



Authorisation of Tasmania's NEM Entry Arrangements

Enhancements to Tasmania's Energy Reform Framework

JUNE 2001

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1. INTRODUCTION

Tasmania's energy sector is undergoing a period of fundamental change. The development of the Tasmania Natural Gas Project by Duke Energy International (DEI) and the development of Basslink by Basslink Pty Ltd (BPL), coupled with the State's entry to the National Electricity Market (NEM) and the emerging entry of new on-island electricity generation sources will introduce strong competition and customer choice in Tasmania's energy sector.

The Government has developed an Energy Reform Framework to accompany these developments. The Framework is explained in the Information Paper titled *Meeting Tasmania's Energy Needs for the 21st Century*¹.

Transition arrangements that form a key part of the Energy Reform Framework have been submitted to the Australian Competition and Consumer Commission (ACCC) for authorisation under Part VII of the *Trade Practices Act 1974* (TPA). The transition arrangements include derogations to the *National Electricity Code* (NEC) and a vesting contract that will support the roll-out of contestability.

There are significant public benefits associated with the Government's Energy Reform Framework and it is unquestionably pro-competitive. Further, Tasmania has been able to keep its transition arrangements to the bare minimum. Accordingly, the basis of the authorisation application for the transition arrangements is that:

- the Government's Energy Reform Framework is a critical contextual element for the authorisation decision; and
- the public benefits of the transition measures and those arising from the Energy Reform Framework significantly outweigh any anti-competitive detriments arising from the transition arrangements.

During the authorisation process, concerns have been raised by interested parties and the ACCC regarding features of the energy reform arrangements, relating to interstate trading arrangements, with possible implications for the development of competition in Tasmania's electricity supply industry.

The Government has explored these issues in depth with the ACCC to provide both parties with an understanding of underlying issues and the options for dealing with any material concerns. The Government's objective has been to establish a clear transition path towards the development of competition as Tasmania joins the NEM.

As a result of these discussions, the Government has agreed to enhance its Energy Reform Framework by implementing additional arrangements that will further facilitate the development of competition in the Tasmanian electricity generation and retail markets. The purpose of this paper is to outline these arrangements.

¹ The Information Paper can be accessed at <http://www.treasury.tas.gov.au/domino/dtf/dtf.nsf/main-v/electricity>

2. BACKGROUND

The Energy Reform Framework is a package of structural and regulatory arrangements that has been designed to ensure that the Government's energy reform objectives are achieved and sustained in the long-term in a financially and economically sustainable manner (see Chapter 1 of the Information Paper).

The reform package contains several essential interdependent features. The structural reform arrangements, including the separation of the Bell Bay Power Station from Hydro Tasmania to an independent entity and the introduction of retail competition, are dependent on the State's participation in the NEM. The State's entry to the NEM is dependent on, *inter alia*, the successful completion of Basslink² and Basslink is underpinned by commercial arrangements negotiated between Hydro Tasmania and BPL, principally the Basslink Services Agreement (BSA).

As discussed in the Information Paper, all the final proposals for Basslink arising from the Basslink Development Board's internationally-based competitive process were for interconnectors based on the market network service provider (MNSP) model. The competitive proponent selection process demonstrated that the only way Basslink would proceed at that time was for it to be built as an entrepreneurial link, underpinned by long-term financial instruments, with Hydro Tasmania being the most suitable counterparty. Importantly, this enables Basslink to be built without project risks and costs having to be borne directly by consumers.

The MNSP model

The MNSP model is a market-driven approach to interconnection, which helps to achieve a key objective of the NEM, namely the strengthening of transmission linkages between regions.

MNSPs obtain revenue by offering their capacity into the NEM (similar to generators offering generation capacity), pursuant to the market rules contained in the NEC, referred to as transport bidding³. In deciding whether to accept a given transport bid, NEMMCO compares the price difference across the link with the transport capacity bid. Bids that are below the difference would be accepted, while bids that are greater than the price difference would not. If NEMMCO does not accept any of the transport bids, no electricity flows across the link and the MNSP earns no revenue.

² With regard to the timing of NEM entry, the Government anticipates commencing the NEM in Tasmania around 6 months prior to Basslink entering commercial service.

³ The fundamental difference between regulated interconnectors and unregulated or entrepreneurial interconnectors like an MNSP is that the costs of regulated interconnectors are recovered from customers via transmission charges, whereas an entrepreneurial interconnector bears the costs and must earn revenue from the market.

Because MNSPs are market driven, there will be different models for the viability of financing a link and earning revenue from the link. What makes each link viable will depend upon the MNSP and the market circumstances in which it operates.

