

Applications for Authorisation

National Electricity Code Administrator

Market Operations for Y2K Regulated Interconnectors and Augmentations and System Security Compensation

Date: 20 October 1999

Authorisation nos:
A90701, A90702, A90703

File no: C1999/391

Commissioners: Asher
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Executive Summary

On 23 July 1999, NECA lodged three applications with the Australian Competition and Consumer Commission (the Commission) for authorisation of changes to the National Electricity Code (the Code) dealing with:

- market operations for Y2K;
- the regulatory test for new interconnectors and network augmentations; and
- deferral of compensation payments for system security directions.

Market operations for Y2K

The proposed change sets a ceiling of \$300/MWh and a zero floor on the electricity spot price in order to manage financial risks in the market over the three days beginning on 31 December 1999.

The application was made under sub-section 88(1) of the *Trade Practices Act 1974* (TPA) for authorisation of an arrangement, which may have the effect of substantially lessening competition within the meaning of section 45 of the TPA.

Market participants disagreed about the level of the proposed price floor. Some parties suggested a -\$300 floor price, generators proposed a -\$50 floor price, while retailers suggested a zero floor price.

The Commission has conditionally authorised the recommendation of the NECA Code change panel. In doing so, the Commission notes that the arrangement is of a short duration and that a zero floor price has been a feature of the market to date.

The Commission has accepted the applicant's arguments that the proposed arrangements provide public benefit as they limit risks and restrict unnecessary losses for end use customers and market participants during the Y2K period. Moreover, subject to a condition, the Commission believes that, on balance, these public benefits outweigh any anticompetitive detriment.

Regulated interconnectors and network augmentations

The proposed change would remove the existing *Customer* benefits test for new regulated interconnectors and network augmentations. This customer benefits test would be replaced with a *regulatory test* to be determined by the Commission.

The application was made under sub-section 88(1) of the TPA for authorisation of an arrangement, which may have the effect of substantially lessening competition within the meaning of section 45 of the TPA.

The Commission believes the proposed regulatory test provides public benefit as it encourages least cost network expansion.

Compensation payments for system security directions

The proposed Code derogation defers NEMMCO's obligation to make compensation payments to generators for system security directions until the earlier of:

- two months after the Code is amended to provide a mechanism for NEMMCO to fund compensation; or
- 31 January 2000.

The application was made under sub-section 88(8) of the TPA for authorisation to engage in conduct that may constitute the practice of exclusive dealing.

The Commission accepts the applicant's arguments that the proposed arrangements provide public benefit. Moreover, the Commission believes that, on balance, these public benefits outweigh any anticompetitive detriment.

Commission considerations

The Commission issued a draft determination outlining its position on the applications on 22 September 1999. No pre-decision conference was called by the applicant or any interested party in respect of the Commission's draft determination.

Subject to certain conditions being met, the Commission considers that the public benefits are sufficient to outweigh anticompetitive detriment. Accordingly, the Commission has granted conditional authorisation to applications A90701, A90702 and A90703.

Moreover, the Commission has included dates at which the authorisation expires. As part of the draft determination, the Commission inadvertently proposed an expiry date of 10 January 2001 for the application relating to market operations for the Y2K period. The Commission has rectified this error in this determination and has stipulated an end date of 10 January 2000 for the application relating to market operations for the Y2K period. The Commission understands that this change will not have an impact on the Code changes which indicate that the Y2K period can only be extended up until the last trading interval on 9 January 2000.

The Commission has limited the period of authorisation:

- to application A90701, market operations for Y2K, to 10 January 2000;
- to application A90702, regulated interconnectors and network augmentations, to 31 December 2010; and
- to application A90703, compensation payments for system security directions, to 31 March 2000.

Conditions of authorisation

C5.1 At least one month prior to the start of the three day Y2K period, NECA must publish its criteria for extending the price cap and floor beyond the three day period. The criteria must be Y2K related. If NECA decides to extend the price cap and floor beyond the three day period, it must publish the reasons for its decision, based on the criteria.

C5.2 NECA must amend clause 5.6.5(q)(2) of the Code to read, 'The ACCC must have regard to the need to ensure that the *regulatory test* is consistent with the basis of asset valuation determined by the ACCC for the purposes of clause 6.2.3'.

