Synergy Submission into the ERA's Draft Balancing Submission Guidelines (Guidelines)

Synergy welcomes the opportunity to comment on the ERA's Draft Balancing Submission Guidelines (**Guidelines**).

1. **Summary**

1.1 Synergy considers that the ERA's interpretation of clause 7A.2.17 (**SRMC Clause**) of the Wholesale Electricity Market Rules as expressed in the Guidelines is legally incorrect, is likely to result in sub-optimal market outcomes and will cause significant practical issues.

1.2 The interpretation of the SRMC Clause in the Guidelines reduces what is clearly a market power mitigation provision to a simple pricing provision (i.e. simply restricts pricing to be at or below SRMC at all times as retrospectively assessed with a detailed consideration of the information that should have been available). If adopted, the Guidelines will create additional uncertainty about the correct application of the SRMC Clause and impose increased costs on the market.

1.3 Further it will create significant practical issues and fails to consider how Market Participants will account for matters such as forecast uncertainty, the distribution of possible forecast errors and step changes and spikes in price estimates between Trading Intervals.

2. **Overview of the Guidelines**

2.1 Based on the Guidelines, Synergy understands the ERA will take the following approach to breaches of the SRMC Clause:

(a) Market power is defined as "*...the ability to influence price and benefit financially from this ability*".

(b) Compliance with the SRMC Clause will be assessed on a Trading Interval-to-Trading Interval basis, including the assessment of whether a Market Participant has market power.

(c) The phrase "One more unit of production", in the economic definition of SRMC, will be treated as a fixed quantity, regardless of the level of output of the Facility at a certain time and the capabilities of that Facility at that time.

(d) It is accepted that compliance with bidding at the interpretation of SRMC used in the Guidelines exposes a Market Participant to losing money.

(e) Average values, or 50% probability of exceedance forecasts, will be used when actual information is not available.

(f) A Market Participant will be deemed not to be in breach of the SRMC clause where it offers prices below its Average Variable Cost (**AVC**) or below an otherwise competitively determined price or both. The concept of AVC used in the Guidelines includes a requirement to "smear" start-up costs over multiple Trading Intervals.

(g) A Market Participant will be deemed to have bid in a manner "related to market power", and therefore, in breach of the SRMC Clause for bidding above SRMC, where it offers prices above its AVC and above the aforementioned competitively determined price.

3. In principle issues and legal interpretation

3.1 In principle:

(a) The method for identifying breaches of the SRMC Clause in the Guidelines is, in effect, the same as the method the ERA employed in the Vinalco SRMC dispute before the Energy Review Board (**SRMC Dispute**).

(b) It assumes the legal position the ERA took in the SRMC Dispute was correct and ignores the fact that the decision was agreed solely for the purposes of settlement and nothing else.

(c) Synergy did not accept the legal analysis in the decision in the Vinalco SRMC Dispute. Synergy maintains its position from the decision in the Vinalco SRMC Dispute and, therefore, opposes the interpretation used in the Guidelines.

3.2 As detailed in its submissions into the Vinalco SRMC Dispute, Synergy considers the following legal interpretation of the SRMC Clause is the proper interpretation:

(a) The phrase "the [SRMC] of generating the relevant electricity by the Balancing Facility" means the ERA is required to examine the marginal cost of generating all of the relevant electricity in an applicable Trading Interval.

(b) SRMC is a forward looking concept and requires some level of forecasting and judgement. Therefore, it is essential to examine whether a Market Generator has priced within its subjective reasonable expectation of SRMC, having regard to the data and information reasonably available to the relevant Market Generator at that time.

(c) Market power can only exist in circumstances where there are no other providers available as a substitute to provide the relevant electricity within a reasonable timeframe and/or limited or no ability for consumers to respond to the relevant pricing.

(d) Except for very rare circumstances, if at all, market power cannot exist for only one Trading Interval.

(e) In the context of the SRMC Clause, the phrase "relates to market power" should be read narrowly to mean "relates to an inappropriate use (i.e. abuse) of market power which results in the market not functioning effectively in accordance with the Wholesale Market Objectives".

4. Compatibility of the effect of the ERA's Guidelines with the Market Objectives and the WEM Rules as a whole

4.1 In Synergy's view the interpretation of the SRMC Clause used in the Guidelines is inconsistent with the Market Objectives. For example:

(a) If a Market Participant prices in accordance with the definition of SRMC used, it will likely lose money.