Commercial arrangements underpinning Basslink

In the case of Basslink, under the terms of the BSA, BPL and Hydro Tasmania have agreed to a financial exchange whereby BPL pays to Hydro Tasmania the pool revenues accruing to the link in return for a fixed facility fee. Specifically, Hydro Tasmania will receive from BPL:

- a stream of income equal to the inter-regional revenues accruing to the link when it is exporting power from Tasmania to Victoria (referred to in this paper as export IRRs); and
- a stream of income equal to the inter-regional revenues accruing to the link when it is importing power to Tasmania from Victoria (referred to in this paper as import IRRs).

The facility fee that Hydro Tasmania has undertaken to pay is essential to the underpinning of Basslink. No other market participant is required to make a contribution to the cost of the link, notwithstanding that they will benefit from the operation of Basslink.

As noted in the Information Paper, Hydro Tasmania has a commercial intention to sell-down the import IRRs in order to reduce its exposure under the facility fee and several key principles underpinning the sell-down arrangements were explained in the Information Paper. The commercial sell-down of import IRRs by Hydro Tasmania was, and remains, an important feature of the Government's Energy Reform Framework.

The BSA also provides Hydro Tasmania with certain rights relating to the way in which BPL will offer (bid) Basslink for dispatch to NEMMCO. The BSA:

- requires BPL to bid the full import and export capacity of Basslink (within the technical parameters of its technical envelope) at a zero price, unless otherwise directed/requested by Hydro Tasmania;
- enables Hydro Tasmania to direct BPL to bid Basslink at a positive price in either direction; and
- enables Hydro Tasmania to request BPL to bid Basslink in either direction at a negative price, with BPL retaining discretion as to whether or not such a request would be implemented.

As discussed in the Information Paper, the underlying economics of the project are predicated on Basslink being flexible to enable electricity flows between Tasmania and Victoria. Basslink enables Hydro Tasmania to change the nature of its business, reflecting the valuable role that hydro plant can play in the peak market in the NEM. Basslink will effectively open a new market of up to 600 MW for all Tasmanian-based generators. One of Hydro Tasmania's primary commercial drivers (and

therefore interest in the project) will be competing with interstate generators in the peak market.

Because the State's hydro system is energy constrained, Hydro Tasmania cannot physically maintain base-load production in Tasmania while fully exploiting these opportunities in the NEM. This creates the opportunity for the development of competition within the State via increases in supply from non-Hydro Tasmania sources (initially through imports via Basslink and over time by new on-island generators). This highlights the pro-competitive nature of the project, underpinned by the BSA. Importantly, these outcomes are delivered without the need to provide Hydro Tasmania with exclusive use of Basslink. The link will operate in accordance with NEM processes, with NEMMCO dispatching generators according to supply and demand conditions and, as necessary, dispatching Basslink in accordance with resultant price differentials.

Contrary to the typical model for MNSPs, under which capacity across the link is constrained by bidding to generate revenue to the link owner/operator, the BSA makes BPL indifferent to the price difference between Tasmania and Victoria, and moreover, incentivises both BPL and Hydro Tasmania to ensure that the link is available to maximise energy trading revenues.

ACCC review of the BSA

Hydro Tasmania and BPL held a series of detailed briefings to the ACCC during September and October 2000. The purpose of these briefings was to explain the BSA to the ACCC and to share with the ACCC the comprehensive competition analysis undertaken by the parties.

As a consequence of its examination of the BSA (which included market consultations), the ACCC advised the parties that it had reached the conclusion that entry into the BSA by the parties "would not be sufficiently likely to contravene Part IV of the Act to warrant any action by the Commission". A copy of the ACCC's advice, in the form of a letter to Hydro Tasmania and BPL, and the joint response is contained in Attachment A and is also available from the ACCC's website (http://www.accc.gov.au/electric/basslink_correspondence.htm).

In light of the ACCC's letter and the parties' own views that the BSA is a pro-competitive means of enabling the Basslink interconnector to be built, the parties advised the ACCC that they would not seek authorisation of the BSA.

Issues raised by interested parties

Two groups of issues have arisen during the authorisation process relating to the arrangements for interstate trade.

1. Issues have been raised as to uncertainties in how Basslink will be bid to NEMMCO and the potential for Hydro Tasmania to instruct BPL to bid Basslink to impact on competition in Tasmania.

2. Issues have also been raised as to a potential lack of inter-regional price risk management tools in the early years of the market, with consequential impacts on the development of competition within Tasmania.

In considering the first group of issues, the Government has worked in consultation with the ACCC to ensure that there is greater certainty for market participants, Hydro Tasmania and BPL regarding the bidding arrangements for Basslink by defining the parameters of legitimate bidding behaviour consistent with the flexibility that Basslink is intended to provide.

Consistent with the State's entry to the NEM, the Government's clear intention has been to facilitate the development of competition and, accordingly, it will amend its Energy Reform Framework in this regard to include measures associated with Hydro Tasmania's ability to influence the bidding of Basslink. These measures are discussed in Chapter 3.

