

Applications for authorisation

National Electricity Code

Settlements Residue Auction Process

Date: 27 October 1999

Authorisation nos:

A90688

A90689

A90690

File nos: C1999/90-92

Commissioners:

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Summary

On 20 May 1999, NECA lodged applications for authorisation of changes to the National Electricity Code (NEC) (Nos: A90688, A90689, and A90690) to enable an auction of portions of the settlements residue¹ to be undertaken by NEMMCO. The applications were submitted by NECA on behalf of itself, NEMMCO and all participants in the NEM.

The applications were submitted under Part VII of the *Trade Practices Act 1974* (the TPA). Amendments to the applications were received on 24 May 1999. The Commission granted interim authorisation to the amended applications on 16 June 1999. NECA submitted amendments to meet the conditions of interim authorisation on 22 June 1999. The Commission notified NECA that the amendments met the proposed conditions on 22 June 1999.

Authorisation under Part VII of the TPA provides immunity from court action for certain types of market arrangements or conduct which would otherwise be in breach of Part IV of the TPA, where the Commission concludes that the public benefits of the arrangements or conduct would outweigh the anti-competitive detriments of such arrangements or conduct.

The settlements residue arises in the NEM because of the differences between the amounts paid by customers to NEMMCO and the amounts paid by NEMMCO to generators. This occurs where prices between regions diverge, due to losses or constraints on interconnectors. Such price differences can pose a significant financial risk to NEM participants undertaking inter-regional trades. The settlements residue can be used to hedge such price risks and hence facilitate inter-regional trade.

In its 10 December 1997 determination, the Commission accepted the importance of inter-regional trade for the overall integrity and efficiency of a national market for wholesale trade in electricity. Inter-regional trade can enhance competition by adding competitors to regional markets. While acknowledging the importance of inter-regional hedges (IRHs), the Commission did not authorise the proposed central provision of IRHs through an IRH exchange to be facilitated by NEMMCO, noting that this proposal did not represent the minimum required to commence a market in IRHs.

The current proposal to auction settlements residue facilitates the development of IRH solutions to enhance inter-regional trade.

The current applications were made under sub-section 88(1) of the *Trade Practices Act 1974* ('the Act') for an 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 Act; and to give effect to a provision of a contract, arrangement or understanding

¹ Over the course of the Code's development, the settlements residue has also been referred to as "settlements surplus", "black hole money" and "link revenue."

where the provision is, or may be, an exclusionary provision within the meaning of s45 of the Act. Application was also made under sub-section 88(8) of the Act for an authorisation to engage in conduct that constitutes, or may constitute, the practice of exclusive dealing.

According to the applications, the settlements residue auction process is designed to:

- facilitate interstate trade in electricity, and
- increase retail competition by giving retailers more ability to manage inter-regional trading risks.

Following consideration of the arguments advanced by the applicant, the Commission considers that the auction process may involve some anti-competitive detriment, primarily due to:

- the exclusion of some NEM participants from the auction process; and
- NEMMCO's power to impose a reserve price.

The Commission is also satisfied that significant public benefits will arise from the introduction of a settlements residue auction process. Implementation of the proposed arrangements should result in NEM participants being better able to manage financial risks inherent in inter-regional trading. Enhanced inter-regional trading will facilitate competition in the retail markets of each region and possibly lower energy prices in the NEM.

The Commission considers that the public benefits are sufficient to outweigh any anti-competitive detriment that may arise from the settlements residue auction process, and proposes to grant authorisation to the proposed arrangements. Accordingly, this draft determination sets out the Commission's decision to grant conditional authorisation in respect of applications **A90688 A90689 and A90690**. The Commission granted an interim authorisation to the proposed arrangements on 16 June 1999.

The Commission proposes to limit the current authorisation of the settlements residue auction process until 31 December 2002.

The interim authorisation granted on 16 June 1999 will lapse on the date the final determination comes into effect.

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Glossary

Bardak	Bardak Energy Services
Commission	Australian Competition and Consumer Commission
Ergon Energy	Ergon Energy (Victoria) Pty Ltd and Ergon Energy Pty Ltd
Hedging	taking steps to protect against, or reduce, the risk of exposure to variations in the spot price.
IRH	Inter-regional Hedge
IRSR	Inter-regional Settlements Residue
MW	Megawatt
NEC	National Electricity Code
NECA	National Electricity Code Administrator
NEM	National Electricity Market
NEMMCO	National Electricity Market Management Company Ltd
SRA	Settlements Residue Auction
SRC	Settlements Residue Committee
TNSP	Transmission Network Service Provider
MNSP	Market Network Service Provider
TPA	Trade Practices Act 1974
TUOS	Transmission Use of System

1. Introduction

1.1 The Application

On 20 May 1999, NECA lodged applications for authorisation (A90688, A90689, and A90690) of changes to the National Electricity Code (NEC) to enable an auction of portions of the inter-regional settlements residue (IRSR) to be undertaken by NEMMCO. The applications were submitted by NECA on behalf of itself, NEMMCO and code participants in the National Electricity Market (NEM).

