Balancing Submission Guideline

Alinta Energy
Submission

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1. *Introduction*

Alinta Energy (**Alinta**) welcomes the opportunity to provide comment to the Economic Regulation Authority's (**ERA's**) on its *Balancing Submission Guideline - Draft* (published 3 January 2018) (**the Guideline**).

Alinta is an active investor in energy markets across Australia. We have an owned and contracted generation portfolio of nearly 3,000MW, including 1,700MW of gas-fired generation facilities and 1,070MW of thermal coal generation facilities. Alinta has a strong renewable investment strategy across Australia and is pursuing renewable energy projects at an increasing scale. Alinta currently retails electricity and gas to more than 830,000 customers including more than 530,000 customers in west coast markets.

As a leading provider of electricity and gas to Western Australian consumers, Alinta has a keen interest in ensuring the efficient operation of the Wholesale Electricity Market (**WEM**) and is a strong advocate and supporter of the Wholesale Market Objectives (**market objectives**).

Broadly, Alinta considers that the proposed Guideline is inconsistent with the market objectives and that consideration should be instead given to moving the current market power mitigation arrangements to better reflect regulatory practice elsewhere in the world. We consider that enabling more flexibility will allow more dynamic and genuine competition in the market, with less risk of inefficient (costly) intervention and no loss of ability for the ERA to review unusual outcomes.

2. *Market power mitigation arrangements*

The current market power mitigation arrangements should be reformed to allow genuine competition in the market.

Alinta supports a competitive, dynamic market founded on clarity, stability, and transparency. To ensure that the broad market design effectively delivers greater efficiency and competitive outcomes market participants must be able to compete actively in the market. Alinta considers that overly restrictive bidding constraints undermine the benefits of effective competitive dynamics in the generation sector.

The continued dominance of Synergy in the WEM means that market power will remain a headline concern. However, government ownership should be a significant mitigating factor in respect of market power abuse by Synergy. Consequently, as advocated previously, Alinta strongly considers a more permissive approach to bidding behaviour ex-ante (before price formation) can and should be adopted to support more dynamic and genuine competition in the market, while utilising the monitoring and review powers of the ERA to identify any materially concerning outcomes that require further investigation.

The greater concern in industries with substantial government ownership, is not market power abuse, but rather how to ensure that government-owned entities will operate in a commercial manner. Market power is a second order concern in such cases from an economic efficiency perspective. Our view is that if Synergy were ever to be privatised, it would need to be split into two or three entities to promote transparent, competition-based behaviours and outcomes[1] . However, as long as Synergy is government-owned, Alinta does not see *abuse* of market power (in the sense of restricting supply to increase prices as being a particularly concerning risk).

Given this context, rather than creating narrow definitions as part of a Guideline, Alinta considers that the WEM's market power mitigation arrangements can and should be redesigned to better reflect regulatory practice elsewhere in the world through enabling more flexibility, reducing current levels of intrusiveness, and seeking to achieve a sustainable balance between market power concerns and the need to maintain system adequacy and security of supply. Put simply, the current bidding rules signal a fundamental lack of confidence in the broader market arrangements.

Specific details of Alinta's recommended reforms are presented in Appendix 1. Alinta considers that the recommended changes represent a better way to express concern for possible abuse of market power as it places more trust on market competition where possible while allowing for appropriate actions to be taken where necessary.

Alinta's proposed reforms are consistent with best practice internationally, while also reflecting an important and valuable modification to the way market power is mitigated in the WEM today.

3. Discussion

Clause 7A.2.17 is inconsistent with the Wholesale Market Objectives

In preparing and publishing the Guideline the ERA itself has highlighted the inconsistency of clause 7A.2.17 with the market objectives, and how it is impossible for Market Participants to form market offers that are entirely consistent with its requirements.

Alinta recommends that consideration should be given to removing clause 7A.2.17 rather than attempting to interpret it through a Guideline. Removing clause 7A.2.17 represents the most effective option of ensuring the market objectives are met. Alinta considers that nothing is lost in terms of ERA's review authority, but ambiguity is removed and the need for an interpretive guideline for an otherwise unworkable clause is also removed.

Alinta's assessment of clause 7A.2.17 against the market objectives is below.

