03 May 2012

Ms Elisabeth Ross
Senior Adviser
Australian Energy Market Commission
PO Box A2449
SYDNEY SOUTH NSW 1235

Dear Ms Ross

Negative offers from scheduled network service providers

Alinta Energy welcomes the opportunity to make a submission in response to the Australian Energy Market Commission's (AEMC) consultation paper entitled *National Electricity Amendment (Negative offers from scheduled network service providers) Rule 2012* (the Rule change proposal) as proposed by International Power-GDF Suez Australia (IPRA) and Loy Yang Marketing Management Company (LYMMCo).

Alinta Energy considers the issue of market network service provider[1] (MNSP) bidding, in this case the operation of Basslink, as one that conflicts with the competitive intent of the National Electricity Market (NEM). Alinta Energy previously expressed concern about this issue as part of the Tasmanian Electricity Supply Industry Expert Panel (the Expert Panel) review.

Those previous comments were made in the context of the structural elements of the Tasmanian electricity supply sector and in particular the relationship between Basslink and Hydro Tasmania. This submission makes references to that relationship but addresses issue from the perspective of the AEMC's role as rule-maker pursuant to the National Electricity Objective.

Alinta Energy's interest in this issue is twofold. First, Alinta Energy has a general concern that failure to address the issue undermines the integrity of the NEM. Secondly, Alinta Energy believes more certainty as it pertains to Basslink will improve contract availability from Victoria's Latrobe Valley generators generally and improve the ability to utilise Tasmanian hedges both in Victoria and Tasmania and will improve the useability of inter-regional revenues which are currently difficult to acquire and manage.

Issue for consultation

The AEMC identifies the problem as a combination of Hydro Tasmania's dominant market share in Tasmania and the Basslink Services Agreement which effectively provides Hydro Tasmania with control over Basslink bidding arrangements.

1 In this submission MNSP refers to MNSPs and SNSPs, consistent with the terminology used by the AEMC in the Rule change proposal.

This is the manner in which Alinta Energy and LYMMCo characterised the issue in the context of the Expert Panel review but this inter-relationship is not the primary concern for the purposes of the Rule change proposal.

The issue at hand is:

1. whether economic efficiency is impeded by allowing MNSP's to bid in a manner which disguises the price of competing generation energy offers; and
2. whether a MNSP's ability to bid positive and negative is fundamental to the financial viability of MNSPs, so that if such MNSP bidding was no longer provided for it would undermine future efficient investment in inter-connection.

These issues apply regardless of ownership or to whom the revenues arising from price differentials between regions accrue. Additionally, neither is specific to the issue of Basslink and its operation by Hydro Tasmania pursuant to the Basslink Services Agreement.

Basslink and Hydro Tasmania

Given the above it is not Alinta Energy's intention to dwell on the specific circumstances of the Basslink Services Agreement. Nevertheless, Alinta Energy is concerned that the Basslink Services Agreement gives rise to an arrangement whereby Hydro Tasmania fixes the price for the supply of electricity in a manner that undermines competition in Victoria and Tasmania.

While this issue is beyond the scope of this paper and is not within the remit of the AEMC it is Alinta Energy's view that this matter requires appropriate consideration.

Additionally, Alinta Energy notes that the manner of Basslink's bidding was of such concern in the lead-up to Tasmania's entry into the NEM that the Ministerial Notice at the time was created for the purposes of artificially constraining Basslink and Hydro Tasmania in a manner that the rules could not so as to give comfort to market participants.

IPRA and LYMMCo concerns

Turning to the substantive issue, the AEMC indicates that:

> *IPRA and LYMMCo are concerned that when Hydro Tasmania instructs BPL to bid at negative prices in the northward direction, Hydro Tasmania can effectively undercut the price floor and so the price offered by the Latrobe Valley generators. Consequently Hydro Tasmania can be dispatched in favour of the Latrobe Valley generators, creating an opportunity cost for them associated with lost revenue.*

Alinta Energy notes the concern and suggests in the context of Basslink it is understandable that IPRA and LYMMCo focus their concerns on the impact of negative prices on northerly flows. However, the issue should be broadened to take account of a "generic" MNSP in the absence of the Basslink Services Agreement and the Ministerial Notice. The latter instrument being relevant as it provides for a prohibition on southerly positive prices where the market rules do not.

Generally speaking, negative prices in one direction have equal bearing on a market participant as positive prices in the alternative direction as either outcome preferences the generation in one region over the generation in the alternative region.

If we relate this back to the Basslink example, Latrobe Valley generators would be disadvantaged compared to Hydro Tasmania in circumstances where the regional reference price in Tasmania is higher than Victoria (lets suggest for the reasons of drought) as Victorian

generation was not able to be dispatched in Tasmania if Basslink bid +$12,500 meaning (excluding losses) a Latrobe Valley generator's offers would be at best +$11,500 (-$1000 price floor + $12,500).

