



12 February 2015

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

Dear Mr Pierce

RE: OPTIONS PAPER NATIONAL ELECTRICITY AMENDMENT (BIDDING IN GOOD FAITH) RULE 2014 (Reference: ERC0166)

ERM Power Limited (ERM Power) welcomes the opportunity to respond to the Commission's Options Paper *National Electricity Amendment (Bidding in good faith) Rule 2014* (Options Paper).

About ERM Power Limited

ERM Power is a diversified Australian energy company with interests in electricity sales and generation, metering, and gas exploration. Trading as ERM Business Energy and founded in 1980, we have grown to become the fourth largest electricity retailer in Australia, with operations in every state and the Australian Capital Territory. We initially focused on larger businesses but now offer our industry leading services to small businesses. We have equity interests in 497 megawatts of low emission gas-fired peaking power stations in Western Australia and Queensland, operate an electricity metering business that trades as Powermetric, and have gas exploration operations in New South Wales.

Introductory comments

In our response to the Commission's previous paper on this topic we advised that ERM Power did not agree with the then proposed changes to the good faith provisions. We specifically disagreed with the concept of reversing the onus of proof from the AER to generators, where generators were to demonstrate material circumstances had changed as the basis for their rebids. As we stated then, in ERM Power's view the proposed approach is inconsistent with the Code objective of light handed regulation and is of fundamental concern when reviewed in the context of Australian law.

However, this does not mean that something does not need to be done. The Commission has noted recent market behaviour in South Australia and Queensland that raises questions about rebidding, with Queensland as a particular case. The Commission's consultant found a:

...statistically significant relationship in Queensland between instances of late rebidding and high demand, low import headroom, and the binding of the 855-871 constraint. While the 855-871 constraint has recently been alleviated through network investment, the QNI constraint which prevents voltage collapse from the tripping of Kogan Creek Power Station continues to be prevalent at times of high market price in Queensland. (Options Paper, page 40)

We note that the analysis in the rebidding study described above covered the period to August 2014. Rebidding activity has been material since then, with unprecedented spot price spikes and significant price increases in the forward contracts market.

What ERM Power has observed in Queensland

ERM Power has observed the Queensland outcomes with interest and concern. Figure 1 below shows the half hourly spot price in Queensland from early November 2014 to end January 2015, showing significant price spikes, with numerous dispatch intervals at the Market Price Cap (MCP). Figures 1 and 2 also show the material increase in the price of forward contracts in Queensland over this period.

