RWE
The energy to lead

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Swindon, UK, 6 February 2015

Dear Mr Pierce

Submission to Options Paper: National Electricity Amendment (Bidding in good faith) Rule 2014

RWE Supply & Trading (RWEST) very much welcomes the opportunity to comment on the issues raised in the Options Paper: National Electricity Amendment (Bidding in Good Faith) Rule 2014.

RWEST shares the concerns about rebidding highlighted in the report. Rather than enhancing efficiency, rebidding has frequently led to price levels and movements which fail to reflect emerging supply and demand fundamentals. As we outline in the attached submission, this significantly undermines wholesale market liquidity and prevents the market from delivering efficient and secure electricity supplies to consumers in both the short and long run. Reduced liquidity leads to higher risk management costs, higher barriers to market entry, less competition and poorer long-term price signals.

The current market design and regulatory framework has not proved adequate to address the rebidding behaviours observed in the NEM recently. RWEST believes that the changes outlined in the Options Paper provide a targeted and proportionate remedy to the problems identified. Specifically, RWEST supports the development of a new behavioural statement of market conduct and the introduction of gate closure to restrict rebidding in the current and subsequent trading intervals to instances of “physical prevention or safety” (Option B.2). The restricted rebids should apply for the remainder of the current and subsequent trading intervals and be limited to re-declarations of availability only and not prices.

We hope you find our submission useful to your deliberations on the rule changes and please do not hesitate to contact me if you would like to discuss any aspect of our response further.

Yours sincerely

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RWE Supply & Trading Submission: National Electricity Amendment (Bidding in good faith) Rule 2014

1 Summary and Overview

RWE Supply & Trading (RWEST) is Europe's largest power and gas trader. We act as a significant provider of liquidity and market maker across Europe's interconnected power and gas wholesale markets. RWEST entered the Australian wholesale market in 2013 and has since become one of the main providers of liquidity to the ASX. This submission draws on our recent experiences in the Australian wholesale market coupled with our knowledge and experience of trading in Europe and North America's wholesale electricity markets.

RWEST very much welcomes the opportunity to contribute to the current debate on rebidding and to respond to AEMC's thorough, thoughtful and comprehensive Options Paper. We particularly appreciate that the design and operation of the NEM are driven by a strong free-market ethos in letting the market decide appropriate outcomes for prices given emerging supply and demand fundamentals. The strong focus on due process, consultation, evidence-based decisions and the caution surrounding the potential damaging consequences of undue market intervention is also a welcome and refreshing change from the politically driven interventions that characterise many other power markets.

RWEST believes, however, that the problems surrounding rebidding identified in the Options Paper are now sufficiently serious to warrant changes to the behavioural and market rules surrounding rebidding. The failure of prices to reflect market fundamentals as a consequence of strategic rebidding by generators is harming customers directly through undue increases in physical spot prices, but also through the pernicious effect that unduly erratic prices has on wholesale market liquidity and wider competition in the market.

The current market design and regulatory restrictions are not adequate to address the behaviours surrounding rebidding observed in the NEM recently. The good faith provisions are no longer workable or enforceable and restrictions on market manipulation in the financial electricity market cannot be applied in the underlying physical market. RWEST recommends that AEMC should develop a new behavioural statement of conduct to address these regulatory deficits.

There is also a strong case for a limited gate closure in addition to a new behavioural statement. The inability of many market participants to respond to price changes within the trading period coupled with the anomaly of 5-minute dispatch intervals but 30-minute trading intervals creates an inconsistency between prices and volumes in the determination of market prices. To address this issue, RWEST recommends that a "light touch" approach to gate closure is introduced with rebids allowed for physical prevention or safety issues (Option B) and with the restriction limited only to the current and subsequent trading period (Option 2). RWEST would, however, recommend that the restriction in Option B is limited to allowing the withdrawal or re-declaration of availability only and not to allow the shifting of availability into new price bands. Availability could be re-declared for the remainder of the current and subsequent trading interval (and not on or off for individual dispatch

intervals across that period). AEMC may also want to revisit the option explored in 2002/03 of adopting a 15-minute trading interval as another mitigant to the 5/30 anomaly.

