



22 July 2011

Mr John Pierce
Chairman
Electricity Supply Industry Expert Panel
GPO Box 123
Hobart TAS 7001

27 July 2011

Dear Mr Pierce

Loy Yang Marketing Management Company (LYMMCo) welcomes the opportunity to make a submission in response to the Tasmanian Electricity Supply Industry Expert Panel, Issues Paper of 24 June 2011.

LYMMCo operates as the arm's length agent for Loy Yang Power, performing the energy trading functions and managing National Electricity Market regulatory and market development activities. Loy Yang Power is the largest single site privately-owned generator in the National Electricity Market (operating the Loy Yang A power station) and the supplier of coal to the Loy Yang A and Loy Yang B stations.

In total, LYMMCo trades in excess of 2,200 MW which represents around one third of Victoria's electricity needs and more than 8% of the total generation for the south-east of Australia.

LYMMCo supports the objectives of the Review; our primary concerns are set out below.

1. The structure of the Tasmanian electricity sector, primarily Hydro Tasmania's dominant position over the region which forms part of the integrated National Electricity Market.
2. Hydro Tasmania's operation of Basslink pursuant to the Basslink Services Agreement (BSA).
3. The legal validity of the BSA and the relationship between Hydro Tasmania and Basslink Pty Ltd (BPL) which arises as a consequence of this agreement.
4. The impacts on wholesale competition in Victoria and Tasmanian as a consequence of items 1 and 2 above, including the inability to enter into long-term contracts with commercial and industrial customers.

Hydro Tasmania's dominant position

LYMMCo has concerns regarding the impact of the Tasmanian region on the Victorian region given the dominance of Hydro Tasmania. While we understand the manner in which the Tasmanian sector has evolved, and the multiple benefits the sector has provided Tasmanian consumers, we understand the view put by some that the dominance of Hydro Tasmania is

problematic. We observe this dominance, and its impacts, when attempting to forge commercial relationships with large-scale load in Tasmania, when impacted by Hydro Tasmania's strategic and probable uncompetitive operation of Basslink, and when bidding for Tasmania-Victoria inter-regional revenues.

Hydro Tasmania's operation of Basslink

Issue

LYMMCo believes Hydro Tasmania's practice of strategically bidding Basslink undermines commitments made by the Government of Tasmania to the Australian Competition and Consumer Commission (ACCC).

This practice, which has been made possible by the Ministerial Notice of 4 May 2008, is directly impacting Victorian electricity generating businesses, and ultimately Tasmanian consumers.

On 30 April 2010 LYMMCo, with other concerned generators, wrote to the then Tasmanian Treasurer, the Hon. Michael Aird MLC (the role is now filled by Premier Lara Giddings) to outline our ongoing concerns with the management of Basslink by the Hydro Tasmania.

Discussion

As you are aware Hydro Tasmania has a commercial agreement, the BSA, with BPL which cedes control of Basslink's bidding to Hydro Tasmania in exchange for certain facilitation fees.

The BSA and the operation of Basslink were the subject of significant scrutiny from the ACCC and industry participants at the time of Tasmania's entry into the National Electricity Market. At the time, LYMMCo drew attention to the issue of Hydro Tasmania's dominant position and the challenges this presented given the development of Basslink.

As a consequence of this scrutiny, including recognition that there were competition issues that industry participants believed required attention, the Tasmanian Government undertook to make a series of enhancements to Tasmania's Energy Reform Framework.

To allay these competition concerns, the Tasmanian Government, over the course of a series of hearings, including the ACCC Determination of Tasmania Derogation and Vesting Contracts, made commitments guaranteeing that Hydro Tasmania would be constrained through regulation from exercising full rights to bid Basslink under the BSA.

The *Electricity Supply Industry Act 1995* provides the Minister with the power to issue a notice in relation to Hydro Tasmania's operations under the BSA. This also requires Hydro Tasmania to develop a compliance plan.

The Ministerial Notice in force prior to 4 May 2008 provided that Hydro Tasmania must not request negative transport bids in either direction and only be allowed positive southward flows in limited technical circumstances.