(b) A Market Participant is unable to price uncertainty and risks into Balancing Submissions.

(c) The interpretation undermines long-term market efficiency by prohibiting competitively determined price discovery.

5. Specific issues with the Guidelines

Issues with the ERA's definition of SRMC (section 3 of the Guidelines)

5.1 The Guidelines state that, because it is impossible for a generator to increase production 'one more unit' [of production] from its zero generation", SRMC cannot include a component for start up costs. This statement appears to be incorrect and based on a narrow, and static, interpretation of the phrase "one more unit".

5.2 In Synergy's view, the Guidelines mistakenly assume that "one more unit" must always be equal to 1MW (or less, but in any case a static number). However, the concept of "one more unit" is inherently dynamic and the size of the next "unit of production" depends on the current output of a Facility. For example, when operating at 0MW, "one more unit" is equal to the difference between 0MW and the 'minimum stable generation' level of the relevant Facility.

5.3 Additionally, the definition of SRMC in section 3 of the Guidelines also undermines the requirement in the WEM for Market Participants to self-schedule their facilities through the available markets and artificially suppresses the market's ability to allow competitive forces to set a price that includes all of the relevant costs, including costs associated with uncertainty.

5.4 The following examples illustrate some of the associated deficiencies in the interpretation adopted in the Guidelines. In each example, the generator is assumed to have market power:

(a) Where a Market Participant forecasts the Balancing Price will equal the AVC of providing any incremental electricity, the Guidelines effectively require it to offer into the Balancing Market at or below its AVC. All else remaining equal, this results in the Market Participant being exposed to a 50-50 chance of making or losing money. For many Market Participants this risk is untenable, especially given the risk of losing money is 0% if the participant bids at the price cap.

(b) Further, it is also likely that, in the above example, the Balancing Price, and the forecasted dispatch profile of the Market Participant's Facility, will change after the Market Participant makes the Balancing Submission. For example, the Facility may now be required to operate at half load. This would drastically increase the AVC of the Facility. However, applying the interpretation used in the Guidelines, it is impossible for the Market Participant to factor in the risk associated with a changed dispatch profile into the price it offers.

(c) In the event the Balancing Submission made in the above example is made just prior to Gate Closure, application of the interpretation in the Guidelines requires a Market Participant to "lock in" a price in its Balancing Submission it knows is likely to be incorrect.

(d) Alternatively, consider the situation where the Market Participant decides that its Facility has a high likelihood of experiencing an Outage if it operates, but does not have a scheduled outage approved. Application of the interpretation in the Guidelines requires the Market Participant to offer at its AVC, rather than offer at the price cap in order to minimise the likelihood of the Facility experiencing a catastrophic failure (which in turn would cause significantly more costs than removing capacity from the Balancing Market). Therefore, the Guidelines require the Market Participant to risk its Facility being extensively damaged in order to meet the ERA’s desired goal of offering prices equal to SRMC in almost all circumstances. (Synergy also notes that it is a requirement that a Market Participant make Balancing Submissions at the price cap to be eligible to request an opportunistic maintenance to resolve the aforementioned risk – the Guidelines would also bar the relevant participant from making such a submission).

Issues with definitions used by the ERA (section 4 of the Guidelines)

Definition of "Reasonable Expectation":

5.5 The ERA claims that this phrase is essentially "what a reasonable Market Generator would have expected with reference to the circumstances known to [it] at that time".

Arguably, this interpretation has the effect of changing the drafting of the SRMC Clause from

(a) "... a Market Participant must not... [offer prices]... in excess of the Market Participant's reasonable expectation of SRMC" (i.e. the express words used in the SRMC Clause)

to

(b) "... a Market Participant must not... [offer prices]... in excess of a reasonable Market Participant's expectation of SRMC" (the words required to give effect to the definition used in the Guidelines)

5.6 The interpretation in the Guidelines also does not allow a Market Participant to factor in any uncertainty associated with the inputs it uses to calculate SRMC. An important aspect of competitive price discovery is that a competitive market will factor in all relevant risks in the prices offered. Such factoring in of risk allows for economically efficient commitment decisions to be made over the short term, and economically efficient investment decisions to be made over the longer term. The approach proposed in the Guidelines stifles the ability of the Balancing Price to signal these economically efficient outcomes.