The IRSR arises in the NEM where prices between regions diverge, due to losses or constraints on inter-regional electricity losses. Such price divergence can pose a significant financial risk to NEM participants undertaking inter regional trades. The IRSR can be used to hedge such risks and hence facilitate inter-regional trade.

The application was made under sub-section 88(1) of the *Trade Practices Act 1974* ('the Act') for an 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 Act; 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 s45 of the Act. Application was also made under sub-section 88(8) of the Act for an authorisation to engage in conduct that constitutes, or may constitute, the practice of exclusive dealing.

The applications are only concerned with the arrangements and provisions set out in the settlements residue auction Code changes. However much of the detail of the proposed arrangements is set out in other documents that is the settlements residue auction rules and auction participation agreements.

In its 10 December 1997 determination on the NEC, the Commission recognised the importance of inter-regional trading to the efficiency of the NEM. However, the Commission expressed concern that the inter-regional hedge (IRH) provisions proposed did not represent the minimum required to facilitate the emergence of inter-regional trade. The establishment of an IRH exchange by NEMMCO was not authorised. Instead of the direct provision of an IRH exchange by NEMMCO the Commission recommended the applicants develop and implement a proposal under which NEMMCO would take a minimum facilitation role in encouraging the provision of IRHs underwritten by the settlements surplus. The current auction proposal represents one way to facilitate inter-regional hedging.

1.2 Statutory test

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

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 subject arrangements or conduct would result, or be likely to result, in a benefit to the public; and
- 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 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.

In deciding whether it should grant authorisation, the Commission must examine the anti-competitive aspects of the arrangements or conduct, the public benefits arising from the arrangements or conduct and weigh the two to determine which is greater. Should the public benefit or expected public benefits outweigh the anti-competitive aspects, the Commission may grant authorisation or grant authorisation subject to conditions.

Determining just what is a benefit to the public is therefore a key issue. Public benefits recognised in the past include:

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

If the Commission determines that the public benefits do not outweigh the anti-competitive detriment, the Commission may refuse authorisation or alternatively, in refusing authorisation, indicate to the applicant how the applications could be constructed to change the balance of detriment and public benefit so that authorisation may be granted.

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 Act. It should be noted, however, that authorisation provides exemption for the particular conduct applied for only. Authorisation does not provide blanket exemption from all provisions of the Act. Further, authorisation is not available for misuse of market power (section 46).

1.3 Public Consultations

The proposed changes to the NEC were developed using the Code Consultation procedures set out in Chapter 8 of the NEC. In accordance with those procedures, the Commission requested NECA to register it as an interested party to enable the Commission to be kept informed of issues and concerns raised by Code Participants.

NEMMCO and NECA provided the Commission with submissions in support of the applications. NECA amended its application on 24 May 1999. These documents were placed on the public register for inspection by interested parties.

Under the TPA the Commission has a statutory obligation to follow a public process when assessing an application for authorisation. Accordingly, the Commission has also requested submissions from any interested parties by way of advertisement in the Australian dated 31 May 1999 and on the Commission's web page. The closing date for submissions on the interim authorisation was Friday 9 July 1999, subsequently extended to 23 August 1999. 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.

Submissions were received from Hazelwood Power, Bardak Energy Services (Bardak), Ergon Energy and United Energy. All of these submissions have been placed on the Commission's public register. Bardak and United Energy were concerned by the broad discretion of NEMMCO to amend the auction rules. Bardak and Ergon Energy also raised issues concerning the procedures to be followed by the Settlements Residue Committee (SRC). The SRC is a decision making body that monitors, reviews and reports on the conduct of the settlements residue auctions under proposed clause 3.18.5 of the NEC. Hazelwood Power, Bardak and United Energy argued for the abolition of the reserve price requirement. The submissions are discussed in further detail in section 4.

1.4 Commission processes

The Commission has produced this draft determination outlining its analysis and views on the NEC according to the statutory assessment criteria set out in section 1.2. The Commission now invites the applicants and other interested persons to notify it within 14 days of the date of this document as to whether the applicants or other interested

persons wish the Commission to hold a conference in relation to this draft determination².

If the applicants or an interested party notifies the Commission in writing within the 14 days that they want the Commission to hold a conference, the Commission will appoint a date, time and place for the holding of the conference (tentatively 11 November 1999 in Canberra) and notify all interested parties. The applicants, interested parties who receive a copy of the draft determination and any other interested parties whose presence the Commission considers appropriate are entitled to participate in the conference.

Following the conference, the Commission will take into account issues raised at the conference, and any related submissions, and will issue a final determination. If no pre-determination conference is called then this draft determination will become the final determination.

A person dissatisfied with the final determination may apply to the Australian Competition Tribunal for its review.

² For the purposes of the conference, an interested person is a person who has notified the Commission in writing that the person, or a specified unincorporated association of which the person is a member, claims to have an interest in the applications and the Commission is of the opinion that the interest is real and substantial.

2. Settlements residue auction proposals

The purpose of the settlements residue auction process is to enable risk management by providing participants with access to inter-regional hedges (IRHs) in the form of rights to specified portions of the settlements residues. The IRSR is split into six directionally-specific inter-regional settlement residue units. Each of these units reflects the directional flow of electricity across interconnectors between the regions for a particular quarter.