Figure 1: Queensland spot and daily futures prices Nov14 – Jan15

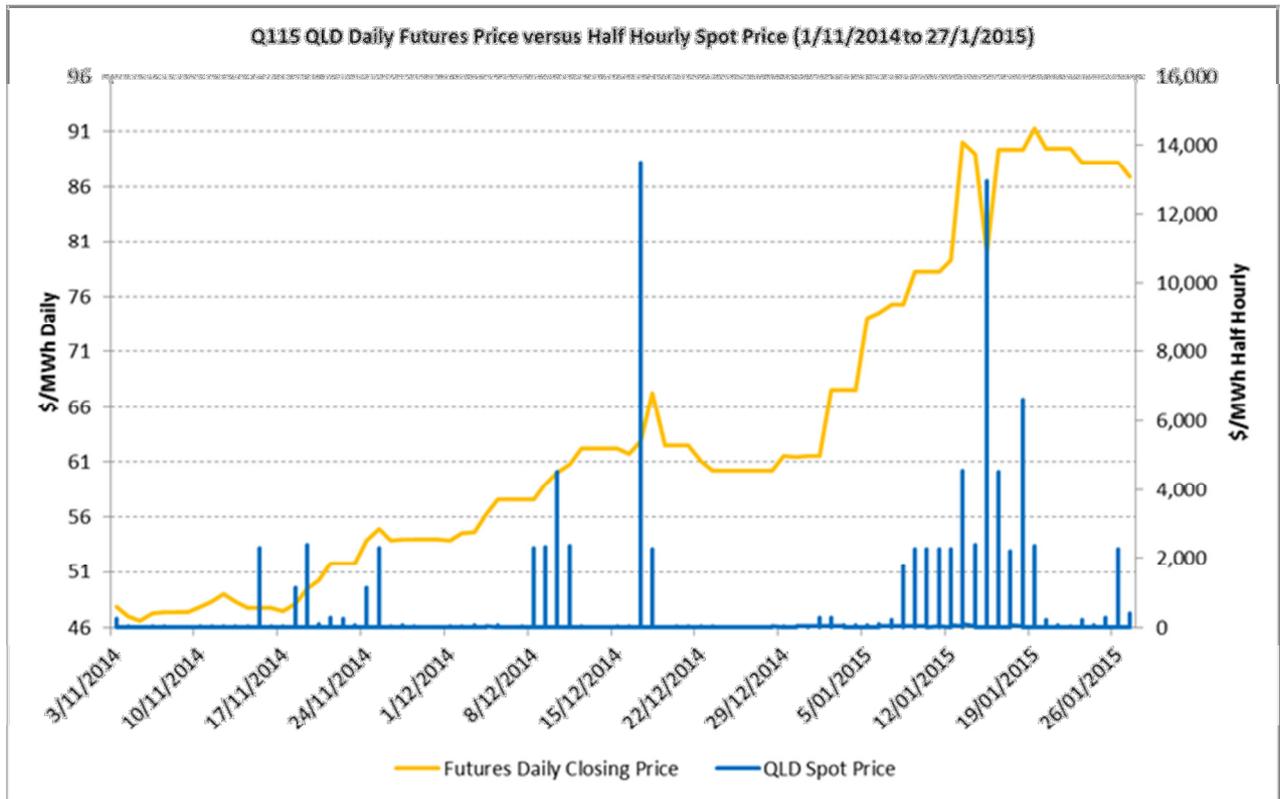
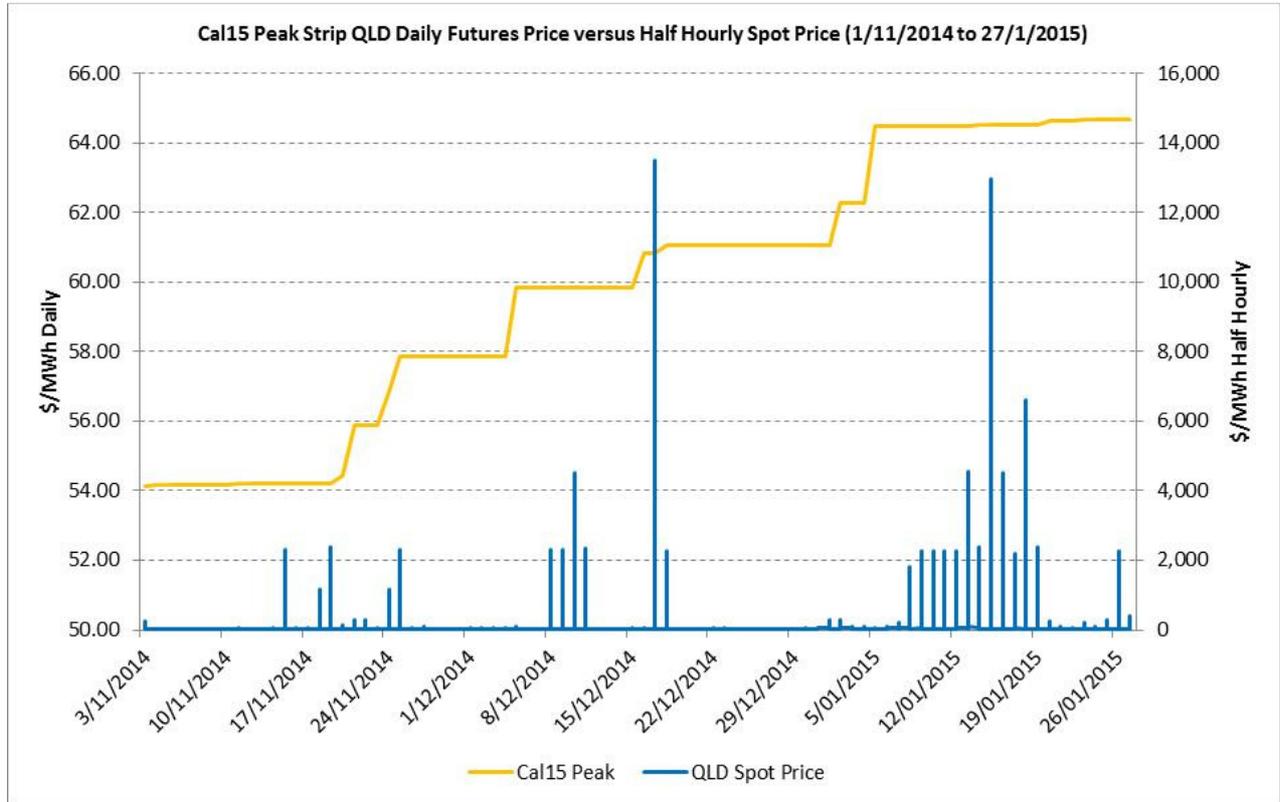