<u>Definition of "Market Power"</u>

5.7 The Guidelines state that market power is the "ability to influence price and benefit financially from this ability". Synergy notes that the effect of this definition is that any Market Participant that sets the Balancing Price has the "ability to influence price", and any price offered in such a case above SRMC "benefits" the Market Participant. This interpretation cannot be correct because:

(a) Any Market Participant that sets the Balancing Price has market power according to the definition of market power used in the Guidelines.

(b) Further, any Market Participant that would have set the price if it had offered at SRMC, but instead offered above SRMC, would also have market power under this interpretation.

(c) Therefore, the Guidelines essentially change the SRMC Clause from a market power mitigation provision into a pricing provision.

(d) Further, because there is no certainty which Facility will set the Balancing Price in any Trading Interval, the interpretation effectively requires all Facilities to offer at, or below, SRMC at all times.

(e) To the extent such a pricing provision was intended, the limitations on the application of the SRMC Clause (i.e. the clause states it only applies in certain instances) are superfluous.

5.8 The Guidelines also propose that the phrase "market power" should be read differently to the normal legal interpretation of the phrase – specifically, the Guidelines state that there could be instances where a Market Participant has market power for a period of as little as 30 minutes. Synergy does not consider deviating from the generally accepted legal interpretation that market power requires an ability to affect price for an extended period of time is warranted.

<u>When pricing "relates to" market power:</u>

5.9 The Guidelines state that pricing behaviour "relates" to market power if a Market Participant with market power changes the prices it has offered relative to situations when it does not have market power.

(a) Whether pricing behaviour "relates to market power" is an element of the SRMC Clause, and therefore the ERA will be required to prove, on the balancing of probabilities, that there is a link between the pricing behaviour and market power. Generally, simple inference from past behaviour is unlikely to satisfy this element, and, therefore, there exists a greater burden of proof that a Balancing Submission "relates" to market power than that proposed in the Guidelines. Therefore, any compliance action initiated on this basis represents an inefficient cost to the market and any actions taken by Market Participants to avoid such compliance action also represent an inefficient cost on the market.

(b) Synergy also considers that the causal link cannot be proven in circumstances where there is an alternative explanation for the behaviour that is unrelated to market power (for example, consider the risk and 'self-scheduling' based reasoning outlined in paragraph 5.3 and elsewhere in this submission).

5.10 The Guidelines also state that a Balancing Submission will "relate to market power" where the price offered is above SRMC but below AVC (see section 3.2 of the ERA Guideline).

(a) The interpretation used in the Guidelines has the effect of re-writing the SRMC Clause so that any prices offered below AVC are not a breach. In effect, this makes the reference to SRMC in the SRMC Clause irrelevant to any determination of compliance with the clause.

(b) Generally, an interpretation that does not require other aspects of a clause, or other clauses, to be superfluous should be preferred.

(c) Synergy considers these points lend further weight to its argument that the ERA's interpretation of SRMC Clause cannot be correct.

Simplified examples hide the practical issues with the approach proposed in the Guidelines (section 5 of Guidelines)

5.11 The simplified examples in the Guidelines hide many practical issues. The Guidelines should explicitly consider and explain how a Market Participant is expected to:

(a) Convert raw SRMC prices into monotonically increasing prices, especially in circumstances where a Market Participant anticipates spikes, or dips, in its estimate of the SRMC at different levels of output.

(b) Account for forecast uncertainty, including the distribution of possible forecast errors (especially regarding forecast Facility and portfolio dispatch profiles).

(c) Account for remaining risks and uncertainty (especially regarding forecast dispatch profiles).

(d) Account for step changes and spikes in price estimates between Trading Intervals.

(e) Account for step changes and spikes in price estimates between tranches in Balancing Submissions for the same Trading Interval.

(f) Deal with a combination of the above issues occurring concurrently.

(g) Deal with instances where a Market Participant expects to be "constrained-on" or "constrained-off" for extended periods of time, and any associated uncertainty.

(h) Estimate the number of Trading Intervals over which start costs can be "smeared" in the calculation of AVC (especially with regards to any uncertainty associated with dispatch profiles), and what to do after that number of Trading Intervals has been exceeded.

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