with the principles put forward by Lew Owens, the South Australian industry regulator in his paper on rebidding distributed at the Commission's forum on rebidding and market power held in Melbourne in February 2002.

The Office of the South Australian Independent Industry Regulator (now known as the Essential Services Commission of South Australia, or ESCoSA) proposal is based on the tenet that the initial bid made by a generator should be firm and should embody each generator's honest intentions at dispatch based on the information available at the

³² Westpac *Submission to draft determination on bidding and rebidding*, 20 September 2002, page 1.

time the bid is lodged. Subsequent rebidding should be restricted unless it is in response to a meaningful change in information, and that the resulting rebid should be in proportion to the new information.

The Commission endorses the intent of the good faith clause because the design of the electricity market auction relies on information being submitted by generators that reflects their true intentions relating to bids and rebids. If accuracy of data being submitted by participants cannot be relied upon, serious questions about the market design and its workability may need to be addressed.

There is a net public benefit associated with the improved accuracy of forecasts and the Commission believes that this provision may have a dampening effect on gaming behaviour in the NEM.

NEMMCO's Projected Assessment of System Adequacy (PASA) and pre-dispatch forecasts provide an insight into the underlying dynamics of the market and assist market participants in making decisions regarding the appropriate amount of capacity to offer based on predicted demand and any network constraints. Subsequent rebidding information, released to the market in the form of new forecasts, assists generators in refining the capacity offered in each price band in order to maximise profits and thus provide an efficient and competitive dispatch merit order.

The intention of the good faith proposal is to ensure that the pre-dispatch forecast price fully reveals information and at an earlier rather than later time. Reliable pre-dispatch forecasts are a public benefit flowing from the good faith proposal. Furthermore, an increase in the reliability of pre-dispatch forecasts aids competitive responses and demand-side management.

Participants that have full contract cover are shielded from any impact of inaccuracies in PASA or pre-dispatch projections. Moreover, PASA projections become less important as forward markets work more effectively. However, while barriers to forward market trade or retail trade may exist that prevent participants from obtaining contract coverage at effective prices, the accuracy of PASA should be preserved.

Some submissions argued that the term good faith is not appropriate for business to business transactions as good faith is typically used where businesses interact with consumers. However, the Commission believes there is sufficient legal precedent to make the term work in this context. Nevertheless, to avoid problems of uncertainty the Commission, through its draft determination, encouraged NECA to develop a clear definition as to what behaviour constitutes bidding in good faith.

To ensure correct compliance with authorisation procedures, the Commission was unable to consider NECA's paper '*Some ideas for a way forward*' as anything other than a submission in response to the draft determination. In its letter of response to NECA (dated 9 October 2002), the Commission outlined its reasoning for not considering the revised proposals in the current application process.³³

³³ Response to NECA is attached at appendix D.

Nevertheless, the Commission acknowledges concerns raised by NECA that without an effects test they may have difficulty establishing whether or not a generator has made a bid or rebid which was not in good faith at the time that bid/rebid was made.

The current procedures under Clause 8.5 provide NECA with considerable and ample powers to investigate any alleged breaches of the code, including those relating to the proposed Clause 3.8.22A.

Clause 8.5.1 specifically explains the extent of information NECA or the Tribunal can request from code participants:

- (a) A Code Participant must, if requested by NECA or the Tribunal, supply it with information relating to any matter concerning this Code in such form, covering such matters and within such reasonable time as NECA or the Tribunal may request.³⁴

Clause 8.5.1(d) states that:

Any report or other documentation referred to in this clause 8.5.1 may be used in any proceeding involving the Tribunal under the National Electricity Law or for the purpose of commencing any such proceeding.³⁵

The Code goes on to clarify the use of information provided to NECA or the Tribunal under Clause 8.5.1(a) in Clause 8.6.1 which requires that NECA, deemed to be a code participant for this purpose, ‘...must use all reasonable endeavours to keep confidential any confidential information which comes into [its] possession or control ...’

The Commission considers that the net public benefit of the good faith proposal, on balance, outweighs any detriment associated with the code change. For this reason the Commission did not impose defining good faith as a condition of authorisation in the draft determination.

However, considering any further uncertainty which may arise from the lack of a definition for good faith, and after taking into account further submissions, staff consider that providing a firm definition of good faith will alleviate any further concerns that participants may have with the code change.

Therefore, the Commission sees it prudent to define good faith according to NECA’s submission, as a participant’s ‘genuine intentions’. The Commission feels that ‘genuine intentions’ more effectively and precisely describes the conduct sought to be prohibited and, therefore, reduces further uncertainty.

The Commission therefore imposes a definition of good faith as a condition of authorisation. The Commission intends to delete subclause 3.8.22A(b) as proposed by NECA in its original application, and insert subclauses 3.8.22A(b) and 3.8.22A(c) as follows:

3.8.22A Variation of offer, bid or rebid

³⁴ National Electricity Code, Clause 8.5.1(a).

³⁵ National Electricity Code, Clause 8.5.1(d).

- (a) Market Participants must make dispatch offers, network dispatch offers, dispatch bids and rebids in good faith.
- (b) In clause 3.8.22A(a) a dispatch offer, network dispatch offer, dispatch bid or rebid is taken to be made in good faith if, at the time of making such an offer, bid or rebid, a Market Participant has a genuine intention to honour that offer, bid or rebid, if the material conditions and circumstances upon which the offer, bid or rebid were based remain unchanged until the relevant dispatch interval.
- (c) A Market Participant may be taken to have contravened clause 3.8.22A(a) notwithstanding that, after all the evidence has been considered, the intention of the Market Participant is ascertainable only by inference from the conduct of the Market Participant, or of any other person, or from relevant circumstances.

The good faith proposal is not a restriction on rebidding per se. It does not limit or restrict generators bidding strategies, save only that bids must be honoured should all circumstances remain unchanged. Rebidding is a key element of the market design because it allows the market to balance supply and demand efficiently to ensure demand is met by efficiently priced supply.

The Commission notes the statements made in most submissions that point to significant costs to the market's operational efficiency if restrictions to rebidding are introduced. Restrictions or a ban on rebidding could require the introduction of a separate balancing market into the market design, or increased and more extensive use of ancillary services.

More importantly however, restrictions on the ability to rebid, or the imposition of incentives not to rebid, could lead to less efficient outcomes and potentially higher prices, as compliance costs are recouped through generator's bids. Restrictions on rebidding could produce a wedge between actual and competitive price outcomes, leading to less efficiency and inefficient dispatch of generation. This is clearly not in the long-term interest of the market.

4.4.2 Reverse onus of proof

The Commission does not support NECA's proposal to reverse the onus of proof for generators. Such a clause would require generators to prove themselves innocent to the satisfaction of the Tribunal if their behaviour was questioned by NECA.

There is concern that the power to accuse a party of acting without good faith has the potential to impose significant costs on participants that are called upon to defend themselves. The Commission supports the principle that an accused party should be required to justify its actions if called to question.

However, it believes that it is not unreasonable to require the Code Administrator to undertake such investigations as are necessary to build a substantive case before making such allegations, rather than the accused party having to prove it acted prudently *before* a case is made against them.

The overall effect of the provision may be to deter new entry and legitimate rebidding, thus diminishing competition and exacerbating the problem it was intended to solve.

It is not accepted that the argument put forward by NECA that section 51A of the TPA is a precedent for reversing the onus of proof in this case. Section 51A was included in the TPA as a special case to prevent parties from making unsubstantiated representations regarding future events. Section 51A requires a party to base claims of future matters on reasonable grounds. The section deems a party to have no basis for making claims unless it adduces evidence to the contrary. A failure to produce such evidence can result in the representation being deemed as misleading and thereby a breach of the TPA.

The point made by Gilbert and Tobin on behalf of Macquarie Generation was that Section 51A reversed the onus of evidentiary proof, that is, it would only apply to evidence used to base future claims. This is significantly different to being required to satisfy a legal burden of proof and prove oneself innocent of allegations, which is what is envisaged under the proposed code change.

The Commission also agrees with submissions that reversing the onus of proof would not be consistent with the code objective 'to provide a regime of 'light-handed' regulation of the market ...'.³⁶ Whilst supportive of the concept of light-handed regulation, if the current market framework is failing to produce competitive market outcomes, and evidence is produced to support this view, more heavy handed regulation may be necessary in the absence of structural change. This issue is discussed in more detail in following sections.

Therefore, while not supportive of the reverse onus of proof clause proposed by NECA, the Commission believes that NECA should be afforded all powers necessary to build a case to prosecute behaviour that breaches the good faith clause. As such, the current information gathering powers are sufficient to enable NECA to build a case.

³⁶ National Electricity Code, Clause 1.4(b)(1).

5 Conduct prejudicial to the market

5.1 What the applicant says

5.1.1 Ensuring the efficient, competitive or reliable operation of the market

Rather than promoting a total prohibition on rebidding, NECA is instead proposing to instigate a prohibition on 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.

NECA believes that the clause will reinforce the NEM objectives of efficient, competitive and reliable market operations, however they concede that a blanket prohibition on rebidding may risk these aims.

NECA is satisfied that the inclusion of a prohibition on the types of bids, rather than on the bids themselves, will provide a substantive regulatory influence.

5.1.2 Draft guidelines

Clause 3.8.22B(b) refers to draft guidelines³⁷ (guidelines) published by NECA which outline how NECA will enforce the provisions under clause 3.8.22B(b) and how it will investigate possible breaches of the provision.

The guidelines explain that NECA will investigate any potential or alleged breach of the code in consultation with the relevant market participant before deciding whether to refer the matter to the National Electricity Tribunal.

The guidelines also list examples of conduct for which it may find reason to investigate:

- *generators withholding capacity* - NECA states that withholding capacity may lead to artificially increased prices, which do not reflect the true dynamics of the market, and increased risks to the reliability and security of supply;
- *sleeper bids* - Such a practice entails bidding significant proportions of capacity at high prices, whilst ensuring that the capacity is available to the market. Whilst this ensures that reserve levels remain appropriate, NECA says that the market is exposed to the risk of inefficient and uneconomic outcomes;
- *exploiting network constraints, reductions in capacity or increases in demand* - If a rebid is tendered in response to interconnector constraints, unplanned reductions in generating or network capacity, or increases in demand, NECA says that the market price can be affected disproportionately to changes in actual or opportunity costs. NECA acknowledges that whilst high prices arising under such circumstances can

³⁷ NECA- *Ensuring the efficient, economic and reliable operation of the national electricity market*, September 2001.

and will reflect the dynamics of the market, they are concerned with determining whether or not the market behaviour that leads to those prices has breached clause 3.8.22B; and

- *manipulating dynamic capability* - Generators are able to rebid ramp rates- the maximum rate at which they are prepared to vary their output. NECA believe that ramp rates below good industry practice can artificially force the dispatch of high priced capacity.