The following sections set out these views in more detail. Section 2 first sets out the reasons for changing the current arrangements including the negative impacts that strategic bidding has directly on consumers and via its negative impact on the wholesale markets. Section 3 and 4 then address the form of the new Behavioral Statement of Conduct and the form of the gate closure mechanism respectively.

2 Why the rebidding rules need to change

RWEST recognises that the real-time "energy only" design of the NEM's pricing arrangements requires regulators to adopt a relatively hands-off approach to pricing. With prices for physical generation determined from real-time dispatch and with payments for energy only (rather than capacity or reserve payments) it is essential that generators can adequately recover non-marginal costs associated with unit commitment and that - at times of market scarcity - generation capacity is appropriately remunerated to preserve dynamic investment signals alongside short-term dispatch signals. Appropriate pricing of output therefore requires a complex and evolving assessment of both the generators' individual capabilities and costs but also the emerging supply and demand fundamentals driving the dispatch of one's own and others' generating units. Rebidding plays a fundamental role in this price discovery process and rebidding relatively close to delivery is important to ensure that prices can better reflect the underlying fundamentals of supply and demand, to underwrite efficient dispatch and to ensure security of supply.

Recent experience in the Australian power market - especially the most recent experience with December spot prices – suggests that the link between market fundamentals and prices has broken down. Current rules on rebidding – including the good faith provisions – have proved insufficient to address this behaviour to date and, in our view, the good faith provisions are effectively unenforceable. There also appears to be nothing in the current rules to prevent market manipulation in the physical market - as opposed to the financial market.

On a technical level the inability of many to respond to price changes within the trading interval and 5-minute dispatch of volumes but 30-minute pricing for delivery, creates a disconnect between prices and volumes which can lead to anomalous prices and inefficient dispatch. We explore each of these issues in further detail below.

2.1 Price changes do not reflect changes in supply and demand fundamentals

Recent experience with price spikes in the NEM (particularly in Queensland and South Australia) suggests that rebidding is being used inappropriately to change prices in ways which fail to reflect the underlying supply and demand fundamentals and to set prices at artificially high levels. Many of the price spikes have occurred at times of high plant availability and with no other emerging fundamentals to justify the increase. Rebids are also consistently made without any apparent changes in the underlying fundamentals of supply and demand since the original bids (or rebids). As

a consequence, pre-dispatch schedules based on initial bids only provide a limited - and often misleading – view of where prices will ultimately turn out.

Given the significant divergence from historic events, RWEST awaits with interest the forthcoming report on the December price spikes. We are particularly interested in having more insight into the reasons and circumstances advanced for the rebids which generated these spikes. (Indeed, wider transparency over the reasons attached to rebids would in itself be a worthwhile area to explore as a remedy to current concerns – see below.)

Even ahead of any findings in the market report though, there is strong *prima facie* evidence that the current rebidding rules are being gamed. A disproportionate number of spikes occur in dispatch intervals 5/6 (Figure 4.4 in the Options Paper) whereas you would expect genuine spikes to be distributed evenly across time and the trading interval with an equal incidence in each dispatch interval. The pronounced bunching of rebids toward the end of the settlement period therefore provides direct and compelling evidence of inappropriate pricing.

The failure of prices to reflect the underlying fundamentals and to mirror pre-dispatch signals has had and will continue to have significant impacts on customers in terms of increased generation costs and reduced liquidity in the wholesale markets. We explore these impacts further in section 2.5 below.

2.2 Late rebidding and the settlement price calculation create an inefficient disconnect between short-term prices and volumes

We have several concerns regarding the rules for price determination in the NEM over and above the concerns relating to generator pricing behaviour. As the options paper highlights, allowing late rebidding into the settlement period can result in prices changing without the prospect of any supply or demand response because of the limited pool of participants that are aware of the change and able to respond in this timescale. The inability of demand to respond in such short timescales is a particular concern in the likely presence of market power in some States and at some times. We therefore share the Commission's view that the specific behaviour to be addressed is generators submitting late rebids where there is an intention to exploit the limited opportunity of other participants to respond.