The proposed arrangements for the settlements residue auction are set out in the NEC, the auction rules and the auction participation agreements. The applicants have only applied for authorisation of the amendments to the NEC, but the rules and participation agreements form an essential component of the structure of the proposed arrangements. It is important to note that the immunity from prosecution conferred by the authorisation process will only apply to the components of the settlements residue auction which are actually specified in the NEC amendments.

2.1 Settlements Residue

The Inter-Regional Settlements Residue (IRSR) arises because transmission losses and constraints on interconnections create a mismatch between the monies received from market customers and those paid to generators as a result of the settlements process. In relation to transmission losses, differences exist between losses priced into the dispatch and settlements process and actual losses for flows of electricity between regional reference nodes. In relation to interconnectors, price separation between regions occurs when an interconnector is constrained.

For the purposes of the auction, the IRSR is divided into “units”, each unit representing the inter-regional price difference relating to 1MW of energy flow in a particular direction between two regions. The units relate to six different inter-regional flows:

- NSW to Snowy;
- Snowy to NSW;
- Victoria to Snowy;
- Snowy to Victoria;
- Victoria to South Australia; and
- South Australia to Victoria.

Inter-regional trading in the NEM is subject to risk where contracts reference a pool price in a region outside the contracting party’s region. The inter-regional risk is the price difference between the two regions multiplied by the volume of exposure. Partitioned into units that represent definable volumes of energy between particular

regions, the IRSR can be used as a non-firm hedge for inter-regional energy transactions.

2.2 Changes to the NEC

The changes to the NEC set out that:

- NEMMCO may conduct settlements residue auctions, in accordance with the auction rules;
- NEMMCO may only distribute settlements residues to persons that are Market Customers, Generators or Traders that meet the eligibility criteria set out in the rules;
- NEMMCO has the power to suspend, or remove a suspension, on auctions for one or more of the directional inter-connectors;
- NEMMCO must develop the auction rules, which must include:
 - Criteria for eligibility;
 - Procedures for conducting auctions
 - Timing of auctions;
 - Mechanisms for calculating the clearing price;
 - Mechanisms for calculating fees;
 - Billing and settlements procedures; and
 - The standard form of auction participation agreement;
- NEMMCO may also incorporate a reserve price for each directional interconnector;
- NEMMCO must structure the auctions to maximise the value of the settlements residues;
- NEMMCO must establish procedures for the distribution of settlements residues and collection of auction proceeds and fees;
- NEMMCO must establish a Settlements Residue Committee (clause 3.18.5);
- Only a fixed portion of the settlements residue will be available for auction, with the remaining of the available residue and auction proceeds being distributed to the transmission NSPs (clause 3.18.4(a)). The settlements residues will be allocated as follows:
 1. giving full effect to Chapter 9 derogations (clause 3.6.5(a)(1));

2. making payments to regulated interconnectors (clause 3.6.5(a)(2)); and
 3. distributing remaining residues to Network Service Providers (clause 3.6.5(a)(3));
- Auction proceeds and unsold settlements residue is to be distributed to importing transmission network service providers, to be passed on to customers by using the money to reduce network charges (existing clause 3.6.5 and proposed clause 3.18.4).

This means that, after the payment of fees associated with the auction, the proceeds of the auction are to be distributed to end use consumers via NSPs reducing network charges. In this way, the commercial trading of the residue in the market will still result in a settlements residue distribution that is transparent as part of the TNSPs regulated income, can be universally applied, and is equitable, as consumers will receive a benefit via reduced transmission charges. This distribution is also efficient in its retention of the locational signals provided by marginal loss factors.

- Information regarding auction clearing prices, bids and the proceeds of each auction are to be published after each auction (Code clause 3.13.5A).

2.3 Auction rules

The auction rules set out in detail the procedures for conduct of the settlements residue auctions, including:

- Participation criteria;
- Definition and quantum of units to be auctioned for each directional inter-connector;
- Auction timetable;
- Reserve price determination methodology;
- Bidding procedures;
- Allocation of units;
- Determination of the clearing price; and
- Procedures for notification of auction results and fees.

2.4 Auction participation agreements

Auction participation agreements will be entered into between NEMMCO and each person wishing to bid in the settlements residue auctions. The agreements set out that a successful bid in an auction means that NEMMCO and the bidder have entered into a settlements residue distribution agreement (SRD Agreement). A SRD agreement

specifies the purchase price and distribution rights that arise from the successful bid. The auction participation agreements also set out:

- Dispute resolution procedures;
- Liability limitations and waivers;
- Termination procedures; and
- Other general terms and conditions.

3. Competitive Impact

3.1 Public benefits

3.1.1 Facilitation Of Interstate Trade & Efficient Use Of The IRSR

The applicants claim that the physical limitations on the transfer of electricity between regions, and the way in which these limitations are incorporated in NEM dispatch and pricing rules result in significant financial risks in inter-regional trade.

The applicants state that the principal objective of the auction process is to provide the basis for a hedge for market participants who trade in electricity (and associated financial products) between regions in the NEM.