Market objective (a) is:

> *to promote the economically efficient, safe and reliable production and supply of electricity and electricity related services in the South West interconnected system;*

[1] Splitting up a government-controlled entity into multiple government-controlled entities is a way to mitigate some concerns over potential non-commercial behaviour and promote a more commercially robust market. Most countries that have retained government ownership within the electricity generation and retail sectors (while also introducing competitive wholesale markets) have restructured around multiple government-controlled entities, mimicking a competitive, long-term market structure, enabling the option to privatise entities in the future, and promoting easier comparisons and greater transparency of behaviours. Consider the experiences New Zealand, Singapore, South Korea, and the Philippines, to name a few.

Clause 7A.2.17 by its very nature restricts the market offers participants can make. Its existence reduces the economic efficiency of the market outcomes, failing the economic efficiency element of the market objectives:

- The efficient dispatch of generation is distorted through the limitation placed on a Balancing Submission. Whenever a Market Participants modifies a market offer to conform with the requirements of Clause 7A.2.17, it has the potential to alter the dispatch pattern and mis-price the marginal value of electricity;

- Allocative efficiency is then distorted as electricity users respond to the distorted price. While the elasticity of demand means that this response is very small, it is growing as more electricity consumers gain the ability to respond short term electricity prices and energy storage devices become more prevalent.

- The restrictions placed on Market Participants and the risks associated with distorted electricity prices change investment decision making, and thereby the dynamic efficiency of the WEM.

Market objective (b) is:

> *to encourage competition among generators and retailers in the South West interconnected system, including by facilitating efficient entry of new competitors;*

As noted above, the restrictions and risks imposed by Clause 7A.2.17 distort the incentive for new entrants. Rather than encouraging competition, Clause 7A.2.17 artificially restricts it, effectively prescribing the price outcome.

Market objectives (c) and (e) are:

> *to avoid discrimination in that market against particular energy options and technologies, including sustainable energy options and technologies such as those that make use of renewable resources or that reduce overall greenhouse gas emissions;*
>
> *to encourage the taking of measures to manage the amount of electricity used and when it is used.*

Market objective (c) promotes neutrality across technologies. Clause 7A.2.17 presents an interesting challenge for energy storage technologies, such as the large lithium-ion batteries that are being installed in the National Electricity Market.

Take the scenario of a battery co-located with a solar or wind power station. Through Clause 7A.2.17 this facility is required to make market offers at its reasonable expectation of Short Run Marginal Cost (**SRMC**), which for the battery would be the expected cost of electricity injected. Where this energy comes from solar or wind this is zero. As written, Clause 7A.2.17 could be interpreted to require the battery to offer its capacity at no cost in all trading intervals, which is not logical. It would breach this market rule to store the energy for a time period where it has higher economic value. Does Clause 7A.2.17 therefore prevent the use of batteries to store energy?

As well as failing market objective (c), this also contravenes market objective (e) which encourages measures to manage the amount of electricity used and when it is used.

Market objective (d) is:

> *to minimise the long-term cost of electricity supplied to customers from the South West interconnected system;*

Rather than use guidelines, which themselves create risk of insufficient flexibility, we strongly urge that clause 7A.2.17 simply be removed. Alinta considers that the distortions clause 7A.2.17 imposes on the market will increase the long-term cost of electricity supplied to customers which is inconsistent with market objective (d).

Removal of clause 7A.2.17 will lead to more competitive market outcomes

The counter-factual argument is to look at what outcomes could be expected if clause 7A.2.17 was removed. Assuming no other changes to the market rules of industry structure, Alinta anticipates that in most Trading Intervals the WEM will be the same or more economically efficient, with market prices more accurately reflecting the SRMC of the marginal generator. This is a pricing outcome consistent with the one prescribed by Clause 7A.2.17 – without the overly restrictive bidding constraints which undermine the benefits of effective competitive dynamics in the generation sector. Further, if left to function correctly, the market will respond with new entrants.

As advocated previously Alinta strongly considers a more permissive approach to bidding behaviour ex-ante (before price formation) can and should be adopted to support more dynamic and genuine competition in the market, while utilising the monitoring and review powers of the ERA to identify any materially concerning outcomes that require further investigation.

The proposed guideline has no formal legal status and does not create meaning or value

Alinta notes that the express purpose of the proposed guideline is to provide an insight into the ERA's current approach to the relevant rule, and is expressly "not binding on the ERA". Further to this the ERA states that its approach may be different when applied to a particular circumstance. Finally, there are no provisions in the relevant legislation, regulations or the Rules that provide for the publishing of the proposed guideline.