Hence, in this context Latrobe Valley generators would be equally disadvantaged by Basslink's ability to disguise their energy prices in either direction.

However, this issue has not been raised by the AEMC, IPRA or LYMMCo in essence because this has not borne out in practice due to the Ministerial Notice prohibition on positive prices for southerly flows. Nevertheless, if we examine the proposition of MNSP bidding between any two generic regions it becomes apparent that positive and negative bids are equally relevant where they impede a generators ability to get dispatched based on their energy offers into the NEM.

Does a MNSP need to be able to bid negatively or positively in the NEM?

Alinta Energy considers this issue from two perspectives: the principle of technology neutrality and the benefit to MNSPs of not being priced at zero.

The principle of technology neutrality suggests that MNSP's should not be penalised due to the situation being observed in Tasmania and likely to be observed for a generic MNSP; however, this ignores the point that MNSP's currently have wider discretion than is currently permitted by the National Electricity Rules by virtue of the absence of a limit on negative prices and the cumulative bid effect.

Alternatively, the principle of technology neutrality is generally raised in the context of generation fuel sources and technology types so as to not distort the National Electricity Rules for the purpose of favouring one participant over another. It is arguable that generators and MNSPs are in many respects different and that each plays a fundamentally different role in the NEM. On that basis, the technology neutrality principle is possibly not relevant.

Nevertheless, arguing for technology neutrality is at a minimum suggesting the National Electricity Rules should be amended so that cumulative bids not exceed -$1000 and $12,500 for the combined cost of generation and MNSP transportation costs. This would mean a MNSP would be acting as a generator into the relevant region i.e. Basslink bidding north would act as a generator bidding into Victoria and bidding south would behave like a generator bidding into Tasmanian.

Nevertheless, Alinta Energy suggests the more relevant assessment is determining how market efficiency is impacted by allowing MNSPs to bid at any price other than zero so as to disguise generator energy offers into the market.

As indicated by the AEMC, MNSP revenue is driven by price differentials between regions. This means the prices set at the node are the most relevant to MNSPs profitability and not prices offered by MNSPs to transfer power between regions.

Hence, a negative price being set by a MNSP may ensure a larger proportion of generation from the lower priced region flows to the higher priced region but it is unlikely to have a significant effect on the price in either region. Without undertaking appropriate modelling, one might expect there would be a trade-off between quantity and price that may make differences in quantities derived from MNSP bidding marginal at best, given it may already be operating at capacity between regions.

In relation to positive bidding, it would appear counter to an MNSP's interests to bid positively if it had the effect of stopping inter-regional residues from accruing between two regions, especially where it would be creating counter priced flows. Thus, there seems little if any benefit associated with a MNSP bidding positive.

As it relates to counter-priced flows, there seems little incentive for the MNSP to want to induce these – leaving aside the 'no go zone' issue for a moment – as the benefit to an MNSP remains the difference between the two regions regional reference nodes.

Hence, aside from the specific set of circumstances that have been illustrated in Tasmania where Hydro Tasmania, and not Basslink, accrues the benefits of Basslink dispatch, there seems little commercial incentive for an MNSP to bid positive or negative in the NEM where the primary revenue incentive is to accrue price differentials between regions.

An argument could be made at a general level that positive and negative bidding is beneficial to an MNSP to manage dispatch risk. However, it is unclear what this risk actually involves as in the absence of established hedge positions dispatch risk may not be a significant concern for a MNSP.

Additionally, this alternative perspective would rely on a MNSP being extremely aggressive so as to game the flow of energy between regions when price dictated that that flow should occur in a opposing direction. In essence, an MNSP primary purpose would not be to fulfil the role of inter-connector and link higher priced and lower priced regions but to challenge market dynamics and distort flows based on their commercial preferences. This is not considered viable. In fact, the existence of the Basslink Services Agreement suggests as much and that Hydro Tasmania's ability to preference its own generation demands a greater premium for Basslink Propriety Limited than attempting to game the market itself.

Managing counter-price flows

There may be a view that negative bidding is needed in order to prevent counter-priced flows. Two points are relevant here.

First, constraints generally drive counter-priced flows with participants on the wrong side of the constraints generally losing out as a consequence of such flows (i.e. generators in the lower priced region does not get access to the higher priced region).

It is arguable that the issue of constraints management is larger than that which relates purely to inter-connectors and MNSPs; however, this issue is being analysed in the context of the Transmission Frameworks Review and should there be an economic case for resolving or better managing constraints it would seem appropriate that both MNSPs and generators are captured by this scheme instead of enabling MNSP bidding to be advantaged.