By facilitating a means for market participants to manage the risks of inter-state trade, the applicants contend that the auction process is intended to promote inter-state trade and enhance competition and market efficiency in the wholesale and retail markets for electricity in the participating jurisdictions, as well as the market for related financial products.

The applicants state that public benefits arise from the facilitation of interstate trade in electricity, and through increased retail competition arising from a better ability of retailers to manage inter-regional trading risks. The applicants also claim that follow-on benefits will arise from the increased competition in the NEM and retail markets. This competition should lower end use prices which will potentially benefit households and industry. The applicants note that increasing retail competition will facilitate reforms as more end users become contestable.

The applicants also submit that the auction process provides a more efficient use of the IRSR than current arrangements, because the IRSR can be used to lower both energy prices (by making the IRSR available as an inter-regional hedging tool) and transmission use of system costs (by distributing the IRSR auction proceeds through NSPs to network users via the NEC provisions).

3.2 Anti-competitive Detriment

Potentially anti-competitive elements of the proposed changes are:

- *Limited Auction Participation*: Clause 3.18.2(1)(b) limits participation in the auction process to those registered under the NEC as Generators, Market Customers or Traders³;
- *Pricing arrangements*: NEMMCO is given the power to set a reserve price in relation to each block of settlement residue sold for a particular region and clause 3.18.3(a)(3) & clause 3.18.3(b)(3) contemplates the setting of a common clearing price. NEMMCO's submission states that the common clearing price is set at the lowest bid price in respect of which inter-regional settlements residue is sold; and
- *NEMMCO's discretion with respect to rule changes*: NEMMCO is given discretion to develop rules governing auctions (clause 3.18.3), and clause 3.18.3(e) provides that NEMMCO must develop and amend the auction rules in accordance with the Code Consultation procedures. However, clause 3.18.3(f) provides a significant exception and states changes to the auction rules can be made by a three-quarters majority of the "Settlements Residue Committee" when viewed as "urgent" or for any reason within three months of the conduct of the first auction.

³ A new clause 2.8A is proposed to be included which defines a Trader as a person registered with NEMMCO as a Trader in order to participate in auctions.

4. Commission Considerations

This section outlines the Commission's evaluation of the proposed IRSR auction process in accordance with the statutory test as set out in section 1.2 of this determination.

4.1 Public Benefits

4.1.1 Facilitation Of Interstate Trade In Electricity & Efficient Use Of the IRSR

What the applicants say

The applicants claim that public benefits arise from:

- the facilitation of interstate trade in electricity; and
- increased retail competition arising from a better ability of retailers to manage inter-regional trading risks.

The applicants also claim that follow-on benefits will arise from the increased competition in the NEM and retail markets:

- lower end use prices will potentially benefit households and industry; and
- reforms will be facilitated as more end users become contestable.

The applicants also submit that the auction process provides a more efficient use of the IRSR than current arrangements, because the IRSR can be used to lower both energy prices (by making the IRSR available as an inter-regional hedging tool) and transmission use of system costs (by distributing the IRSR auction proceeds through NSPs to network users via the NEC provisions).

Commission Considerations

In its 10 December 1997 determination, the Commission accepted that inter-regional trade is important to the overall integrity and efficiency of a national market for wholesale trade in electricity. The Commission still holds this view.

That previous determination also rejected the central provision of an IRH exchange by NEMMCO, as this was not seen to represent the minimum required in order to commence a market in IRHs. The current proposal gives NEMMCO a lesser role than central provision of an IRH exchange. The SRA process does not involve NEMMCO in secondary trading of IRHs or require NEMMCO to develop and sell inter-regional contracts. The SRA proposals are seen as a proposal that facilitates inter-regional hedging, as required by the 10 December 1997 determination.

The Commission agrees that being able to hedge the price separation between adjacent regions in the NEM reduces trading risk and thus increases the potential for inter-regional trade in electricity. The Commission agrees that the facilitation of interstate

trade should result in a benefit to the public, with greater competition leading to greater economic efficiency and potentially lower energy prices.

This benefit should arise through an increased ability to manage the price risks associated with inter-state trade on the part of generators and retailers. As such, the benefits may manifest themselves in both increased retail competition in each region of the NEM and lower energy prices, reflecting the lower risk management costs.

The Commission notes that, in addition to enhancing available inter-regional trading hedging mechanisms, the IRSR auction process still enables the IRSR auction proceeds to be used to deliver benefits to customers through the reduction in TUOS charges in accordance with the Commission's 10 December 1997 determination.

4.2 Anti-competitive detriment

NECA submitted changes to the NEC for authorisation under Part VII of the TPA. Other documents relating to the Settlements Residue Auction process, namely the Auction Participation Agreements and the Auction Rules, do not form part of the applications and therefore do not receive immunity from the Act. Therefore, some of the conditions imposed in this draft determination ensure that elements of anti-competitive detriment that wish to obtain immunity from the TPA are specifically referred to in the NEC provisions presented for authorisation.