5.2 Submissions to the Commission

5.2.1 Ensuring the efficient, competitive or reliable operation of the market

Interpretation - 'has the purpose, or has or is likely to have the effect'

Submissions claim that the United Kingdom licence provisions on which this clause is based, stated that contravention would only occur if a generator were to 'knowingly or recklessly' act in a manner likely to materially prejudice the safe, economic and efficient operation of the market. They believe that NECA's changes go further than the UK proposals, which were considered too harsh to implement. Due to the wide variety of factors affecting the NEM, submissions do not believe that a generator in the market is able to accurately predict or assess how their bidding conduct is 'likely' to affect market operations. Similarly, submissions contend that a breach of clause 3.8.22B(a) may occur inadvertently, as a breach simply requires a generators bid being deemed as 'likely to have the effect' on market operations. Some also suggest that the clause should only apply to offers, bids or rebids that have the purpose of lessening competition.³⁸

Interpretation - 'materially prejudice'

Some submissions are concerned with the potential uncertainty surrounding the meaning of behaviours that would 'materially prejudice' the market, and contend that what constitutes material prejudice may require a close analysis of the bid or rebid and its impact on a number of factors. It may be almost impossible to consider all these factors in the available time frame leading up to a rebid decision.³⁹

Interpretation - 'efficient, competitive or reliable operation'

In support of clause 3.8.22B(a) AGL accepts that it needs to be complex and broad in its effect to capture the variety of poor behaviours that may arise in the operation of the market. In contrast, other submissions criticise the complexity of the clause, saying that each of the requirements for generators' bids not to prejudice 'efficient', 'competitive' and 'reliable' operations of the market may work counter to each other. For example, they say that to ensure reliability, market participants would potentially be required to deliberate on individual bidding actions to ensure shortages do not prevail. This, it is

³⁸ Enertrade, Loy Yang, Macquarie, Origin and Southern Hydro submissions.

³⁹ Eraring, Enertrade and Tarong submissions.

argued, would run counter to the competitiveness requirement and have an ambiguous impact upon ‘efficiency’. Further, submissions argue that it is NEMMCO’s responsibility to consider the impact of generator’s offers or rebids on system reliability, not theirs. They contend that generators will rarely be in a position to assess the likely impact of their bidding conduct on market reliability because they do not have access to all the information about factors affecting it.⁴⁰

Interpretation - ‘reasonable cause’

Submissions believe that under the requirements of the proposed changes, there is considerable uncertainty as to what would constitute a market participant having ‘reasonable cause’ in relation to a bid or rebid that they make. Reasonable cause could mean simply that the generator held an honest belief regarding a bid or rebid and the likely effect on the market. They contend that an honest belief may not be sufficient defence if it were proved that the market participant knew how to take steps to prevent the contravening bid or rebid from occurring in the first place, in the case of an unanticipated event such as a breakdown. It was also claimed that the changes are retrospective in nature in that they rely on the interpretation by outside parties of what was intended by the participant at the time of the bid.⁴¹

Further, submissions question from whose perspective must the cause for bidding be considered ‘reasonable’, whether it is from the perspective of a market participant, NECA, NEMMCO or another party. They are also concerned that Clause 3.8.22B(a) may not be workable in this form, because the standard for triggering the clause is too high.⁴²

5.2.2 Draft guidelines

The ESCoSA is supportive of NECA changing the market rules to expose rebidding more clearly to anti-competitive scrutiny and enforcement under the TPA. Furthermore, it perceives a need for guidelines to be developed that accurately define anti-competitive behaviour. AGL also supports the idea of guidelines that establish how NECA is to apply clause 3.8.22B(a), although not in their current form.

Authorising the guidelines

Submissions believe that the proposed code changes and the guidelines are inextricably bound, and as such, suggest that the guidelines should be considered as part of the code change proposal, rather than lie outside the authorisation process. Some submissions consider that there is evidence that the guidelines themselves could breach sections 45 and 47 of the TPA in their own right. Further submissions suggest that reference to the guidelines should not be made until they are in a more finalised form. They quote

⁴⁰ Enertrade, Macquarie and Southern Hydro submissions.

⁴¹ Eraring and Origin submissions.

⁴² Enertrade, Macquarie and Ergon Energy (Ergon) submissions.

NECA's admission that the guidelines are a 'first draft' and were rushed, and that they will need to be amended.⁴³

Submissions also raise concerns that if adopted, the code changes will give NECA the power to modify the guidelines without consultation with market participants. Submissions suggest that clause 3.8.22(c)(3) should be amended to state that the guidelines can only be modified in accordance with code consultation procedures, and not 'from time to time' as NECA have suggested in their submission.⁴⁴

Compliance

Submissions criticise the current format of the guidelines, saying that they should provide objective rather than subjective criteria to assist market participants to comply with the code, rather than identifying only a limited type of circumstance in which NECA would investigate behaviour. They recommend that NECA should define what behaviour is inappropriate based on specific actions, and they say that it is not 'reasonable or in fact practical to focus on effect rather than actions'.⁴⁵

EnergyAustralia believes that the code changes must be supported by adequate penalties that will serve as a deterrent, and they question what penalties will likely apply in the event of a breach.

Content

Some submissions believe that the guidelines discriminate between different energy sources and they argue that this is contrary to code objectives. Objection to the rule against sleeper bids is raised, with two underlying issues. Firstly, submissions claim that the rule is discriminatory because it would apply to offers and rebids of base load generators, but not to offers and rebids of peak generators. Secondly, submissions see no economic justification in deterring sleeper bids, arguing against NECA's claim that they produce 'inefficient and uneconomic outcomes.' Furthermore, they add a reminder that the market clears at the settled price as ultimately determined by NEMMCO. Objection is also directed at the rule planned to target the exploitation of network constraints, with submissions saying that its requirements impose a vague standard with which generators must comply.

It is similarly stated that the lack of clarity applying to the rule against manipulating dynamic capability creates regulatory uncertainty.⁴⁶

Reliability

Eraring argues that reliability hinges on the existence of a robust system operating on known principles that produce predictable outcomes. They quote the definition of reliable as contained in the code:

⁴³ EMEAL, Enertrade, Loy Yang, InterGen and NRG Flinders submissions.

⁴⁴ Ergon and Origin submissions.

⁴⁵ InterGen and Macquarie submissions.

⁴⁶ Enertrade and Loy Yang submissions.

The expression of a recognised degree of confidence in the certainty of an event or action occurring when expected.⁴⁷

Eraring believes that the overall code changes, being based on non-codified and easily changeable guidelines, will not add to the reliability of market operations.

5.3 Further submissions arising from the draft determination

None of the submissions received were critical of the Commission's condition of authorisation in the draft, which specified that reference to clause 3.8.22B be deleted.

5.4 Commission's considerations

The prohibition of bids that could prejudice the market is a broad ranging clause that would be difficult to comply with because it links individual actions to market outcomes that are the culmination of actions and reactions of all market participants. Given the amount of information in the market and the unlimited ways in which new information can be interpreted and responded to within the market, it is not certain that the code change will be workable.

The conduct prejudicial clause refers to the guidelines that explain how NECA will enforce clause 3.8.22B(a). However the guidelines are, in NECA's own view, a first draft with further development likely to be needed. Technically, the guidelines stand outside the authorisation process, however as they are important to the Commission's analysis of the code changes, they are discussed in this section in some detail.

Clause 3.8.22B does not provide any explanation as to the status of the guidelines. It is not clear whether behaviour must breach the guidelines to breach the conduct prejudicial clause (clause 3.8.22B), or whether additional behaviour not specified in the guidelines may also breach the clause. Whilst it is stated in the guidelines that the guidelines would only be changed in accordance with code consultation procedures, the clause fails to make any mention of this. There is concern that without specification within the code, the guidelines could be changed without due consultation and consideration.

Further, the guidelines are broad ranging and will require significant clarification through the legal processes before they are made definitive. Interpretation of the guidelines is uncertain and for this reason they are likely to lead to increased compliance costs. To avoid prosecution, firms may feel compelled to bid and rebid more conservatively, leading to less flexibility in the market which may, on occasions, be manifested through fewer competitive responses.

The question is whether the change in behaviour targeted by the rebidding code changes (including the guidelines) is likely to lead to more competitive outcomes in the

⁴⁷ National Electricity Code, Glossary.

market. For there to be a net public benefit associated with the code changes, the anti-competitive detriment resulting from the proposed restrictions would have to be less than the anti-competitive detriment inherent in the current situation. The Commission remains unconvinced that the proposed code changes achieve this.

The guidelines intend to target market power. They outline specific behaviour in the market that NECA considers inappropriate. However, market power can manifest itself through mechanisms other than the ability to bid and rebid. The guidelines therefore seem to encompass outcomes and behaviour that are not necessarily related to the bidding and rebidding mechanism.

The wording of the guidelines has met with specific criticism from market participants. NECA claims that the wording is based on licence conditions that were proposed for, but not implemented in, the New Electricity Trading Arrangements (NETA) which were introduced in the UK market as a response to market power concerns. NEM participants debate the similarity.

Regarding concerns raised by submissions relating to the interpretation of the term 'knowingly or recklessly', and given the dynamic nature of the market, it may be difficult for a generator to be sure of how its actions would impact on the market. Similarly, the use of wording such as 'likely to have the effect' is too broad to be effectively applied to the prohibition of bidding and rebidding. The interpretation of the guidelines is too subjective and would be difficult to apply with consistency.

The Commission is somewhat sympathetic to the argument put that it is inappropriate for generators to be forced to consider the impact of their offers or rebids on system reliability given that the code specifies system reliability as NEMMCO's responsibility.

A number of submissions argue that generators will rarely be in a position to assess the likely impact of their bidding conduct on market reliability because they do not have access to all the information about factors affecting it.⁴⁸ While this is true to an extent, the Commission is cognisant of recent action taken by NECA against Macquarie and Delta in regard to rebidding 'must run' capacity on 19-20 December 2001.

