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**Australian Energy Market Commission**

## **CONSULTATION PAPER**

# **National Electricity Amendment (Potential Generator Market Power in the NEM) Rule 2011**

### **Rule Proponent**

Major Energy Users Inc.

14 April 2011

**RULE  
CHANGE**

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## **About the AEMC**

The Council of Australian Governments, through its Ministerial Council on Energy (MCE), established the Australian Energy Market Commission (AEMC) in July 2005. The AEMC has two principal functions. To make and amend the national electricity and gas rules - and to conduct independent reviews of the energy markets for the MCE.

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# 1 Introduction

## 1.1 Rule change request

On 23 November 2010, the Major Energy Users Inc. (MEU or Proponent) submitted a Rule change request to the Australian Energy Market Commission (AEMC or Commission) in relation to the potential exercise of market power by generators in the National Electricity Market (NEM).

The Proponent's Rule change request is entitled "Proposed Rule change to enhance generator competition outcomes during high demand periods in the NEM". The stated purpose of the proposed Rule change is to prevent or constrain the exercise of market power by generators in the NEM. In particular, the Proponent considers that during periods of high demand, some large generators do not face effective competition and have the ability to use their market power to increase the wholesale price. The Proponent states that this issue is a particular concern in South Australia, but is also a potential issue in other NEM regions.

To address this perceived problem, the Proponent proposes amendments to Chapter 3 of the National Electricity Rules (Rules) that would:

- require the Australian Energy Regulator (AER) to assess which generator(s) in each NEM region has market power and declare that generator(s) to be a 'dominant generator' when regional demand exceeds a specified level; and
- impose restrictions on the dispatch offers that may be submitted by a 'dominant generator' so that when regional demand exceeds the level at which the generator has been declared to be a dominant generator, the dominant generator must offer all of its available capacity for dispatch at a price that does not exceed the administered price cap (APC) of \$300 per megawatt hour (MWh).

The Rule change proposal is described in more detail in Chapter 3 below.

## 1.2 The Rule change process

On 14 April 2011, the Commission published a notice under section 95 of the National Electricity Law (NEL) setting out its decision to commence the Rule change process in relation to this Rule change request.

The Commission is required to commence the Rule change process in relation to any Rule change request it receives that meets the requirements of section 94 of the NEL. We have carefully considered whether the Rule change request meets the statutory requirements, including whether the Commission has the power to make the proposed Rule. This consideration has included issues related to any potential inconsistency between the proposed Rule and the matters covered by the *Competition and Consumer*

*Act 2010* (Cth) (CCA).<sup>1</sup> We have concluded that the Rule change request meets the statutory requirements and that, subject to the issues noted in section 4.3.1, the Commission has the power to make the Proposed Rule.

Commencing the Rule change process does not indicate that the Commission intends to make the proposed Rule. The outcome of this Rule change process may be that the Commission decides to:

- make the Rule change proposed by the Proponent;
- make a more preferable Rule that is different from the Rule change proposed by the Proponent; or
- not make any Rule change.

The Commission may only make a Rule change if it determines that the Rule change will, or is likely to, contribute to the achievement of the National Electricity Objective (NEO).<sup>2</sup> Under section 91A of the NEL, the Commission may only make a more preferable Rule if it is satisfied that, having regard to the issues that were raised by the Rule change proposal, the more preferable Rule will or is likely to better contribute to the achievement of the NEO.

The Rule change process set out in the NEL involves, as a minimum, at least four weeks of public consultation on the Rule change proposal, publication of a draft Rule determination, an option for a public hearing after publication of the draft Rule determination, public consultation on the draft Rule determination, and publication of the final Rule determination.

Due to the complex nature of this Rule change proposal, the Commission has determined to extend some of the standard periods under the NEL, including the period for consultation on the Rule change request, and provide for additional opportunities for consultation with stakeholders. On 14 April 2011, the Commission published a notice under section 107 of the NEL extending the period for publication of the draft Rule determination until 30 April 2012.

The proposed process and indicative timeframes for the Commission's consideration of this Rule change proposal are set out in section 4.2 below.

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<sup>1</sup> On 1 January 2011, the *Trade Practices Act 1974* (Cth) was renamed as the *Competition and Consumer Act 2010* (Cth).

<sup>2</sup> See section 88 of the NEL. The NEO is set out in section 7 of the NEL and discussed in section 4.1 below.

### **1.3 This Consultation Paper**

This Consultation Paper has been prepared by the staff of the AEMC to facilitate public consultation on the Rule change proposal and does not necessarily represent the views of the AEMC or any individual Commissioner of the AEMC.

The remainder of this Consultation Paper is structured as follows:

- chapter 2 provides an overview of the background to this Rule change proposal and describes the issue that this Rule change proposal is intended to address;
- chapter 3 summarises the Proponent's proposed Rule changes;
- chapter 4 discusses the proposed framework for assessing this Rule change proposal;
- chapter 5 identifies a number of issues and questions to guide stakeholders in responding to this Consultation Paper;
- chapter 6 outlines the process for making submissions; and
- Appendix A sets out the Proponent's draft Rule amendments.

## 2 Background to the issue the proposed Rule is seeking to address

### 2.1 Current regulatory framework

The Rules currently do not contain any provisions directly addressing the exercise of market power by market participants.

Clause 3.8.22A of the Rules requires that dispatch offers, dispatch bids and rebids must be made in good faith. However, this clause does not directly address market power issues.

Instead, the Rules state that anti-competitive practices are to be addressed by the CCA. Clause 3.1.4(b) of the Rules provides that:

*“This Chapter is not intended to regulate anti-competitive behaviour by Market Participants which, as in all other markets, is subject to the relevant provisions of the Trade Practices Act, 1974 and the Competition Codes of participating jurisdictions.”*

The CCA prohibits a range of restrictive trade practices, including the misuse of market power. Section 46 of the CCA provides as follows:

#### **46 Misuse of market power**

- (1) A corporation that has a substantial degree of power in a market shall not take advantage of that power in that or any other market for the purpose of:
- (a) eliminating or substantially damaging a competitor of the corporation or of a body corporate that is related to the corporation in that or any other market;
  - (b) preventing the entry of a person into that or any other market; or
  - (c) deterring or preventing a person from engaging in competitive conduct in that or any other market.

Subsequent subclauses of section 46 provide guidance as to the application of this prohibition. Provisions similar to section 46 have been enacted in State and Territory legislation pursuant to the Competition Code Agreement.

Conduct only breaches section 46 if each of the following elements is established:

- the corporation has a substantial degree of power in a market;
- the corporation took advantage of that market power; and
- it did so for one of the proscribed anti-competitive purposes.

As discussed further in section 5.2 below, the CCA does not prohibit the mere existence of market power. It also does not prohibit a corporation from exercising its market power unless it does so for an anti-competitive purpose.

## **2.2 Issue the proposed Rule is seeking to address**

The Proponent considers that some generators in the NEM have market power. The Proponent also considers that during periods of high demand, those generators have the ability and incentive to use their market power to increase the wholesale price.

In the Rule change request, the Proponent defines 'market power' in this context as "an ability of a generator to manipulate the spot price at a regional demand less than the maximum regional demand, by either physical or economic withholding of its capacity."<sup>3</sup> Physical withholding of capacity involves a generator determining not to offer a proportion of its available capacity to the market. The Proponent defines 'economic withholding' as occurring where a generator prices a proportion of its capacity near the market price cap so that it is less likely to be dispatched and other generators will be dispatched ahead of it.<sup>4</sup>

The Proponent considers that there is evidence of the exercise of market power in South Australia. The Proponent also refers to potential instances of the exercise of market power by generators in other regions.