C5.3 Relevant clauses of 5.6.1 to 5.6.6 that talk of comparing network options with generation and demand side options should be amended to ensure that any market network service provider option is also considered as part of the assessment.

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1. Introduction

On 23 July 1999, the National Electricity Code Administrator (NECA) lodged three applications with the Australian Competition and Consumer Commission (the Commission) for authorisation of changes to the National Electricity Code (the Code) dealing with:

- market operations for Y2K (application A90701);
- the regulatory test for new interconnectors and network augmentations (application A90702); and
- deferral of compensation payments for system security directions (application A90703).

Applications A90701 and A90702 were made under sub-section 88(1) of the *Trade Practices Act 1974* (TPA) 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. Application A90703 was made under sub-section 88(8) of the TPA for authorisation to engage in conduct that constitutes, or may constitute, the practice of exclusive dealing.

1.1 Statutory test

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

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 anticompetitive aspects of the arrangements, the public benefits arising from the arrangements and weigh the two to determine which is greater. Should the public benefit or expected public benefits outweigh the anticompetitive 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 the public benefits do not outweigh the anticompetitive 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 TPA. However, authorisation provides exemption for the particular conduct applied for only. Authorisation does not provide blanket exemption from all provisions of the TPA.

2. The Applications

2.1 Electricity industry reform

Since the mid 1980s, the Australian electricity industry has undergone significant changes to improve performance. Initially reforms focused on efficiency improvements, such as increasing labour productivity and subsequently on administrative and structural reforms. Most recently, a market for the trade of electricity commenced operating in NSW, Victoria, South Australia, Queensland and the ACT on 13 December 1998. Modification of the market arrangements continues through the Code change process. This assessment considers three such proposed Code changes.

2.2 Market operations for Y2K

NECA, on behalf of Delta Energy, propose a Code change to set a ceiling of \$300/MWh and a zero floor on the electricity spot price in order to manage financial risks in the National Electricity Market (NEM) over the three days beginning on 31 December 1999. There is also scope to extend the arrangement, if necessary, for up to a further seven days in response to a Y2K event.

The application concerns a price cap and price floor, which may constitute a price fixing arrangement in breach of section 45 of the TPA. These arrangements may distort market signals during the Y2K period.

Under most circumstances, management of financial risk is the responsibility of participants. However, the Y2K period is seen as unique and unpredictable. Measures that might otherwise be taken to manage the perceived risks may unnecessarily increase costs, including ultimately to end-use customers. NECA contend that, on this basis, there is a case to intervene in the market process with a market wide mechanism that restricts risks and caps unnecessary and excessive losses, during the critical period.

NECA's proposed price ceiling of \$300/MWh is intended to limit excessive prices whilst not interfering with normal market volatility. Currently, there is a zero floor price and a price ceiling set at VoLL, (\$5000/MWh). The floor price will cease on 13 December 1999 as result of an earlier Commission authorisation condition. The level of VoLL was reviewed and there are proposals to increase it to \$10,000/MWh or \$20,000/MWh over the next few years. The effect of this Code change would be to reintroduce the zero floor price and reduce VoLL to \$300/MWh for three (or ten) days over the Y2K period.

On the basis of its own public consultation, the NECA Code change panel proposed the zero floor price. This represented a change to the original application in which Delta had proposed a floor price of \$-50/MWh.

NECA's rationale is that during the Y2K period, the greatest risk lies with load rather than generation. A large decline in load would lead to a period of excess generation and the spot price would fall below \$0/MWh. In these circumstances, as a result of the working through of contract positions, the generators would stand to make a windfall gain, which could create perverse incentives. Conversely, over contracted retailers and in turn, end use customers would be at risk of substantial losses.

2.3 Regulated interconnectors and network augmentations

Two issues emerged following the National Electricity Market Management Company's (NEMMCO's) rejection of the application for the proposed regulated South Australia – NSW interconnector:

- NEMMCO found the *Customer* benefits test to be highly volatile, which would make it difficult for any proposed augmentation to satisfy the criterion; and

- the NSW Government believed the test was deficient and placed it on the issues register, meaning the NEM would not commence until the issue was resolved to their satisfaction.

NEMMCO approached the Commission to undertake a review of the criterion as part of the Commission's Draft Regulatory Principles.

