

2 March 2015

Mr John Pierce
Chairman
Australian Energy Market Commission
PO Box A2449
South Sydney NSW 1235

By facsimile: 02 8296 7899

Dear Mr Pierce

Options Paper – National Electricity Amendment (Bidding in good faith) Rule 2014 (Project Reference Code: ERC0166)

Arrium Limited ("**Arrium**") appreciates the opportunity to provide comments in response to the Options Paper titled *National Electricity Amendment (Bidding in good faith) Rule 2014* dated 18 December 2014.

Arrium is an ASX listed company with assets both in Australia and overseas. Its Australian assets include steel manufacturing, recycling and distribution facilities across Australia as well as iron ore mining operations in South Australia.

Arrium is a large energy user operating in all regions of the National Electricity Market ("**NEM**") and, as such, has a strong interest in ensuring that the electricity market is and remains competitive and operates efficiently and effectively.

Executive Summary

It is clear that the current National Electricity Rules ("**NER**") are not effective in preventing bidding behaviour that could be used by some generators to exploit the inability of other market participants to respond to rebids made close to the point of despatch.

Whilst it is noted in the Options Paper that the recent rise in late rebidding has been limited to Queensland and to a lesser extent in South Australia¹, it would seem this is likely to be the result of current market conditions where surplus generation capacity may limit the ability of generators in other regions to engage in similar practices. However, the concern is that, when demand/supply conditions in other regions come back into balance, similar behaviour will be seen unless the NER are modified.

A continuation of the recent market outcomes in Queensland, and the potential for such outcomes to extend into other regions in the future, is not in the long-term interest of electricity consumers and, for this reason, must be addressed.

¹ Options Paper, p iii.

Arrium is of the view that the proposed rule in the rule change request made by the South Australian Government, whilst it has merit, will not be sufficient to address the problems that arise from late rebidding in the NEM.

Arrium strongly supports both the introduction of a gate closure mechanism in the NEM as well as a new Behavioural Statement of Conduct (incorporating an obligation for bids and rebids to be made in good faith) supported by appropriate investigatory powers for the Australian Energy Regulator (“AER”).

Arrium recommends that a 30 minute gate closure period is adopted with rebids permitted within the gate closure period only as follows:

- a rebid should be allowed to the extent that:
 - it is necessary to prevent injury to any person or material damage to property; or
 - the generator is prevented from despatching in accordance with the previous bid or rebid due to an unplanned operational or technical constraint; and
- a rebid should be allowed where the generator is rebidding additional capacity into the market or is rebidding capacity from a high price band to a lower price band.

However, Arrium suggests that the AEMC undertake a review within 12 to 24 months to consider whether the 30 minute gate closure period is sufficient to address the problem of late rebidding or should be extended.

Late Rebidding

Arrium acknowledges that rebidding plays an important role in the competitive outcomes in the NEM by facilitating a process of price discovery where market participants are able to respond to price signals from other participants.

However, as the AEMC has noted, the concern with rebidding arises where it occurs close to the point of despatch because certain generators and energy users are unable to physically respond to the price signal that arises from the rebid.²

The outcome of late rebidding is often, therefore, a higher price than would otherwise have occurred if sufficient time was available for a physical supply and/or demand response.

As analysis by Visy Industries Australia Pty Ltd has shown previously, the number of late rebids that result in high price outcomes disproportionately occur in the last 5 minute dispatch interval of a trading interval.³

The impact of a late rebid is exacerbated if it occurs in the last 5 minutes because it means that virtually any fast-start generation or demand-side response is not possible.

From the perspective of demand-side participation, if a high price event occurs at the start of a trading interval, the energy user is at least able to avoid some of the impact of the high price event (and the potential for further high prices in that trading interval) by reducing consumption for the remainder of the trading interval. However, if the high price event occurs at the end of a trading interval, the impact of the higher price cannot be avoided.

² Options Paper, p7.

³ Visy Industries Australia Pty Ltd, Letter to the AEMC re Rule Change Proposal – SA Govt – Bidding in Good Faith, 22 May 2014.

Therefore, a late rebid in the last despatch interval virtually guarantees no supply or demand response in the trading interval. The effect is twofold. First, it increases the likelihood that the late rebid will spike the price in the last despatch interval which increases the 30 minute average price for the trading interval. Second, it maximises the generation output across the trading interval impacted by the higher settlement price.

Therefore, even where a rebid by a generator results in a low despatch by that generator in the last despatch interval, that generator will still benefit from the higher settlement price if it has despatched load during the other despatch intervals.

In this way, the current design of the market incentivises generators to rebid late and, in particular, to target the last despatch interval in a trading interval.

The Problem

The problem with late rebidding is that it leads to outcomes that are inconsistent with the National Electricity Objective (“NEO”).