Figure 2: Queensland spot and peak strip daily futures prices Nov14 – Jan15



While it is difficult to quantify the overall market cost increase associated with the described increase in forward market prices, one methodology is to quantify the increase in value of the Queensland futures market contracts held immediately prior to the increased rebidding activity. Table 1 below shows the increase in value of three types of 2015 Queensland futures contract strips before and after the more recent rebidding activity in Queensland until 27 January 2015. The ‘open interest’ in Calendar Year 2015 (Cal15 Flat) futures contracts was valued at \$533.7m at 3/11/2014. On 27/1/2015 these same contracts were valued at \$735m. That is, during the period of the increased spot market activity, the Cal15 Flat contracts increased by \$201m, or 38 per cent. Similarly, Cal15 Peak contracts increased by \$1.1m and Cal 15 Caps by \$38.7m.

Table 1: Increase in 2015 Queensland futures contract strips

| Face Value (\$) | Cal15 Flat | Cal15 Peak | Cal15 \$300 Caps |
|-----------------|----------------|--------------|------------------|
| 3/11/2014 | \$ 533,672,302 | \$ 2,322,053 | \$ 27,243,792 |
| 27/01/2015 | \$ 735,234,246 | \$ 3,435,210 | \$ 66,019,464 |
| Delta (\$) | \$ 201,561,944 | \$ 1,113,158 | \$ 38,775,672 |
| Delta (%) | 38% | 48% | 142% |

The above increases in futures contract values do not take into account the price increases in the Over the Counter (OTC) contracts. If we include OTC contracts the impact on the value of forward contracts curve could be close to \$400m in 2015 alone.¹ This analysis only extends to standard swap and cap derivatives

¹ This is based on the 2014 Australian Financial Markets Report assessment that OTC contract volumes represent approximately 65 per cent of the volume traded on the futures exchange.

and therefore does not extend to options and non-standard financial products, nor does it take into account swap and cap derivatives traded throughout November, December and January. Therefore the \$400m amount may be a modest assessment of the overall financial impact. We encourage the Commission to further assess the impact of the behaviour and associated price impacts on the Queensland forward curve.

Defining the problem to be solved

The problem of late strategic rebidding has been addressed at some length through the consultation to date. However, there are some elements of rebidding activities in Queensland that we want to draw out further.

First, it is worth pointing out that the rebidding activity that we see as problematic is where there is a concerted effort to drive up wholesale prices by generators regularly economically withdrawing large volumes of capacity using very fast ramp rate plant in the last minutes of a trading interval. In Queensland, generators have been rebidding in this manner on days where the result of this action has been to bind the QNI interconnector, economically 'separating' the state from the rest of the NEM. This then provides for transient market power for those select generators: the market in a broader sense cannot respond to the high prices. We have seen certain plant switched off and on for five minute periods on many occasions on certain days.

Second, and related to the first point, we note that the Commission has stated in its Options Paper that transient pricing power 'is only a concern if it occurs frequently enough and to a significant magnitude that it leads to wholesale prices that are sustained above the long-run marginal cost of new generation capacity and that barriers to entry exist that prevent or increase the costs of new investment' (page 47). The transient pricing power discussed above fits the criteria to be a concern; it is certainly difficult to contemplate new generation capacity that could be built to efficiently remove the transient pricing power currently demonstrated in Queensland. For example, ERM Power has led the development of more than 2000MW of generation in Australia, and has two development approvals in place in Queensland to build new peaking power stations. We would be well placed to build a new peaking power station in Queensland. However, we would not do this because the lateness of the current rebidding means that new plant could still not react to the higher prices.

In short, the high prices both in the spot market and in the forward contracts market in Queensland do not seem to be the result of genuine supply and demand conditions. This outcome is clearly inconsistent with the National Electricity Objective (NEO); that is, it does not support operational and price efficiency in the market to meet the long term interests of consumers. While we have focussed on Queensland in this submission and this is where the problem is currently of most concern, we believe that the fact that this behaviour is able to occur in the NEM without apparent penalty (or at least a meaningful enforcement approach) is unacceptable. We do not support the view put forward by some stakeholders that the regional nature of the issue means that no action is required.