The Commission engaged the firm Ernst & Young to assist it in conducting the review. In undertaking the review, the Commission conducted a public consultation process. The Commission published the Ernst & Young report in March 1999. Following this, the Commission publicly released a staff paper that acknowledged the merit in the Ernst & Young proposal to change the regulatory test from a *Customer* benefits test to a market benefit test based on maximising net public benefits. On the basis of a further round of public consultations, the Commission released a draft of the regulatory test on 22 September 1999.

Reflecting these developments, NECA, on behalf of NEMMCO propose a Code change that removes the existing *Customer* benefits test for regulated interconnectors and network augmentations and replaces it with a *regulatory test* to be determined by the Commission.

Specifically, the proposed change:

- provides a definition of the regulatory test;
- requires the Commission to promulgate the test and ensure it is consistent with the Commission's assessments of asset values;
- binds all network service providers to apply the test in deciding which network augmentations should proceed; and
- requires the Inter Regional Planning Committee and NEMMCO to apply the test when considering possible system augmentations.

The change is intended to clear the path for the Commission to finalise and promulgate the precise form of the regulatory test. The Commission intends to finalise and promulgate the regulatory test shortly after the proposed Code changes are finalised.

2.4 Compensation payments for system security directions

NECA will shortly submit Code changes to the Commission describing the methodology for NEMMCO to make compensation payments to generators for system security directions.

Until these Code changes are finalised, NECA on behalf of NEMMCO propose a Code derogation to defer NEMMCO's obligation to make compensation payments to generators for system security directions. The deferral is until the earlier of either:

- two months after the Code is amended to provide a mechanism for NEMMCO to fund compensation; or
- 31 January 2000.

3. What the applicant said

3.1.1 Market operations for Y2K

NECA submitted that the NEM is a key area where system failure would have significant adverse impacts on the community. Excessive contracting for the period, particularly of the form envisaged, would add to the cost of electricity for the period. The proposed Code change is aimed at restricting financial risks for both the market and end use customers and to limit unnecessary increases in costs.

NECA add that the anticompetitive detriment is limited as the price cap and floor are set outside the prices which would normally be expected to apply during the period, if the Y2K problem did not exist.

NECA contend the Code change provides public benefit through:

- allowing participants to concentrate on maintaining secure and reliable supply;
- removing the requirement for excessively defensive market positions to manage risk. This reduces the cost of supply to customers; and
- ensuring the market remains within the price boundaries expected during normal operations. This limits the requirement for excessive demand side and supply side rebidding during the period.

3.1.2 Regulated interconnectors and network augmentations

NECA submitted that NEMMCO and the Inter-regional Planning Committee have characterised the current Code test as unworkable. This means the public benefits expected from network expansion are compromised. An alternative test, proposed by the Commission, would allow the public benefits envisaged in the Code to be realised.

This Code change replaces the existing test in the Code, with the test developed by the Commission and thus provides:

- a more appropriate and effective test;
- greater assurance to customers that they are only paying for efficient investments; and
- the public benefit of least cost network expansion.

3.1.3 Compensation payments for system security directions

NECA submitted that the derogation would benefit the public by ensuring that no claims for compensation are processed prior to the appropriate funding mechanism being in place. This will ensure that NEMMCO does not have to increase participant fees, which would potentially introduce a distortionary charge.

4. Public consultations

On 23 July 1999, NECA lodged the application for authorisation with the Commission. The application was placed on the Commission's public register for inspection by interested parties.

The Commission commenced a public consultation process on 2 August 1999, placing a call for submissions in the press and on the Commission's Internet site. Submissions closed on 30 August 1999.

The Commission received submissions from The Australian Cogeneration Association, Australian Greenhouse Office, Edison Mission Energy, EnergyAustralia, Hazelwood Power, Loy Yang Power, NEMMCO, South Australian Department of Treasury and Finance, TransGrid and VENCORP. Copies of the submissions are available from the Commission's public register in the Canberra office.

On the release of the draft determination, there was a further opportunity for interested parties to comment on the Code changes. The Commission received no requests for a pre-decision conference nor were there any submissions on the draft determination.

4.1 What the interested parties said

4.1.2 Market operations for Y2K

The electricity retailer, Energy Australia, was supportive of the proposed Code change and argued that:

Given the enormous focus and uncertainty around Y2K, EnergyAustralia believes that is prudent to put in place the additional commercial protection that would be given by the proposed cap and floor. This would benefit the public by protecting the financial interest of consumers and market participants.

