

22 May 2014

Mr. Sebastien Henry
Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

Dear Mr. Henry

Subject: ERC0166 National Electricity Amendment (Bidding in good faith) Rule 2014

Arrow Energy Pty Ltd (Arrow) welcomes the opportunity to provide comments to the Australian Energy Market Commission (AEMC) on the proposed rule change for Bidding in good faith.

Attached with this letter is Arrow's submission covering the questions raised by the AEMC. Arrow supports the objective of transparent and predictable market outcomes; however, we strongly contest the call for the effective reversal of the onus of proof in relation to Bidding in good faith. Not only is it likely that the proposed rule change will be ineffective in achieving what is set out to be addressed, but it introduces even greater compliance risk and additional burden on generators. Conditions around events that are being sought to be addressed are varied and complex and a simple rule change is unlikely to be effective. Exposing generators to the risk of an automatic compliance breach action in the absence of 'sufficient' proof of a 'material change' seems to be a disproportionate approach.

If you require further clarification on Arrow's submission, please contact Walter Schutte, Commercial Manager Market Operations on phone (07) 3012 4681 or email Walter.schutte@arrowenergy.com.au. Arrow would be happy to be involved in further consultation with the AEMC in regard to the Review.

Yours sincerely



Tony Knight
Vice President - Exploration & Corporate Services

ARROW SUBMISSION – MAY 2014
AUSTRALIAN ENERGY MARKET COMMISSION
BIDDING IN GOOD FAITH

Background of Arrow

Arrow is owned by Royal Dutch Shell and PetroChina. In 2011 Arrow took full ownership and operation of Braemar 2 Power Station (**Braemar 2**), from ERM Power Limited. Braemar 2 is a 450MW Open Cycle Gas Turbine (OCGT) located approximately 40km south west of Dalby, Queensland.

The rule change request

On 17 December 2013, the South Australian Minister for Mineral Resources and Energy (**proponent**) submitted a rule change request to the Australian Energy Market Commission (**AEMC**) proposing changes to the provisions in the National Electricity Rules (**NER**) that require generators to bid in good faith.

The rule change request has come about as a consequence of, what the proponent believes to be, uncertainty as to the operation of the 'bidding in good faith' provisions in light of a Federal Court decision. The proponent further purports that the Court's interpretation is inconsistent with the original policy intent and that the rule change would resolve the uncertainty and address alleged inefficient market outcomes. The proponent believes that this is achievable by, in the main, an effective reversal of the onus of proof onto generators to demonstrate that rebids have been made in good faith. This proposal is made without going to the heart of the uncertainty around what is considered to be material change and what constitutes 'sufficient' proof, but rather merely shifts the obligation of proof to the generator to prove to the AER's satisfaction before action is taken.

The proponent also conditions the information that can be relied on in making a rebid or in defence of the rebid. Rebids must not be made other than in response to a significant and quantifiable change in price, demand or other data published by AEMO. The non-fulfilment of a trader's expectations is not seen to be sufficient justification to warrant a rebid. In support of this change, the proponent considers that the term 'material conditions and circumstances' should be changed to 'material circumstances' as it is potentially unclear as to whether material conditions may refer to the conditions subjectively viewed by the trader.

In addition, the rule change request proposes that the AER be able to take into account a generator's bidding behaviour in relation to its entire generating portfolio assessing compliance with the good faith provisions.

Arrow's summary position

Arrow supports the objective of the NER ensuring a stable and predictable electricity market. The approach to be taken by the AEMC in defining the problem, determining the materiality, (if appropriate) identifying potential solutions and determining net benefit of any change is consistent with Arrow's view of how the issue should be analysed. The proposal focuses on a niche set of events, but the underlying cause may require a more fundamental look at the design of the NEM.

Arrow opposes the proposed rule change in light of what seems to be a disproportionate response to a select number of events, and suggests that little, if any, market benefit is achieved whilst introducing significant uncertainty for generators. Arrow regards the 'Bidding in good faith' provisions as a very strong obligation and treats this as a very serious compliance matter.