The calculation of the settlement price as the average of the dispatch interval prices also creates an interesting anomaly in that the price received and paid for generation in earlier dispatch periods can be and is changed *retrospectively* by rebidding in later dispatch intervals. The ability to rebid dispatch periods later in the half-hour settlement period – coupled with prices averaged across the trading period - effectively allows generators to re-price their output after dispatch. Similarly, consumers may choose to consume (or turn down) on one price early in the half-hour only to pay a different price later. This appears completely anomalous, contrary to fair market principles and inefficient. There is therefore a strong case for a gate closure mechanism to ensure that prices and volumes can be concluded consistently within a sufficiently large pool of potential market participants in addition to the role that gate closure will play in restricting inappropriate rebidding behaviour.

2.3 The good faith provisions do not work and cannot be enforced

We have considered carefully the arguments surrounding the good faith provisions. While the original intent – to stand by the delivery of the bids made - was appropriate, we share the South Australian Minister's view that the provision is no longer fit for purpose in the light of the Stanwell case.

The Stanwell judgement itself seems reasonable: non-fulfilment of subjective expectations may indeed represent a change in material conditions and circumstances which would justify a rebid, eg, "demand turned out lower than I expected so I rebid downwards to get called". Similarly, this would not mean that the original bid was not made in good faith. For this reason, we do not support the original proposal to reverse the burden of proof and to exclude subjective expectations as a reason for a rebid. This would unduly restrict genuine price formation, result in inefficient dispatch and – potentially – endanger security of supply.

However, the problem is that each and every rebid could in theory result from a change in subjective expectation. This renders the good faith provisions unenforceable in practice in the absence of clear evidence of bad faith (eg, a written statement that a bid would not be honoured). Given that most participants could be expected to avoid such smoking guns, the restriction effectively becomes empty and "I changed my mind" becomes an unassailable justification. For this reason, RWEST believes that behavioural rules should focus on the behaviours themselves – coupled with undesirable impacts – rather than the mind-set of the bidder. We develop these thoughts further below in the discussion on a behavioural statement of conduct.

2.4 There is a regulatory gap in market manipulation provisions between physical and financial markets

The current good faith provisions also fail to address the regulatory gap between the physical market and the financial wholesale market. As the options paper notes, the Corporation Act prohibitions on derivative market manipulation cannot be applied to physical markets. This largely renders the Corporation Act redundant in the electricity derivatives markets and indeed wider commodity markets. Manipulating the underlying physical market to set prices at artificial levels and to leverage the benefit to a financial contract position *is precisely the way* in which electricity and commodity markets can be most easily manipulated. This is a serious deficit in the regulatory framework that should be addressed in step with action on late rebidding. As the next section illustrates, allowing market manipulation in the physical market has a pernicious effect on wholesale markets which further damages competition in the market, increases costs to consumers and threatens investment and security of supply.

2.5 Actual and potential price manipulation imposes significant costs on consumers

As noted above, several elements of the current rebidding rules lead to significant distortion and inefficiency in the physical market and the existing market design and regulatory controls have proved inadequate to address these issues. This has several serious and material impacts on consumers, directly and indirectly, and in both the short-term and long-term. The direct costs include:

- Excessive pricing directly benefits generators at the expense of consumers.
- Strategic pricing and rebidding results in dispatch "mistakes" and inefficiency which increases the cost of meeting customer demand.
- Excessive rents available for plant able to exploit the rebidding rules will distort investment decisions in favour of highly flexible resources at the expense of more efficient plant.

The reality or threat of market manipulation also has a crucial impact on liquidity in the wholesale market. Market intermediaries such as RWEST add significant liquidity to wholesale markets by allocating risk capital to underwrite our ability to consistently post both bid and offer prices and to take on open risk positions. This enables market participants to buy when they want to buy, and to sell when they want to sell, without individual transactions having a material impact on market prices. This allows market participants to effectively hedge their business which: reduces the cost of running and financing supply and generation businesses; facilitates investment and protects security of supply; and lowers barriers to entry into generation and retail markets.