The Proponent considers that the exercise of market power has significantly increased wholesale prices in South Australia. The Proponent also considers that the consequences of the exercise of market power by generators include:<sup>5</sup>

- major energy users incurring substantial economic losses;
- an increase in prices of retail contracts and a general increase in electricity prices;
- an increase in the risk and cost of making transactions in the NEM;
- the exit from the retail market by retailers that are unable to obtain hedge contracts to manage risks; and
- the creation of barriers to new entry in generation and retail.

The Proponent considers that the CCA does not effectively address the problem that this Rule change proposal seeks to address. As discussed above, section 46 of the CCA prohibits the taking advantage of substantial market power for an anti-competitive purpose. The Proponent considers that the generator bidding behaviour that is the subject of this Rule change proposal will not infringe the CCA because the generators' actions are not motivated by an anti-competitive purpose.

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<sup>3</sup> MEU, Rule change request, 23 November 2010, p32.

<sup>4</sup> MEU, Rule change request, 23 November 2010, p37.

<sup>5</sup> MEU, Rule change request, 23 November 2010, p8.

The Proponent states that the NEM is unusual compared with overseas jurisdictions in leaving generator market power issues to be regulated by general competition law and not including specific provisions in the Rules to prevent generators exercising market power. The Proponent considers that electricity markets require additional specific provisions addressing the exercise of market power because of the unique features of electricity markets including the relative inelasticity of demand for electricity and the need to constantly balance supply and demand.

The Proponent considers that the proposed Rule will prevent or constrain the exercise of market power by generators and will have the following benefits:

- the wholesale market will be able to operate as intended by dispatching generation in a merit order based on dispatch offers that reflect each generator's marginal cost;
- wholesale price volatility will reduce, which will also reduce costs and risks faced by market participants;
- retail competition will increase due to the reduced exposure of retailers to wholesale price volatility;
- liquidity in the contract and futures markets will improve; and
- retail electricity prices for consumers will reduce, which will promote downstream investment.

### **2.3 Previous reports regarding potential generator market power**

In the Rule change request, the Proponent states that concerns regarding potential generator market power in the NEM have previously been raised by several bodies. In particular, the Proponent refers to the following two reports.

In its January 2007 report to the Council of Australian Governments, the Energy Reform Implementation Group stated:<sup>6</sup>

“In assessing market performance overall, ERIG accepts that, in the NEM, there is some evidence of the on-going exercise of market power. This appears to be persistent, but intermittent.”

In its State of the Energy Market 2009 report, the AER stated:<sup>7</sup>

“Despite generally benign conditions, concerns remain that some generators have been exercising market power in some regions. The NEM was designed to minimise the risk of market power, through an interconnected transmission grid that allows competition between

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<sup>6</sup> Energy Reform Implementation Group, Energy Reform: The way forward for Australia, January 2007, p71.

<sup>7</sup> AER, State of the Energy Market 2009, 8 December 2009, p3.

generators. But there are circumstances in which baseload generators can price capacity at around the market cap and be certain of at least partial dispatch. This behaviour is often more evident at times of peak demand, typically on days of extreme temperatures...

There have been continuing concerns in South Australia, where spot prices in the past two years were significantly higher than in other mainland NEM regions. In the early months of 2009 South Australian spot prices exceeded \$5000 per megawatt hour (MWh) on 27 occasions. The bidding strategies of AGL Energy for its Torrens Island power station were a key contributing factor on most occasions...

More recently, market bidding strategies emerged as a concern in Tasmania. In June 2009 the spot price in Tasmania exceeded \$5000 per MWh on 13 occasions. The spikes were often driven by Hydro Tasmania making sudden and repeated cuts in the output of its non-scheduled (mini-hydro) generators, in conjunction with strategic bidding for the rest of its portfolio."

### 3 Summary of the proposed Rule

The Rule change request proposes to address the issues discussed above by adding additional provisions to Chapter 3 of the Rules.

In summary, the proposed Rule would impose restrictions on the dispatch offers that can be submitted by a generator that is declared by the AER to be a 'dominant generator'. The proposed Rule would not impose any restrictions on the dispatch offers of generators that are not declared to be a 'dominant generator'.

The key elements of the proposed Rule are as follows:

- The AER would determine which generator (or generators) in each NEM region is a 'dominant generator'. For each dominant generator, the AER would determine the level of regional demand at which that generator becomes a dominant generator.
- The Proponent's draft Rule amendments provide that a 'dominant generator' is any generator that has the ability to exercise market power at or above a certain level of regional demand. The AER would be required to publish guidelines on how it will determine if a generator is a dominant generator. The Rule change request contains the following comments that indicate the Proponent's intended tests for determining whether a generator is a dominant generator:
  - A dominant generator is a generator that "is able, at particular demand levels in a region, to set prices without any effective competition from other generators or has the ability to manipulate prices and supply in a regional market, to the extent that the actions of other competitors will have no effect in influencing the regional spot price."<sup>8</sup>
  - "The process by which a dominant generator would be identified is that if it can be demonstrated that the maximum regional demand at any time cannot be met without dispatch of that generator, then that generator is a 'dominant generator'."<sup>9</sup>
  - This assessment would be based on all generating units owned by an entity and any other generation over which the entity has dispatch control.<sup>10</sup>
- The AER would conduct this assessment annually. The list of dominant generators is therefore likely to change over time. More than one generator may be declared to be a dominant generator in any region, as illustrated by the example in Box 3.2 below.

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<sup>8</sup> MEU, Rule change request, 23 November 2010, p32.

<sup>9</sup> MEU, Rule change request, 23 November 2010, p32.

<sup>10</sup> MEU, Rule change request, 23 November 2010, p68. The assessment therefore would not be based on individual power stations, but would consider the combined generation output of all generating units owned or controlled by a generator in a NEM region.

- If a generator is declared to be a dominant generator then:
  - when regional demand is less than or equal to the level of demand at which the generator has been declared to be a dominant generator, no additional restrictions would apply to the generator and it can offer any amount of generation for dispatch at any price (subject to the existing Rules);
  - when regional demand exceeds the level of demand at which the generator has been declared to be a dominant generator, the generator would be required to offer all of its available capacity for dispatch at a price that is no more than the APC (currently set at \$300/MWh).
- The Australian Energy Market Operator (AEMO) would be required to make amendments to the dispatch algorithm to implement these restrictions.
- No new restrictions apply to generators that are not declared to be a dominant generator. Those other generators can offer any amount of generation for dispatch at any price (subject to the existing Rules).
- The regional reference price (RRP) would continue to be determined as under the current Rules and would apply to all generators including the dominant generator. If the RRP is set at more than \$300/MWh due to dispatch offers above that level by generators that are not dominant generators, all generators including the dominant generator would receive the RRP.
- Additional investigation and enforcement powers would be conferred on the AER to ensure compliance with these new provisions. In particular:
  - the AER would have the same investigation and enforcement powers that the Australian Competition and Consumer Commission (ACCC) has when enforcing a breach of sections 46 to 48 of the CCA;<sup>11</sup> and
  - the Rules would confer on the AER the same ability to seek or impose penalties as the ACCC has under the CCA.<sup>12</sup>

The following examples illustrate the potential application of the proposed Rule change. These examples are based on examples contained in the Rule change request.<sup>13</sup> The inclusion of these examples does not indicate that the Commission considers that

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<sup>11</sup> The Proponent considers that additional investigation and enforcement powers are required to ensure that a dominant generator does not engage in physical withholding of capacity in breach of the proposed Rule, for example to determine whether any claimed outages were genuine. In particular, the Proponent considers that additional powers similar to the ACCC's powers under section 155 of the CCA are required for the AER to effectively investigate allegations of physical withholding.

<sup>12</sup> It appears that the Proponent's intention is that the AER could seek Court imposed civil pecuniary penalties similar to the maximum penalties under section 46 of the CCA, which are the greater of \$10,000,000, three times the value of the benefits obtained from the breach, or (if the Court cannot determine the value of the benefits) 10% of the annual turnover of the body corporate.