Arrow believes that, if it is determined that certain behaviour needs to be addressed, that behaviour be clearly described and a more focused means of dealing with developed. The proposed rule change is too widely cast and the uncertainty that is introduced (due to its non specific nature) is likely harmful to the future interests of the market.

In particular Arrow is concerned about the provision being recast to restrict defences to any allegation of non-compliance. This places a generator in a position of automatic breach if it cannot demonstrate to the AER's satisfaction the material change in circumstances upon which the rebid is based.

The proposed rule change places undue obligation on generators to substantiate good faith without providing further context or definition to what is considered to be 'material circumstances' or 'sufficient' proof. The associated vagueness as to what is considered 'sufficient proof' will create compliance uncertainty for all generators across all rebids and will result in significant increased burden. Prevailing conditions and circumstances underpinning rebids are diverse and complex and the materiality is subject to the specifics for each participant. Describing the elements that were incorporated into the considerations and the commensurate materiality should not be limited for this reason.

It should be noted that parties that currently engage in behaviour identified by the AER would be in a good position to pre-emptively structure their case and build the supporting evidence as to why they acted in a particular way, but those responding to the behaviour (attempting to lessen the impact) would be at a disadvantage as they need to respond quickly.

The proposal to disallow a trader's expectations to be considered as lawful justification for making further rebids is nonsensical as the original bid is based on exactly that: the expectation of the trader to be dispatched at a generation level against a particular price. It would thus follow if the trader's expectation was not met, or was believed to not be met, a rebid would be a logical and lawful consequence.

The rule change request proposes to introduce a requirement for participants to vary their bids only in response to a significant and quantifiable change in price, demand or other data published by AEMO in respect of the relevant trading interval. This proposal is at odds with the fundamental reason for allowing rebidding and is impractical as aspects such as plant availability, fuel status and contract position are not readily observable yet changes in these should clearly merit legitimate rebids. The rule change would also discredit basing rebids on in-house developed systems aimed at providing competitive advantage and revenue optimisation.

Responses to AEMC questions

Question 1: Late strategic rebidding, p18

Late strategic rebidding may generate higher wholesale spot prices, reduce the predictability of spot price outcomes and can impact the ability of unscheduled load and generation participating in the market. It should be noted that conditions leading up to periods that are conducive to undertaking late strategic rebidding can be anticipated and action can be taken to reduce the risk of that rebidding having the intended effect. Irrespective, market participants need to be able to make bids and rebids at any point in the day to be able to manage their portfolio efficiently and effectively

Question 2: 5 minute dispatch and 30 minute settlement, p20

The NEM trading arrangements of five-minute dispatch and 30-minute settlement may create a dynamic that gives greater effect to late strategic bidding. The 30-minute settlement does however assist in providing a “smoothing” of volatility. If settlement was on a five minutes basis it may create greater volatility in periods of true market events (forced outages or short sharp demand spikes) and even fewer generators would be able to react.

If settlement went to a 60-minute timeframe, the same late strategic rebidding, with potentially greater detrimental impact, would occur.

Arrow believes that even though this issue potentially contributes to the dynamics of late strategic rebidding, dispatch periods and settlement periods should not be changed to attempt to manage rebidding behaviours. Clearer understanding and definition of the behaviour that is sought to be discouraged is required to allow for the formulation of more focused approach in dealing with the issue. Note that any change made to the formulation of the Regional Reference Price (RRP) may have a consequential impact on ISDA based agreements.

As stated before, generators should be able to bid and rebid every five minutes to reflect plants operational capacity, commerciality and to respond to market conditions.

Question 3: Reversing the onus of proof

Even though the formulation does not strictly reverse the onus of proof, Arrow is concerned that this is effectively the outcome of the proposed change. The proposal restricts the reasons that are to be considered as material and then goes further as to limit the defence of disputed rebids to the reasons given. This would not only introduce an inordinate burden on generators, but ignores the fact that market drivers are diverse and complex (often proportionate to correlation of changes).