Our overarching requirement in providing risk capital to the Australian and other wholesale electricity markets is that the market prices reflect the underlying supply and demand fundamentals. We invest significant analytical resource and cost into monitoring and analysing market fundamentals such as the weather, renewable penetration, environmental constraints, plant maintenance cycles, closure and mothballing decisions to underwrite our pricing decisions. In turn, this requires that the market is sufficiently transparent and competitive for us to understand and monitor the fundamental drivers of price and sufficiently confident that competitive forces result in prices which reflect those drivers. We are less comfortable in markets where prices fail to reflect fundamentals as a result of market manipulation or the unpredictable exercise of market power.

The prospect and reality of market manipulation is corrosive to wholesale market liquidity. Intermediaries face the prospect of trading with counterparties not just with the power to move contract settlement prices, but with asymmetric information on when and how prices might move. The result is a vicious circle of declining liquidity and increasing cost to consumers:

- The risk of taking on positions from market participants increases which leads to corresponding increases in the bid-offer spread. This translates directly into increased cost to consumers as generators and retailers must pay more to hedge their physical businesses.
- Faced with unpredictable prices and high costs of entering and disposing positions (ie, high bid-offer spreads) existing wholesale participants limit the size of their positions and/or withdraw from the market.

- Physical participants are forced to manage risk in a less efficient and more costly way (eg, via the insurance markets or physical changes in operations to mitigate market risk).
- Potential wholesale market participants do not enter or limit their positions in the market further reducing liquidity.
- Price formation in the forward markets becomes unreliable and the liquid horizon shrinks. This undermines future investment and security of supply.
- Barriers to the entry of new generators and retailers increase because of the increased cost and/or inability to hedge their requirements in the market. This reduces competition yet further to the detriment of consumers who pay ever higher prices.

We would note that these wholesale market costs and impacts can arise *whether or not there is ongoing distortion in the physical market:* the mere prospect that prices can be manipulated and the absence of appropriate regulatory constraint can deter potential liquidity providers. Steps to underwrite market integrity and confidence can therefore yield significant benefits in and of themselves.

3 AEMC Should Develop a New Behavioural Statement of Conduct

As discussed above, RWEST considers that the current good faith provisions are no longer workable in the light of the Stanwell judgement and that any behavioural statement focused on the expectations and intentions of the bidder is likely to be unverifiable and unenforceable. **RWEST therefore supports Option 3: replacing the good faith provisions with another behavioural statement of conduct.**

We would support the proposed coverage of the statement as far as it goes in prohibiting a market participant from making offers, bids or rebids which:

- are misrepresentative of its capability to achieve if dispatched; or
- mislead other participants; or
- exploit the limited opportunity of other participants to respond.

As noted in the options paper, the exact structure of the statement of conduct will play a key role in determining the enforceability of the provisions in preventing the adverse behaviour. In this regard, it would also be useful to expand and to clarify the specific pillars of any prohibition with appropriate detailed guidance, safe harbours etc. This would both facilitate generator compliance and wider market participants' understanding of the parameters and constraints surrounding bidding and rebidding decisions.

More widely, the prohibitions proposed do not directly tackle the linkage between the physical generation market and the associated financial wholesale electricity market (albeit they do touch on misleading information). As we have highlighted above, this is a serious deficit in the current regulatory framework as market manipulation in the physical markets can be used to leverage financial positions in the associated wholesale market. Recent efforts within the EU have focused on

closing a similar gap in the EU market abuse framework amid concerns about commodity market abuse. A new Market Abuse Regulation[1] extends the financial market abuse regime to related physical commodity markets and the Regulation on Energy Market Integrity and Transparency (REMIT)[2] has translated the financial market abuse regime directly across to the power and gas markets.