Anti-competitive effects from the proposed code change are considered negligible. (Page 1)

Interested parties were either supportive or silent on the level of the proposed price cap.

Interested parties also supported the proposal for a price floor. However, they disagreed about the appropriate level of the floor price. On the one hand, EnergyAustralia supported a zero floor price during the Y2K period. Hazelwood Power submitted that as long as the zero floor price is removed at the planned date (13 December 1999, one year after commencement of the NEM) then it supports the zero floor price during the Y2K period.

Conversely, the generator Loy Yang Power supported a -\$50 floor price. The generator Edison Mission Energy also supported a -\$50 floor price, but submitted that a -\$300 floor price, to mirror the price cap, was more appropriate. Edison Mission Energy argued that a zero floor price unnecessarily protects market participants. They added:

Participants have had adequate time to set up hedge portfolios appropriate for the period (year 2000).

Participants who trade in secondary financial markets are by definition sophisticated market

Participants and hence have contracted over the year 2000 period with expertise, knowledge and

foresight. In fact most Participants have already built the year 2000 risks into their portfolio. (Page 4)

The only other aspect of the proposed Code change that interested parties commented on was the provisions for extending the period for the price cap and floor beyond the initial 3 day period, for up to a further 7 days. Specifically, Loy Yang Power submitted:

We agree with the proposal that NEMMCO seek the prior approval of NECA to extend the period, but would like to see a fully explained justification for any decision made. (Page 1)

4.1.2 Regulatory test for new interconnectors and network augmentations

Interested parties supported authorisation of the Code change that provides for new regulated interconnectors and augmentations to be assessed according to a test determined by the Commission. For example, NEMMCO submitted:

NEMMCO agrees with having the Code point to a Regulatory Test promulgated by the ACCC. (Page 1)

While TransGrid submitted:

TransGrid broadly supports the replacement of the current Customer benefit criterion for regulated transmission investment with a regulatory test to be promulgated by the ACCC. (Page 1)

Submissions largely focussed on the precise form of the Commission's regulatory test.

4.1.3 Compensation payments for system security directions

Only two parties commented on authorisation of this derogation, Hazelwood Power and Loy Yang Power. Hazelwood Power did not raise concerns with the derogation, noting the methodology for compensation payments for system security directions is in need of review.

5. Commission considerations

5.1 Market operations for Y2K

In the Commission's 10 December 1997 authorisation of the Code, the Commission raised concerns with price caps in the NEM. In particular, the Commission noted that if the price cap is too low, it might affect long term investment signals.

The Commission in that determination also raised concerns with a zero price floor, as not allowing market customers to see negative prices has significant anticompetitive effects upon the efficiency of market outcomes. The Commission concluded one of the conditions of authorisation was the removal of the zero floor price, one year from commencement of the NEM. This means the NEM currently operates with a zero floor price, which will cease on 13 December 1999, only a short time before NECA's proposed zero floor price for Y2K is due to commence again.

The Commission remains of the view that price caps and floor lead to anticompetitive detriment, as they constitute a form of price fixing that distorts market signals and efficient market outcomes.

However, Y2K is an extraordinary set of circumstances and any anticompetitive detriment from constraining market outcomes is limited by the fact that the price cap and floor will only remain in place for a short duration.

Market participants disagreed about the appropriateness of the proposed zero price floor. For example, some generators suggested a -\$300 floor price to mirror the price cap, other generators proposed a -\$50 floor price, while retailers suggested a zero floor price.

The Commission is not in a position to judge the merits of these arguments. The Commission will authorise the recommendation of the NECA Code change panel. In doing so, the Commission notes that under these arrangements there will be a short return to the zero floor price, which operated in the months preceding Y2K.

The Commission notes the concerns of participants regarding an extension of the price cap and floor beyond the initial three day period, for up to a further 7 days. The Commission considers at least one month prior to the start of the three day Y2K period, NECA should publish their criteria for extension of the price cap and floor. These criteria should be Y2K related, not market related.

The Commission has accepted the applicant's arguments that the proposed arrangements provide public benefit as they limit risks and restrict unnecessary losses for end use customers and market participants during the Y2K period.