Alinta notes that, while the ERA may in future enforcement matters refer a court to the proposed guideline, and the court might have regard to it if it considered it to be persuasive, it has no formal legal status.

Alinta challenges the ERA's statement that the Guidelines will create a shared understanding, nor are they likely to improve the efficiency of the market. Given this, coupled with the flexibility reserved by the ERA, and the fact that the Guidelines have no formal legal status, Alinta questions whether the Guidelines create any meaning or value.

4. ERA's proposed approach to interpretation

The proposed approach to defining market power is different from the approach courts have taken under the CCA, albeit in a different legislative context

The ERA interprets Clause 7A.2.17 as requiring a causal link between Balancing Market offers and the Market Participant's market power. In interpreting market power, the ERA states:

a. there is no express requirement that market power be significant or sustained;

b. the provision is capable of being mobilised in respect of 'any Trading Interval', in connection with the generation of the 'relevant electricity'; and

c. it links market power to prices above the generator's reasonable expectation of its SRMC.

The proposed guideline suggests that "any" market power, even if not "significant or sustained", is of concern under Rule 7A2.17 and that "the timeframe over which the assessment [of market power] is made is no longer than is necessary for trading to take place. In the WEM, this is a single Trading Interval."

In cases under the Competition and Consumer Act 2010 (CCA), Australian courts have rejected a short-term approach to assessing market power. The Australian Energy Market Commission has also adopted a different interpretation of market power to the ERA in assessing rule change proposals for the National Electricity Market (NEM).

Alinta is concerned that the proposed guideline might be read as suggesting that a single Trading Interval involving bidding above-SRMC (as defined by the ERA) could constitute evidence of market power. If this is the ERA's intent, then Alinta is strongly opposed to this principle given that numerous, legitimate bidding strategies unrelated to market power could be interpreted as resulting in bids that appear to exceed SRMC values when narrowly defined for particular trading intervals. At a minimum there should be a cost-effectiveness consideration here. The potential pursuit of absolutely everything by absolutely anybody at absolutely any time no matter how immaterial or what might be the individual circumstances appears somewhat excessive. Further, this means that any attempt to enforce Clause 7A.2.17 is likely to be economically inefficient.

Alinta considers that an economic approach to considering market power would be more appropriate, in a similar way to the OECD definition:

> ***Market power*** *refers to the ability of a firm (or group of firms) to raise and maintain price above the level that would prevail under competition is referred to as market or monopoly power. The exercise of market power leads to reduced output and loss of economic welfare.*[2]

[2] *https://stats.oecd.org/glossary/detail.asp?ID=3256*

In this definition there is an express recognition that the ability to maintain increased prices is a necessary requirement of market power. Alinta considers that the inclusion of a temporal aspect when interpreting market power is vital and is absent in the approach proposed by the ERA.

Using an economic definition of market power creates the opportunity for an alternative approach to interpreting Clause 7A.2.17. Alinta considers the true intent of Clause 7A.2.17 is to require the ERA to investigate the Balancing Market offers of Market Participants. By undertaking an assessment of Market Participants that have the ability to raise and maintain prices, the ERA will be able to limit is consideration of clause 7A.2.17 to the Balancing Market offers of those participants. This will significantly reduce the work load of the ERA and allow most (and potentially all) Market Participants to make Balancing Market offers without fear of being in breach of Clause 7A.2.17.

Having limited the application of clause 7A.2.17 to the Balancing Market offers of Market Participants with the ability to raise and maintain prices as market power is defined, the ERA can then focus its efforts on whether or not the Market Participant has misused its market power to its advantage with its Balancing Market offers. This approach would bring the ERAs efforts into line with those of other regulators in Australia, notably the ACCC. The anti-competitive behaviour tests employed by the ACCC provide a useful reference as to how regulators monitor and measure the abuse of market power.3

Further, using an economic definition of market power and employing the approach suggested here will also ensure the ERAs activity is consistent with the WEM objectives, promoting competition and the efficiency of market-based outcomes.

The proposed approach to the interpretation of SRMC is inconsistent with the Market Objectives

Failing the removal of Clause 7A.2.17, Alinta offers this alternative guidance on how the reference to SRMC could be interpreted with reference to the market objectives - the promotion of efficiency and encouragement of competition.