Interested parties have also raised issues with the arrangements for import IRRs across Basslink, suggesting that these could lead to a limited market for inter-regional risk management tools, such that competition in the Tasmanian region will be constrained.

In this regard, the ACCC has sought information regarding the import IRR sell-down arrangements in addition to that provided in the Information Paper. The ACCC has been keen to ensure that the arrangements developed for import IRR sell-down maximise the scope for the development of competition in the Tasmanian region of the NEM. Specifically, the ACCC has sought to ensure that import IRRs are made available to the market and not unreasonably withheld by Hydro Tasmania, notwithstanding its stated intention of a commercial sale.

The Government believes that the availability of inter-regional price risk management tools is an important aspect of the design of the market, particularly during the transition period in which competition is evolving in Tasmania. Accordingly, additional measures have been incorporated into the Energy Reform Framework designed to facilitate market participants obtaining risk mitigation products to assist the early development of competition in Tasmania's electricity supply industry, while maintaining the commerciality of the arrangements for Basslink. These measures are discussed in Chapter 4.

3. BASSLINK TRANSPORT BIDDING ARRANGEMENTS

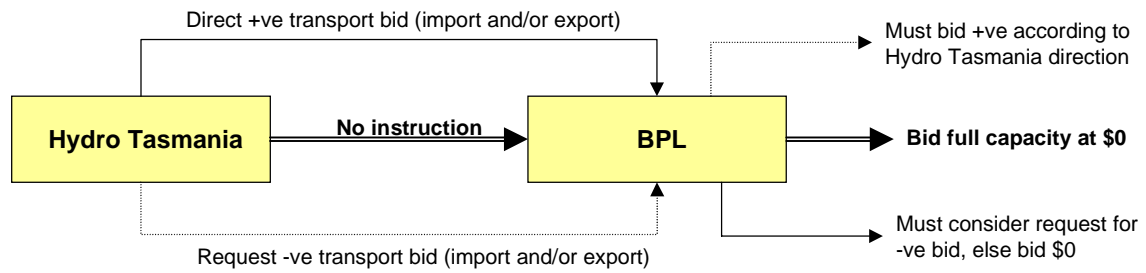
In operating Basslink as an MNSP, BPL must follow the bidding rules contained in Chapter 3 of the NEC as they relate to MNSPs. The rules for bidding MNSPs are similar to those applying to generators. Under the NEC, an MNSP must submit network dispatch offers (transport bids) to NEMMCO, indicating the capacity of the link available for dispatch, with these offers containing up to 10 different price bands in each direction. The bids represents the minimum net revenue to be earned by the MNSP (the difference in electricity prices at either end of the link multiplied by the volume flowing across the link) before tranches of capacity will be dispatched. Similar to generators, a MNSP is free to specify any price bands between the market floor (-\$1000) and VoLL. Whether a MNSP is dispatched (and if so, at what volume and price) is determined by NEMMCO via the normal market clearing mechanism.

As discussed in Chapter 2, BPL and Hydro Tasmania have entered into the BSA, which is a long-term financial agreement underpinning Basslink. Under this contract, BPL has agreed to pay Hydro Tasmania the variable revenue stream from Basslink's operation in the market and allow Hydro Tasmania the right to influence the bidding of the link, in return for a facility fee (which includes some market-risk sharing arrangements). While BPL continues to be the link owner/operator, and therefore must be the party that submits transport bids to NEMMCO, the BSA contains a suite of requirements regarding how BPL will make transport bids to NEMMCO (see Figure 1). Specifically, the BSA:

- requires BPL to bid the full capacity of the link within its technical envelope (in both northwards and southwards direction) to NEMMCO;
- requires BPL to specify a zero price for that capacity unless otherwise directed/requested by Hydro Tasmania (which means that the link will be available to transport electricity between Tasmania and Victoria even if there is no price difference between the two connection points⁴);
- requires BPL to specify a positive transport bid if directed by Hydro Tasmania (which would set a minimum price difference between Victoria and Tasmania connection points before the link will be dispatched at specified capacities); and
- enables Hydro Tasmania to request BPL to specify a negative transport bid, which BPL can either accept, or otherwise BPL must place a zero transport bid.

⁴ Under the NEC, BPL must advise NEMMCO of the dynamic loss equation for Basslink for use in the dispatch process. In practice this will result in limits to transfers where the price differences between the connection points are very small.

Figure 1: Bidding of Basslink under the BSA



Interested parties have raised concerns that there could be anti-competitive motivation behind Hydro Tasmania’s bidding directions/requests to BPL in some circumstances. The argument has been put that Hydro Tasmania’s position as a generator in Tasmania could create incentives for it to achieve certain market outcomes via the transport bidding of Basslink. This is misconceived as it misunderstands the role of Basslink in the market and neglects the impact of the facility fee on Hydro Tasmania’s incentives.