The action taken to investigate the matter demonstrates that the code already provides some remedies where deliberate abuse of provisions that cater for technical factors can be shown. Requiring generators to consider system security when bidding for non-technical reasons may complicate the existing code security operations that appear to be working successfully.

Uncertainty

The Commission agrees that there is certain behaviour that is unacceptable because it has a detrimental affect on the market's operations and effectively games market outcomes. However, there are circumstances where the application of these strategies will be legitimate. Identifying the difference between a set of bids that leads to a legitimate outcome and a similar set of bids that leads to an unacceptable outcome makes well targeted code changes difficult to draft.

⁴⁸ Enertrade, Macquarie and Southern Hydro submissions.

For example, the first guideline bans ‘economic withholding’, described to be when a generator places a significant amount of capacity in one or more very high price bands, thus removing that capacity from the likelihood of dispatch. This can lead to an overall fall in supply, and typically results in higher spot prices. However, a generator’s decision to offer plant capacity in a high price band could have arisen from the asset owner’s preference to not use the unit, due to maintenance requirements, or other technical limitations. Only when a sufficiently high dispatch price becomes a reality may the asset owner risk using the unit. Where the generator considers the price insufficient to cover the risk, the generator is not likely to use the unit. This appears to be a legitimate strategy, and could actually work to the benefit of the market in contributing capacity to the reserve margin.

A similar explanation could be mounted for the second guideline that prohibits ‘high priced sleeper bids’. Sleeper bids, although not defined by NECA, are thought to refer to capacity that is placed in very high price bands and remain there (that is, not rebid down to lower priced bands closer to dispatch). A generator that places a sleeper bid hopes to take advantage of a possible tight supply situation that may result in high priced capacity being dispatched. Most of the time sleeper bids are priced far above the marginal bid and are not dispatched, but for a generator it could be worth taking a risk, particularly if it was not recovering its fixed costs.⁴⁹

The guidelines also identify the manipulation of dynamic capability as something it aims to curb. NECA has not provided information to demonstrate how ramp rates being bid in at lower standards than good practice is detrimental to the market or how it could facilitate an exercise of market power. Substandard ramp rate offers, unless for legitimate reasons, below a generator’s registered capacity could be regarded in a similar light as capacity withholding, albeit on a smaller scale. It effectively prevents the dispatch of cheaper capacity in favour of higher priced capacity that has the effect of driving spot prices higher.

Finally, the guidelines seek to prohibit behaviour that exploits network constraints. This guideline is of greatest concern because it fundamentally questions whether generators should profit maximise. NECA is concerned that price spikes sometimes occur due to network constraints, without a change in the underlying costs to electricity production. Whilst this is an understandable concern, such an outcome is surely an issue to be addressed through change to the NEM market framework. It is economically rational for a generator to structure its bids to deliberately exploit a constraint in the market, or take advantage of a sudden surge in demand, or another generator trip. To fail to take advantage of such opportunities would not be profit maximising behaviour.

Economic withholding

The Commission believes that withholding of capacity to deliberately force a tight supply situation may not be conducive to efficient market outcomes in markets that are not perfectly competitive.

⁴⁹ High priced sleeper bids and economic withholding could be synonymous if the volumes placed in high priced sleeper bids are large enough to cause a supply shortage.

There is concern about recent bidding and rebidding behaviour in the NEM that appears to be characterised by economic withholding. Since 18 May 2002, several base load generators have moved large amounts of capacity into high price bands which has led to a fall in supply in more reasonably priced price bands. In some instances, expensive gas fired turbines have met demand when low-cost base load capacity was priced too high for dispatch, which raises issues of allocative efficiency.

However, flexibility must be built in to any code change that prohibits such behaviour, to allow a reprieve for generators where there is a legitimate basis for such bids. The potential anti-competitive detriment of deterring investment could well outweigh the public benefits of prohibiting economic withholding where it is undertaken to game market outcomes.

The introduction of a prohibition on types of bids such as those proposed will significantly change the nature of bidding in the pool. To date, all bidding strategies have been acceptable provided they fall within the rules. A rule prohibiting economic withholding would change this fact and could be the first step in a more interventionist approach to the spot market. The Commission is generally opposed to intervention in markets but recent behaviour in the NEM could indicate the need for intervention in the future to preserve the efficient operation of the market.

In terms of the current code changes, NECA's proposal to prohibit bids that represent economic withholding is too uncertain in its application and therefore any public benefits arising from its application would be significantly outweighed by the potential detriment of less effective competition.

Sleeper bids

The Commission has not received sufficient evidence to suggest that sleeper bids have had a detrimental impact on the market to date and believes that a prohibition on such bids or rebids could deter new entrants and have an adverse impact on competition. For example, generators that face significant competition from prices at or around short run marginal cost (SRMC) may use a high priced sleeper bid as a legitimate strategy to achieve a return to cover fixed costs when there is a supply constraint and where prices have risen in response. A prohibition on such bids could deter new entrants because it removes one mechanism through which they may be able to cover fixed costs in a competitive market. On the other hand, a high priced sleeper bid could indicate the exercise of undue market power with resultant detriment to the market. The proposed guideline does not discriminate between these two scenarios.

There is concern about high priced sleeper bids being used strategically to deter entry into the market because they can reduce reasonably priced supply but can be rebid at short notice if there is a threat of new entry. If high priced sleeper bids are dispatched on an ongoing basis, they are more likely to signal to new entry rather than be a deterrent. In most cases, the threat of new entry will force a generator to rebid any high priced capacity down to more reasonable prices to ensure dispatch.

Ramp rates

While there may be an ability to exercise market power through nominating reduced ramp rates, there may also be legitimate reasons for doing so. Should NECA believe

ramp rates to be an issue that requires specific action, a code change directed at this behaviour would be a better way of addressing the issue.

Network constraints

Behaviour that deliberately exploits constraints effectively punishes the market for under-investment or lack of development. Price spikes identify investment opportunities in transmission or generation. Without these signals the energy-only market would cease to work effectively. The fact that such constraints can be used indicates that constraints and congestion in transmission pricing in the NEM is being inadequately addressed. Investment opportunities may be more effectively signalled if there were more regions in the NEM, or if nodal pricing was introduced. In their absence, pricing signals on the supply side should be maintained. Any muting of these signals will raise questions about the market's design and its ability to develop into the future.

There is some evidence to suggest that the market is already addressing constraints. Investment in base load generation in Queensland and peaking generation in South Australia and Victoria could be an indication of the market's reaction to higher energy prices. Similarly, there are proposals to upgrade and build new inter-connectors to take advantage of price differences between regions. This is the market at work.

Due to the lead times involved in large scale investments like electricity transmission and generation, delays can arise between the time when prices begin to signal the need for new investment and the time that such investment is brought online and begins to moderate prices. It is often argued that electricity prices deviate from marginal cost in the short run because of lumpiness of investment due to economies of scale in the industry. Hence there can be a problem in distinguishing between monopoly rents arising, for example from artificial price spikes, from scarcity rents which are legitimate investment incentives. In practice it may be necessary to tolerate some short term price spikes in order to encourage efficient investment.

Provided there is a liquid and competitive contract market, it should be practicable for prudent customers and retailers to shield themselves from spot price excursions and any associated attempts to extract monopoly rents. The resultant contracts would be likely to influence additional capacity to enter the market, eventually moderating spot price behaviour. Alternatively, customers with half hour metering might elect to shield themselves through demand side initiatives, thereby bypassing the need to contract with new generating capacity.

It follows that in assessing the overall level of abuse of market power it will be important to consider the operation of the contract market as well as the spot market, and this is further discussed in chapter 7 of this determination. The present workings of the contract market, so far as this can be ascertained from information that is readily accessible in the public domain, is briefly reviewed in chapter 8, together with consideration of factors that might influence the level of competition in those markets.

Short term price spikes are common to deregulated electricity markets, and the Commission believes that focusing on price outcomes over a short period of time is irresponsible, as it can lead to biased conclusions. The Commission has taken a longer term view in its analysis of these code changes and believes that the high priced periods

of 2001 that raised initial concerns are largely part of the cycle of development for the NEM. While recent bidding behaviour lends support to the view that changes should be made to prevent contrived price spikes, the Commission is wary of short term solutions that could impact negatively on the long term development of the market. Having said this, the Commission believes that there are opportunities for the NEM framework to be refined if sufficient consultation is conducted to target specific anti-competitive behaviour.

Initial bids

The requirement to make bids and rebids based on the generator's honest intentions at the time of dispatch will not stop generators from bidding above marginal cost in their initial bids. As stated by McLennan Magasanik Associates Pty Ltd (MMA) in a report⁵⁰ prepared for the Commission, generators have an incentive to bid above marginal cost and will do so whenever they can. The good faith clause proposed by NECA will not target market power in this context.

Effective competition occurs in the absence of market power - where there is a sufficient number of competitors that compete with each other for dispatch in various sectors of the market and where none of these generators are able to influence the price above the competitive level.⁵¹ This scenario is unlikely to occur in the NEM as the size of individual units and portfolios is very large and the number of competitors is relatively small. Without divestiture or some other fundamental changes to the market structure, intrusive regulation may need to be introduced to recreate competitive market outcomes. International markets have followed different routes to address market power. Some of these mechanisms are outlined below.

International efforts to address market power

Powers to audit generator costs in order to scrutinise bids have been given to the market regulator in the Greek electricity market. In that market, generators are expected to bid at average variable cost. When an offer is made, this information is compared to the registered and declared information that generators are obliged to provide to the market manager. The Greek regulator for energy can audit this information if it is felt there is any discrepancy between the unit's average variable cost and the value of the offer.

In the PJM⁵² market, generators must satisfy the regulator that they have taken steps to limit their market power before they are able to bid generation into the wholesale market. Generators are also required to submit market power analysis reports twice a year.

Mitigating market power in the Alberta (Canada) electricity market is partly aided by the operation of Power Purchase Agreements (PPA). The three major generators in

⁵⁰ MMA- *Impact of Rebidding on the National Electricity Market*, 20 May 2002.

⁵¹ The competitive level in the electricity market is not necessarily SRMC, as prices that only cover marginal costs could lead to under investment because of limited return to cover fixed costs especially where economies of scale exist. SRMC pricing is unlikely to be sustainable or desirable in this context.

