

Defining the issues raised by the rule change request



SEBASTIEN HENRY
SENIOR ADVISER
AUSTRALIAN ENERGY MARKET COMMISSION

The rule change request

- The rule change request explores potential inefficiencies in market outcomes created through generator bidding strategies, and identifies the good faith provisions in the NER as the appropriate means to address these issues.
- The issues raised relate to the bidding process which is fundamental to the operation of the NEM and the promotion of efficient price outcomes.
- Our assessment framework has considered the issues within the broader context of the role that rebidding plays in the NEM.

Rebidding promotes efficiency in market outcomes

- In a competitive energy market environment, price signals provide the incentives to guide participants' actions.
- Whether a market outcome is efficient or not can depend upon the time period involved. Participants can respond:
 - in the short term through changes in production or consumption and re-pricing; or
 - in the long term through changes in behaviour or physical changes in the design and operation of plant.
- Rebidding promotes efficiency in market outcomes by allowing participants to respond to changes in market conditions or the actions of other participants.

Generator bidding is based on expectations

- In the NEM, there is an incentive to bid capacity at prices lower than those of your competitors in order to be dispatched and earn revenue.
- The extent to which generators are willing to lower their prices is limited by their ability to earn sufficient revenue to cover:
 - incurred costs, which includes actual expenditure made or directly incurred in that period as a result of increased output, such as fuel costs; and
 - the extent to which they can earn economic rents to cover their fixed costs and costs attributable to start-up, shut-down and changes in output.
- Generators will bid to cover their incurred costs, but the extent to which a generator bids to attain economic rents will depend on its expectations of the bids of its competitors.

Efficient price discovery

- A market event can be characterised as a change in market information that will impact on generators' expectations as well as their expectations of other generators' expectations.
- While participants will generally have a good idea about the implications of the occurrence of a given event on their relative position and costs, they are less likely to know the implications for other market participants and how they will react.
- The period following a market event is typically characterised by an iterative process of adjustment where the expectations of all market participants shift.
- This process of participants learning and responding to the actions of other participants facilitates the discovery of efficient prices.
- While a change in the environment that is readily observable and objective may trigger a change in expectations, it could also occur in the absence of such a change.

Late rebidding inhibits the discovery of efficient prices

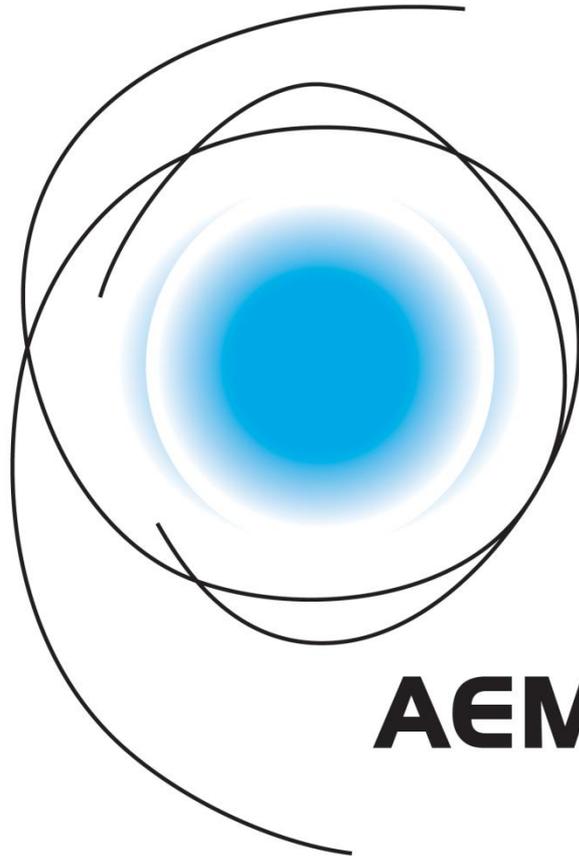
- The NEM can be distinguished from other commodity markets by the requirement that supply and demand must be matched continuously. The instantaneous delivery of electricity creates a deadline by which a price for production and consumption must be determined.
- Generally, a generator has an incentive to wait until the last possible moment to make a rebid because that is when the most amount of information is likely to be available upon which it can make a decision on its final market position.
- However, rebids made very close to dispatch are likely to be less valuable to the process of efficient price discovery because they leave less time for the iterative process to play out.

Responding to a late rebid

- Rebids can trigger responses by other participants which can be classified as one of two forms:
 - Price response – a generator may respond to a competitor's rebid by re-offering its current generation output at a different price through its own rebid.
 - Physical response – a generator may respond to a competitor's rebid by changing production to meet its existing offers.
- Adjustments in production involve time lags and costs. As such, the inefficiencies created by late rebidding can therefore be expected to be higher in the latter circumstance. It is the inability of participants to physically respond in time that drives most of the impacts of late rebidding.
- The incentives to engage in late rebidding are further exacerbated by the NEM dispatch and settlement arrangements.

Intentional late rebidding

- Late rebids can lead to inefficient market outcomes if they do not provide sufficient time for a competitive response.
- However, there are additional costs that relate specifically to the intentions of the rebidding generator and whether the late rebid is a part of a strategy of behaviour that misleads competitors.
- A strategy of late rebidding over time has the potential to impair the efficacy of the price discovery process by casting doubt on the reliability of information.
- The costs arising from this behaviour are not readily susceptible to economic evaluations such as those used to assess evidence of market power. Policy must instead focus on the conduct itself and the motivations and intentions that lie behind it.



AEMC