The proposition of simply restricting changes that can be considered material in defence of a rebid thereby solving the issue of proof of good faith bidding is nonsensical. Such a formulation seems to be an unfocused attempt at addressing specific behaviour and relies on the increased risk generators face due vague definition of the objective function.

Arrow agrees with the view outlined by the ACCC in that significant costs would be imposed on participants not only to ensure they are able to defend themselves, but it would lead to a conservative, less flexible market having a negative impact on competitiveness and economic viability of operating generators.

Under the current rules generators should already be keeping information to substantiate that their rebidding practices have complied with good faith provision. There are no guidelines as to exact information that should be kept. Arrow would support the establishment of clear guidelines to allow more timely and cost effective investigations to occur. It would also be prudent for any disputes or enquires regarding good faith bids to be investigated as soon as possible so the full intention of a trader or generator is captured.

Question 4: Rebids to reflect all known conditions and circumstances, p24

- a) Generators operate within market and plant environments that are very diverse and any restriction in conditions and circumstances would place additional risk on generators. All known conditions and circumstances should be allowed to be considered when a generator bids and rebids.
- b) As described in our answer to question 3, Arrow does not believe the proposed change to be sufficiently specific to address the issue, and may in fact result in greater uncertainty. The proposed rule change is not practical and in particular does not clearly define what is to be considered to be included in the redrafted 'change in material conditions and circumstances'.
- c) Arrow supports the in principle position that rebids should only be limited to the occurrence of significant change in conditions and circumstances. Achieving this ideal in practice is difficult as what may be a significant change in condition or circumstance for one generator may not be for another.

(Examples: (1) A price move of \$0.01 could significantly change the output of the marginal generator. (2) A change in gas flow rate which may be only material for one generator will not be for another. Materiality is thus subjective and requires a full understanding of conditions and the trader's mindset at the time to appreciate – it is very difficult to retrospectively consider a decision as knowledge of the subsequent events alter the perspective.

Question 5: Rebidding on the basis of published AEMO data, p25

The proponent suggest that participants only vary their bids on a significant and quantifiable change in price, demand or other data published by AEMO in respect of the trading interval. Arrow believes this to be impractical for the following reasons:

- Plant and fuel conditions are not known to AEMO
- AEMO demand forecasts are not sufficiently reliable
- Organisations that have developed proprietary systems to provide them with competitive advantage would no longer be able to rebid based on the output from these systems
- This would reduce overall market competitiveness
- Rebidding to implement commercial decisions would be disallowed.
- Does not allow traders that have developed greater skill over time to optimise outcomes
- May result in greater risk to system security
- May reduce the incentives to investment in generation in the longer term

Questions 6: Options based on market design and the bidding process, p27

Disallow rebidding of generation volume into different price bands within three trading intervals prior to dispatch.

This approach would still allow generators to rebid strategically and then lock out any generators from rebidding to meet demand or prices. This option may in fact lead to an uncompetitive outcome and cause system security issues. It would allow unscheduled generation or unscheduled load to react, but as there is little by way of unscheduled generation or load in the market, that actively participates it would create more volatility.

Only allow rebidding that has the effect of depressing spot prices

Arrow agrees with the ACCC's position that to only allow rebidding that has the effect of depressing spot prices is an inequitable option. Biasing lower price outcomes would encourage market participants to not hedge and will eventually place huge costs recovery pressure on generators. This would also impact investment in the longer term thus putting system security and adequacy at risk.

This approach ("90 minute rule") was trialled and resulted in meaningless pre-dispatch forecasts as all generators bid their volumes in at high bid bands and brought the volume down to lower levels as required. Note that this can also result in higher than expected market outcomes.

Only allow rebidding for bona fide technical reasons

This option presents similar issues in terms of implementation as definitions around technical qualification for rebidding is complex and difficult to describe. It does not resolve the issue of being able to clearly describe good faith rebidding.