⁵² Pennsylvania, New Jersey and Maryland (PJM)

Alberta remain state-owned, but a non-affiliated party can buy their capacity at a PPA auction. The winning bidder at a PPA auction obtains the rights to sell a certain amount of the generation capacity of a state-owned generator to the Power Pool, or to one or more distributors through a hedging contract. This mechanism facilitates the state-owned generators' participation in the Power Pool while also diluting the market power they hold. A similar strategy was put forward for New South Wales earlier this year.

Concerns of market power have been of such significance in overseas markets that some regulators have introduced further structural separation and/or heavy handed measures to curb market power. Such changes may not be an option for the NEM at this time. However, the Commission recommends that such mechanisms be more seriously considered if concerns remain about generators' ability to use market power.

Two of the three consultants' reports to the Commission have concluded that market power in the NEM is not a systemic problem.⁵³ Generally, the Commission's disposition is to favour market solutions over regulatory intervention. However, when market power is present, caution needs to be exercised and the performance of the market closely monitored. If sufficient evidence is presented to show that market power is increasingly detrimental to market outcomes, some action should be taken. The types of structural reforms mentioned above are more likely to have a lasting beneficial effect on market behaviour than continued refinement of the rebidding rules, although the Commission concedes that in the absence of structural reform, reform of bidding rules may be the only option available.

⁵³ In its analysis of the proposed code changes, the Commissions engaged, and received reports from, Intelligent Energy Systems (*Review of Generators' Bidding and Rebidding- Report to ACCC*, 18 December 2001), and Bardak Ventures Pty Ltd (*A Review of Generator's Bidding and Rebidding Practices in the National Electricity Market-* 11 December 2001) in addition to a report from MMA.

6 Principles for power system security

6.1 What the applicant says

The changes to clause 3.11.3 and 4.2.6 are specifically intended to address the occurrence of short-term loading constraints, and the handling of non-market ancillary services.

Clause 3.11.3

Section 3.11.3 of the code governs the procedures for determining quantities of non-market ancillary services. NECA proposes to supplement the clause by including a reference that specifies that these procedures should also aim to enhance the value of spot market trading.

As follows, the proposed clause 3.11.3(b) stipulates that:

... NEMMCO must develop and publish a procedure for determining the quantity of each kind of non-market ancillary service required for NEMMCO to have to achieve the power system security and reliability standards and to enhance the value of spot market trading.

Clause 4.2.6

Section 4.2.6 of the code- *General principles for maintaining power system security* explains how NEMMCO is to manage instances where the power system becomes constrained. Section 4.2.6 currently stipulates that following a credible contingency or significant change in power system conditions, the system must be restored 'as soon as practical to do so, and, in any event, *within thirty minutes*'.

NECA believes that NEMMCO interprets the current requirements of clause 4.2.6 to mean that the system must be restored, wherever possible, within a single (five-minute) dispatch interval. NECA considers that this interpretation is too strict, and that a more flexible approach to restoring the system to a secure operating state needs to be taken. They argue that the current use of the clause leads to the inefficient and expensive short-term dispatch of additional unnecessary plant.

Therefore, the change to clause 4.2.6 proposes a requirement that the system be restored 'to a secure operating state *within at most thirty minutes*'.

6.2 Submissions to the Commission

Clause 3.11.3

Origin believes that NECA must establish a clear set of rules defining NEMMCO's actions under the proposed specifications of section 3.11.3(b) of the code. Origin says that NEMMCO operates under a defined set of rules so as to ensure market participants of surety in their operations. As such, Origin believes that NEMMCO should not be afforded such discretion as may exist under the new arrangements of clause 3.11.3(b).

Clause 4.2.6

NEMMCO advises that it does not oppose the proposed change to clause 4.2.6. They interpret the changes to mean that NEMMCO has an obligation to restore the system to a secure operating state ‘in as gradual a means as allowable so as to minimise the level of any price spikes’.

However, NEMMCO stress that such a policy approach inevitably decreases the security of the power system as the risk of a major system disturbance is increased as the power system remains in a vulnerable state for a longer period. NEMMCO considers that such an increased risk may be regarded as an acceptable trade-off for reduced spot prices, but along with others⁵⁴ they believe that such a decision should not be left for them to make alone. NEMMCO believes that any such decision needs to be defined in explicit terms by the Reliability Panel in a more formal review process.

Ultimately, NEMMCO believes that the proposed changes to clause 4.2.6 will not address real concerns regarding price spikes and their effects on the financial markets. As such, they oppose these code changes unless they are introduced as part of a more comprehensive package of changes.

Finally, Southern Hydro believes that the changes have the potential to cause NEMMCO to run foul of the new clause 3.8.22B.

6.3 Further submissions arising from the draft determination

Most submissions cited no objections to the proposed rule changes relating to power system security. However EnergyAustralia contends that any changes affecting power system security issues should not be processed as part of the current code change process. They believe that such changes need a much more comprehensive review and be given greater consideration than has occurred as part of the current authorisation process.

TransGrid is concerned should the Reliability Panel be given such responsibilities. They point out that the Market and System Operator Review Committee (MSORC) recommended that before the Reliability Panel can be given an enhanced role, the Governance Review process must be reactivated.

NEMMCO raises two concerns that it has with the proposed rule changes. Firstly, NEMMCO is concerned with the nature of the statement ‘to enhance the value of spot market trading’. NEMMCO contends that the intention of clause 3.11.3(b) should be made specific and believes that it is appropriate for the clause to state this intention directly.

Secondly, NEMMCO has concerns regarding clause 3.11.3(b) with respect to NEMMCO developing and publishing ‘a procedure for determining the *quantity* of

⁵⁴ Origin and Southern Hydro submissions.

each kind of non-market ancillary service required'. NEMMCO believes that it is intended for these procedures to cover the dispatch of non-market ancillary services to meet the new requirements. It further contends that the dispatch of ancillary services would be chosen from the services that it has available from the ancillary service tendering process. Considering how the clause is currently worded, it is NEMMCO's view that it could be interpreted that NEMMCO would need to source non-market ancillary services during the ancillary service tender process in order to enhance the value of spot market trading. NEMMCO believes this lies outside the proposed intention of the clause.

For these reasons, NEMMCO proposes the following wording for clause 3.11.3(b):

'NEMMCO must develop and publish a procedure for the *dispatch* of each kind of non-market ancillary service required for NEMMCO to achieve the power system security and reliability standards and, where available, to maximise network transfer capability whilst still maintaining a secure operating state when, in NEMMCO's reasonable opinion, the expected resulting increase in non-market ancillary service costs will not exceed the expected increase in the value of spot market trading.'

6.4 Commission's consideration

In its draft determination, the Commission noted that the actual meaning of NECA's original proposal under Clause 3.11.3(b), with regard to determining quantities of non-market ancillary services, was not clear. NEMMCO also has concerns with the wording, asking that the word 'dispatch' be substituted in place of 'determining the quantity'.

The clause is intended to provide NEMMCO with the opportunity to source non-market ancillary services prior to a network contingency. This has the potential to ease constraints in some cases, which would have a direct effect on spot market outcomes. Not all contingencies can be identified prior to their occurrence, but where they can, the decision as to the amount of non-market ancillary services required before the actual contingency occurs may enhance the value of spot market trading, which in any event is the purpose of the clause. 'Determining the quantity' of non-market ancillary services appears in the current version of the code.

NEMMCO considers that the requirement to utilise non-market ancillary services to enhance network transfer capabilities should be limited to dispatch time decisions. It should not include sourcing non-market ancillary services for that purpose during the tender process. NEMMCO is concerned that broadening the present tender requirements could have detrimental effects in terms of requiring NEMMCO to deal with providers who may possess market power, and in creating confusion for market participants.

Empowering NEMMCO to deploy non-market ancillary services to enhance network transfer capabilities offers potential benefits through realising benefits of trade in the spot market that would otherwise be foregone. NEMMCO's proposal that this be constrained to dispatch time decisions is likely to diminish these benefits, as it would restrict NEMMCO to working with whatever services it had under contract at the time. There may be some risk of offsetting negative impacts, however it is anticipated that the negative impacts can be minimised through the development of procedures that are

clear, objective and closely aligned with the goal of enhancing network transfer capabilities only where cost effective to do so. On balance, the restriction requested by NEMMCO would not be desirable.

Nevertheless, the provision represents a new departure and hence it would be appropriate to review its operation after a suitable time. The code already requires NEMMCO to review and report on the provision of network control ancillary services. This may provide an appropriate context in which to evaluate the operation and effectiveness of the new provision for deploying non-market ancillary services to enhance network transfer capabilities.

NEMMCO also raises concerns regarding the meaning of 'to enhance the value of spot market trading when it is cost effective to do so' as contained in Clause 3.11.3(b). The Commission has considered these concerns and believes there to be value in providing additional clarification that NEMMCO should only attempt to enhance the value of spot market trading when it can be done without prejudicing system security and when it is cost effective to do so. For example, NEMMCO could pursue greater amounts of interruptible load in South Australia to ensure that the constraints on the Heywood interconnector could be relaxed.

The Commission supports the intent of the further change proposed by NECA to apply a more flexible approach to restoring the power system to a secure state.

The code currently requires NEMMCO to bring the power system back to a secure state as soon as practicable and in any event within half an hour. These arrangements have the potential to impose significant costs on the market to cover the, often remote, possibility of a second contingency occurring when the system is already in a vulnerable state. Prompt restoration can incur costs for example from having to recruit additional ancillary services or from benefits of trade foregone as a result of the immediate imposition of more stringent network transfer limits.

On the other hand the repercussions of a second contingency before the system was restored to a secure state could be extremely severe, such as a regional power system collapse. Hence there is a need to maintain an appropriate balance.

If the cost required to meet the code's conservative approach to system security is significant and the market identifies a way to reduce this cost, then such action should be taken provided that essential system security principles are preserved.

Allowing a more flexible timeframe within which NEMMCO can bring the power system back to its secure state will provide more opportunities for slower start gas plant to enter the market, thus widening the number of competitors and potentially leading to offers at lower prices.

While supportive of the intent of the change to clause 4.2.6(b), the Commission is sympathetic to NEMMCO's comments in its submission that the code change will introduce a level of discretion that NEMMCO has not exercised to date, and fails to give sufficient guidance as to how such discretion should be exercised. NEMMCO is understandably reluctant to undertake this role without guidance.