<sup>13</sup> MEU, Rule change request, 23 November 2010, pp35-36.

the generators referred to in these examples have market power or would be declared as dominant generators if the proposed Rule was made.

**Box 3.1 Example 1 - one 'dominant generator'**

The MEU considers that AGL would be a dominant generator in South Australia when regional demand exceeds 2,500 MW. The MEU considers that above this level of demand, AGL can offer any price it wishes for its generation capacity and be assured of dispatch because the combined output of all other generators is not enough to meet regional demand.

If the AER made a dominant generator determination on this basis then:

- when South Australian regional demand is 2,500 MW or less, the current Rules would apply without any additional restrictions on pricing by generators;
- when regional demand exceeds 2,500 MW, AGL would be required to offer all of its available capacity at a price not exceeding \$300/MWh. The offers of generators would be dispatched as usual and the RRP would reflect the last offer dispatched, which may be an offer by a generator other than AGL for a price exceeding \$300/MWh. All generating units that were dispatched, including AGL's generating units, would receive the RRP for their output.

**Box 3.2 Example 2 - more than one 'dominant generator'**

In New South Wales, the MEU considers that Macquarie Generation would be a dominant generator when regional demand exceeds approximately 12,000 MW and Delta Electricity would be a dominant generator when regional demand exceeds approximately 12,500 MW. The MEU also considers that other generators such as Eraring Energy may be dominant generators at higher demand levels.<sup>14</sup>

If the AER made a dominant generator determination in relation to Macquarie Generation and Delta Electricity on this basis then:

- when NSW regional demand is 12,000 MW or less, the current Rules would apply without any additional restrictions on pricing by generators;
- when NSW regional demand is between 12,001 and 12,500 MW, Macquarie Generation would be required to offer all of its available capacity at a price

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<sup>14</sup> The MEU's analysis in this example is likely to be affected by the recent sale of 'Gentrader' rights in relation to some of Delta Electricity's and Eraring Energy's power stations to TRUenergy and Origin Energy respectively. Delta Electricity and Eraring Energy continue to own and operate these power stations, but TRUenergy and Origin Energy have become the registered participants for these power stations and control dispatch decisions.

not exceeding \$300/MWh;

- when NSW regional demand exceeds 12,500 MW, Macquarie Generation and Delta Electricity would each be required to offer all of their available capacity at a price not exceeding \$300/MWh.

The Rule change request states that the Rule change proposal could have unintended effects in Tasmania and would result in Hydro Tasmania being declared as a dominant generator at all levels of demand. As a result, the Proponent states that Tasmania is a special case and that a jurisdictional derogation appears appropriate so that the Rule amendments do not apply to the Tasmanian region. However, the Proponent's draft Rule amendments do not contain any jurisdictional derogations.

The Proponent's draft amendments to the Rules are set out in Appendix A to this Consultation Paper.

## 4 Assessment framework

### 4.1 Assessment framework

The Commission's assessment of this Rule change request must consider whether the proposed Rule will, or is likely to, contribute to the achievement of the NEO as set out in section 7 of the NEL, which is as follows:

“The objective of this Law 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-

- (a) price, quality, safety, reliability and security of supply of electricity;  
and
- (b) the reliability, safety and security of the national electricity system.”

The assessment framework for this Rule change request will consider whether:

- the proposed Rule will, or is likely to, better contribute to the achievement of the NEO than the status quo; and
- having regard to the issues raised by the Rule change proposal, there is a more preferable Rule that is likely to better contribute to the achievement of the NEO than the proposed Rule.

The assessment framework for this Rule change proposal involves the following steps.

#### 4.1.1 Step 1: Defining the problem

Before it is possible to properly assess the effect of the proposed Rule change on the NEO, it is necessary to clearly define the problem that the Rule change proposal is seeking to address. In doing so, the problem should be defined by reference to its potential impact on efficiency.

The first step in the assessment of this Rule change proposal therefore involves answering the following questions:

- What is 'market power' in the context of the NEM?
- What is the 'exercise' of market power in the context of the NEM?
- In what ways can the exercise of market power by generators reduce productive, allocative or dynamic efficiency in the NEM?

These questions and a number of related issues are discussed in sections 5.1 to 5.3.

#### 4.1.2 Step 2: Assessing whether there is evidence of a problem

Based on the definitions developed in step 1, the next step is to investigate whether there is evidence of the exercise of market power by generators in the NEM.

If the Commission determines that there is evidence of the exercise of market power by one or more generators, this step will also investigate and assess:

- whether the conduct has a material effect on efficiency in the NEM and the long term interests of consumers;<sup>15</sup>
- whether that conduct (or similar conduct by the same generator or other generators) is likely to continue in the absence of a Rule change; and
- whether that conduct is within the scope of the CCA.<sup>16</sup>

These questions and a number of related issues are discussed in section 5.4.

#### 4.1.3 Step 3: Assessing solutions to the problem

If step 2 leads the Commission to conclude that there is evidence that:

- one or more generators are exercising market power;
- that conduct has a material impact on efficiency in the NEM and adversely affects the long term interests of consumers;
- that conduct (or similar conduct by the same generator or other generators) is likely to continue in the absence of a Rule change; and
- that conduct is not within the scope of the CCA,

step 3 will involve an investigation and assessment of the potential solutions to that problem.

If the evidence from step 2 is that one or more of these requirements are not met, then a Rule change is unlikely to be justified and the Commission could move directly to issuing a draft Rule determination not to make a Rule change.

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<sup>15</sup> Section 5.3 discusses how the exercise of market power by generators may affect the economic efficiency of the wholesale electricity market (and potentially other related markets). It is likely that the exercise of market power would have a detrimental effect on efficiency in the NEM and the long term interests of consumers, but that needs to be confirmed and the materiality of the impact needs to be assessed.

<sup>16</sup> It is not a purpose of this Rule change process to determine whether any generator has breached the CCA. However, if the only conduct that is identified as a potential concern in this step 2 is likely to be prohibited by the CCA then there is unlikely to be a problem that justifies a Rule change.

In step 3, the effectiveness of the proposed Rule and its likely impact on achievement of the NEO will be assessed. This step will also consider whether there are other options that would effectively address the problem and that are likely to better contribute to the achievement of the NEO than the proposed Rule.

To do so, the following questions will be addressed:

- Is the proposed Rule likely to prevent or constrain the ability of generators to exercise market power in a manner that reduces efficiency in the NEM and adversely affects the long term interests of consumers?
- Are there are other options that are likely to prevent or constrain the exercise of market power by generators and that may better contribute to the achievement of the NEO than the proposed Rule?
- Would the proposed Rule, or a more preferable Rule, better achieve the NEO than the status quo, or are the detrimental impacts of any Rule change likely to outweigh the potential benefits of removing or constraining the exercise of market power by generators?<sup>17</sup>

These questions and a number of related issues are discussed in sections 5.5 to 5.7.