This position was considered a manageable outcome by the relevant parties, including LYMMCo; however, we still retained some concerns that we believed required further legal investigation but had elected not to progress then at that stage.

The 4 May 2008 Ministerial Notice revoked the previous position, which the concerned parties had come to live with, and has since permitted Hydro Tasmania to bid Basslink negative where mainland transmission constraints are causing Basslink northerly flow to be reduced.

To the best of our knowledge no public statement outlining the reasons for this change has been made available to the affected participants, the wider market or the ACCC.

As you would appreciate mainland transmission constraints impact all affected generators who rely on that part of the transmission network to dispatch their generation to the market. Hence, when a transmission constraint arises in the Latrobe Valley the problem of network flow being reduced is experienced by all generators situated on the same side of the constraint including Hydro Tasmania.

In these instances affected generators are free to reprice their output lower, to as low as the market floor of -\$1000/MWh, in order to avoid or at least limit the volume of generation being constrained off. If all the affected generation is priced at the market floor, the cost of the constraint is shared between generation parties in accordance with the normal dispatch arrangements.

However, a problem arises for the Victorian based generators when Hydro Tasmania, in the face of this constraint, bids its output to the market floor, which is appropriate, but also bids the northerly Basslink flows at a negative price. In essence, the two negative bids operate cumulatively and have the effect of enabling Hydro Tasmania to bid its generation to below the market floor. This provides Hydro Tasmania with preferential treatment over all other participants in the National Electricity Market and therefore impedes competitive responses available to affected generators.

For example, during the incidents of 2 and 3 February 2010, Hydro Tasmania repriced all of its capacity to -\$1000/MWh and Basslink was rebid to -\$968.20/MWh. The market operator's dispatch engine (NEMDE) commenced increasing the exports into Victoria reaching close to maximum export flow. The increased flow from Tasmania, resulted in further constraint of the output of Latrobe Valley based generators. We estimate the cost to the affected generators to be as much as \$3 million over the two days.

Attachment A contains further technical information.

Suggested approach

We consider this situation to be unacceptable and not in the spirit of the commitments made by the Tasmanian Government over the course of the process which led to Tasmania's inclusion in the National Electricity Market. These commitments were made to address serious competitive neutrality and competition concerns at the time.

Given, the unique role played by Basslink as a unregulated interconnector and the inability of the market operator's dispatch engine to ignore negative Basslink bids at this stage, we believe the most appropriate course of action is for the Tasmanian Government to

reinstitute the restrictions on Hydro Tasmania that were outlined in the 31 July 2005 Ministerial Notice.

LYMMCo received a response from the then Treasurer indicating that it would be appropriate to air these issues with the Panel. While we are not convinced actions should be dependent on the Panel's analysis we submit this information for your consideration, including recognition of the competition issues it raises.

The relationship between Hydro Tasmania and Basslink Pty Ltd

Issue

As is commonly known Hydro Tasmania has a commercial relationship with BPL through the BSA. In essence, the BSA provides that BPL must not specify a price other than zero unless Hydro Tasmania requests BPL to do so. Therefore, Hydro Tasmania may request BPL to make positive or negative dispatch offers for Basslink in either direction.

By entry into the BSA, BPL has ceded its independent freedom at law to set the terms of its Basslink dispatch offers to Hydro Tasmania.

In this regard, in its analysis the Panel should not consider Basslink as an independent entity providing a separate source of capacity competing against Hydro Tasmania and instead must consider the competition implications of this arrangement.

Discussion

As it concerns the BSA, LYMMCo is concerned that, by entering into the BSA and by giving effect to it, BPL has contravened, and continues to contravene, Part IV of the *Commonwealth Consumer and Competition Act 2010*.

In particular, the provisions in the BSA in relation to the bidding of Basslink appear to have the purpose and the effect of fixing the price including for the supply of electricity by BPL in Tasmania in competition with Hydro Tasmania.