The Commission considers that NEMMCO is very well placed to undertake this role as it will be consistent with its current role of maintaining system security and therefore has the technical skills to understand the issues involved in managing security. NEMMCO is an independent body and faces no financial rewards from its decisions. This means that NEMMCO's choices are likely to be dispassionate and not subject to compromise or bias through vested interests.

In consultation with NEMMCO, the Commission believes that it is appropriate that the Reliability Panel sets the parameters within which NEMMCO should exercise its discretion by determining the appropriate trade off between risk and the cost to secure the system. The Commission agrees with NEMMCO that these decisions are policy decisions and therefore should not be made by the system operator.

NECA's proposed changes could leave NEMMCO significantly exposed to challenge if either security risks were deemed too high or costs were thought to be higher than necessary. However, NEMMCO's liability would not increase significantly from its current level if NEMMCO were to act according to guidelines set by the Reliability Panel. These guidelines should be developed in consultation with NEMMCO and other market participants.

In further discussions between NEMMCO and the Commission, NEMMCO raised concerns regarding the timing of these particular code changes. NEMMCO recommended to the Commission that the methodology to be used should depend on the Reliability Panel's decision as to whether soft network constraints are introduced to the market. According to NEMMCO, any methodology used to optimise the trade off between cost and system security risk would be extremely complex and time consuming to develop.

NEMMCO state that they are unable to expend resources developing two distinct methodologies. Instead it requests that any development of a methodology be postponed until the Reliability Panel's decision on network constraints. Furthermore, NEMMCO believes that regardless of the methodology chosen, a significant testing period would be required to ensure that during times of system stress, the more flexible standards could be used effectively. If the Commission were to agree with NEMMCO's suggestions, the changes to the power system security provisions could be delayed considerably.

The proposal to use non-market ancillary services to enhance transfer capabilities might be considered as representing a new departure. Hence it would be appropriate to review its operation after a suitable time. The code already requires NEMMCO to review and report on the provision of network control ancillary services. That may provide an appropriate context in which to evaluate the operation and effectiveness of the new provision for deploying non-market ancillary services to enhance network transfer capabilities.

The Commission therefore imposes conditions of authorisation to clause 3.11.3(b) and clause 4.2.6(b) to ensure that the public benefits resulting from the code changes outweigh the potential detriment resulting from its operation. The Commission intends to impose conditions to the effect that:

C4: The wording of clause 3.11.3(b) should be altered to:

NEMMCO must develop and publish a procedure for determining the quantity of each kind of non-market ancillary service required for *NEMMCO*

- (1) to achieve the power system and reliability standards; and
- (2) where practicable to enhance network transfer capability whilst still maintaining a secure operating state when, in *NEMMCO's* reasonable opinion, the resultant expected increase in non-market ancillary service costs will not exceed the resultant expected increase in benefits of trade from the spot market.

Finally, NECA advised the Commission on a minor change to clause 4.2.6(b) whereby they requested the deletion of any reference to ancillary services. The clause would therefore imply that *NEMMCO* should maintain system security while keeping the cost to an acceptable level, not just the cost of ancillary services.

C5: The wording of clause 4.2.6(b), or and other relevant parts of the code should be altered to the extent necessary to implement the following changes:

- The Reliability Panel must establish guiding principles and guidelines that determine how *NEMMCO* should maintain system security while taking into account the costs and benefits to the extent practicable;
- The guidelines referred to above must be developed using the appropriate consultation process and must take into account:
 - the need for transitional arrangements to allow for development and testing of an appropriate methodology by *NEMMCO*; and
 - the results of any decision by the Panel to revise network constraints.
- Until the Reliability Panel publishes guidelines and an appropriate testing period has been completed, the current system of preserving system security will continue to apply.
- NECA should review and report on the way *NEMMCO* has used its new powers and whether the more relaxed standard of system security has led to market benefits over all. This review should take place 2 years after the guidelines have come into effect.

7 Other issues

In addition to the formal draft determination decision, the Commission made a number of suggestions in its draft for NECA to consider. This chapter summarises the reasoning behind the suggestions, how they have been received by interested parties (through submissions), and a final consideration of the issues. A number of further issues, namely price volatility, interconnection, review of penalties in the code and game theory and auction design have also been reviewed, given the interest noted by submissions to the draft determination.

7.1 Economic withholding

The guidelines accompanying NECA's application list a number of examples of conduct that NECA considers it would find reason to investigate, including generators withholding capacity. For reasons stated in section 5.4 of this determination, the Commission concludes that the guidelines, in accompaniment of clause 3.8.22B of the proposed changes, do not satisfy the authorisation test.

As an alternative to the issue of economic withholding, the Commission suggested in the draft that 'NECA consider drafting a specific code change to prohibit economic withholding where it is used to deliberately tighten supply and raise prices'.

7.1.1 Submissions

Some submissions are critical of NECA's and the Commission's use of the term economic withholding without adequately defining the term.⁵⁵ They say that economic withholding is a term borrowed from overseas markets where generators are paid for capacity whether it is used or not. Loy Yang says that in terms of an energy only market, the term has not been defined and therefore the concept has no application to the NEM.

Hydro Tasmania believes the suggestion is unworkable from a commercial perspective with no proper cost/benefit analysis.

Yamasa does not believe that consumers have suffered from the spot prices caused by generators withholding capacity, sleeper bids, generators exploiting network constraints, or manipulating dynamic capacity. Rather, Yamasa asks whether these are just legitimate business tactics. Yamasa is also critical of the lack of analysis of the forward contract market.

7.2 Ramp rates

In its guidelines, NECA lists manipulating dynamic capability (the ability of generators to rebid ramp rates) of potential concern to market operations, stating that ramp rates

⁵⁵ Loy Yang and Stanwell submissions.

below good industry practice can artificially force the dispatch of high priced capacity. NECA noted in the guidelines that it would use its powers to require information under clause 8.5.1 of the code, to investigate any potential or alleged breaches of clause 3.8.22B. The guidelines are intended to provide general examples of conduct that may be investigated, and procedures NECA would follow when investigating possible breaches of the clause.

Rather than a general discussion of manipulating dynamic capability amongst the guidelines, in the draft determination the Commission instead suggested that ‘NECA consider specific restrictions on bidding of ramp rates if the ability to exercise market power through ramp rates remains of concern’.

7.2.1 Submissions

EnergyAustralia cites support for the Commission’s suggestions of variations addressing ramp rates, however other submissions oppose moves to restrict rebidding of ramp rates to technical limits.⁵⁶ Hydro Tasmania believes the suggestion is unworkable from a commercial perspective with no proper cost/ benefit analysis.

TXU believes that the Commission’s suggestion would achieve the reverse of their intention. If the option to ramp quickly is lost, TXU believes generators will be limited in their ability to respond to transient high prices, and they predict that price spikes would become more frequent and severe.

7.3 Contract market and disclosure rules

In its draft determination, the Commission suggested that NECA ‘consider compulsory but confidential disclosure of contract volumes and price information for all generators’ in any further proposals for bidding and rebidding changes.

The Commission noted in the draft determination that if contract information was made known, the impact of bidding and rebidding behaviour on participants would be quantifiable, and the motives behind such behaviour would become clearer. It was also noted that disclosure of contract information may go some way to addressing the difficulty in determining the difference between economic withholding undertaken for genuine reasons, and economic withholding undertaken to produce a shortfall in supply and influence spot prices.

In response, NECA proposed an addition to Clause 8.5.1, governing investigations to aid enforcement of the code:

(a1) For the purposes of clause 8.5.1(a) ‘information relating to any matter concerning this *Code*’ includes volume and price information for forward contracts for electricity *generation* to which a *Code Participant* is a party. Information of this type must be treated as ‘confidential information’ in accordance with the provisions of clause 8.6.

⁵⁶ Hydro Tasmania, TXU and Westpac submissions.

The Commission has considered NECA's proposal of an addition to Clause 8.5 (governing investigations to aid enforcement of the code), however for reasons discussed earlier, it is unable to further this suggestion. In addition, the clause could be too limiting in its specification of '.....volume and price information for forward contracts.....'. In any respect, the current wording suggests that NECA does have this power.

7.3.1 Submissions

NECG agrees that full disclosure of contract information might assist NECA and the Commission in the monitoring of the market, however NECG challenge the benefits that this would provide, by pointing to the potential harm arising from leaks of such information to the wider market.

Others do not believe that the provision of contract information to NECA will assist in categorising bids as legitimate or otherwise in other than an arbitrary manner,⁵⁷ with TXU saying that financial market regulation is well outside NECA's scope and expertise. Westpac cites the proposal as unprecedented, and assert their strong opposition to it.

Delta is critical of the Commission's claim that consideration of the spot and forward markets is important in understanding market power in the NEM. Delta further claims that the draft determination fails to give proper consideration to the effect of forward contracts on spot price volatility.

7.4 Information disclosure

The Commission made a further suggestion in the draft determination that 'NECA consider delaying the release of aggregate bidding information, currently released one day after dispatch, to a period of several weeks or months'. This was suggested as a possible alternative mechanism through which to mitigate against tacit collusion in the marketplace in the future.

7.4.1 Submissions

At this stage, the NSW Government states that they do not support amending the current information disclosure regime unless market power concerns are more conclusively proven. Correspondingly, Stanwell argues that the disclosure of NEM information is a cost-effective way of ensuring information symmetry, especially important for new entrants. In addition to others,⁵⁸ Stanwell says that an informed market is an efficient market.

EnergyAustralia argues that the code changes should focus on improving the quality of the available data rather than restricting its release because of concerns it may be used to signal strategies to other participants.

⁵⁷ Loy Yang and Stanwell submissions.

⁵⁸ EnergyAustralia, Loy Yang and Stanwell submissions.

Loy Yang believes that the impact of the delay has not been sufficiently analysed to determine the benefits and/or costs to the market. Loy Yang points to compromised security of supply, reduced liquidity in the contract market and increased participant risk as possible detriments from such disclosure, with TXU highlighting that smaller players and slow-start peaking plant are more vulnerable to such effects.

TXU states that it makes great use of next-day market data to facilitate its decision making processes, and says that prediction is an important part of their operation.

Westpac argues that any proposed reduction of information will reduce the quantity of swap contracts from market intermediaries that rely on this information to make decisions. They further point out that a healthy financial contracting market has been identified as crucial for further development of the NEM, and they say that should the proposal be implemented, it will serve to increase the market power of generators in the contracting market.