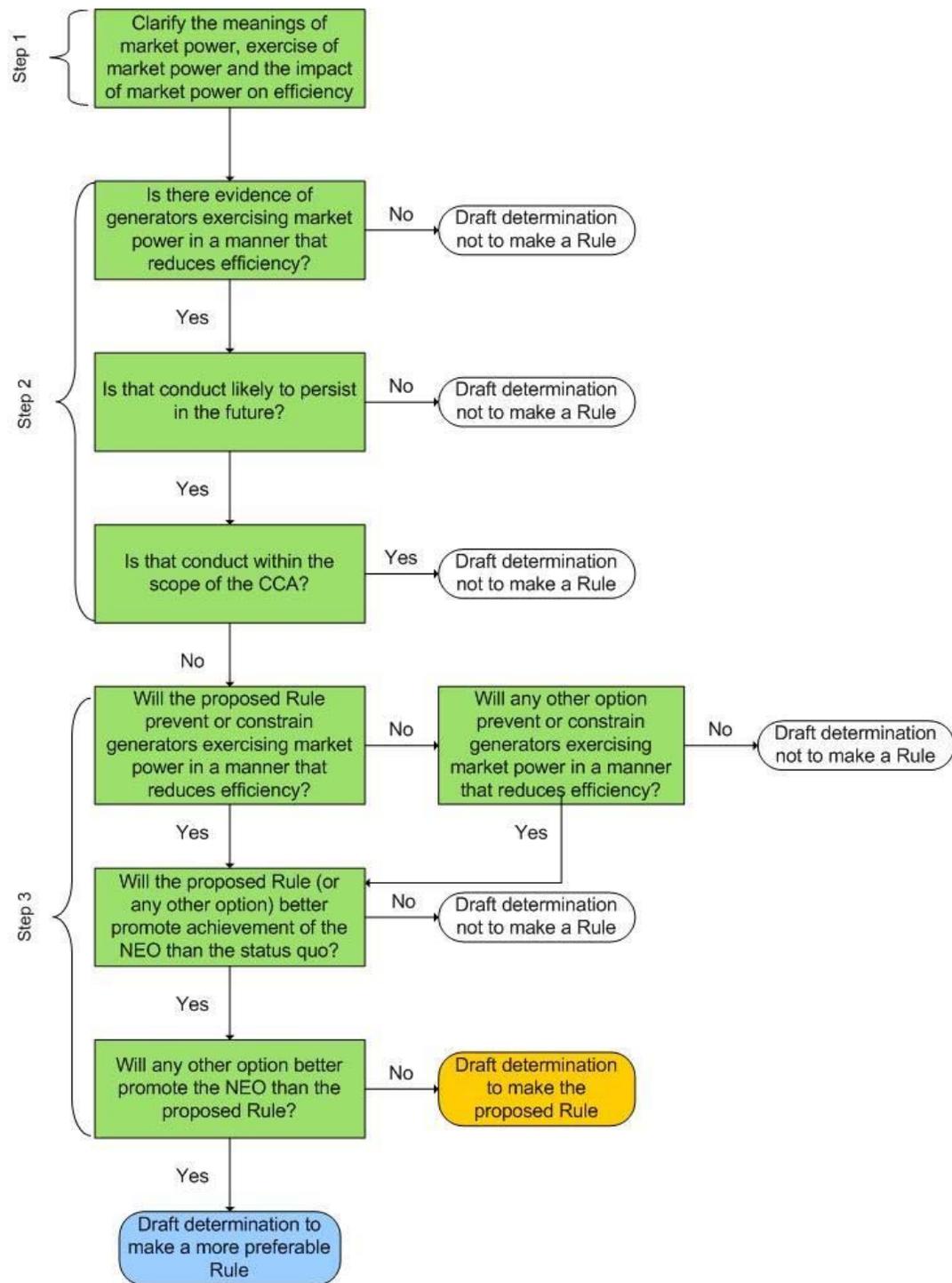
#### **4.1.4 Assessment framework diagram**

This assessment framework and the key decisions that are required to be made as part of the assessment of the proposed Rule are illustrated in the following diagram.

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<sup>17</sup> For example, if the proposed Rule effectively addressed the exercise of market power by generators but also significantly affected behaviour that did not constitute an exercise of market power, the assessment of the proposed Rule would need to consider the costs of that unintended effect.

**Figure 4.1 Assessment framework decision tree**



## 4.2 Proposed process

The process for this Rule change proposal will reflect the multi-stage assessment framework discussed above, with the publication of additional papers prior to the draft

Rule determination so that stakeholders can provide submissions at each key step of the process. These anticipated steps are set out in the following table.

Stage	Paper	Content	Proposed date
Step 1 of the assessment framework	Directions Paper	The Commission's proposed definitions of 'market power' and the 'exercise' of market power and initial views on the potential impacts on efficiency and the long term interests of consumers of the exercise of market power by generators	Mid 2011
Step 2 of the assessment framework	Preliminary Assessment and Options Paper	The Commission's assessment of whether there is evidence of the exercise of market power by generators and, if so, the extent and effects of that exercise of market power on efficiency and the long term interests of consumers	By the end of 2011
Initial stages of step 3 of the assessment framework		If there is evidence of the exercise of market power by generators, the paper will also identify any potential options to address the exercise of market power that should be considered in addition to the proposed Rule	

## 4.3 Scope issues

### 4.3.1 Aspects of the Rule change request that are outside of the AEMC's powers

The Rule change request proposes the following amendments that we consider are outside of the AEMC's Rule making powers under the NEL:

- an amendment to section 58 of the NEL to provide that the AER has the same powers as the ACCC has when investigating and enforcing a breach of sections 46 to 48 of the CCA; and
- an amendment to clause 3.8.2 of the Rules to provide that the AER shall carry out investigations into potential breaches of the new obligations on dominant generators as if it were the ACCC investigating a breach of sections 46 to 48 of the CCA and that, in setting penalties for a breach of those obligations, the AER shall follow the same approach as the ACCC would do under the CCA.<sup>18</sup>

The AEMC does not have the power to amend the NEL as part of the Rule change process. The AEMC also does not have the power to make a Rule that creates an

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<sup>18</sup> Part of the intended effect of this amendment appears to be to allow the AER to seek civil pecuniary penalties similar to under section 46 of the CCA, as discussed in Chapter 3 above.

offence for a breach of a provision of the Rules or provides for a civil or criminal penalty for a breach of the Rules.<sup>19</sup>

Accordingly, this Rule change process will not result in amendments to the NEL or the creation of new offences or new penalty provisions in the Rules. We consider that these aspects of the proposed Rule can be severed from the remainder of the proposed Rule without rendering the remainder of the proposed Rule ineffective.

Subject to these limitations on the AEMC's powers, this Rule change process will consider whether any additional powers should be conferred on the AER to enable it to investigate and enforce the proposed Rule.<sup>20</sup> If the AEMC considers that additional investigation or enforcement powers are appropriate but those powers are outside of the AEMC's Rule making powers, the AEMC may decide to recommend an amendment to the NEL or recommend that particular Rule provisions be classified as civil penalty provisions.

#### **4.3.2 Scope of the market power issues that are covered by the proposed Rule change**

The scope of the Proponent's Rule change request is limited to specific types of conduct that the Proponent considers constitute an exercise of market power. It does not address all potential forms of market power in the NEM.

Based on the scope of the Rule change request, it is proposed to limit the scope of the market power issues that will be considered as part of this Rule change process to conduct:

- by generators only, not other registered participants;
- in relation to the wholesale energy market, not other markets such as ancillary services; and
- that has the purpose or effect of increasing the wholesale price of electricity.

The Rule change request raises the issue of potential tacit collusion or parallel behaviour by generators.<sup>21</sup> However, the proposed Rule appears to be limited to the unilateral exercise of market power by generators and does not appear to address coordinated conduct that could result in smaller generators collectively exercising market power. Section 5.5 seeks submissions on whether this Rule change process should consider coordinated conduct or be limited to the unilateral exercise of market power.

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<sup>19</sup> See section 36 of the NEL.

<sup>20</sup> The AER already has a broad range of powers under the NEL to investigate, and take action in relation to, breaches of the Rules - see for example sections 15, 28 and 58-69 of the NEL.

<sup>21</sup> MEU, Rule change request, 23 November 2010, pp43-44.

The Rule change request also states that the proposed Rule is only intended to prevent a generator from exercising market power "in the absence of supply scarcity".<sup>22</sup> The NEM is designed so that prices will rise to signal a shortage of supply, whether that shortage is caused by a transmission or generation outage or by a shortage of installed generation compared with peak demand. The proposed Rule, and this Rule change process, are not seeking to remove all instances of high prices that will arise from such circumstances.

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<sup>22</sup> MEU, Rule change request, 23 November 2010, p7.