4.2.1 Limited Auction Participation

Clauses 3.18.2(b) and 3.18.3(a)(1) give NEMMCO broad powers to set criteria that define the "eligible persons" that may bid in the auctions for the settlements residue. NEMMCO has indicated that these provisions of the NEC will be used to create auction rules that:

- exclude current South Australian generators from participating in the settlements residue auctions in respect of imports of electricity into South Australia from Victoria; and
- exclude network service providers from participating in settlements residue auctions.
- The auction rules also allow for exclusion from the settlements residue auctions where prospective participants:
 - are not party to an auction participation agreement; or
 - have defaulted on payment obligations, either in respect of auction participation agreements or NEC obligations; or
 - are believed by NEMMCO to be acting for or in concert with a participant that would otherwise be excluded from participating in the settlements residue auctions.

Issues for the Commission

The exclusion of South Australian generators and network service providers from the auction process may breach section 45 by constituting an exclusionary provision or by substantially lessening competition.

The Commission considers that the exclusion of defaulting parties, of those who are not bound to Auction Participation Agreements and of those believed to be acting in concert with excluded parties reflects sound commercial practice and does not raise any competition concerns.

What the applicant says

NEMMCO states that the purpose of these participation restrictions is to ensure that the inter-regional settlements residue can be acquired by persons likely to use it to support inter-state trade in electricity.

NEMMCO states the participation of South Australian generators in the auction process for residues flowing from Victoria to South Australia would defeat the primary objective of facilitating competition in the retail markets in South Australia. This is because the South Australian generators have the ability to influence the regional spot price for electricity through their bidding strategies. The vesting contract arrangements in South Australia attempt to remove the incentive for generators to attempt to set high spot prices. However, as spot prices are a determinant of the inter-regional settlements residue, allowing South Australian generators to participate in auctions for the residue relating to flows from Victoria into South Australia creates an incentive for the generators to attempt to drive spot prices in South Australia to very high levels, so as to maximise the value of the settlements residue. NEMMCO states that this is likely to inhibit rather than promote competition.

Further, NEMMCO states that the purchase of the settlements residue rights by South Australian generators would place generators in a position to control contracting in relation to the supply of electricity in South Australia.

NEMMCO also notes that the restricting of South Australian generators from participating in the settlements residue auction in respect of South Australian imports does not restrict the generators from participating in any other settlements residue markets, including any secondary markets that may develop.

In a similar fashion, NEMMCO states that, as owners of regulated interconnectors, transmission network service providers have the ability to influence the flow of electricity across the inter-connector, and thus the value of the settlements residue. NEMMCO state that this is likely to inhibit rather than promote competition. With an ability to influence the size of the settlements residue, NEMMCO argue that transmission network service providers could have an incentive to bid to acquire the settlements residue for their own benefit, rather than making the residue available for use as an inter-regional hedge.

What interested parties say

None of the submissions referred to the issue of limited auction participation.

Commission Considerations

The limits on participation are intended to ensure that certain parties do not unfairly capture the benefits of the settlements residue auction process. In particular, South Australian generators and transmission network service providers have limited access to bidding for the IRSR because of their ability to influence the value of the settlements residue.

In relation to South Australian generators, their ability to influence the South Australian regional spot price is significant, because the SA/Victorian interconnector is frequently constrained. As a result, marginal generators in SA can set the regional price and thus have a direct influence on the size of the settlements residue. If they have rights to the residue for energy flows imported into the South Australian region, they have both the incentive and the ability to inflate both the spot price and thus the residue outcome.

Transmission Network Service Providers (TNSPs) have the ability to directly influence the constraints applying to interconnectors, and thus the volume of electricity dispatched through an inter-connector at a particular time. This will directly impact upon the residue outcome.

However, the eligibility provisions of the auction rules provided in the original application (auction rules dated 22 June 1999) have the effect of excluding all network service providers from the auction process, which is likely to also exclude many incumbent market customers (where the market customers are linked to distribution network service providers). NEMMCO have advised the Commission that distribution NSPs were not intended to be excluded from the auction process. More importantly, the amendments to the application proposed by NECA on 22 June 1999 make it clear that only TNSPs, and not DNSPs, are excluded.

In relation to South Australia, the Commission sees merit in the exclusion of South Australian generators from bidding for units relating to flows from Victoria to South Australia, and the total exclusion of TNSPs from the auction process to avoid market distortions. Wherever a party has both the incentive and the ability to directly influence the residue outcome, allowing that party to bid for the settlements residue will create marketplace distortion, simultaneously depriving the other bidders from obtaining the residue necessary to hedge their inter-regional risk.

Furthermore, it would seem logical to extend this prohibition to all parties in a position to directly influence the residue outcome. Snowy is unique in the NEM for being the only region not containing loads, relying entirely on inter-regional trade between Snowy and the NSW and Victoria regions. As spot prices are a determinant of the inter-regional settlements residue, the SMHEA's bidding strategies as a generator have the ability to influence the size of the residues between Snowy and other regions. The Commission therefore sees merit in the exclusion of Snowy from bidding for residues flowing into it from NSW and Victoria. As this limitation will not apply to flows exported from Snowy, this should not have a deleterious impact upon Snowy's ability to hedge inter-regional trades.