There is a view that every time BPL makes zero, positive or negative Basslink dispatch offers in accordance with the BSA, BPL is giving effect to the price fixing agreement with Hydro Tasmania in contravention of sections 44ZZRD(2), 44ZZRK(1) of the Act. We note that under section 44ZZRG(1) of the Act offending parties may be liable to criminal prosecution.

It also appears that BPL has no statutory immunity from the application of these provisions in relation to this conduct. Furthermore, there is no authorisation from the ACCC for the making of the BSA or BPL's conduct in giving effect to it.

(We note that at the time of Tasmania's entry into the NEM the issue of authorisation from the ACCC was not pursued as it was strongly contested by impacted stakeholders. This in part relates to outcomes associated with the Ministerial Notice that arose at this time.)

LYMMCo has concerns with the entire agreement between BPL and Hydro Tasmania to the extent that it affects the bidding of Basslink.

Given the significance of these concerns, and the ongoing distortionary impact on the competitive market, LYMMCo believes it necessary that BPL cease to give effect to the provisions of the BSA which set terms of Basslink's dispatch offers and refrain from making any Basslink dispatch offers upon request by Hydro Tasmania.

In the absence of the BSA, BPL would be free to act as an independent commercial agent, not unlike other participants in the NEM.

Suggested approach

We believe that the current arrangements undermine the confidence of the market and give rise to inappropriate commercial relationships. The arrangements and therefore Hydro Tasmania's control over Basslink through BPL should be reviewed.

A fulsome analysis of the appropriate method for the management and operation of Basslink needs to occur with a view to eliminating possible anti-competitive relationships and inappropriate outcomes.

If it is concluded that Basslink, as a commercial entity, is not viable in the absence of the BSA given the structure of the Tasmanian sector and the dominance of Hydro Tasmania, then we would suggest that Basslink be rolled into the regulated inter-connector framework.

Wholesale market outcomes

The existing market structure raises a number of undesirable outcomes.

First, Hydro Tasmania's dominant control over the regional reference price and of the Basslink inter-connector ensures Hydro Tasmania is the price setter in nearly all circumstances. Therefore, it can be argued that Tasmanian prices do not derive from competitive tension between generators in that region and generation inflows from other regions.

In Tasmania, it appears that the strategy of the Government owned Hydro Tasmania, which may or may not be influenced by broader Government policy objectives and positions not directly related to the competitive market, is more likely to influence Tasmanian outcomes than competitive tension. In that sense, the Tasmanian region is not in line with other regions.

Second, the management of Basslink, including the IRRs, primarily serves the interests of Hydro Tasmania and does not benefit: Tasmanian retail consumers; or external generators, especially those in Victoria whose product would be best placed to compete with Hydro Tasmania.

Basslink acts as generator bidding into Victorian market, with no competition behind it, and with a bidding advantage in the dispatch engine. Furthermore, counter-priced flows are at Hydro Tasmania's discretion. Both of these outcomes require review.

The availability of IRRs is artificially constrained with no open transparent market for purchase. In our experience, the application process was absurdly complicated, was not transparent and appeared designed to freeze out parties other than Hydro Tasmania. Prices were not readily revealed and pricing structures and timing limits impeded access.

There is an open question on whether if a party is successful in obtaining IRRs are they at risk of having their value minimised based on the strategy of Hydro Tasmania in that region and most importantly its management of Basslink. Given the IRRs value will be maximised or minimised largely based on the decisions of one party, Hydro Tasmania, some would suggest it makes little sense to obtain IRRs unless you are that party. While we acknowledge problems with inter-regional competition exist generally, the unique IRRs arrangements make Tasmania most problematic.

Third, Hydro Tasmania's dominance disincentives entry into the Tasmania region. Clearly, IRRs can not be used effectively to manage risk in Tasmanian for generators based in other regions wishing to enter that market. Hence, we agree with the view that Hydro Tasmania's ownership of the vast bulk of supply ensures that "all roads lead to Hydro Tasmania" when any party seeks to take a position in the market. Furthermore, that Hydro Tasmania has a dominant price setting position given its monopoly makes it difficult to conceive how a private sector participant could risk entering that market for a sustained period.