The NEO is:

“to promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity with respect to – price, quality, safety, reliability, and security of supply of electricity; and the reliability, safety and security of the national electricity system.”

Late rebidding does not promote the efficient operation of the market or efficient investment in the market.

Rather, late rebidding allows certain generators who are in a position to exploit the current market design to achieve high pool price outcomes which do not reflect the underlying supply and demand conditions.

Whilst this might be good for some generators and their shareholders, it is not good for consumers.

Late rebidding that results in high pool prices today creates an expectation that there will be a continuation of such behaviour which is likely to result in higher pool prices in the future. An expectation of higher pool prices in the future will typically result in higher hedge prices and ultimately higher prices for consumers.

In addition, a less transparent and efficient market is likely to discourage new investment. In particular, late rebidding is likely to discourage investment in new generation that is unable to respond to higher prices within the limited timeframes allowed by such rebidding practices. This could lead to a less optimal mix of generation technologies in the NEM over time.

For these reasons, late rebidding is likely to lead to a higher cost, and a less reliable and secure, supply of electricity in the future.

The Solution

The problem of late rebidding must be addressed in a manner that results in the most optimal outcome for consumers over the long-term.

Any solution must recognise that participants will always operate in their own commercial interests and, therefore, provisions imposing obligations of good faith and behavioural statements of conduct which are inherently difficult to enforce will always be of limited effect.

Whilst such provisions and statements of conduct have a role to play in ensuring that the standard of behaviour expected of market participants is clear, the key is to address the underlying market design issues and, where possible, to create incentives that promote behaviour that is desirable, and to remove incentives that promote behaviour that is undesirable.

It is Arrium's view that a gate closure mechanism which limits rebidding close to dispatch, in combination with a clear and strong behavioural statement of conduct, will result in the most effective means of addressing the problem of late rebidding.

Gate Closure Mechanism

A gate closure mechanism will address the underlying market design issue that has allowed for the rise of late rebidding by preventing or restricting rebids close to the point of despatch.

The argument against gate closure is that it reduces the flexibility for market participants to respond to changing market conditions.

However, this argument fails to recognise that a rebid is, of itself, a change in market conditions because it changes the supply conditions in the market – and such a change can be very material. Whilst there will always be a last rebid, where the rebid occurs close to despatch, many participants are not able to respond due to physical constraints. Therefore, the late rebid itself reduces the flexibility of the market to respond to changing market conditions.

On the contrary, a gate closure mechanism that is of sufficient duration to allow for a meaningful supply and demand response to a rebid will have the effect of improving (not limiting) the ability of the market to respond to changing market conditions.

This view would seem to be supported by international experience. It is instructive to note that all overseas jurisdictions surveyed by the Competition Economics Group ("CEG") imposed a gate closure period. It is submitted that the AEMC should give significant weight to this fact.

The Design of a Gate Closure Mechanism

The AEMC states in the Options Paper that determination of the appropriate form of gate closure requires consideration of the trade-off that exists between:

- the promotion of an iterative process of price discovery and the flexibility of the market to respond to changing market conditions; and
- limiting the ability of participant rebids to disproportionately influence price outcomes close to dispatch.⁴

The AEMC also points out that the level of restrictions on rebids, and the period of time over which the restrictions apply, are both relevant factors in considering this trade-off.⁵

Gate Closure Period

Arrium acknowledges that the longer the gate closure period, the less information that is available to the market to make an informed decision and the less opportunity there is for market participants to respond to any change in market conditions up to the point of dispatch.

Therefore, the gate closure period should be no longer than is needed to allow for a meaningful demand and supply response.

⁴ Options Paper, p42.

⁵ Options Paper, p42.

Arrium understands that a gate closure period of no less than 30 minute would be sufficient to allow for fast-start generators to respond and, according to analysis by Oakley Greenwood, should allow for demand-side response of up to 0.4GW.⁶

A 30 minute gate closure period would also limit the ability for generators to engage in late rebidding that targets the last despatch interval in a trading interval.

While 30 minutes may not be sufficient to allow for all generators and end users to initiate a physical response to a rebid, it should be sufficient time to allow for a meaningful supply and demand response that will act to constrain rebidding activities which are aimed at producing price outcomes which do not reflect genuine market conditions.

For these reasons, Arrium considers that a 30 minute gate closure period should provide a reasonable compromise between reducing the ability of some participants to manipulate prices and maintaining sufficient flexibility for participants to respond to changing market conditions.

Gate Closure Restrictions

Given a 30 minute gate closure period is relatively short (at least by international standards), Arrium recommends that limited exceptions for rebids within the gate closure period be allowed as follows:

- a rebid should be allowed to the extent that:
 - it is necessary to prevent injury to any person or material damage to property; or
 - the generator is prevented from despatching in accordance with the previous bid or rebid due to an unplanned operational or technical constraint; and
- a rebid should be allowed where the generator is rebidding additional capacity into the market or is rebidding capacity from a high price band to a lower price band.