Australia has a strong competition law regime under Part IV of the TPA, and issues relating to the effect or likely effect of conduct on competition in a market are most appropriately handled at the national level by the ACCC pursuant to its powers under the TPA, rather than by State-based measures.

Nevertheless, the Government is of the view that to assist the development of effective competition in Tasmania, particularly in the transition years, it would be desirable for there to be greater certainty regarding the way in which Basslink will be bid. In doing so, the Government is mindful that it must balance giving that certainty during the transitional phase while preserving the flexibility that Basslink provides.

It should be noted that the issues raised do not relate to transport bidding *per se*. Therefore, the Government has addressed the issues raised via limitations on Hydro Tasmania’s bidding instructions under the BSA, rather than seeking to impose any amendments to the arrangements contained in the NEC relating to the bidding of MNSPs⁵.

Transport Bidding Arrangements

As an element of its Energy Reform Framework, the Government will implement arrangements such that, to the extent Hydro Tasmania has rights to instruct or request BPL in relation to bidding for Basslink capacity, such instruction or requests must not specify:

- negative transport bids in either direction; or

⁵ To the extent that parties have concerns about the general transport bidding arrangements (eg. the specification of negative transport bids by MNSPs), these are issues for the NEM generally and should be addressed at a national level.

- positive transport bids for southwards flows, except in certain limited circumstances, described below.

These arrangements are represented in Figure 2.

At this stage, with Basslink not yet under construction, it is not prudent to rule out positive bidding on southward flows completely. There may be scenarios under which a positive transport bid is appropriate.

- For example, if there were short-run marginal costs incurred in operating the link, it would be appropriate from a pricing efficiency perspective for these costs to be reflected in the bidding of the link (pricing signals and market outcomes would be distorted if prices were forced below short-run marginal costs).
- Limited positive bidding may also be appropriate for technical (including environmental) reasons associated with the operation of the link, such as to prevent the link from rapid and multiple switches in direction.

A key design feature of Basslink will be its ‘dynamic rating’, which enables the link to operate for periods above its continuous rating of 480 MW. Basslink has been designed so that it can operate at up to 600 MW for up to 10 hours, provided that it is pre-cooled (6 hours at no more than 300 MW). The dynamic rating feature of the link is a core element of the economic proposition underlying Basslink’s development.

The Tasmanian system is presently able to support the link operating at only 150 MW during times of import. However, to enable a higher rate of import flow, BPL is implementing a System Protection Scheme (SPS) as part of the Basslink project, with the funding of the SPS included as part of the Basslink facility fee paid by Hydro Tasmania under the BSA. The SPS will enable the link to initially operate at 300 MW in import mode.

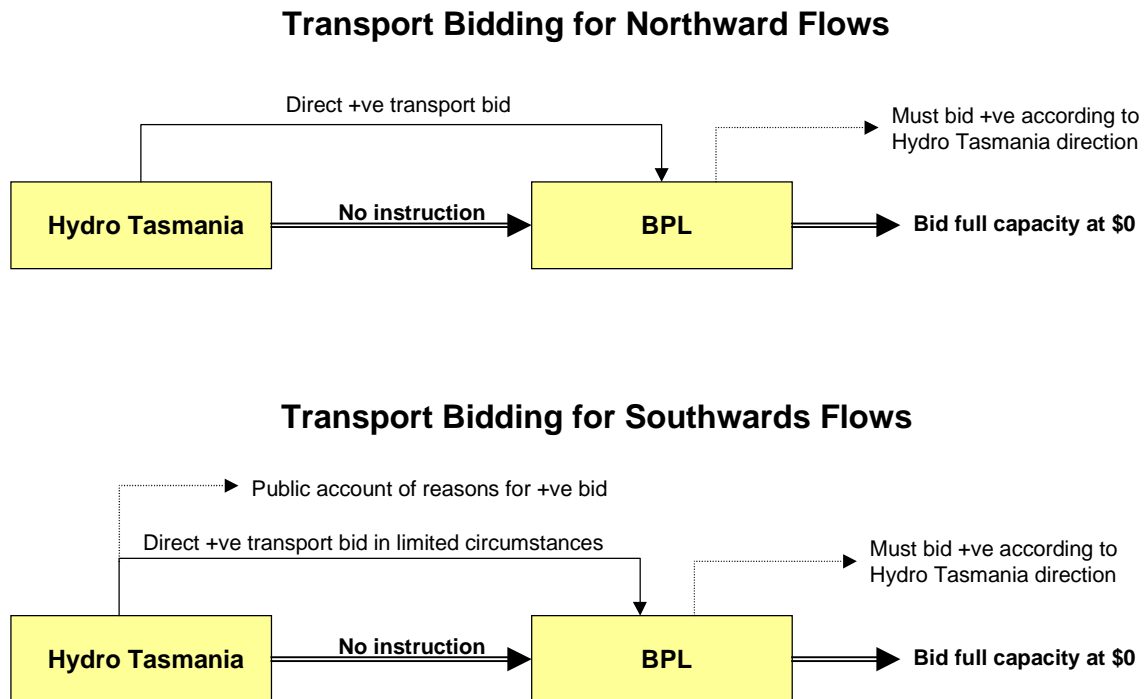
At this level of import capability, there is expected to be no impact on the dynamic rating of the link. However, if additional load shedding could be sourced in Tasmania, such that the import capability of the link were able to be increased beyond the level required for pre-cooling (eg. if the link could operate in import at a capacity of 400 MW, whereas the pre-cooling requirement was 300 MW), it may be that to preserve the pre-cooling regime, the link may be required to import at less than its full capacity for certain periods. It is the Government’s view that the dynamic rating feature of the link must be preserved, given its importance in underpinning the commerciality of the project.