Other options

A number of alternatives could be investigated once the offending behaviour is clearly articulated and defined. The consequential impact of each should be analysed in detail before being considered for implementation.

1. Reduction of the Market Cap Price (MCP) may be a more cost effective solution. The impact on investment signals (particularly peaking plant) should be considered.
2. Leaving the MCP unaltered but introducing a 'growth curve' (ratcheting) process whereby the dispatch price can only increase through given price 'steps' over time – thus only reaching MCP in prolonged market event conditions.

Responses to Proponent's Change Request

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The Proponent suggests that the rule change request intends to “clarify what is meant by good faith for the purposes of the Rules, and specifically to state when a dispatch offer, dispatch bid or rebid would not be considered to have been made in good faith”. The changes does nothing other than constrain what can legitimately be seen as a material change and limits defences to any allegation of breach. This is not seen to provide any additional clarity.

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Arrow questions how the proposed rule change will alter the behaviour described in the paragraph: “..interpretation of what is a material condition and circumstance. Therefore, as it is currently drafted, Rule 3.8.22A cannot prevent or hinder repeated attempts by a trader to cause price spikes by shifting capacity into higher price bands”. The rule change only restricts the changes that can be relied on for lawful rebidding and is not focused sufficiently on deterring the behaviour. Instead, the rule change merely makes it harder for parties intending to prevent the impact of the behaviour to respond.

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The proponent makes the following point: “AER's reports demonstrated that in some cases a change in market conditions, which was stated as the reason for the rebid, was known ahead of time. Despite notification of a network constraint or high demand,...”. Even though notification of network constraints may have been given, the extent of the constraint and the impact is not always clear until the effective dispatch period. In cases where the continuation of the event requires a generator to rebid there should be no impediment to doing so. Note also that there usually is a degree of probability that applies to any forecasted information – eg. if AEMO forecast 6500MW demand for a particular dispatch period there is a chance this may not eventuate; and in many cases generators have different views on this. As time moves toward that dispatch period the degree of uncertainty reduces and ‘better’ decisions can be made.

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The proponent makes the following point: “..with rebids being observed in circumstances where demand and capacity were at close to forecast levels.”. It should be noted that generators typically monitor a number of factors, considered in combination, to inform decisions. Thus isolating one factor, which may in isolation seem unchanged, is an overly simplistic analysis of the situation.

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The proponent states: “Recasting clause 3.8.22A(b) in the negative is also intended to assist with this problem. If a trader makes a rebid when nothing has changed from the earlier bid, the new wording more clearly allows an inference to be drawn that the original bid was not made in good faith.” Structuring the provision in such a manner that, if in the view of someone other than the trader “nothing has changed”, leads to the assumption of the bid not having been made in good faith effectively reverses the onus of proof.

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Factors monitored by traders often change, but may not necessarily translate into a rebid. In some cases the duration of the change in the factor may have a more significant bearing on the need to rebid. For example, a transmission element may unexpectedly constrain, but from previous experience, the condition is reversed soon after. On the particular day, the constrained condition persists for longer than expected – this should be the basis for a valid rebid. The position posed by the proponent “inclusion of the requirement for a participant to rebid as soon as practicable after the change comes to its attention is designed to ensure the rebid is made in a timely manner and should therefore be an important characteristic of bidding in good faith. Proposed additions to Rule 3.8.22A would bring this change in to effect” is inconsistent with the valid example provided.

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The proponent suggests generators be required to “provide accurate and complete data and information that substantiates that the dispatch offer, dispatch bid or rebid has complied with the good faith provisions, if requested to do so by the AER. When assessing compliance against these provisions, the AER should be assured that in response to their questions, the participant is providing full and complete information regarding their bid and rebid”. This requirement will place significant additional workload on traders that undertake many rebids per day. The AER’s request for information should be very specific to ensure that satisfactory detail response is provided. It is likely that the level of detail provided in response to a general AER request for data (typically short response time) would be quite different to that prepared for a court case. Constraining the information that can be used in defence of court proceedings does not seem appropriate.