ERM Power's position

While we acknowledge that price volatility is part of an effectively competitive market, if prices are regularly pushed to the MCP in an otherwise oversupplied wholesale environment then there is reason to question whether the market is operating as intended. This is particularly because high prices occurring late within a trading interval cannot be economically responded to by the market itself.

It is reasonable to consider how regulation might be improved so that the threat of enforcement might reduce or eliminate behaviour that undermines market confidence. We note the Commission's conclusions that the National Electricity Rules (NER), existing Australian Consumer Law and the Corporations Law are not currently adequate in such a role, and so we agree that a change to the NER is a reasonable alternative.

ERM Power supports a new statement in the NER that clarifies that the regulator is able to take action against generators where there is reason to believe the market is being manipulated or there is other undesirable trading behaviour. This would be enforcement against generator behaviour that results in harmful outcomes and undermines confidence in the market.

We do not support the gate closure mechanisms included in the AEMC Options Paper. These are still too broad and will further reduce the effectiveness of the market to respond to price events. If a gate closure approach is to be considered we would prefer a limitation on bids that provides for the majority of rebids to still be made up until dispatch; the issue is how to prevent the 'wrong' sort of rebidding.

These views are explained in more detail below.

The existing good faith provisions or a behavioural statement of conduct

The Commission's Options Paper describes the trade-off between regulating to limit late strategic rebidding (in the sense we have referred to the practice above) and allowing for the necessary flexibility for generators to rebid in the NEM in a reasonable commercial sense. ERM Power absolutely agrees that flexibility is vital for the efficient functioning of the market, and we would caution against regulatory approaches that apply blanket statements or limitations that might unintentionally limit or prohibit reasonable commercial behaviour from generators. In our view the original rule change proposal went too far in that it applied this blanket coverage, as did the Commission's initial view that the proposal was about 'reversing the onus of proof' back to generators (although this was stated by the rule proponent as not its intent).

However, we believe that there should be some way of better defining acceptable/unacceptable behaviour in the wholesale market. The behaviour we have seen to date has caused (and is still causing) material harm in Queensland and can be expected to cause further harm in other jurisdictions when the circumstances provide for it. The behaviour will continue because the AER believes it cannot pursue the issue under the current rules, despite the outcomes being misaligned with policymakers' intent or consumers' likely reasonable expectations. The apparently unenforceable nature of the existing good faith bidding provisions has also had a negative effect on the confidence of market participants.

In ERM Power's view the discussion on how to improve the good faith provision needs to begin by asking whether the existing or proposed rule can be enforced while legal interpretation appears to rely on a view of a trader's good or bad faith intent when making a bid. The case *Australian Energy Regulator v Stanwell* demonstrated the difficulty for an external body (that is, anyone other than the trader in question) to prove that an individual's intent to honour a bid was any different from what the individual said it was. Of course it is not in a trader's interest to admit that his activity is anything other than a reasonable response

to circumstances as allowed under the law. This leaves circumstantial evidence at best for a prosecuting authority, where this evidence may exist but would seem unlikely in the case of individual bids.

We therefore agree with the Commission that a regulatory approach could shift from a focus on specific bidding events to the longer term effects of generator behaviour on the market across units within a generation entity. This also links better to the NEO, which primarily focusses on effects of the market on the long term interests of consumers.

The question is then how to apply a more general legal obligation on market participants to behave with integrity in the market, and specifically to not undermine the public interest or confidence in the market. As noted by the Commission, the *Corporations Act* 2001 section 1041A provides legal precedent regarding market manipulation that may be referenced for a replacement for the NER good faith provision. We agree that while the Corporations Law cannot currently cover the NEM as a physical market, its market manipulation provisions may be of assistance as a template for a new NER provision.² We recognise the issue raised by the Commission that it may be harder in the NEM to determine and define an artificial price; however, this approach still seems to be worth pursuing and we encourage the Commission to continue to address how market manipulation precedents from Corporations Law may be translated into a revised approach to the NER good faith provision.