As noted by the ERA, the adoption of an economic definition of SRMC for the purposes of Clause 7A.2.17 would cause problems for a generator operating in the WEM. The ERA notes the physical limits of minimum generation levels and “U” shaped cost curves, and concludes that, for the purposes of Clause 7A.2.17, pricing at or below Average Variable Cost (AVC) is a valid approach. Thus the ERA conclude that the reference to SRMC in Clause 7A.2.17 should be interpreted as AVC.

Alinta does not agree with the ERA’s interpretation of this and suggests that in applying Clause 7A.2.17, a greater consideration of the market objectives be used in arriving at an alternative definition for SRMC.

- To promote economic efficiency, generators should have the freedom to make market offers with all necessary flexibility to match those offers to their expected opportunity costs. The interpretation of Clause 7A.2.17 should acknowledge that a contracted market participant has

[3] https://www.accc.gov.au/business/anti-competitive-behaviour/misuse-of-market-power

the natural incentive to make market offers at SRMC, and any Balancing Offer from a contracted (or vertically integrated) generator should be automatically acceptable.

- In addition, and over the longer term, the definition of SRMC needs to acknowledge that the safe and reliable operation of the electricity supply industry requires that market participants understand and expect that they will not be penalised by their legitimate efforts to recover their opportunity costs when making offers.

- Competition can only occur when outcomes are not prescribed. The chosen definition of SRMC needs to be sufficiently broad so as to allow generators to compete for the opportunity to be dispatched. At the limit, SRMC could be safely defined as being unrestricted, as the worst-case outcome under this interpretation will be price outcomes that encourage new market entry, in line with the market objectives.

Rather than limit the definition of SRMC to AVC as the ERA is proposing, a superior approach would be to use a far broader definition to encourage competition and market efficiency, thereby delivering lowest cost outcomes to WA electricity consumers, and then to focus on achieving the longer-term benefits of actual competitive rivalry.

Clarification of the new terms introduced in the Guideline

We have outlined our preference for the removal of Clause 7A.2.17, and failing this, a different interpretation of the market power and SRMC terms within it. The Guideline also introduces new concepts that require interpretation.

- The ERA introduces a new undefined term of standard pricing behaviour in an attempt to interpret when pricing behaviour in an individual Trading Period relates to market power. It reads that if a generator offers remain consistent over the course of an extended period of time then its behaviour does not relate to market power, whereas if a generator offers a unique price due to circumstances it may be considered market power. While the opposite is actually more likely to be true, if the term standard pricing behaviour is to be used it requires definition.

- In the Guideline the ERA defines AVC as the sum of all variable costs and Avoidable Fixed Costs without defining the time period for this averaging. Consistent with the ERA's acknowledgement that generators making losses in the Balancing Market is not sustainable in the long term, Alinta assume that (if the use of AVC is maintained) the applicable time period for the AVC definition will be able to be defined by the Market Participant, and will be of sufficient duration to ensure all applicable costs commitments can be included.

- The ERA acknowledges that the SRMC is a forward-looking concept but are not explicit in whether the calculation of AVC is to also be forward looking. We would assume that it is, and that the same latitude for forecasting and judgment are to apply.

5. Conclusion

In conclusion, Alinta considers that the most appropriate course of action is the removal of Clause 7A.2.17 from the market rules. Until this is achieved, we recommend that Clause 7A.2.17 would be more appropriately interpreted with reference to an economic definition of market power and that SRMC should be largely unrestricted. This approach would afford the opportunity for the outcome to be consistent with the market objectives.

Appendix 1: Alinta's proposed reforms

- **Evolution of the market oversight role of the ERA towards a greater focus on ex-post inspection**. This is because ex-post inspection should have priority over ex-ante restrictions.

  While Alinta recognises that ex-post review introduces risk in terms of ambiguity as to what outcomes will be reviewed, ex-ante restrictions introduce risk in terms of whether the restrictions are consistent with relevant underlying costs and values. Logically, it also means that in a changing world with new technologies and competitive pressures, ex ante -oriented enforcement will always be chasing the future by imposing filters, screens, guidelines and so forth that reflect what someone thought was appropriate based on the past. Alinta believes that the ERA can manage these risks appropriately and that a focus on ex-post review provides a better basis to evaluate market performance and competitive dynamics, especially in a rapidly evolving sector.