A rebid of additional capacity would enable the market to respond to generation (or network) outages that occur within the gate closure period. This would allow participants to manage market risks and would not be objectionable from a competition or market efficiency perspective.

A rebid for technical or operational reasons recognises that unplanned events can occur which cannot always be avoided.

However, such an exception can still provide opportunities for gaming where, for example, it is not possible to determine the cause of a generation unit tripping or whether the rebid was proportionate to the real impact of the constraint.

For this reason, any generator making a rebid made for technical or operational reasons should be required to provide detailed reasons as to the nature of the constraint, the cause of the constraint and the impact of the constraint. Strong penalties should apply to companies and individuals for providing any false or misleading information or for any failure to provide relevant information in connection with the rebid.

In addition, the rules governing the operation of the market should minimise or, where possible, remove any incentive to use this rebidding exception for commercial reasons.

One option could be to adjust the settlement price in the relevant trading interval for any generator that elects to avail itself of the right to rebid within the gate closure period due to a

⁶ Oakley Greenwood, The impact of late rebidding on the provision of demand response by large electricity users in the NEW, 25 November 2014, p28.

technical/operational constraint such that the settlement price for that generator is calculated as the lower of:

- (a) the average of the price in all dispatch intervals in a trading interval excluding the despatch interval/s in respect of which any such rebid is made; and
- (b) the settlement price (ie the average of the price in each of the six despatch intervals).

In this way, the generator that elects to rebid would not benefit (or, at least, not directly) from any higher price that results from the rebid. This would discourage generators from using technical/operations constraints as potential reasons to justify actions or non-action aimed at achieving commercial outcomes. It would also mean that generators do not benefit financially from plant failures which adversely impact other market participants. The risk of generation plant outages should sit with the generator, not the consumer.

Any surplus monies collected by AEMO in respect of any trading interval where there is a rebid within the gate closure period could be used to fund the operations of the market (which are ultimately borne by consumers) including actions taken by the AER to investigate and, where necessary, prosecute any breaches of the Behavioural Statement of Conduct and the NER as well as the ACCC for any breaches of the *Competition and Consumer Act 2010* ("CCA") and ASIC for any breaches of the *Corporations Act 2001* in relation to activities in the NEM.

It should be noted that, where rebidding within the gate closure period is limited to technical/operational constraints, it would be expected that the instances of late rebidding, and the potential for such instances to correspond with high prices, should be relatively infrequent.

Behavioural Statement of Conduct

Arrium supports the development of a Behavioural Statement of Conduct in combination with the introduction of a gate closure mechanism as the most effective means of addressing the problem of late rebidding.

Rather than replacing the current good faith provisions in the NER, the Behavioural Statement of Conduct should incorporate a general obligation of good faith which requires that a generator must have a genuine intention to honour an offer, bid or rebid at the time it was made and which requires the generator to update a bid or rebid as soon as there is a change in the intentions of the generator.

The Behavioural Statement of Conduct should also specifically prohibit market participants from making offers, bids or rebids which are misrepresentative of its capability to achieve if despatched or which mislead other participants and exploit the limited opportunity of other participants to respond.

Arrium acknowledges the inherent difficulty in enforcing obligations that are based on the subjective intentions. However, subjective intentions can be inferred from a pattern of conduct over time and, therefore, can be beneficial in addressing undesirable conduct that is ongoing. It is also useful in making clear the standards of behaviour that are expected of market participants.

The AEMC notes in the Options Paper that statements of conduct could be developed which target generator behaviour that could likely have led to the creation of false expectations.⁷

⁷ Options Paper, p61.

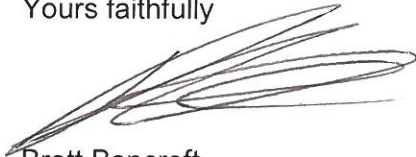
However, the AEMC observes that, while such regulations may be more enforceable, they also risk penalising generators that make a rebid close to despatch where there was a genuine need to do so or which would have led to a more efficient price outcome.⁸

Whilst this is a reasonable observation, it would not seem unreasonable to require generators to provide an explanation for a rebid which is likely to have the effect of creating false expectations. Where the generator is unable to point to a genuine operational/technical need for the rebid or to demonstrate that the rebid was likely to lead to a more efficient price outcome, the generator would be taken to have contravened the regulations.

The AER should be given appropriate powers to investigate any suspected breaches of the Behavioural Statement of Conduct, including the power to require market participants to provide information in connection with their activities in the NEM. Strong penalties should apply for any contraventions.

For further information or clarification in relation to this submission, please contact me by email at brett.bancroft@arrium.com or by telephone on 02 4935 5400 or 0428 257 200.

Yours faithfully



Brett Bancroft
National Manager – Energy & Carbon

⁸ Options Paper, p61.