7.5 Market Review Forum

The Commission suggested that 'NECA contribute to the Market Review Forum as a mechanism for NEM participants to contribute to debate on topical issues'. A number of submissions note their endorsement of the Commission's initiative regarding a Market Review Forum,⁵⁹ and the Commission is planning to progress this initiative. Further discussion of the Forum is contained in chapter 9 of this determination.

7.6 Price volatility

Hydro Tasmania believes that the issue of price volatility is inherent in the rebidding debate and is therefore critical of the lack of any vigorous analysis of its significance in the NEM. They say that price volatility is the real issue to be addressed.

However Yamasa regards price spikes as a normal mechanism of the energy only market in its balancing of demand fluctuations, and maintains that price spikes have not been of concern to them.

Similarly, CS Energy asserts that the market mechanisms that currently exist in the NEM are working well, and as such, should not be disturbed by market intervention. It is argued that year average prices in the NEM are not increasing,⁶⁰ with CS Energy stating that year average prices are trending towards new entrant long-term average costs in those states where supply and demand are closer to balance. In states such as Queensland and South Australia, where average prices are historically higher, CS Energy points to recent commitments to new generation investment and greater interconnector capacity.

⁵⁹ Hydro Tasmania, InterGen and NECA submissions.

⁶⁰ CS Energy and NECG submissions.

EnergyAustralia believes that the current level of VoLL, coupled with existing bidding and rebidding rules, has created an environment that rewards opportune market behaviour, and therefore recommends a reduction in the level of VoLL to reduce the risks to retailers of very high price events.

Some submissions point to analysis of price spikes made by NECA and the Commission. They contend that it is not possible to understand the contribution rebidding makes to efficiency, nor market outcomes, when attention is directed and confined to only a very small number of extreme events.⁶¹

7.7 Interconnection

NSW is critical that the Commission has ‘underplayed’ the importance of interconnection in the NEM, and in particular, in NEM reforms.

7.8 Review of penalties in the code

While EnergyAustralia is not supportive of changes to behavioural rules, if such a course is pursued, they suggest a review of penalties so that a sufficient deterrent is introduced. EnergyAustralia does not consider penalties of \$10 000 are a sufficient deterrent compared to the significant and substantial gains to be made by generators who successfully engage in strategic and anti-competitive bidding behaviour.

7.9 Game theory and auction design

The NECG do not believe that the Commission’s game theory model represents the workings of the NEM, saying that it misrepresents the underlying theoretical auction process. They also criticise the Commission’s discussion of spectrum auctions in the United States Electricity Market, specifically saying that the Commission fails to show a relationship between the Federal Communication Commission Spectrum Auction process in the United States and the NEM auction process.

7.10 Commission’s considerations

It was intended that the suggestions made by the Commission in the draft determination would generate debate on certain issues as identified by NECA to be problematic in the NEM. Due to the formal procedures to be followed in an authorisation process, the Commission has been unable to further any of NECA’s solutions to the issues raised in this determination.

However, it is apparent from the comments received by submissions that these issues, as well as others, are certainly of contention amongst participants and interested parties, and will be worthy of further discussion in another form. The Commission believes that

⁶¹ NECG and Tarong submissions.

the Market Review Forum will provide an appropriate setting to further such discussion.

8 Contract market

The application for authorisation of changes to the code rebidding rules has fostered much debate on bidding and rebidding, their effect on changes to the spot price, and spot price outcomes in the NEM.

Due to the nature of the code changes being proposed by NECA, it is understandable that much of the focus has been on the spot market. However, generators in the NEM also receive revenues through the contract and ancillary services markets, as well as the spot market.

In the NEM, nearly all electricity supplied in the participating jurisdictions must be traded through the spot market. Nevertheless, the inherent volatility of the spot market encourages most participants to hedge their exposure through the contract market and perhaps 90 per cent of electricity is thus hedged. The upshot is that effectively only 10 per cent of electricity is traded at spot price while 90 per cent is supplied at prices determined in the contract market. In volume terms, the contract market is thus the dominant trading forum.

Therefore, in trying to analyse bidding and rebidding strategies by generators, solely focussing on spot market outcomes, which form only a residual component of total electricity traded, ignores significant revenues associated with trade in other areas of the market.

Analysis of the contract market is necessary to understand bidding and rebidding behaviour in the NEM. As such, this chapter seeks to explain the relevance and importance of the contract market when assessing the prevalence of undue market power or when seeking to ameliorate its exercise.

8.1 Energy-only design

Because electricity cannot be stored for future use, supply must always be responsive to variations in demand. Therefore, during periods of capacity shortage, it is reasonable to expect that spot prices, through price spikes, can reflect shortages. In instances where price spikes occur more frequently, or persist for longer than expected, price spikes may signal the need for new investment. However, the inherent volatility of the spot market and the high capital costs of most investments mean that proponents are unlikely to proceed on the basis of current or projected spot prices. Prospective investors, and in most cases their respective debt providers, are likely to be much more influenced by what opportunities are available in the contract market.

8.2 Contract market

The contract market has the characteristic of transferring the risk associated with trading electricity in the pool to those most willing to bear it. Therefore, rather than rely solely on spot prices to compensate for capacity, generators choose to contract most of their capacity. The level of contracting sold by a generator depends on its own risk

aversion. If a generator chooses to contract all of its capacity, it faces the risk of having to pay the pool price if a contingency event, such as plant failure, occurs.

Similarly, retailers and customers exposed to the pool are assumed to be risk averse, and will also hedge their exposure to volatile prices through the contract market.

With most commodities, the spot market could be expected to have a strong influence on contract prices since low cost arbitrage is possible by warehousing the commodity. However the problem remains that the cost-of-carry model of forward prices does not hold with a commodity which is not storable, such as electricity.⁶² This being the case, the ability to arbitrage between the spot price and the forward price is restricted in the short-run, due to this inability to store the commodity. This does not imply that arbitrage profits are not obtainable, but rather that they cannot be exploited if one does not possess generation assets.

Risk free arbitrage is only available to those with spare production capacity or flexible consumption patterns. The potential impact on risk premiums of this inability to arbitrage between spot and forward prices is hard to measure. But given the assumption that retailers and end-users are risk averse, it would not be surprising if a significant risk premium existed, in addition to expected spot prices, if generators were able to bear the risk of volatile spot prices better than end users. Thus, at least over short to medium time scales, it may be unsafe to assume that the spot market will 'drive' contract prices.

Conversely, contract holdings are likely to have a strong influence on spot market behaviour. For example, a heavily contracted generator has less to gain from strategic bidding and rebidding than one who is uncontracted.

For all these reasons, it will be prudent to monitor the contract market, as well as the spot market, when assessing the prevalence of undue market power, and to consider factors which may affect the operation and competitiveness of both markets.

8.3 Volatility in the spot market

Spot price outcomes over the period February to August 2002 are illustrated in Figure 1 (Appendix C). The volatility is evident. The time-weighted average is around new entrant levels for base load generation in Victoria and South Australia, commonly asserted to approximate \$40/MWh, although it is somewhat higher in the other states. In principle, the prices in New South Wales and Queensland should be high enough to attract new generation into the market but, as discussed earlier, it is unlikely that investors would commit their capital on the basis of those prices or possible projections. Prospective investors are more likely to be swayed by the contract market.

The Australian Financial Markets Association (AFMA) provide a forward curve for three types of contracts (off-peak, peak and flat contracts) trading electricity forwards

⁶² The cost-of-carry model for a commodity implies that the forward price is equivalent to the expected spot price discounted at the continuously compounding risk free rate and adjusted for storage costs and convenience yields.

for each region of the NEM. The information used, and methodology involved, in construction of these curves can be obtained from the AFMA website.⁶³

Figure 2 (Appendix C) illustrates the price curves that AFMA reported in September 2002 for 'flat' contracts, that is, those contracts that relate to a flat load profile. It is this type of contract that would have the most direct relevance for a prospective base load generator. Assuming a construction lead time of around two years, a potential investor will currently be most interested in prices applying to contracts for 2004 onwards. Perusal of the diagrams in Figure 2 reveals prices around \$35/MWh to \$40/MWh for such contracts, which may be slightly below the new entrant level.

From this brief analysis, there is little to indicate conclusively that there is significant abuse of market power occurring at present. There is no evidence for example that contract prices are remaining above new entrant levels without enticing new entrants, as might occur for example if new entrants were being deterred by the threat of predatory pricing. On the contrary, contract prices appear to be at or below new entrant levels and it appears that there is ongoing recruitment of new capacity in those areas where supply is scarcest.

However, there is some evidence of the average spot market price exceeding new entrant prices, and this would be of concern if the condition persisted over a period long enough to allow new entrants to enter, for example, two years or longer. In the meantime, the direct impact of high spot prices is likely to be softened by the significant level of contracting that is thought to be present.⁶⁴

Of course, this brief analysis cannot be taken as conclusive. There is uncertainty regarding key data such as forward prices and volumes. In addition, the relevance of peaking generation to the debate has not been examined. It is included here primarily for illustrative purposes.

8.4 Preventing abuse of market power in the contract market

To the extent that the spot market drives the contract market, it may be appropriate to seek remedies to abuse of market power in the contract market through refinement of spot market design. For example, it appears that recent spot market volatility has influenced the price of short term forward contracts (but not longer term contracts). If the spot price volatility was artificial and was addressed through spot market design changes, the consequent volatility in the contract market may also be removed.

However, as already discussed, the contract market may, to some extent, behave independently of the spot market. Local abuse of market power might occur in the contract market if, for example, there were artificial barriers to long distance contracting. Such barriers may perhaps be present due to the non-firmness of settlement residue rights and the inability to obtain cost-effective hedging for intra-regional

⁶³ www.afma.com.au

⁶⁴ In some jurisdictions, risk management arrangements introduced in relation to the retail markets may have inadvertently reduced contract levels.

constraints. It is possible (but purely hypothetical at this stage) that factors such as these could lead to anti-competitive outcomes in the contract market, the dominant market in financial terms, despite a well-functioning spot market.

Electricity Tariff Equalisation Fund

Significant price spikes have been observed in the spot market between May and July 2002 that appear to have been in part the result of a strategic withdrawal of capacity, increasing year average prices significantly. There is a concern about the ability of generators to affect spot prices and the relative lack of competitive generator response witnessed over this period.