## **5 Issues for consultation**

Taking into consideration the assessment framework discussed in Chapter 4, we have identified a number of issues for consultation that appear to be relevant to this Rule change request.

The issues outlined below are provided for guidance. Stakeholders are encouraged to comment on these issues as well as any other aspect of the Rule change request or this Consultation Paper, including the assessment framework, process and scope issues discussed in Chapter 4.

Stakeholders will have a further opportunity to provide detailed submissions on the issues covered in sections 5.4 to 5.7 during subsequent stages of the Rule change process. Accordingly, in their comments on this Consultation paper, stakeholders are encouraged to focus on the issues raised in sections 5.1 to 5.3, together with initial comments on the issues in sections 5.4 to 5.7.

### **5.1 What is 'market power' in the context of the NEM?**

As discussed in section 4.1.1, assessing the proposed Rule change first requires us to clearly articulate the problem that this Rule change proposal is seeking to address. The first step in setting out the problem is to define what is meant by 'market power' in the context of the NEM. The term market power may be interpreted in different ways, and it is important to establish a common understanding for the purpose of assessing and consulting on this Rule change request.

#### **Defining the market**

Determining the existence of market power in the context of the NEM first requires us to define the relevant market. In defining the market for the purposes of competition law, the following dimensions are usually considered:

- the product (i.e. a description of the relevant good or service);
- the functional level of the market (i.e. the point in the supply chain);
- the geographical scope; and
- the relevant timeframe during which to assess whether an entity has market power.

The approach taken to market definition in competition law is a useful guide for the purposes of this Rule change process, but it may not necessarily be appropriate to follow that approach exactly. It is also noted that CCA cases and commentators have

emphasised that the approach to market definition should take into account the context. For example, Norman and Williams have stated that:<sup>23</sup>

“The aim of the process of definition is not to arrive at some proposition which can be judged to be true independently of the problem before the Court or Tribunal; rather the market is defined to clarify the process of analysing the competitive relationships which need to be explored before the ultimate questions of the case can be decided.”

The product and functional dimensions are likely to include, at a minimum, electrical energy supplied to the wholesale electricity market. Arguably the product market could be expanded to include electricity derivative products such as swaps, futures or options.<sup>24</sup>

The relevant geographical and temporal dimensions are less clear. For example, the geographic scope could be the entire NEM, which is connected through a series of interconnectors. However, during periods of high demand (the period over which the proposed Rule would apply) it is likely that at least some of these interconnectors would be constrained. There may therefore be an argument that there are separate markets for each jurisdiction, which is the approach that the Proponent appears to take in the Rule change request.

Similarly, the time period over which the analysis should apply is not straightforward to determine. Generators are required to submit dispatch offers for each 30 minute trading interval, making it possible that market power (if present) may only be exercised over short periods of time. However, given the magnitude of the market price cap<sup>25</sup> relative to the average spot price, a few periods of high prices could have a large impact on the average annual spot price.

The Rule change request states that 'dominant generators' only have market power during periods of high demand in a region, and face effective competitive constraints at other times. This raises the question of whether these periods of high demand constitute a separate temporal market, or whether a generator's market power should be assessed over a longer timeframe.

### **Defining market power**

The Proponent defines market power in the NEM as "an ability of a generator to manipulate the spot price at a regional demand less than the maximum regional demand, by either physical or economic withholding of its capacity".<sup>26</sup>

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23 Norman and Williams, *The analysis of market and competition under the Trade Practices Act: Towards the resolution of some hitherto unresolved issues* (1983) 11 *Australian Business Law Review* 396.

24 See, for example, *Australian Gas Light Company v Australian Competition and Consumer Commission* (No 3) [2003] FCA 1525 at [380].

25 The market price cap is administratively set and represents the maximum price that a generator may offer into the market. The market price cap is currently \$12,500/MWh.

26 MEU, Rule change request, 23 November 2010, p32.

In economics, market power is generally defined as the ability of a firm to profitably raise the price for a product or service above the competitive level. For example, Werden defined market power as the ability of a seller to "profitably...maintain prices above competitive levels by restricting output below competitive levels".<sup>27</sup>

Legal definitions often build on the economic definition of market power. For example, in *Queensland Wire Industries Pty Ltd v Broken Hill Pty Co Ltd*, market power was defined as:<sup>28</sup>

"the ability of a firm to raise prices above the supply cost without rivals taking away customers in due time, supply cost being the minimum cost an efficient firm would incur in producing the product..."

CCA case law, however, recognises that the ability to raise prices is not the sole indicator of market power, and several cases have adopted a broader definition of market power. Based on case law and the guidance provided by section 46(3), market power for CCA purposes can be defined as the power to behave, to a substantial extent and for a sustained period, in a manner not constrained by competitors or potential competitors. This definition reflects the fact that section 46 only applies if a corporation has a 'substantial' degree of power in a market.

The equivalent provision to section 46 in the European Union (EU) prohibits the abuse of a dominant position in a market.<sup>29</sup> Accompanying guidelines define dominance as:<sup>30</sup>

"a position of economic strength enjoyed by [a corporation] which enables it to prevent effective competition being maintained on a relevant market, by affording it the power to behave to an appreciable extent independently of its competitors, its customers and ultimately of consumers."

The guidelines also confer an interpretation of "dominance" that closely aligns with the CCA, namely that a corporation "enjoys substantial market power over a period of time" where competitive constraints are insufficient.<sup>31</sup>

An inquiry conducted in the United Kingdom in 2000 into generator market power set out a working definition of market power as "the ability of a generator, acting independently, to raise prices consistently and profitably above competitive levels."<sup>32</sup>

While these definitions of market power differ, they have a number of common elements. These include an ability to raise prices above a level that is considered

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<sup>27</sup> Werden, Identifying Market Power in Electric Generation, Public Utilities Fortnightly, 15 February 1996.

<sup>28</sup> *Queensland Wire Industries Pty Ltd v Broken Hill Pty Co Ltd* (1989) 167 CLR 177.

<sup>29</sup> Treaty on the Functioning of the European Union, Article 102.

<sup>30</sup> The European Commission's Article 82 Guideline, paragraph 10.

<sup>31</sup> The European Commission's Article 82 Guideline, paragraph 10.

<sup>32</sup> Competition Commission, AES and British Energy: A report on references made under section 12 of the Electricity Act 1989, December 2000, p3.

competitive for a sustained period, an absence of competition and therefore constraint on behaviour, and in some cases an element of whether the behaviour is profitable.

### **Barriers to entry and other limits on the exercise of market power**

A key component of assessing whether an entity has market power is determining whether barriers to entry exist. Where new entrants are freely able to enter and exit the market, the opportunities for a corporation to exercise market power by profitably increasing prices for a sustained period of time are limited or may not exist at all. This is because the presence of economic rents will attract new entrants, increasing competition and thereby competing away any excess profits. However, where barriers to entry exist, such opportunities may be limited.

Similarly, existing competitors may provide sufficient constraints on the ability of a corporation to exercise market power. In the case of the wholesale electricity market, competitive constraints may exist where there is sufficient generation capacity such that any one generator that increases its dispatch offer above its costs would face the risk that other generators will be dispatched instead of it.

#### **Question 1      What is market power in the context of the NEM?**

- 1.1      What is an appropriate definition for the relevant market in which to examine whether market power is being exercised? What are the relevant product, functional, geographic and temporal dimensions?**
- 1.2      How should market power be defined in the context of the NEM?**
- 1.3      Do barriers to entry in the market exist such that the exercise of market power would not be constrained by potential entrants?**

### **5.2      What is 'exercise' of market power in the context of the NEM?**

The Proponent does not appear to explicitly set out a test to determine whether market power has been exercised by a 'dominant generator'. Instead, if a generator is considered to have market power based on its size relative to other generators and peak demand in its region, then the Proponent proposes that the generator's dispatch offers should be constrained to the APC (currently \$300/MWh) whenever regional demand exceeds a certain level. This approach may imply that the Proponent considers that offers over \$300/MWh by a dominant generator always constitute an exercise of market power.