A similar approach would appear to offer significant benefits to the Australian electricity market in increasing confidence in the integrity of the wholesale market with little if any downside to genuine price formation in the physical market. More specifically we would urge the AEMC to consider:

- **Further requirements for transparency and information publication** to ensure that all market participants can properly assess the evolution of supply and demand fundamentals and their impact on bids and rebids. Specifically in this area, AEMC should require generators to publish the detailed rebidding logs rather than the shorter rebid reason fields. This directly addresses the information asymmetry between generators and other market participants and adds significance and weight to the prohibition on misleading other market participants.
- **A prohibition on insider trading** to complement the transparency requirements and to ensure that all market participants are able to access the same information as generators have when considering their rebidding decisions.
- Ensuring that the **prohibition on misleading other market participants covers the dissemination of misleading information or fictitious devices or other contrivances in an attempt to deceive** (eg, erecting temporary accommodation on site to give the impression that a major outage is imminent).
- **Ensuring that the prohibition extends to activity which secures or attempts to secure prices at artificial levels**.

As discussed in the Options Paper, defining "artificial levels" for enforcement purposes can be difficult and involves wider questions about the associated competition policy backdrop to the NEM. We would note, however, that in the context of financial market regulation "artificial" is more targeted at behaviour which gives a false impression on prices rather than passing judgement on whether price levels reflect the exercise of market power or not. It would for example, include deliberate attempts to "paint the tape" or manipulate an index benchmark. In the electricity context, it could also be used to cover deliberately pricing too low or too high relative to the market to leverage a financial contract position. As noted above, the development of detailed guidelines, "Q&As" and safe harbours alongside the prohibitions should be sufficient to clarify the intent here (if it is indeed intended to avoid entering competition policy territory).

[1] Regulation (EU) No 596/2014 of the European Parliament and of the Council of 16 April 2014 on Market Abuse (Market Abuse Regulation).

[2] Regulation (EU) No 1227/2011 of the European Parliament and of the Council of 25 October 2011 on Wholesale Energy Market Integrity and Transparency.

4 A Gate Closure Mechanism Should be Adopted

As noted above, there appears a strong case to introduce a gate-closure mechanism alongside a new behavioural statement. **RWEST would support the following options for the design of a gate closure mechanism:**

- **Option B: That rebids are permitted relating to physical prevention or safety on the affected generation unit**
- **Option 2: No rebids in any dispatch interval within current and subsequent trading interval.**

We believe that this pair of options strikes an appropriate balance between ensuring sufficient "depth" of competition in the market among those able to provide a volume response while ensuring sufficient pricing flexibility as dispatch approaches. In only limiting rebids for the current and subsequent trading period, the restrictions ensure that any changes in market fundamentals can be assimilated within the market within an hour at the very most. This should limit any potential inefficiency associated with restrictions on rebidding. We would also note that, to the extent that dispatch interval prices are based on marginal prices, there is already some mitigation for changing circumstances for all other than the marginal generator (ie, those who get a higher price if a more expensive unit is dispatched and vice versa).

We would further recommend that AEMC adopts an amended version of Option B **which restricts the rebidding to the upwards or downwards re-declaration of availability for the remainder of the current and subsequent trading periods only but not to allow shifting of availability between price bands.** Our concern is that views on what is necessary for "physical prevention or safety" would be based on a subjective and unverifiable risk assessment. This could therefore still be used as an undue justification to move availability between price bands. One alternative – already employed in many other electricity markets – would therefore be to limit re-pricing after gate closure completely, but to allow availability to be withdrawn (or re-declared) across the unit as a whole for the remainder of the current and subsequent trading intervals. This would allow generators to account for a trip and/or an unexpected return to service by withdrawing availability from offered bands or re-declaring positive availability, but would not permit the shifting of availability between price bands or opportunistic re-declarations of availability/non-availability in individual dispatch intervals.

RWEST would also recommend the re-examination of the 5/30 issue first addressed in 2002/03 in the light of these changed circumstances. Specifically, given the detriments identified, a move toward a 15-minute trading interval could significantly mitigate gaming concerns and pricing anomalies while offering the potential for future relaxation of the proposed restrictions on rebidding.

RWEST believes that these proposals – taken alongside a new behavioural statement – should be sufficient to mitigate the negative impacts of rebidding identified in the options paper. In remaining targeted at the problems identified, the proposals have the benefit of bringing very little downside in terms of potential loss of inefficiency from the restrictions on rebidding.