The Council of Australian Governments (COAG) draft energy market review proposes that the New South Wales Electricity Tariff Equalisation Fund (ETEF) be abolished. The report found that the ETEF arrangements create a bias towards less bilateral contracting, which reduces liquidity in the forward market and, by potentially leaving generators more exposed to the spot market, exacerbate spot price volatility.

The Commission recognises that there is a legitimate role for Governments to protect household consumers, especially lower income households. Along with other measures, ETEF was established to achieve this objective. However, the Commission considers that the experience to date shows that ETEF significantly distorts the operation of the spot market and that there are less distortionary ways of achieving these consumer protection objectives. At the time ETEF was established the Government anticipated that the number of households covered by the fund would decrease over time with the onset of Full Retail Contestability (FRC). FRC gives customers the option of selecting an alternative provider. In practice, relatively few households have made the switch which means that the distortionary impact of the fund has not subsided as anticipated.

Should the ETEF fund accumulate to a significant level, such as occurred in May and June 2002, generators may face few restrictions on bidding behaviour in the spot market. The spot market price spikes observed during May and June 2002 may, at least in part, have occurred as a consequence of ETEF deterring bilateral contracting, and the failure of the market to impose an alternative discipline on generator behaviour. In general the lower contract coverage the stronger the incentives for economic withholding.

Replacing ETEF with less distortionary measures would be an important step toward increasing liquidity in the contract market and restoring the discipline that contract holdings can normally be expected to exert on generator behaviour in the spot market.

In the meantime the good faith provisions will help NECA to investigate and pursue price spikes over the coming months. The Commission will also be vigilant in monitoring price outcomes during the upcoming summer period to ensure compliance with the TPA. In particular, possible contraventions of section 46 relating to misuse of market power and section 45 relating to anti-competitive agreements.

Finally, the question remains whether the low spot price outcomes over the 18 months leading to May 2002 have flowed onto consumers. Ultimately, the ETEF fund balance is a contribution from consumers who have paid prices according to regulated tariffs and not the spot prices which eventuated over the period.

Conclusion

The Commission believes that further debate and analysis of the interaction between the spot and contract market may enable more effective developments to the market design and rules of the NEM. In particular, there may be benefit in exploring:

- more intensive monitoring and statistical reporting of the forward markets, and exploring whether NECA is best equipped to undertake this task; and
- market design and/or structural initiatives that might serve to lessen the opportunities for the exercise of market power in the forward markets.

In addition, further debate will help to educate consumers, and better inform commentators, of the inherent risks involved in trading in the NEM.

The Commission is also interested in identifying any potential cyclical effects in contract volumes and prices as they may explain the incidence of prolonged periods of uncontracted generation, particularly during peak periods. Cyclical effects may also help identify whether or not premiums are implicit in the price of contracts during certain periods of time considering the lack of liquidity in the market.

The Commission proposes to use the Market Review Forum as a vehicle for rigorous debate of the issues raised in this section, and specifically discussion on how contract volumes and prices could be disclosed on a confidential basis to allow closer analysis of the underlying transfer of risk in the NEM.

9 Market Review Forum

During consultation on the rebidding code changes, and from issues raised at the bidding and rebidding forum chaired by the Commission, a number of industry participants proposed that the Commission facilitate an industry based Market Review Forum to review evolving market behaviour on an ongoing basis. Proponents argue that this Forum would contribute to a deeper understanding of how the market operates, and propose that it functions as a body for analysis and advice to regulators and government on NEM issues.

Proponents believe the Forum should have a particular emphasis on identifying, reviewing and reporting on factors, including those related to conduct, that affect the NEM's efficiency and overall performance. The Forum will require the application of specific economic criteria that will encourage rigorous debate and the development of sound market principles.

Furthermore, it is suggested that the Forum be run in addition to, and not in replace of, any of the existing roles undertaken by the regulatory institutions in the NEM such as NECA, the Commission or the jurisdictions. It is not proposed that the Forum be given powers to make decisions, but rather would simply aim to reach consensus through rigorous evaluation of the efficiency of market outcomes. Such consensus could lead to recommendations for code changes to be lodged with NECA or could provide initial consultation on topical issues.

The proponents suggest that the Commission is the appropriate body to facilitate the Forum because of its interest in efficiency and competition in all markets. However they suggest it be chaired by someone independent of the Commission and the other NEM institutions.

The Commission welcomes this innovative and consultative proposal. At present there are limited avenues through which behaviour within the market can be discussed without accompanying concerns of enforcement action. The Commission sees merit in a forum that is inclusive and participant oriented and that could potentially generate consensus in identifying important issues and directions for development.

The Commission believes that this Forum would provide a mechanism for effective and ongoing market monitoring by participants as an addition to the monitoring work currently undertaken by NECA. It would provide industry participants with input to a structured mechanism for discussion and analysis of a wide range of market behaviours and topical issues.

10 Determination

After consideration of the issues raised in chapters 2-6 the Commission concludes that, subject to the conditions set out below, in all the circumstances the proposed amendments to the code:

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

The Commission therefore grants authorisation to application numbers A90797, A90798 and A90799. In its review of these code changes, the Commission has identified a number of provisions that will detract from the public benefit or increase the level of anti-competitive detriment attributable to the implementation of these arrangements. Authorisation is therefore granted subject to the conditions and deletions below. The Commission proposes to limit the period of the authorisation to 31 December 2010.

Conditions of authorisation

- C1 Sub-clause 3.8.22A(b) must be deleted.**
- C2 In place of subclause 3.8.22A(b) deleted as per condition 1, the following subclauses 3.8.22A(b) and 3.8.22A(c) be inserted:**
- (b) In clause 3.8.22A(a) a dispatch offer, network dispatch offer, dispatch bid or rebid is taken to be made in good faith if, at the time of making such an offer, bid or rebid, a Market Participant has a genuine intention to honour that offer, bid or rebid, if the material conditions and circumstances upon which the offer, bid or rebid were based remain unchanged until the relevant dispatch interval.**
 - (c) A Market Participant may be taken to have contravened clause 3.8.22A(a) notwithstanding that, after all the evidence has been considered, the intention of the Market Participant is ascertainable only by inference from the conduct of the Market Participant, or of any other person, or from relevant circumstances.**
- C3 The proposed clause 3.8.22B of the code relating to ‘conduct prejudicial to the market’ must be deleted including all references to guidelines under this clause.**
- C4 The wording of clause 3.11.3(b) be altered to:**

NEMMCO* must develop and publish a procedure for determining the quantity of each kind of non-market ancillary service required for *NEMMCO

- (1) to achieve the power system and reliability standards; and**
- (2) where practicable to enhance network transfer capability whilst still maintaining a secure operating state when, in *NEMMCO's* reasonable opinion, the resultant expected increase in non-market ancillary service costs will not exceed the resultant expected increase in benefits of trade from the spot market.**

C5 The wording of clause 4.2.6(b) and other relevant parts of the code should be altered to the extent necessary to implement the following changes:

- The Reliability Panel must establish guiding principles and guidelines that determine how *NEMMCO* should maintain system security while taking into account the costs and benefits to the extent practicable;**
- The guidelines referred to above must be developed using the appropriate consultation process and must take into account:
 - the need for transitional arrangements to allow for development and testing of an appropriate methodology by *NEMMCO*; and**
 - the results of any decision by the Panel to revise network constraints.****
- Until the Reliability Panel publishes guidelines and an appropriate testing period has concluded, the current system of preserving system security will continue to apply.**
- *NECA* should review and report on the way *NEMMCO* has used its new powers and whether the more relaxed standard of system security has led to overall market benefits. This review should take place two years after the guidelines have come into effect.**

Appendix A - Submissions to the application

AGL Energy Sales and Marketing Limited

Delta Electricity

Duke Energy Australia Trading and Marketing Pty Ltd

Edison Mission Energy Australia Limited

EnergyAustralia

Enertrade

Eraring Energy

Ergon Energy

Hydro Tasmania

InterGen (Australia) Pty Ltd

Loy Yang Power Management Pty Ltd

Macquarie Generation

National Electricity Market Management Company Ltd

National Generators Forum

NRG Flinders Operating Services Pty Ltd

New South Wales Treasury

Origin Energy Electricity Limited

The Office of the South Australian Independent Industry Regulator (now known as the Essential Services Commission of South Australia)