- **Explicit recognition that market power is not the only concern that may arise in relation to market bidding and price formation** and therefore should not continue to be the only focus of the Market Rules pertaining to bidding and pricing.

  The other important concern from a design perspective is that prices must be high enough to support timely and efficient behavioural and investment responses. Consequently, a focus only on market power, with a view to ensuring that prices are as low as possible, introduces into the design the risk that prices will be constrained too low. Regulatory oversight of market prices should be equally alert to both concerns – balancing them accordingly when evaluating outcomes.

- **Removal of the current detailed definition of SRMC and broadening of scope of specified mitigation controls.**

  Although SRMC is theoretically the optimal bidding price in a fully competitive market (given static equilibrium conditions), it is well-known that estimation of SRMC is not always simple, and that markets are dynamic and have self-correcting incentives over time. We do not consider it is possible to develop a clarified set of detailed guidelines for calculating SRMC that fully captures the challenge of estimating appropriate SRMC-based bids at all times. Consequently, we consider any guidelines need to be "higher level", which implies the need for greater flexibility.

  In particular, as the WEM is a self-commitment market in which start-up costs are recovered through accepted energy market offers, SRMC is always going to vary widely depending on circumstances. With intermittency, there is likely to be a greater need for start-up costs to be incurred even as expectations of duration of dispatch are unclear and likely short. For mid-merit and peaking capacity, at minimum, the appropriate SRMC bid can vary widely depending on expectations concerning how long a given start-up to shut-down cycle will run.

- **Implementation of a reference level trigger for review of bids by the ERA to confirm whether they were competitive.**

  Consistent with best practice in other markets, we support a safe harbour concept for bids that are within at least 20% of reported levels subject to considering the need to recover start-up costs, the opportunity cost associated with limited fuel supplies, and other similar costs.

Alinta does not believe it is necessary (and is instead mutually burdensome) to provide cost data to support every bid in each hour. Instead, we suggest the adoption of a reasonable standard benchmark cost range. If a unit has materially higher costs, then application can be made for appropriate exceptional treatment. Note that adjustments to the benchmark level as a result of changing fuel costs would be required potentially.

Alinta supports a reference level set based on cost stack plus ~20%. We consider that adopting at least 20% as a level to trigger a review would be required as start-up costs are incorporated into bids within the WEM and so a larger level of volatility in bid levels is possible than in other jurisdictions which adopt 10%.

The appropriateness of the reference level should be subject to occasional review by the ERA to ensure that reviews of bids are being triggered at appropriate times. To the greatest reasonable extent, the reference level should be set as high as practicable so as to allow competition dynamics to work.

A problem with the current arrangements is that they do not allow any natural evolution towards greater reliance on competition itself, as the Market Rules are explicit about SRMC bid constraints under all market conditions. We note a more flexible approach would be to allow the use of overall bid caps as seen in other markets and for those caps to be evaluated and revised as appropriate.

- **Consideration of implementing scarcity pricing arrangements.**

  The rebalancing between the energy and capacity mechanisms means that energy pricing plays an important role in signalling readiness, and ensuring system adequacy and security can be maintained during contingency arrangements. Higher energy prices during contingency events are not simply about signaling investment in capacity.

  Best practice in several markets is to implement special scarcity pricing arrangements which result in a relaxation of bid constraints or other market power mitigation measures under situations where there is deemed to be a high risk of an outage. Such arrangements seem particularly appropriate for the WEM, particularly, given the small, lumpy, and volatile nature of the market.

- **Retain Gross Cost of New Entry (CONE)[4] approach for determining the Benchmark Reserve Capacity Price** given the peakiness of SWIS which makes it difficult to reconcile any assumed "net" energy market revenue for peaking capacity.

  If in the future Net CONE were to be adopted, much higher energy bid caps would be required as any material net revenue for peaking capacity in the energy market would necessitate much higher market prices as the market approaches scarcity in order to represent a material contribution to the cost of new entry.

[4] CONE is an estimate of the unit cost of (installed) capacity for the most economical form of new construction, excluding variable energy costs. Gross CONE includes all fixed costs related to the construction and availability of a facility, including those related to capital, financing and fixed OM&A. Net CONE equals gross CONE minus the expected margin on sales.