The Commission considers that the exclusion of these categories of participants will enhance the public benefits arising from the conduct of the settlements residue auctions, by enabling the residue to be made available to parties that wish to utilise the hedging properties of the IRSR, rather than allowing the IRSR to be bought by those that are well placed to influence its future value.

Market Network Service Providers (MNSPs) are non-regulated interconnectors provided for by the NEC. In the future, depending upon the degree to which an MNSP's activities can influence flows across regulated interconnectors and prices between regions the subject of IRSR auctions, their ability to participate in Settlements Residue Auctions as a purchaser of units of IRSR may need to be reviewed.

As a condition of its interim authorisation, the Commission required that the criteria for exclusion from the auction process be specified as part of clause 3.18 in the NEC, rather than residing in documents outside the NEC such as auction rules and auction participation agreements. The Commission believes that the criteria for exclusion should be included in the NEC provisions to ensure transparency and clarity relating to participation conditions, as those interested in the SRA process need not resort to documents outside the NEC to discover the conditions of participation.

Condition of Authorisation

In its interim authorisation, the Commission imposed the following condition concerning limitations on auction participation:

C4.1 Clause 3.18.2 of the NEC must be amended to state that the eligibility criteria set out in the auction rules may only exclude:

- (a) persons that have not entered into an auction participation agreement; or**
- (b) transmission network service providers; or**
- (c) persons registered under the Code as Generators and licensed to generate electricity under the Electricity Act 1996 (South Australia) or exempted from the requirement to obtain such a license, as at 1 January 1999, but only in relation to bidding and purchasing units of settlements residues relating to the Victoria to South Australia directional inter-connector; or**
- (d) persons who have defaulted on payment obligations under an auction participation agreement or otherwise under clause 3.15.21 of the NEC; or**
- (e) any person acting on behalf of or in concert with a person described in paragraphs (a) to (d) above.**

This condition was imposed to ensure greater transparency, by including the exclusions from participation in the Code itself, rather than in external documents. This was also done to eliminate the ability to introduce further restrictions on participation through

terms and conditions in documents outside the Code such as the Auction Rules and the Auction Participation Agreements.

NECA submitted amendments to clause 3.18.2 on 22 June 1999 to meet the condition of interim authorisation C4.1 described above. This draft determination imposes the same condition of authorisation, adding one more category of exclusion from participation:

- (ca) the Snowy Mountains Hydro Electric Authority, registered under the Code as a Generator, but only in relation to bidding and purchasing units of settlements residues relating to the New South Wales to Snowy directional inter-connector and the Victoria to Snowy directional inter-connector; or**

4.1.2 Pricing Arrangements

The proposed changes to the NEC (clause 3.18.3(b)) allow for a reserve price to be set for each unit of settlements residue to be auctioned. Clause 3.18.3(b) also provides that the auction clearing price for each unit of settlements residue in relation to each directional inter-connector will be a common clearing price.

Issues for the Commission

The setting of a reserve price and the use of a common clearing price may constitute conduct which could contravene section 45 of the Act by maintaining, controlling or fixing prices.

What the applicants say

Section 8.9.2 of the Commission's 10 December 1997 determination relating to the NEC stated that the proposal to distribute the settlements residue to end use consumers via NSPs reducing network charges was the most transparent, equitable and efficient distribution of the IRSR.

NEMMCO has noted section 8.9.2, stating that the purpose of the reserve price and common clearing price provisions is to meet the Commission's objective of providing the benefit of the IRSR to end-use consumers by way of reduced network service charges and accordingly, ensuring the most efficient possible use of the IRSR.

NEMMCO stated that the auctions have been designed to achieve bid prices so that the auction proceeds (and, accordingly, the reduction in network service charges) reflect the value of the settlements residue. NEMMCO states that jurisdictions are concerned that the value of the settlements residue is preserved, and therefore favour the setting of a reserve price by NEMMCO.

What interested parties say

As part of the code change consultation conducted by NECA and subsequently as part of the Commission's consultation process, Hazelwood Power expressed concern at the need to set a reserve price. Bardak and United Energy expressed similar concerns.

Hazelwood Power's submission stated that unfettered access to the settlement residues should enable inter-regional price exposure to be managed, leading to increasing liquidity in the financial swaps market and a more efficient retail market.

Hazelwood Power agreed with the applicants that a fair market price should be paid for the IRSR, as the proceeds of the auctions will be used to offset the TUOS charges incurred by end-use customers. However, Hazelwood Power contend that market participants are able to more accurately estimate the value of the IRSR than consultants and the jurisdictions. The market would quickly establish an appropriate price to be paid for the IRSR sold at auction.

Commission considerations

Reserve price

The rationale for setting a reserve price is to maintain the value of the IRSR at auction. The jurisdictions, as representatives of end use customers, wish to ensure that the auction proceeds – which will flow to end use customers via a reduction in TUOS charges – reflect the initial value of settlements residues. In setting a reserve price, the end use customers are guaranteed a minimum benefit, and the opportunity for auction participants to make windfall arbitrage gains is decreased.