Under the CCA, there is no prohibition on merely having market power. Market power must be used in some way for a prohibited purpose. This approach acknowledges that, under workable competition,<sup>33</sup> corporations may experience transitory periods where they are able to influence the market price. However, over time this ability is expected to be competed away by existing or potential competitors, driving the market towards efficient outcomes. In contrast, a sustained ability to influence the market price may drive a wedge between efficient costs and prices, leading to persistent inefficiencies in the market. It is conduct resulting from market power in this latter case that raises concerns.

As discussed in section 2.1, conduct only breaches section 46 of the CCA if a corporation has a substantial degree of power in a market, the corporation took advantage of that market power, and it did so for an anti-competitive purpose.<sup>34</sup>

To determine whether a corporation has taken advantage of its substantial market power, the following test is typically used:<sup>35</sup>

“If the impugned conduct has a business rationale, that is a factor pointing against any finding that conduct constitutes a taking advantage of market power. If a firm with no substantial degree of market power would engage in certain conduct as a matter of commercial judgment, it would ordinarily follow that a firm with market power which engages in the same conduct is not taking advantage of its power.”

Similarly, in the EU it is not in itself illegal to be in a dominant position. However, a corporation that has a dominant position must not 'abuse' its dominant position by conducting itself in a way so as to impair competition.<sup>36</sup>

The United Kingdom Competition Commission considered the key factors in assessing what may constitute an abuse of market power included "the ability of a generator to act independently"; "for the conduct to be consistent and to have a material impact"; "prices are raised above the competitive level"; and that "the conduct of the generator should provide it with additional profit".<sup>37</sup>

In determining whether market power has been 'exercised' in the NEM, it will be necessary to devise an appropriate test. It is likely that the appropriate test should be

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<sup>33</sup> Workable, or effective, competition is where there is sufficient rivalry between businesses to ensure that they strive to deliver the goods and services consumers demand at least cost, and for product and process improvements. A market that is considered to be workably competitive need not have reached a state of perfect competition.

<sup>34</sup> Section 4F of the CCA and case law provide that the anti-competitive purpose does not need to be the sole purpose or even a dominant purpose, provided that it is a substantial purpose. Section 46(7) of the CCA provides that a corporation's purpose may be established by inference from its conduct or other relevant circumstances.

<sup>35</sup> *ACCC v Boral Ltd* [1999] FCA 1318.

<sup>36</sup> The European Commission's Article 82 Guideline, paragraph 1.

<sup>37</sup> Competition Commission, AES and British Energy: A report on references made under section 12 of the Electricity Act 1989, December 2000, p44.

linked to the efficiency considerations discussed in section 5.3 below and should only encompass conduct that is likely to have a detrimental impact on efficiency in the NEM. We are seeking views from stakeholders on whether it is appropriate to base the test on the competition law tests of 'taking advantage' or 'abuse' of market power, or whether the Commission should develop a different test for 'exercising' market power in this context.

**Question 2      What is 'exercise' of market power in the context of the NEM?**

- 2.1    Are the existing competition law tests for 'taking advantage' or 'abuse' of market power an appropriate test in the context of this Rule change request?**
- 2.2    Alternatively, should the Commission develop a different test for assessing whether market power has been exercised in the context of generation in the NEM? If so, what elements might it contain? For example, should it contain the concepts of sustained price rises above the competitive level and/or profitability?**

**5.3      What impact is the exercise of market power likely to have on efficiency?**

The Proponent contends that the consequences of the exercise of market power by generators include:<sup>38</sup>

- major energy users incurring substantial economic losses;
- an increase in prices of retail contracts and a general increase in electricity prices;
- an increase in the risk and cost of making transactions in the NEM;
- the exit from the retail market by retailers that are unable to obtain hedge contracts to manage risks; and
- the creation of barriers to new entry in generation and retail.

The sustained exercise of market power could potentially have a number of impacts on the efficient operation of the NEM and the long term interests of consumers.

First, allocative inefficiencies may result where the exercise of market power serves to increase wholesale prices. For example, prices above cost may reduce production and consumption below the levels that would exist in more competitive market conditions, resulting in a deadweight loss. In those circumstances, load that is sufficiently flexible might choose to reduce its demand in the face of high prices. Where prices are higher than the competitive level, the consequent reduction in output is likely to be inefficient.

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<sup>38</sup> MEU, Rule change request, 23 November 2010, p8.

Second, there may be a loss in productive efficiency. This will arise where a generator with higher unit costs is dispatched in place of a generator with lower unit costs. In other words, where a low-cost generator exercises market power by bidding above its short run costs, more expensive generation may be dispatched in its place, inefficiently increasing the overall cost of generation.

Finally, there may be an impact on dynamic efficiency. For example, if prices are above efficient levels due to the exercise of market power, this may result in an inefficiently high level of generation investment entering the market in response (provided that the new entrant considered that those higher prices would continue post entry).

There could also be efficiency impacts in electricity derivatives markets. This may occur where generators consider the spot market to be highly profitable as a result of artificially high prices and so reduce the level of forward contracting. This will, in turn, reduce liquidity in the market for hedges, driving up prices in the contract markets and thereby impacting the ability of retailers and large users to obtain efficiently-priced hedges.

In considering these potential efficiency losses it will be necessary to consider carefully whether occasional high prices in the wholesale market are the result of the exercise of market power and therefore may be inefficient, or simply a sign of a well-functioning market. In particular, occasional high prices can be an important signal for new investment in generation capacity. It is therefore important to ensure that analysis of the efficiency of outcomes in the NEM accounts for such signalling mechanisms.

<p><b>Question 3      What impact is the exercise of market power likely to have on efficiency?</b></p> <p><b>3.1    How might the exercise of market power impact on allocative efficiency in the NEM?</b></p> <p><b>3.2    How might the exercise of market power impact on productive efficiency in the NEM?</b></p> <p><b>3.3    How might the exercise of market power impact on dynamic efficiency in the NEM?</b></p> <p><b>3.4    What other impacts might the exercise of market power have on efficiency and/or the long term interests of consumers?</b></p>
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#### **5.4      Is there evidence of the exercise of market power by generators?**

In the Rule change request, the Proponent claims that exercises of market power occurred between 2007 and 2010 in relation to the Torrens Island Power Station in South Australia. The Rule change request contains information that the Proponent considers supports this claim.

The Proponent also makes comments regarding the exercise of market power by Macquarie Generation in NSW and the possible exercise of market power by Hydro Tasmania,<sup>39</sup> but does not provide evidence of any such exercise of market power.

As discussed in Chapter 4, step 2 of the assessment framework for this Rule change involves investigating whether there is evidence of the exercise of market power by generators. We intend to conduct analysis and modelling to determine whether there is evidence that any generators in the NEM have market power and have exercised that market power, based on the definitions of those terms that are developed during step 1 of the process.

Modelling and analysis of past behaviour by generators can only demonstrate whether a generator exercised market power at a specific point in the past. To assess the effect of the Rule change on the NEO, it is necessary to assess whether any previous exercise of market power is likely to continue in the future in the absence of a Rule change. If any exercise of market power is unlikely to continue in the future, for example because of likely changes in market conditions that will remove the generator's market power, then a Rule change is unlikely to be justified.

As noted in Chapter 2, clause 3.1.4(b) of the Rules currently provides that the Rules are not intended to address anti-competitive conduct, which is subject to the CCA. The Proponent proposes amending this clause to state that the CCA "does not prevent a generator in the electricity market from using its market power to manipulate the spot price, because this does not reduce competition which is the focus of the [CCA]".<sup>40</sup> It is likely that a modification to the policy position set out in clause 3.1.4(b) is only justified if there is evidence of the exercise of market power by generators in a way that reduces efficiency in the NEM but that does not infringe the CCA. If the conduct is within the scope of the CCA, a change to the Rules is likely to be unnecessary and is not likely to contribute to the achievement of the NEO.