South Australian Department of Treasury and Finance

Snowy Hydro Trading Pty Limited

Southern Hydro

Tarong Energy Corporation Ltd

Appendix B - Submissions to the draft determination

CS Energy

Delta Electricity

Edison Mission Energy Australia Limited

EnergyAustralia

Eraring Energy

Hydro Tasmania

InterGen (Australia) Pty Ltd

Loy Yang Power Management Pty Ltd

Macquarie Generation

National Electricity Code Administrator

Network Economics Consulting Group

National Electricity Market Management Company Ltd

NRG Flinders

New South Wales Ministry of Energy and Utilities

Origin Energy Electricity Limited

South Australian Minister for Energy

Snowy Hydro Trading Pty Limited

Southern Hydro

Stanwell Corporation

Tarong Energy Corporation Ltd

Transgrid

TXU Electricity Ltd

Westpac Institutional Bank

Yallourn Energy Pty Ltd

Yamasa Australia

Appendix C – Demand and Spot market outcomes during 2002

Figure 1: Demand and Price outcomes February 2002 – August 2002

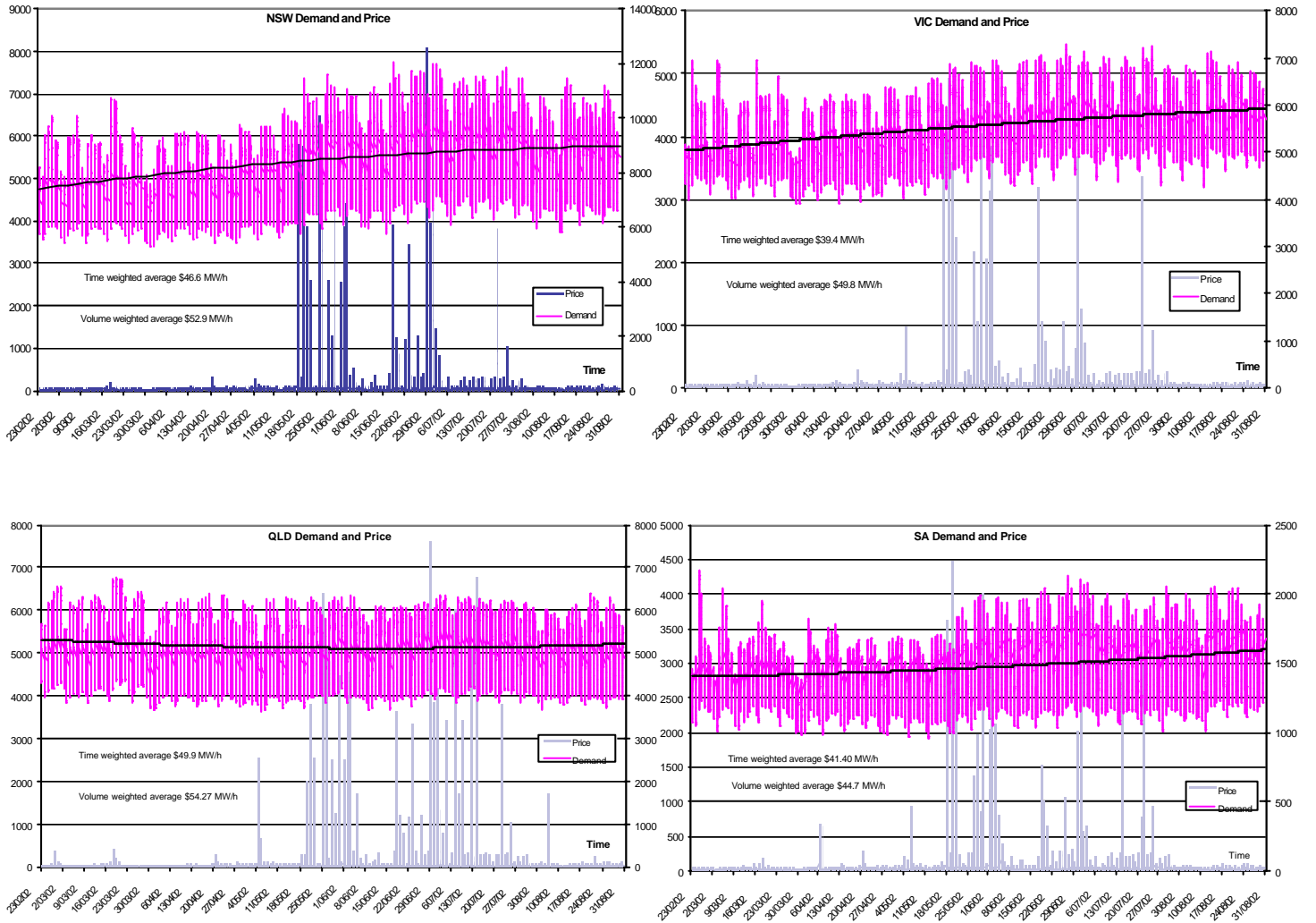
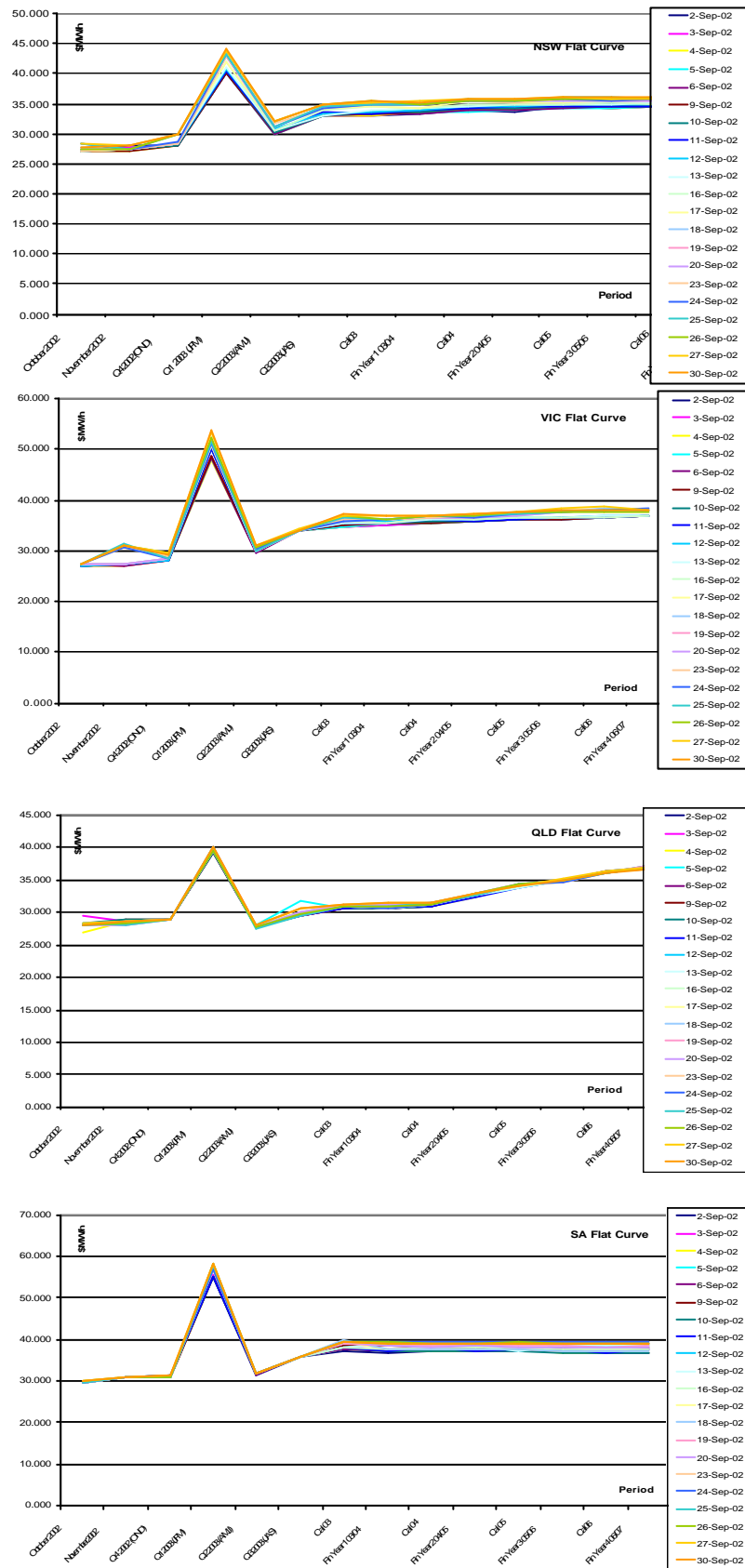


Figure 2: Flat Forward Curves for all Regions September 2002



Appendix D – Response to NECA regarding revised proposals



Australian Competition & Consumer Commission

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Dickson ACT 2602
Australia

Ph (02) 6243 1123
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9 October 2002

Stephen Kelly
Managing Director
NECA
Level 5, 41 Currie Street
ADELAIDE SA 5000

Dear Mr Kelly

Re : Current application for authorisation of bidding and rebidding rules and NECA's Revised Proposals

Thank you for your letter of 4 September 2002 concerning the application for authorisation of changes to the bidding and rebidding rules currently before the Commission, and for your ideas on a way forward.

I am encouraged that we share the same views on further structural changes to the National Electricity Market. These structural changes may potentially alleviate the occasional inefficient outcomes in the spot market.

With respect to the current application, the Commission's draft determination supported the principle of requiring bids and rebids to be made in 'good faith'. The Commission was of the view that the 'good faith' provision would increase the public benefits of the proposed code changes in the form of reliable pre-dispatch forecast prices. However, to avoid the problems of uncertainty, the Commission encouraged NECA to develop a clear definition as to what behaviour would constitute bidding in 'good faith'.

Regarding NECA's Revised Proposals in relation to the 'conduct prejudicial' code change, it is the Commission's view not to consider them as part of the current application and provides its reasoning as follows:

Timing of the authorisation process to incorporate the Revised Proposals

The Commission is aware of the importance of having the current application in place for the upcoming summer peak period. Consideration of the Revised Proposals with the current application would jeopardise the timing of the authorisation process, so that the code changes would not be in place when they are needed the most.

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At a minimum, the authorisation process incorporating the Revised Proposals would require another round of consultation, and submissions would need to be called for from interested parties. Given the complexity and importance of the issues, interested parties would need to be given at least three weeks to develop submissions. The Commission would then need to prepare and issue a revised draft determination, and conduct a public consultation process on the draft. The consultation process would involve a request for further submissions and in all likelihood a pre-determination conference. I anticipate that this process would extend into March 2003, well beyond the summer peak period when the current application would be needed the most.

By contrast, progressing the Revised Proposals as a separate application would allow the 'good faith' provisions to be implemented before summer. The Commission sees no reason to hold up the authorisation process involved with the current application.

Development of the Revised Proposals

The Commission believes the Revised Proposals are not developed to a stage where the authorisation test may be applied in a meaningful way. The proposals are incomplete in two areas. The first is that the uncertainty as to what would constitute reasonable grounds for bids and rebids during a 'price watch' interval has not been addressed in the Revised Proposals. The Commission notes that this same uncertainty was evident in the current application with regard to what would constitute reasonable cause for a breach of the draft guidelines.

The second is that there is little guidance on what investigation process NECA would follow in assessing whether there is a breach, including what enforcement mechanism it might take. NECA has responded to the Commission's concerns about the enforcement of the 'good faith' provision with its proposal of the 'good faith test'. However, with no enforcement mechanism for the 'conduct prejudicial' provision, the Revised Proposals are incomplete.

For this reason, the Commission recommends that NECA further develop the Revised Proposals before applying for authorisation.

Power of the Commission to Impose Conditions

It has been put to the Commission that it has the power to grant the application for authorisation, on the condition that the proposed Code changes be amended to include the Revised Proposals. The Commission accepts that it has the power to authorise proposed Code changes on the condition that they are amended so as to enable them to satisfy the test for authorisation. This course of action has been frequently followed in the past.

However, it has also been put to the Commission that, in this case, the Revised Proposals go beyond an amendment that the Commission can require as a condition of authorisation. In light of the Commission's views on the need for a more thorough assessment of the Revised Proposals under the relevant code change process, it has not

been necessary for the Commission to reach a view on whether it has the power to grant authorisation to the current application on the condition it is amended to incorporate the Revised Proposals.

Yours sincerely

A handwritten signature in black ink that reads "Allan Fels". The signature is written in a cursive, flowing style.

Professor Allan Fels AO
Chairman