In summary, the limited circumstances under which Hydro Tasmania would be able to direct BPL to place a positive transport bid for southward flows on Basslink include:

- technical (including environmental) reasons associated with the operation of the link;
- short-run marginal costs incurred in operating the link; and
- to preserve Basslink’s dynamic rating.

To provide additional transparency, the Government will also implement measures that will require Hydro Tasmania to publicly disclose the reasons for any positive bidding instruction made to BPL.

Figure 2: Bidding of Basslink under BSA and amended Energy Reform Framework



It should be noted that these arrangements are specific to Hydro Tasmania and would not apply to any other party that may, in the future, obtain rights, either directly or indirectly, to make transport bids for Basslink.

Importantly, the implementation of these transport bidding principles does not impinge on the operation of Part IV of the TPA in relation to the bidding of Basslink, including any instructions from Hydro Tasmania in this regard.

Implementation Issues

There are several approaches available to the Government to implement the transport bidding principles within the Tasmanian regulatory framework. The final selection of the most appropriate mechanism, and its detailed development will take further time to resolve. The Government anticipates working in consultation with the ACCC, as well as with Hydro Tasmania and BPL, to resolve the detailed arrangements that will support the implementation of the transport bidding principles.

The Government notes that the existing NEM rules contained in the NEC have been authorised by the ACCC until 2010⁶. Consistent with these arrangements, the transport bidding principles outlined in this paper will apply once Basslink has entered commercial service⁷ and remain in place for:

- the duration of the authorisation of the NEC (ie 2010); or
- until there are significant modifications to the transport bidding arrangements for MNSPs.

The transport bidding principles represent a pro-active approach by the Government to deal with issues raised by the ACCC and other parties during the authorisation process. As such, the Government will review the appropriateness of the transport bidding principles and the mechanism by which they are given effect on a regular basis. Key issues that would be considered in such reviews include:

- the development of on-island generation competition in Tasmania and the market position of Hydro Tasmania;
- the development of commercial arrangements for import IRRs;
- developments for the bidding of MNSPs and/or developments of the NEC more generally; and
- any unintended consequences of the implementation of the principles that impact adversely on consumer welfare in Tasmania.

⁶ While the MNSP provisions have received interim authorisation to date, it is expected that the ACCC will make a final determination on these arrangements in the near term.

⁷ The Government's Energy Reform Framework will not limit the operation of Basslink during its commissioning phase. In any event, Hydro Tasmania has no bidding rights for Basslink until the link has entered commercial service.

4. THE IMPORT IRR RELEASE FRAMEWORK

Inter-regional contracting is emerging as an important issue in relation to the operation of the NEM. A discussion of inter-regional price risk and the mechanisms available to manage it is contained in Attachment B.

The Government recognises that it may take a period of time for the market in Tasmania to grow in sophistication such that a wide variety of competing inter-regional price risk mitigation products emerges. It is therefore likely that, in the early years of the Tasmanian market, import IRRs may be an important (albeit imperfect) risk mitigation tool for market participants contracting between other regions of the NEM and Tasmania.

At the same time, the Government does not wish to inhibit the development of more appropriate risk mitigation products by Tasmanian market participants. For example, on-island generators such as Hydro Tasmania, the Bell Bay Power Station or the Duke Joint Venture may offer firm inter-regional price swaps with generators in Victoria, which would provide superior risk protection for Victorian generators compared with simple import IRRs.

The Government also recognises that Basslink is clearly a commercial project. Hydro Tasmania has entered into the BSA from a purely commercial perspective (as it is required to operate under the *Government Business Enterprises Act 1995*). The arrangements developed for import IRRs sell-down must be consistent with the commerciality of the project. This means that Hydro Tasmania must be assured that it will receive fair and reasonable commercial value for import IRRs made available to the market.