The fact the reserve prices are set as a fraction⁴ of the independently assessed value to the market of the settlements residue using historical market data, does not, on its own, distort the likely market outcome. To estimate whether the prices would have been lower without the reserve, auction results up to and including September 1999 have been examined. 14 separate auctions have been conducted, relating to quarters up to and including July 2000. The structure of the auction process provides for 4 auctions in relation to each relevant quarter. At each of these auctions, 25% of the available IRSR in relation to a particular quarter is made available to bid for. These auctions are held 3 months apart. In relation to each individual tranche available for auction, none of the units auctioned has sold for the reserve price. All auctions have been at prices exceeding the reserve price.

It would seem therefore that while the reserve has acted as the floor, the market has assessed the value of the IRSR to be greater than that implied by the reserve price. It would therefore follow that if there was not a reserve price, the auction would have still produced largely similar results.

Nevertheless, the Commission is of the view that not allowing market customers to bid below a pre determined bid price risks creating anti-competitive effects that impact upon the efficiency of market outcomes. Accordingly, the Commission believes there is an argument that the setting of a reserve price should be an interim measure only, to

⁴ Clause 7 of the Auction Rules (dated 22 June 1999) sets out the proportion of the IRSR valuation which is to form the reserve price. The highest proportion exists in relation to the Victoria to South Australia directional interconnector, where the reserve price is 70% of the estimated value of the settlements residue. The lowest proportion (0%) exists in relation to reserve prices for the South Australia to Victoria and NSW to Snowy directional interconnectors. The reserve price is zero in relation to those interconnectors.

assist in the process of price discovery while the market for IRSR through the auction process is immature. Consequently, this ability to set a reserve price is not to be applied in relation to IRSR accumulated after 31 December 2001. However, the Commission welcomes further comments from interested parties relating to this issue.

C4.2 Clause 3.18 of the NEC must be amended to state that the setting of reserve prices in relation to auctions of units of inter-regional settlements residue will only apply to residues accumulated on or before 31 December 2001.

Common clearing price

The Commission believes that the calculation of the common clearing price is unable to influence bidding strategies and therefore is unlikely to distort market outcomes.

4.1.3 NEMMCO's discretion and rule change processes

Among other things, the changes to the NEC allow NEMMCO:

- to suspend or cancel auctions; (clause 3.18.2(d) and 3.18.2(e)⁵) and
- to choose the valuations which make up the reserve price; (clause 3.18.3(b) states that the reserve price may be set, but the discretion of NEMMCO in this regard is set out in Rules); and
- to set conditions on auction participation (clause 3.18.2); and
- to set the *auction expense fees* payable by all auction bidders (clause 3.18.3(a)(4)).

Clause 3.18.5 establishes a “Settlements Residue Committee” made up of representatives for the market participants. This Committee’s functions will include approving proposed auction rule changes, auction suspensions and costs and expenses incurred by NEMMCO in conducting auctions: clause 3.18.5(b). Within 3 months of the conduct of the first auction or at any other time if the amendment is considered “urgent”, clause 3.18.4(f) enables NEMMCO to avoid the Code consultation procedures by obtaining the agreement of a ¾ majority of the Settlements Residue Committee in relation to the proposed changes.

⁵ Code clause 3.18.4(d) provides that NEMMCO can amend the rules at any time with the approval of the SRC. Clause 3.18.5 of the Code changes provides that the SRC is to be made up of a chairman appointed by NEMMCO, and one representative for each of the following participants: a Generator, a Market Customer, Transmission Network Service Providers, Traders, Ministers of participating jurisdictions, and end use customers. In every participation category apart from end use customers, the appointment or removal of the representative is to be agreed by 1/3 of that class of participant. In the case of end use customers, NECA has the power of appointment (clause 3.18.5(c)(7)) and can remove the representative at any time for any reason (clause 3.18.5(g)).

Issues for the Commission

In giving considerable discretion to NEMMCO to define the rules governing the conduct of settlement residue auctions, clause 3.18.3 has the potential to affect the public benefit or anti-competitive detriment of the auction arrangements. In a similar way, the power to amend the rules conferred on NEMMCO with the approval of the Settlements Residue Committee in clause 3.18.3(d) –(f) is indicative of a wide discretion which can alter the balance of the anti-competitive detriment and public benefits associated with the settlements residue auction process.

What the applicants say

NECA has stated that the changes to the NEC seek to “ensure that NEMMCO is property and adequately accountable for the way in which it administers the auction process.”

What interested parties say

As part of the consultation process conducted by the Commission, Ergon Energy, Hazelwood Power, and United Energy expressed concerns relating to the discretions that can be exercised by NEMMCO, and the role of the “Settlements Residue Committee” (SRC) in the exercise of those discretions.

Ergon Energy is concerned about how the role of overseeing NEMMCO performance is given to the SRC. They submit that the existence of the SRC is not sufficient oversight for the auction rule change process.

Ergon Energy and Hazelwood Power also express concerns about the ability of NEMMCO and the Committee to change the auction rules when viewed as “urgent” or for any reason within three months of the conduct of the first auction. The term “urgent” was not defined, and they argue disputes may arise as to if this broad power is triggered.