We also note the New Zealand concept of an Undesirable Trading Situation (UTS), where the regulator (the New Zealand Electricity Authority) has been provided with the ability to investigate and take any action it considers appropriate where there is ‘an extraordinary event which threatens, or may threaten confidence in, or the integrity of, the wholesale market that cannot be resolved under the Code’.³ The concept of maintaining confidence in the market is broad, providing the necessary flexibility for the regulator to investigate and act to resolve issues such as the problems currently experienced in Queensland. A UTS is not explicitly defined, with the *Electricity Industry Participation Code* 2010 clause 5.1 (2) stating that it includes (but is not limited to):

- (a) manipulative or attempted manipulative trading activity;
- (b) conduct in relation to trading that is misleading or deceptive, or is likely to mislead or deceive;
- (c) unwarranted speculation or an undesirable practice;
- (d) material breach of any law;
- (e) a situation that threatens orderly trading or proper settlement; or
- (f) any exceptional or unforeseen circumstance that is contrary to the public interest.

The New Zealand approach seems the most instructive to date, because it grants the regulator powers to act to resolve issues rather than having them continue and then be the subject of court action. The New Zealand Electricity Authority is empowered to commence an investigation into a UTS (only within 10 days of the event taking place), consult, and make specific directions. The Authority may direct that an activity

² We note that the 2013 case law precedent for interpretation of s1041A has shown that ‘it is sufficient to show that the buyer or seller set the price with the sole or dominant purpose of setting or maintaining the price at a particular level rather than in circumstances reflecting the genuine forces of supply and demand’ (see <http://www.corrs.com.au/thinking/insights/market-manipulation-what-is-an-artificial-price-and-why-does-it-matter/>). Importantly, the regulator ‘does not need to establish that: the price at which the transaction occurred was outside a notional “genuine” price in the market in order to determine whether an “artificial price” was created or maintained by the transaction; or the transaction actually affected the behaviour of genuine buyers and sellers’.

³ See <https://www.ea.govt.nz/code-and-compliance/uts/what-is-an-undesirable-trading-situation/>.

be suspended, limited or stopped (either generally or for a specified period), direct that completion of trades be deferred for a specified period, and direct a participant to take specific actions to overcome the undesirable trading situation. We support these kinds of provisions for the AER in the NEM;⁴ swift identification and resolution of market issues according to the principles of UTS regulation will be in the public interest and support confidence in the market. We also suggest that the revised good faith provisions could include public notification of AER investigations into trading activity, as this would ensure market participants were quickly made aware of areas of concern and provided an opportunity to adjust behaviour accordingly.

None of this is to say that the existing good faith provisions should be completely replaced. While we doubt the enforceability of the existing NER clauses we recognise the argument that the one legal case (*Australian Energy Regulator v Stanwell*) does not prove the argument. The good faith provisions also establish a clear expectation of market participants. We thus expect that the best response to the problematic rebidding activity discussed in this submission is a *combination* of:

- good faith provisions that require an entity's current dispatch offer or rebid to represent its genuine intentions to honour its bids and rebids (Option 2 of the Options Paper, pages 58-59), to ensure this principle is still clear to market participants; *and*
- a New Zealand UTS-style provision that gives the AER power to investigate and act to resolve undesirable trading events, which include market manipulation (where guidance, if required, may be provided by the Australian Corporations Law). This is an alternative to (or version of) the Commission's Option 3 (pages 59-60), where a UTS may be related to behaviour over time (rather than specific bids) but is primarily behaviour that undermines the integrity of the market.

Gate closure

ERM Power notes the work carried out by the Commission and its consultants on international precedents for gate closure, as well as the timing issue explored in some depth by the Commission. We are concerned that the options proposed would unduly restrict the vast majority of rebids that are entirely consistent with a functioning electricity market, and particularly negatively impact peaking plant. The ability for fast start peaking plant to react commercially to new information in close to real time is inherently a material component of the benefit these facilities provide to the market and consumers.

ERM Power currently operates peaking plant in the Western Australian Electricity Market, where a two hour gate closure exists. The gate closure mechanism in Western Australia only allows rebidding associated with a loss of availability of plant. As a decision to start or stop a facility for any other reason (such as a commercial decision in response to new information) is prohibited after a gate closure, the owner of a peaking plant has a strong economic incentive to decide prior to the gate closure whether it should operate or not. This leads to clearly inefficient operation in nearly all periods where it would be efficient for a peaking plant to respond to market events. The issues would be magnified in the NEM with a much higher market price cap.

We support rebidding being allowed up until dispatch; the issue is how to prevent the rebidding that is outside of the intent of the NEO. If the Commission intends to pursue gate closure we would like to see a

⁴ The Authority may also direct that any trades be closed out or settled at a specified price. ERM Power does not support this approach; in our view it grants excessive discretion to the regulator to act as if it was the market and this is risky and inappropriate.

more sophisticated policy approach that only targets the types of rebids that are the cause for longer term customer harm. The vast majority of rebids do not fall into this category and so should be allowed if the market is to be efficient and flexible. We have outlined a potential gate closure model in Appendix A.