The Government has taken into account these factors in developing the Import IRR Release Framework (IRF), which will ensure the release of import IRRs to the market to assist the early development of competition in Tasmania's electricity supply industry.

The IRF will be a medium-term feature of the Government's overall market design, under which Hydro Tasmania will have obligations until the end of 2010.

In the first instance, Hydro Tasmania is encouraged to seek private commercial arrangements (long or short term) under which some or all of the import IRRs are sold directly to a third party or are used as a component of another risk mitigation instrument. To the extent that private commercial arrangements do not result in sufficient import IRRs being sold, the Government's IRF has a "safety net" auction feature to ensure that the import IRRs are made available to the market.

Volumes of IRRs to be made available under the IRF

Under the IRF, Hydro Tasmania would be obliged to make available for sale all of the import IRRs available to it under the BSA. There will be no restriction on who may purchase the import IRRs (market participants and others), except that Hydro Tasmania will not be allowed to participate in the auction process.

The physical flows across the link will be according to the NEMMCO dispatch process and are not related to the IRR arrangements. Market participants will be able to use a portfolio of risk mitigation tools to support physical trading across the link, only some of which are based on the underlying ‘physical’ position of link revenues.

During the early roll-out of contestability, the volume of import IRRs that must be made available by Hydro Tasmania will be directly related to the size of the contestable market (which is expected to be less than the physical import capacity of Basslink for some time). The principle will be that the volume of import IRRs that must be made available will be not less than the size of the contestable market. Once the size of the contestable market is equivalent to the import capacity of Basslink, Hydro Tasmania must make available all the import IRRs available to it under the BSA.

Table 1 below sets out the contestability timetable, the expected size of the contestable market and an indicative roll-out of import IRRs through the IRF.

Table 1: Indicative rollout of import IRRs via the IRF^(a)

Contestable Load	Tranche size (GWh)	Tranche size (MW _{avg})	Cumulative contestable market (MW _{avg})	Indicative IRRs volume available through IRF (MW)
Tranche 1	841	96	96	100
Tranche 2	366	42	138	150
Tranche 3	466	53	191	200
Tranche 4	443	51	242	250
Full contestability ^(b)	2787	318	560	300

(a) Assumes Basslink physical import capability of 300 MW

(b) Excludes volume in established MI contracts that continue past the date of full contestability.

Type of Sale

The import IRRs would be made available to the market through private commercial arrangements negotiated between Hydro Tasmania and interested parties, with any unsold import IRRs sold via an auction process overseen by the Government.

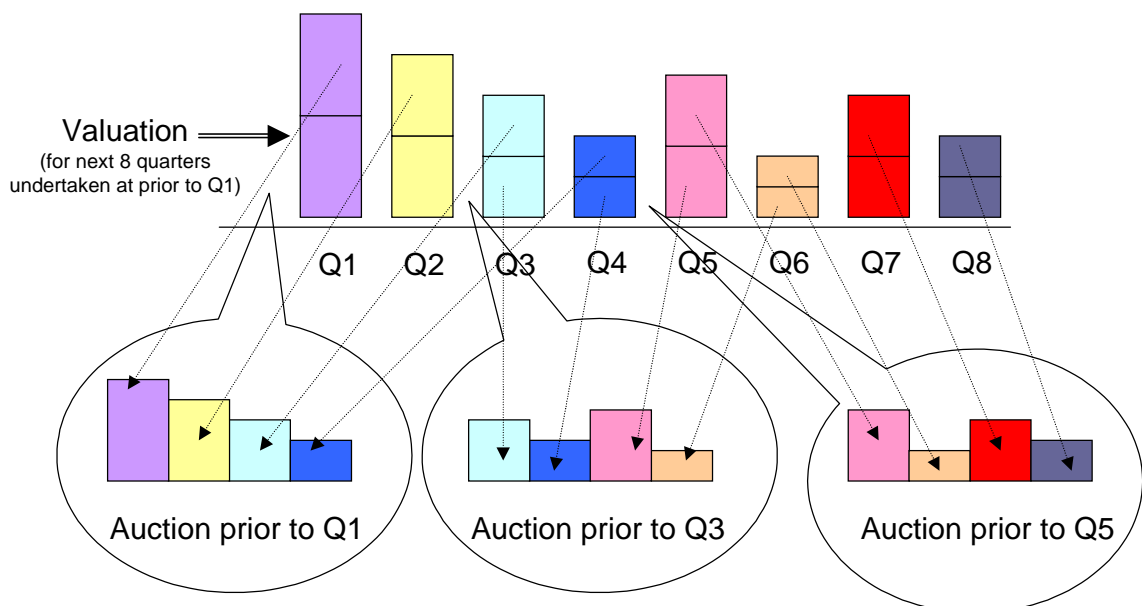
Hydro Tasmania would be free to sell either simple import IRRs or packaged products on a commercial basis to interested parties. This provides the scope for the development of more effective inter-regional price risk management tools and will address the potential shortcomings of a fixed auction arrangement. For example, a retailer would be able to negotiate with Hydro Tasmania for a long or short term arrangement, whereas under the proposed auction arrangements, the maximum cover available at a single point is yearly. Similarly, there is no limit on the volume that Hydro Tasmania may make available under a private arrangement, whereas the proposed auction arrangements apply only to specific volumes in tranches.