**Question 4      Is there evidence of the exercise of market power by generators?**

**4.1      Is there evidence that one or more generators in any region of the NEM has market power and has exercised that market power to increase the wholesale price? Please provide specific examples and evidence to support your response.**

**4.2      Do you agree with the Proponent that the conduct referred to in the Rule change request constitutes an exercise of market power? If so, do you consider that this conduct is currently continuing and is likely to continue in the future?**

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<sup>39</sup> The Proponent states that Hydro Tasmania has market power in Tasmania, but that it is difficult to separate when Hydro Tasmania has used its market power for commercial gain and when it has operated on the basis of scarcity of supply - MEU, Rule change request, 23 November 2010, p10.

<sup>40</sup> MEU, Rule change request, 23 November 2010, p67.

**4.3 Do you consider that the CCA adequately addresses the exercise of market power by generators, or do you consider that specific Rules provisions are required to supplement the CCA provisions?**

## **5.5 Will the proposed Rule effectively address the exercise of market power?**

If there is evidence of the exercise of market power by generators, the proposed Rule change is only likely to promote the NEO if it is effective in preventing or constraining that conduct and preventing similar conduct by the 'dominant generator' or other generators. If the dominant generator can engage in different conduct that has a similar effect, or if other generators that are not dominant generators under the proposed Rule are likely to start engaging in conduct that has a similar effect, then the Rule change will not be effective and is unlikely to improve efficiency.

The Proponent considers that the Rule change will prevent, or at least substantially constrain, the exercise of market power by generators. The specific form of the exercise of market power that the Rule change proposal is aimed at is economic withholding (as defined in section 2.2 above). The Proponent recognises that if the Rules prevent economic withholding, a dominant generator may seek to achieve a similar result by physical withholding. Accordingly, the proposed Rule also contains provisions that seek to prevent physical withholding by a dominant generator.

As noted in section 4.3 above, the Rule change request raises the issue of potential tacit collusion or parallel behaviour, but the proposed Rule appears to be limited to the unilateral exercise of market power. The Proponent acknowledges that it is possible that "tacit/parallel collusion" by smaller generators could exploit the limitations that are imposed on the dominant generator by the proposed Rule with the result that these smaller generators effectively have market power when they previously had no such power.<sup>41</sup> However, the Rule change proposal does not contain an analysis of how other generators are likely to behave if the Rule change is implemented and what impact their behaviour may have on the effectiveness of the Rule change.

The CCA contains provisions that prohibit cartel conduct (sections 44ZZRA to 44ZZRV) and contracts, arrangements or understandings that have the purpose or effect of substantially lessening competition in a market (section 45). If concerns regarding the potential for collusive behaviour are adequately addressed by the CCA, then it is unlikely to contribute to the achievement of the NEO to also address those matters in the Rules.

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<sup>41</sup> MEU, Rule change request, 23 November 2010, p43.

**Question 5 Will the proposed Rule effectively address the exercise of market power?**

- 5.1 Do you consider that the proposed Rule is likely to prevent or constrain the ability of generators to exercise market power in a manner that reduces efficiency in the NEM and adversely affects the long term interests of consumers (if there is evidence of any such exercise of market power)?**
- 5.2 How are other generators that are not declared to be a 'dominant generator' likely to change their behaviour if the proposed Rule is made?**
- 5.3 Should any Rule change that seeks to address the exercise of market power by generators also address tacit collusion or parallel behaviour by generators, or is it appropriate to limit the Rule change to the unilateral exercise of market power?**

**5.6 What other options could effectively address the exercise of market power?**

Under section 91A of the NEL, the Commission may make a more preferable Rule if it is satisfied that, having regard to the issues that were raised by the Rule change proposal, the more preferable Rule will or is likely to better contribute to the achievement of the NEO. A more preferable Rule may be materially different to the Proponent's draft Rule, provided that it relates to the issues that were raised in the Rule change request.

The Rule change request notes that there are a variety of potential approaches to addressing market power issues in electricity markets. In particular, the Proponent states that market power issues could be addressed by:

- a structural approach, which would require generators to be restructured so that they are sufficiently small that they do not have market power;
- an ex ante approach (one example of which is contained in the Rule change proposal), which would apply constraints on how a generator is permitted to bid with the aim of preventing the generator from exercising market power; or
- an ex post approach, which would require a regulator to assess after the fact whether a generator has exercised market power in a prohibited manner and impose penalties for doing so.

The Proponent provides several examples of overseas jurisdictions where it considers that specific electricity regulatory requirements have been implemented to address the exercise of market power by generators. Each of those overseas examples differs from the proposed Rule.

**Question 6      What other options could effectively address the exercise of market power?**

- 6.1    Do you consider that there are other options that could prevent or constrain the ability of generators to exercise market power in a manner that reduces efficiency in the NEM and adversely affects the long term interests of consumers (if there is evidence of any such exercise of market power)?**
- 6.2    If so, are those options likely to better contribute to the achievement of the NEO than the proposed Rule, and why?**

**5.7      What are the likely impacts of the proposed Rule on achievement of the NEO?**

The Rule change request states that the proposed Rule would promote the achievement of the NEO in several ways, including by:

- promoting competition between generators, which would result in lower costs for consumers;
- allowing the wholesale market to operate more efficiently by ensuring that lowest cost generation is dispatched first; and
- improving competition in the hedge, contract and retail markets.

The Proponent notes in the Rule change request that incentives must be maintained for investment in new generation capacity. The Proponent considers that, if the proposed Rule was implemented, it would significantly reduce average wholesale prices and would result in peaking generation being dispatched less often. The Proponent acknowledges that these effects would reduce returns for existing generators and could diminish the business case for new generation investment. However, the Proponent considers that the proposed Rule is unlikely to have a significant negative impact on generation investment incentives.

The effects of the proposed Rule on the achievement of the NEO will be analysed by considering what effect the proposed Rule is likely to have on:

- efficient investment in generation, including incentives for efficient new investment;
- efficient operation of the wholesale market, for example by ensuring that lowest cost generation is dispatched first;

- efficient operation of the market for electricity derivative products (for example, swaps, futures or options)<sup>42</sup> and the retail electricity market; and
- efficient use of electricity services, for example avoiding inefficient demand reductions by users during periods of high prices caused by the exercise of market power.

As part of this analysis, it is necessary to weigh the likely benefits and detriments of the proposed Rule. This analysis will include consideration of whether the likely detrimental impacts of the proposed Rule (or a more preferable Rule to address the exercise of generator market power) are likely to outweigh the likely benefits of removing or constraining the exercise of market power by generators.

<b>Question 7</b>	<b>What are the likely impacts of the proposed Rule on the achievement of the NEO?</b>
7.1	What impact is the proposed Rule likely to have on wholesale electricity prices?
7.2	What impact is the proposed Rule likely to have on efficient investment in generation, in particular incentives for efficient entry of new generation?
7.2	What impact is the proposed Rule likely to have on the efficient operation of the wholesale electricity market?
7.3	What impact is the proposed Rule likely to have on the efficient use of electricity services?
7.4	What impact, if any, is the proposed Rule likely to have on the market for electricity derivative products and/or the retail electricity market?
7.5	Do you consider that the proposed Rule is likely to have any other impact on the achievement of the NEO?

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<sup>42</sup> As noted in section 5.1, the Commission has not yet formed a view on the definition of the appropriate markets, including whether electricity derivative products comprise a separate market (or more than one market) or part of a broader wholesale electricity market.

## **6 Lodging a submission**

The Commission has published a notice under section 95 of the NEL for this Rule change proposal inviting written submissions. Submissions are to be lodged online or by mail by 26 May 2011 in accordance with the following requirements.