LYMMCo has established relationships in the commercial sector but we do not feel these relationships can be leveraged to incorporate Tasmanian commercial and industrial customers. If we took the risk of taking on an industrial or commercial contract in Tasmania we would in essence be reliant on the bidding of Hydro Tasmania. This makes entering the Tasmanian market a Government policy issue not a competition issue given Hydro Tasmania's ownership and its single entity status. We believe the market is largely untenable on those grounds.

LYMMCo believes that absence of supply-side competition is a route cause of the bulk of concerns regarding Tasmania's integration into the NEM and the Tasmania region outcomes. A single Government owned company with control of Basslink is highly problematic and reform options should be explored.

Yours faithfully



Jamie Lowe
Manager, Regulation and Market Development

Hydro Tasmania Compliance Plan Notice - 3 February 2010 for 2 February

- HT instructed BPL to positively bid Basslink southward flows and to bid negative on northward flows on Tuesday 2nd February 2010, after constraint V>>V-HYLY_1, was binding and affecting Latrobe Valley while VIC price was higher than TAS price and TAS price was negative.
- The instruction was given at 12:37 for trading interval 13:00 (period ending). This bid was extended, on two occasions at 12:59 (for all periods ending 17:00) and again at 16:54 (for all periods ending 18:00). Link bid was removed at 17:23, after an unexpected change in market prices.
- These conditions comply with the compliance plan.

Rebidding Instructions for 2 February

- 20100202 12:37 1235A CONSTRAINT MANAGEMENT
- 20100202 12:59 1255A CONSTRAINT MANAGEMENT

Hydro Tasmania Compliance Plan Notice - 4 February 2010 for 3 February

- HT instructed BPL to positively bid southward flows and to bid negative on northward flows on two occasions on Wednesday 3 February 2010, after constraint V>>V-HYLY_1 was binding and affecting Latrobe Valley while VIC price was higher than TAS price and TAS price was negative.
- The first instruction was given at 12:32 for trading interval 13:00 (period ending). This second instruction was given at 13:37 (all trading intervals up to and including 17:00).
- These conditions comply with the compliance plan.

Rebidding Instructions for 3 February

- 20100203 12:32 1230A BASSLINK < EXPECTED, V>>V-HWLY_1 BINDING SL
- 20100203 13:37 1340A VIC PRICE > FORECAST, ESI CONDITIONS MET

Actual outcomes

- V>>V-HWLY_1 constraint.
- The relevant Victorian generators responded to the constraint by repricing all MW to -\$1000/MW, this action initially served to shift the impact of the constraint to the Tasmanian generators.
- When Hydro Tasmania repriced all MW to -\$1000 and the Basslink MNSP rebid to -\$968.20, NEMDE commenced increasing the exports into Victoria reaching close to maximum export flow.
- At the same time Basslink southern flows were bid positive, at top band (up \$10,000). This stopped Victorian energy going into Tasmania, which would only occur when prices in Tasmania are higher than Victoria which was not the case on this day.
- The increased flow from Tasmania, resulted in further constraining of the LY based generation. This occurred because the Tasmanian generation priced at close to -\$1000

and the Basslink transfer price of -\$968.20 made this generation cheaper than the Loy yang based generation priced at -\$1000.

'What-if' outcomes for a scenario where Basslink was consistently bid at zero

- V>>V-HWLY_1 constraint.
- Had Basslink North flow not been bid negative, the price at the LY node would have been set by the LY generators bidding at -\$1000 and merit order at the LY node would have seen the lowest bidding (i.e. those at -\$1000) Victorian generators dispatched ahead of Basslink.
- This means in the face of the constraint where prices are high, had Basslink not bid North flows negative, it would not get preference.
- Therefore, the volume of Basslink exports should have been dispatched proportional to the volume of MW's priced at the -\$1000 price band up. Any remaining MW's within the constraint limit would then have been dispatched by Basslink on merit order.
- There still would be price separation between Tasmania and Victoria as Basslink was at its limit and therefore energy would not be flowing from Victoria to Tasmania.