Auction process

Hydro Tasmania would be obliged to report to Government on a half-yearly basis the volumes of IRRs sold under private commercial arrangements, either as simple IRRs or via packaged products. If Hydro Tasmania retains any import IRRs for the following 12 month period, an auction process will be triggered for the remaining volume of import IRRs for that period.

Should it be necessary to proceed to an auction process, there will be at least two auctions per year under which buyers would bid for units of quarterly import IRRs⁸. Assuming a half yearly auction timetable and that Hydro Tasmania does not sell any import IRRs privately, at each auction, rights to 50 per cent of the available import IRRs for each of the next four quarters will be made available for sale. Figure 3 illustrates the structure of the auction process.

Figure 3: Structure of the auction process



Unless already totally sold down via private sales, at each auction participants can bid for import IRRs accruing to Basslink in any (or all) of the next four quarters. For example, at the auction prior to Q1, participants can bid for IRRs in quarters Q1-Q4.

⁸ A decision on the number of auctions per year can be made once the IRF is developed in greater detail and the costs and benefits of more regular smaller versus less frequent but larger auctions can be assessed.

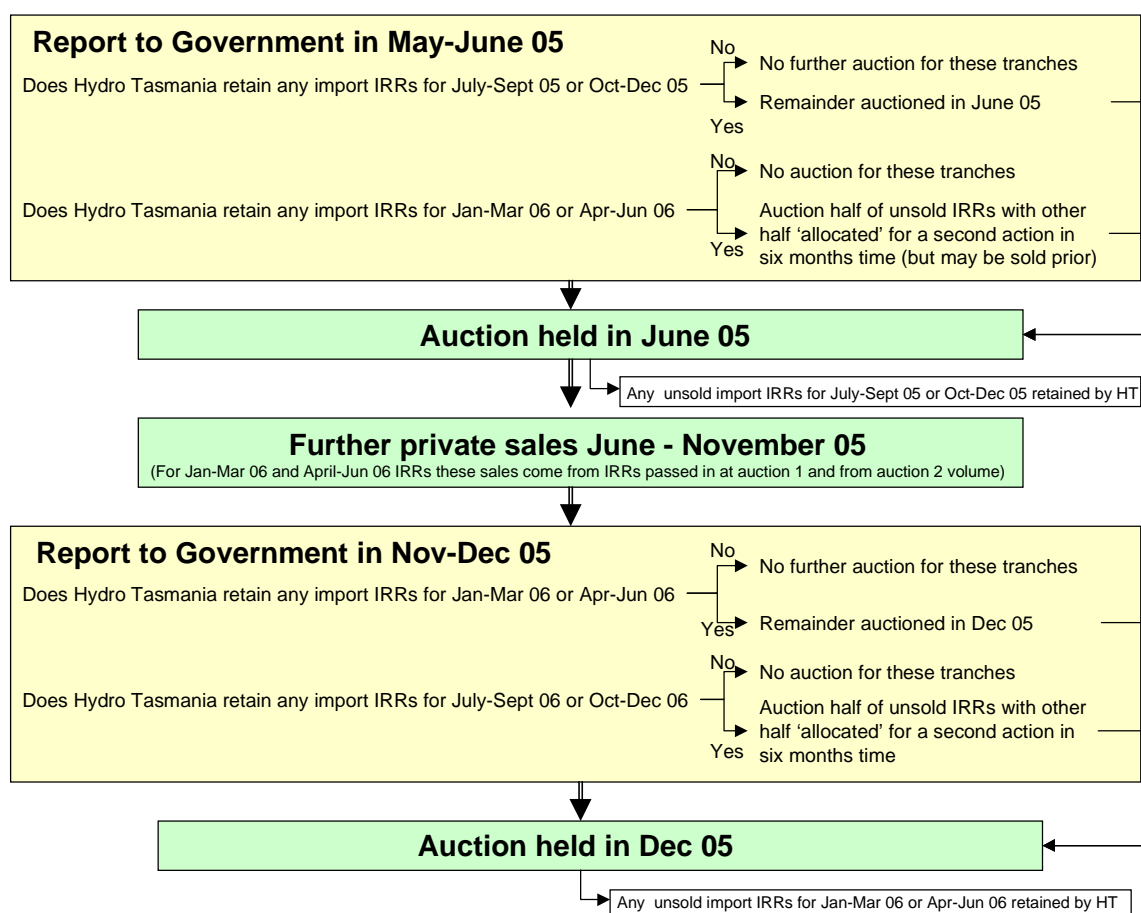
As an example, assuming Hydro Tasmania was required to sell-down all 300 MW of the import IRRs for a particular quarter, and it had sold the equivalent of 120 MW of IRRs privately, the remaining 180 MW of import IRRs would be required to be sold under the auction process. Assuming two auctions per year, this volume would be allocated in the following way:

- 90 MW in the next 6-monthly auction; and
- 90 MW in the subsequent auction.