Gate closure of any type also requires the conduct provision discussed above: while a modified gate closure methodology could provide for better ability for peaking plant and demand management to provide an economically reasonable response, it can still potentially be gamed and so cannot on its own maintain participant confidence in the market. As noted by the Commission, there will always be a last rebid.

Please contact me or Dr Fiona Simon (03 9214 9318) if you would like to discuss this submission further.

Yours sincerely,

[signed]

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Appendix A: Alternative gate closure approach

If gate closure is to be adopted, we would only support an approach as described below.

A targeted gate closure approach could provide for:

- a) rebids within a gate closure period that increase available capacity in price bands, as long as the price in that price band is less than a specified *price threshold*, and
- b) the *gate closure* period to be defined reasonably narrowly.

The approach differs from policy such as the ‘90 minute rule’ used in Queensland in the past, as generators will be able to rebid from lower price bands to higher price bands (and vice versa) as long as this is below a defined price threshold.

The core concepts could be defined as follows:

- The *price threshold* in a gate closure period should be set at a level higher than the expected reasonable ranges of marginal cost of generating plant or cost of demand response. This is important because during a gate closure period operators of peak power plant still need to be able to vary the operation of the facility (including starting and stopping the plant). The peak power plant needs to be able to commercially reduce the operation of a facility (or not run it at all) in response to the latest information by moving volume from low price bands to a price band less than the price threshold. Practically a price spike of \$300/MWh that exists for one dispatch period only is insufficient to cover the cost of fuel, starting costs, and other variable costs. ERM Power suggests \$1000/MWh for this price threshold. This should allow all reasonable costs across peaking plant and demand response approaches.
- The *gate closure* could be set such that the forecast impact of any final unrestricted rebids will be made public in the latest 30 minute pre-dispatch information. This will allow the impact of the bid to be made public with sufficient time to respond. As the Commission has noted, adequate response times are essential for the market to function effectively.

Developing the concepts further, the relevant draft clauses could be as shown in Table 2.

Table 2: Proposed gate closure clauses

| Proposed clause | Explanation |
|--|---|
| 1. A Scheduled Generator or Semi-Scheduled Generator must not make a rebid that increases available capacity in a price band where the price in that price band is greater than the <i>price threshold</i> during a <i>gate closure trading interval</i> . | This will allow rebidding up to the MPC prior to the gate closure, and following the gate closure will only restrict increasing volume in price bands greater than the rebid price threshold. That is, a late rebid that moves volume from low prices to prices above the price threshold will not be able to occur. The majority of economic rebids can still be made; this approach does not restrict movement of capacity between price bands that are lower than the rebid price threshold. Any new capacity made available during the gate closure will need to be bid in at prices below the price threshold. |
| 2. Other than for abnormal plant conditions or other abnormal operating conditions, a Scheduled Generator or Semi-Scheduled | This clause will allow rebidding generation unavailable for commercial reasons prior to the gate closure, but following the gate closure will |

| Proposed clause | Explanation |
|--|--|
| <p>Generator must not make a rebid that reduces the available capacity of a unit during a <i>gate closure trading interval</i>. For any rebid reducing available capacity of a unit during a <i>gate closure trading interval</i> the rebid available capacity of that unit must equal the reduction in available capacity due to the abnormal plant conditions or other abnormal operating conditions.</p> | <p>restrict removing capacity for economic reasons not related to physical plant requirements. Any reduction in rebid capacity will have to equal the technical reduction.</p> |
| <p>3. Other than due to a rebid reducing available capacity in compliance with clause 2, the sum of the <i>available capacity</i> in the price bands lower than the <i>price threshold</i> cannot decrease as a result of a rebid during a <i>gate closure trading interval</i>.</p> | <p>This will ensure a generator cannot restrict the overall available capacity in low price bands unless in response to a reduction in actual capacity.</p> |
| <p>4. Other than due to a rebid reducing available capacity in compliance with clause 2, a decrease in <i>available capacity</i> in a <i>price band</i> above the <i>price threshold</i> that occurs as a result of the <i>rebid</i> during a <i>gate closure trading interval</i> must have a corresponding increase in <i>available capacity</i> in one or more <i>price bands</i> below the <i>rebid price threshold</i>.</p> | <p>This will allow rebidding volume from high prices to lower prices.</p> |