Second, the market already provides for a mechanism to manage inter-regional risk. It is essential to the integrity of the market that the inter-regional residue arrangements across all the inter-connectors are managed uniformly. One of the chief complaints about the Tasmanian region has been the inability to access inter-regional residues because they are effectively controlled by a single participant and it is difficult to capture those residues when energy offers between regions are distorted by the type of pricing behaviour that has already been discussed.

If there is any general criticism of the inter-regional residue arrangements this would probably relate to the effectiveness of these residues in the face of constraints. Again this is a matter that should be resolved through the Transmission Frameworks Review and does not justify an exception for a MNSP.

Technical issues

There is seemingly some specific operational issues with Basslink which may motivate positive and negative prices due to the "no go zone"; however, none of these technical matters considered by the AEMC appear to be key drivers of market efficiency, at least to the extent that generators revealing price preferences drives efficiency and that those price preferences should not be masked for technical reasons related to a single MNSP.

Additionally, it is not clear that these technical issues can not be dealt with by alternative means. Further, Alinta Energy is unclear how Basslink managed these issues when the earlier Ministerial Notice prohibited all negative bidding.

How is efficiency impacted by MNSP positive and negative bidding?

It is important to consider the efficiency implications of the status quo and an alternative where there is no positive or negative bidding on MNSPs. The status quo needs to include the expectation that additional MNSPs would be developed moving forward.

IPRA and LYMMCo have indicated that the impact on Latrobe Valley generators is that in the event of a constraint – although in the absence of Tasmanian Government restrictions, at any time – Hydro Tasmania's generation is preferenced to the Melbourne node.

It is important that the market is designed efficiently and gives rise to bids and prices in which the preferences of participants are revealed accurately. In this manner, prices should reflect the opportunity cost of gains from trade being secured (or not secured) determined by an individual firm based on that firms costs, including resource costs and contractual exposure. This is within the context of the available revenues that will accrue to the participant.

Hence, the most productive outcome will be the least cost generators securing the maximum value of trade. However, in circumstances where generator bids can be masked by the bidding behaviour of MNSPs this efficient mechanism is undermined. Leaving aside the impact of cumulative bidding for a moment, it suggests that a generator would be required to disorderly bid in order to countenance the impact of MNSP bidding. Alinta Energy is not convinced this would be an efficient outcome.

Further, as it relates to consumers, this does not guarantee that the generator dispatched is actually the most competitive least cost generation. Alinta Energy suggests that the cumulative effect of bids as has been illustrated by IPRA and LYMMCo further distorts the market mechanism and undermines efficiency.

Assuming that MNSP bids are effectively always zero, and hence in the absence of constraints, energy will always flow from lower priced to higher price regions, Alinta Energy is of the view that generators will reveal their prices in a manner that does not need to account for MNSP distortions and will be likely to contract additional volumes of generation.

Notably, this issue does not resolve the issue of congestion or the instances in which inter-regional residues do not afford the desired level of cover against inter-regional risk. Alinta Energy notes this and believes this does not detract from the efficiency gains from requiring MNSP bids to be zero and having MNSPs rely on accruing inter-regional residues for revenue. This outcome appears in the best interests of consumers and consistent with the National Electricity Objective.

Given MNSP investment is primarily driven by accruing such residues it is Alinta Energy's belief that the abolition of MNSP bidding will not impact the economics of MNSP entry from the status quo. Further, the ceding of bidding control to Hydro Tasmania in exchange for a fee suggests the present owners of Basslink preferred a stable revenue stream over playing the market. For MNSPs, this would suggest if exposure to inter-regional residues was considered to volatile the sale or contracting of those rights would be a viable option.

Interestingly, this would appear to be the basis upon which Hydro Tasmania and Basslink entered into the Basslink Services Agreement given that the Ministerial Notice in force at the time constrained Basslink from bidding negative in either direction and bidding positive southwards. In essence, Basslink operated at a zero bid price until relatively recently. Returning to this original position, by way of National Electricity Rules amendment applying to all MNSPs, is endorsed by Alinta Energy.

Conclusion

Alinta Energy welcomes the IPRA and LYMMCo rule change but suggests the AEMC expands its analysis away from the specific circumstance of negative northerly bidding, as has been the case for Basslink, to look at the wider inefficiencies created by allowing MNSPs to transport energy at any price other than zero.

While Alinta Energy acknowledges there are some specific technical issues which require resolution for Basslink, it is considered that economic efficiency is maximised where generators energy offers are not disguised by artificial MNSP bids.

If you have any queries in relation to this submission please do not hesitate to contact me on (02) 9372 2633.

Yours sincerely,

Jamie Lowe
Manager, Market Regulation