Subject to the condition below, on balance, the Commission believes the public benefit outweighs the anticompetitive detriment.

The Commission will limit the period of authorisation to 10 January 2000. This date is shortly after NECA's proposed Y2K arrangement would cease.

Condition of authorisation

C5.1 At least one month prior to the start of the three day Y2K period, NECA must publish its criteria for extending the price cap and floor beyond the three day period. The criteria must be Y2K related. If NECA decides to extend the price cap and floor beyond the three day period, it must publish the reasons for its decision, based on the criteria.

5.2 Regulated interconnectors and Network Augmentations

The Commission believes the proposed regulatory test will provide public benefit as it encourages least cost network expansion.

However, the Commission notes that part of the proposed change relates to clause 5.6.5 (q)(2) of the Code, which cross references clause 6.2.3 of the Code. However, clause 5.6.5(q)(2) is attempting to place a more onerous obligation than the cross referenced clause 6.2.3. The Commission considers there is need for consistency between clause 5.6.5(q)(2) and clause 6.2.3 of the Code.

The Commission is of the view that proposed regulated augmentations should not unnecessarily pre-empt nor distort potential unregulated augmentations. Hence, the Commission considers the Code must require proponents of regulated augmentations to demonstrate that regulated options provide greater market benefit than all unregulated options.

Subject to the conditions below, on balance, the Commission believes that, on balance, the public benefit outweighs any anticompetitive detriment.

The Commission proposes to limit the period of the authorisation to 31 December 2010, the same date for which Commission authorisation of the Code will cease.

Conditions of authorisation

C5.2 NECA must amend clause 5.6.5(q)(2) of the Code to read, ‘The ACCC must have regard to the need to ensure that the *regulatory test* is consistent with the basis of asset valuation determined by the ACCC for the purposes of clause 6.2.3’.

C5.3 Relevant clauses of 5.6.1 to 5.6.6 that talk of comparing network options with generation and demand side options should be amended to ensure that any market network service provider option is also considered as part of the assessment.

5.3 Compensation payments for system security directions

The Commission accepts the applicant’s arguments that the proposed arrangements provide public benefit. Moreover, the Commission believes that, on balance, these public benefits outweigh any anticompetitive detriment.

The Commission will limit the period of the authorisation to 31 March 2000, the date of when this derogation will cease.

6. Determination

For the reasons outlined in section 5 of this determination, the Commission concludes that subject to the conditions below, in all circumstances the proposed arrangements and conduct for which NECA has sought authorisation:

- are likely to result in a benefit to the public which outweighs the detriment from any lessening of competition that would be likely to result from the arrangements; and
- are likely to result in such benefit to the public that the arrangements should be allowed to be given effect to.

On 22 September 1999, the Commission issued a draft determination proposing to grant conditional authorisation of the proposed Code changes. There was no request, pursuant to section 90A of the Act, for a pre-decision conference to be held in respect of the draft determination. The Commission therefore affirms its draft determination and grants conditional authorisation in respect of applications A90701, A90702 and A90703.

Moreover, the Commission has included dates at which the authorisation expires. As part of the draft determination, the Commission inadvertently proposed an expiry date of 10 January 2001 for the application relating to market operations for the Y2K period. The Commission has rectified this error in this determination and has stipulated an end date of 10 January 2000 for the application relating to market operations for the Y2K period. The Commission understands that this change will not have an impact on the Code changes which indicate that the Y2K period can only be extended up until the last trading interval on 9 January 2000.

The Commission has limited the period of authorisation:

- to application A90701, market operations for Y2K, to 10 January 2000;
- to application A90702, regulatory test for new interconnectors and network augmentations, to 31 December 2010; and
- to application A90703, compensation payments for system security directions, to 31 March 2000.

The date of this determination is 20 October 1999. A person dissatisfied with this determination may apply to the Australian Competition Tribunal for its review.

Conditions of authorisation

C5.1 At least one month prior to the start of the three day Y2K period, NECA must publish its criteria for extending the price cap and floor beyond the three day period. The criteria must be Y2K related. If NECA decides to extend the price cap and floor beyond the three day period, it must publish the reasons for its decision, based on the criteria.

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C5.3 Relevant clauses of 5.6.1 to 5.6.6 that talk of comparing network options with generation and demand side options should be amended to ensure that any market network service provider option is also considered as part of the assessment.