When looking at the decision-making power of the Settlements Residue Committee, Ergon Energy also expressed concern that the level of consensus required to obtain the “approval” of the Committee was unclear. This “approval” is required for:

- changes to the auction rules (clause 3.18.3(d));
- the suspension of, or the removal of suspension of an auction (clause 3.18.2.(d)); and
- the amount of auction expense fees to be levied (clause 3.18.4(c)).
- clause 3.18.3(f) provides that auction rule changes need not go through the Code consultation procedures if three quarters of the SRC agree and NEMMCO considers that the amendment is “urgent” and the amendment is made within three months of the first SRA. The first SRA was conducted during July 1999. Therefore, the ability to make changes to the auction rules which do not conform with the Code consultation procedures ceases in October 1999.

The power of NEMMCO to cease conducting auctions after complying with Code consultation procedures under clause 3.18.2(d) and (e) is also of concern to Ergon Energy and Hazelwood Power. Hazelwood Power states that the cessation of auctions may, in effect, expose market participants to regulatory risk by removal of an expected vehicle for risk management, and should therefore be avoided.

Clause 3.18.5(e) provides that, apart from the NEMMCO employee acting as chairperson and the end user representative appointed by NECA, one third of the relevant class of Code participants in each category must agree to the appointment and removal of the committee representative for that category. Ergon Energy point out that it is quite possible that two candidates advanced by opposing sections of a Code Participant class could rally more than one third of the support of that class of Code Participant, rendering that clause ineffective.

In relation to the auction expense fees, Ergon Energy and Hazelwood Power express concern that the level of these fees is unknown.

Commission considerations

When considering the amendment of the auction rules, clause 3.18.3(d) provides that the approval of the settlements residue committee is a prerequisite. In general, these amendments must be developed utilising the Code consultation procedures provided in Chapter 8 of the NEC to take into account the impact on all participants by ensuring that the decision making explicitly takes into account their interests.

The role of the Settlements Residue Committee in approving the actions of NEMMCO relating to the suspension or recommencement of the auction process and the charging auction fees represents a new level of scrutiny and accountability in relation to NEMMCO's exercise of its functions.

The Commission considers that the establishment of a Settlements Residue Committee is a step forward in ensuring that NEMMCO is properly and adequately held accountable for the way in which it administers the auction process. This is especially reflected in the auction monitoring, review and reporting role the Settlements Residue Committee is given in clause 3.18.5 of the Code.

NEMMCO's accountability is enhanced by seeking to ensure that the Committee's industry representatives are genuinely representative of their market sectors, and that all market sectors, including end users, are included. The involvement of the Committee in approving NEMMCO's proposed changes to the auction rules provides for a greater level of accountability to Code participants and end users than is provided for in relation to NEMMCO's market operations role.

Although greater procedural clarity is desirable, the Commission believes that inclusion of the proposed consultation procedures, involving both the code consultation procedures and the settlements residue committee, will reduce the risk of inappropriate use of NEMMCO's discretionary powers, and thus enhance overall public benefits.

5. Draft Determination

Although the Commission considers that some of the proposed arrangements and conduct set out in the SRA proposals would be likely to lessen competition, it also considers that there is likely to be a significant public benefit resulting from the proposed arrangements and conduct. For the reasons outlined in section 4, the Commission concludes that, subject to the conditions set out below, in all the circumstances the proposed Settlement Residue Auction arrangements and conduct:

- 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; and
- 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.

The Commission proposes, subject to any pre-determination conference requested pursuant to s.90A of the TPA, to grant conditional authorisation to applications A90671, A90672 and A90673 as amended on 24 May 1999 and 22 June 1999.

The Commission now invites the applicants or interested parties to notify it within 14 days of 27 October 1999 as to whether the applicants or interested party wishes the Commission to hold a pre-determination on this draft. Note that, if a pre-determination conference is not called, this draft determination will become final. If authorisation is granted, it will expire on 31 December 2001.

The authorisation that the Commission proposes to grant is subject to the following conditions:

- C4.1 Clause 3.18.2 of the NEC must be amended to state that the eligibility criteria set out in the auction rules may only exclude:**
- (a) persons that have not entered into an auction participation agreement; or**
 - (b) transmission network service providers; or**
 - (c) persons registered under the Code as Generators and licensed to generate electricity under the Electricity Act 1996 (South Australia) or exempted from the requirement to obtain such a license, as at 1 January 1999, but only in relation to bidding and purchasing units of settlements residues relating to the Victoria to South Australia directional inter-connector; or**
 - (ca) the Snowy Mountains Hydro Electric Authority, registered under the Code as a Generator, but only in relation to bidding and purchasing units of settlements residues relating to the New South Wales to Snowy directional inter-connector and the Victoria to Snowy directional inter-connector; or**

- (d) persons who have defaulted on payment obligations under an auction participation agreement or otherwise under clause 3.15.21 of the NEC; or**
- (e) any person acting on behalf of or in concert with a person described in paragraphs (a) to (d) above.**

C4.2 Clause 3.18 of the NEC must be amended to state that the setting of reserve prices in relation to auctions of units of inter-regional settlements residue will only apply to residues accumulated on or before 31 December 2001.