Where practicable, submissions should be prepared in accordance with the Commission's Guidelines for making written submissions on Rule change proposals.<sup>43</sup> The Commission publishes all submissions on its website, subject to a claim of confidentiality.

All enquiries on this project should be addressed to Richard Owens on (02) 8296 7800.

### **6.1 Lodging a submission electronically**

Electronic submissions must be lodged online via the Commission's website, [www.aemc.gov.au](http://www.aemc.gov.au), using the "lodge a submission" function and selecting the project reference code "ERC0123". The submission must be on letterhead (if submitted on behalf of an organisation), signed and dated.

Upon receipt of the electronic submission, the Commission will issue a confirmation email. If this confirmation email is not received within 3 business days, it is the submitter's responsibility to ensure the submission has been delivered successfully.

### **6.2 Lodging a submission by mail**

The submission must be on letterhead (if submitted on behalf of an organisation), signed and dated. The submission should be sent by mail to:

Australian Energy Market Commission  
PO Box A2449  
Sydney South NSW 1235

Or by Fax to (02) 8296 7899.

The envelope must be clearly marked with the project reference code: ERC0123.

Except in circumstances where the submission has been received electronically, upon receipt of the hardcopy submission the Commission will issue a confirmation letter.

If this confirmation letter is not received within 3 business days, it is the submitter's responsibility to ensure successful delivery of the submission has occurred.

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<sup>43</sup> This guideline is available on the Commission's website.

## Abbreviations

ACCC	Australian Competition and Consumer Commission
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
APC	administered price cap
CCA	<i>Competition and Consumer Act 2010 (Cth)</i>
Commission	See AEMC
EU	European Union
MEU	Major Energy Users Inc.
MWh	megawatt hour
NEL	National Electricity Law
NEM	National Electricity Market
NEO	National Electricity Objective
Proponent	See MEU
RRP	regional reference price
Rules	National Electricity Rules

## **A The Proponent's draft Rule amendments**

The Proponent's Rule change request contains draft amendments to the Rules, which are set out below. The amendments below are reproduced from the Rule change request without amendments or corrections, except for minor formatting and punctuation changes. The Rule change proposal also includes explanatory notes, which have not been reproduced below.

The Rule change proposal also contains a draft amendment to the NEL to give the AER additional investigation and enforcement powers.<sup>44</sup> As discussed in section 4.3 above, the AEMC does not have the power to amend the NEL as part of the Rule change process. Accordingly, the Proponent's draft amendment to the NEL is not set out in this Appendix.

### **[1] Clause 3.1.4 Market design principles**

After clause 3.1.4(a)(9), insert:

- (10) Enhancing competitive outcomes in the spot market by preventing a generator from using its market power to manipulate the spot price in a region.

### **[2] Clause 3.1.4 Market design principles**

At the end of clause 3.1.4(b), insert:

However it is recognised that the Trade practices Act, 1974 does not prevent a generator in the electricity market from using its market power to manipulate the spot price, because this does not reduce competition which is the focus of the Trade Practices Act. These rules therefore aim to limit the ability of a generator to exercise its market power when the regional demand is at a level where a generator has the potential and economic interest to exercise its market power.

### **[3] Clause 3.8.1 Central Dispatch**

At the end of clause 3.8.1(d), insert:

The dispatch algorithm must:

- (i) Provide an alarm that if, when the regional demand exceeds the level determined in clause 3.8.2(f), the dominant generator prices its output higher than the Administered Price Cap. AEMO must advise both the dominant generator and the AER that the dominant generator is not complying with clause 3.8.6(a)(5).

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<sup>44</sup> The MEU proposes amending section 58(c) of the NEL by adding the following words at the end of that section: "In the case of a breach of rules, the AER has the same powers as the ACCC when the ACCC is prosecuting a breach of the Trade Practices Act 1974, in relation to sections 46, 47 and 48 of the TPA."

- (ii) Insert a price no more than the Administered Price Cap into the algorithm to represent the offer a dominant generator is required to make when the regional demand exceeds the level determined in clause 3.8.2(f).

#### **[4] Clause 3.8.2 Participation in central dispatch**

After clause 3.8.2(e), insert:

- (f) The AER must assess the generation in each region to identify which generators have the ability to exercise market power and at what level of regional demand. If this level of demand is less than the forecast regional demand then those generators will be determined to be dominant generators.

The AER must develop guidelines as to how it will determine if a generator is a dominant generator. These guidelines will include the following features:

- (1) the AER shall assess each region each year in March of each year to identify if there is a dominant generator in a region;
- (2) generator output will be determined based on a number of factors, including nameplate rating, actual maximum recorded output of the combined generating plants under the control of the generating company in the previous four years, and the amount of generation advised to AEMO in its assessment of its EAAP [Energy Adequacy Assessment Projection] for the period;
- (3) the dominant generator must give an acceptable explanation to the AER why the GELF [Generator Energy Limitation Frameworks] that it advises to AEMO as part of the development of the EAAP does not reflect the maximum actual recorded capacity;
- (4) generation plant will be the output of generating plant owned by the generating company as well as any generation over which the generator has dispatch control;
- (5) inflows on interconnectors should be assessed in terms of likely congestion limiting flows, nominal capacity and actual transfers measured over the previous four years;
- (6) the forecast regional demand shall be determined by AEMO at the 10% Probability of Exceedence (PoE); and
- (7) a dominant generator shall only be declared where the level of demand where it can exercise market power is less than the forecast regional demand for the next high demand period

The AER will declare generators which have market power in a region, and at what level of regional demand they have market power.

The AER declaration shall be made each 1 April and the declaration shall force for the ensuing twelve month period.

Once the AER has determined which generators have market power at what regional levels, it shall publish this information and advise the AEMO of its decisions. AEMO will use this information to modify the dispatch algorithm as required by clause 3.8.1(d)

- (g) The AER shall monitor regional demands, and shall review:
  - (1) the pricing offered by dominant generators when the regional demand exceeds the level at which the AER has determined they have market power; and
  - (2) the amount of output the dominant generator provides when it is considered to have market power.

If the AER considers that the dominant generator has not provided pricing as required by rule 3.8.6(a)(5) or the dominant generator has not offered the maximum available capacity the dominant generator is considered to have, then the AER shall carryout an investigation to determine why the dominant generator did not price its output as required, or offer its maximum available capacity.

For the assessment of available generation capacity, the AER will consider the amount of capacity offered by the dominant generator in the periods before and after the period when the dominant generator is considered to have market power.

The AER shall carryout such an investigation as if it were the ACCC investigating a breach of the Trade Practices Act 1974, in relation to sections 46, 47 and 48 of the TPA.

In setting penalties, the AER shall apply the same approach as the ACCC would do if it found a breach of the TPA.

## **[5] Clause 3.8.6      Generating unit offers for dispatch**

After clause 3.8.6(a)(4), insert:

- (5) If a scheduled generator is declared under clause 3.8.2(f) to be a dominant generator in a region then when the regional power demand reaches the level determined under clause 3.8.2(f) then a dominant generator must:
  - (i) offer all of its output at a price no more than the Administered Price Cap (APC); and
  - (ii) offer all of its available generation capacity to the market.

**[6] Clause 3.13.7 Monitoring of significant variation between forecast and actual prices by AER**

After clause 3.13.7(c), insert:

- (c1) The AER must prepare and publish a report annually which provides the determination of which generators are classed as dominant generators and under what conditions. The AER shall include in the report details of:
    - (1) all times when a dominant generator did not offer pricing conforming with clause 3.8.6(a)(5)(i) and was price constrained by the AEMO dispatch algorithm;
    - (2) when and to what extent the dominant generator did not offer all of its available capacity to the market conforming with clause 3.8.6(a)(5)(ii); and
    - (3) what actions the AER took and the outcomes of these actions caused as a result of any investigations made in accordance with clause 3.8.2(g).
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