Hydro Tasmania will retain the ability to sell import IRRs privately between auctions, and conceivably could sell all the remaining IRRs, such that there would be no need for a second auction for that tranche of import IRRs. This provides an incentive for Hydro Tasmania to actively seek private sales (to avoid the need for a subsequent auction) and also provides an incentive for participation in the auction process for interested parties (in that there is no guarantee that IRRs will be available at a second auction).

Figure 4 provides an illustrative example of the reporting and auction process.

Figure 4: Illustrative ‘annual snapshot’ of reporting and auction structure



Note: Reporting and auction dates illustrative only. Actual timings will be determined as details of IRF further developed.

Leaving aside private sales, tranches of import IRRs for any quarter would be available in at least two auctions. Assuming two auctions per year, the first auction would be 7-12 months prior to the quarter in which the IRRs are generated and the second 1-7 months prior to the quarter in which the IRRs are generated (see Figure 4).

Product sold at auction

At this stage, it is anticipated that participants in the auction would bid for units of import IRRs, rather than the IRRs corresponding to a firm quantum of capacity.

- For example, assuming the interconnector had an import capability of 300 MW and Hydro Tasmania had sold the equivalent of 100 MW of import IRRs via private arrangements, 200 units (notionally representing 1 MW each) would be made available at auction. The holder of one unit would be entitled to 1/300th of the import IRR for the given period.
- The auction is therefore for a non-firm product and neither Hydro Tasmania nor BPL would be required to 'firm-up' the product, although these (and other) parties may make commercial products available separately that have this effect.

Auction Reserve Price

A reserve price would be set for each tranche to ensure that a fair and reasonable price is achieved, given the fact that Hydro Tasmania has already paid for the import IRRs as a part of the facility fee under the BSA. Reserve pricing arrangements would apply for the duration of the IRF (ie for all auctions until 2010).

- The reserve will be set independently of Hydro Tasmania, BPL and the Tasmanian Government.
- The reserve price would be set at the expected cash value of the import IRRs, as determined by an independent expert. Valuations would be undertaken at least annually, and would value the IRRs over a two-year period.
- The reserve price will not be published.
- Any unsold import IRRs (bids for which fell below the reserve price) would be initially retained by Hydro Tasmania. Hydro Tasmania would retain the ability to sell IRRs that were handed in at auction, but would be required to make available any import IRRs it holds at the final auction prior to the period in which the import IRRs accrue. If any such import IRRs fail to sell at the final auction, they will be retained by Hydro Tasmania.

Attachment C details the principles and process under which the reserve price would be set.

Auction Selling Prices

Units would be sold according to the highest bids made on a pay-as-bid basis (ie there would not be a single clearing price). The range of selling prices and total volumes sold for the import IRRs would be made publicly available shortly after the auction. Coupled with a rolling auction where slices of half yearly import IRRs are sold, this

process of price discovery will assist in the achievement of market value for the import IRRs.

Auction Administration

The party undertaking the auction would have no financial interest in the auction outcomes and would be independent of Hydro Tasmania. The selection of an auctioning body would be made in consultation with the ACCC.

The auctioning body would provide potential bidders with a descriptive statement, endorsed by the Government. The statement would detail:

- the instrument being sold;
- a description of the relevant contractual rights held by Hydro Tasmania under the BSA;
- technical information relating to the interconnector (eg losses);
- expected link availability from NEMMCO's PASA; and
- risks of the investment.

The statement would not contain commercial information relating specifically to individual Tasmanian or Victorian generators. Participants in the auction would be able to draw on publicly available information in preparing bids.

The costs of the auction process, including the preparation of the descriptive statement and the independent valuation used to establish the reserve, would be met by successful participants in the auction process. Hydro Tasmania would be the ultimate recipient of all revenues from the sales process. Hydro Tasmania will meet the auction costs on a pro-rata basis for any import IRRs offered but unsold at auction. As noted above, Hydro Tasmania will not be permitted to participate in the auction.

To avoid the need for complex prudential arrangements, participants would be required to settle in full at the time of their successful bid.

The first tranche of import IRRs for which the IRF will apply is expected to be those accruing in the quarter six months after Basslink is operational (12 months after the commencement of the NEM in Tasmania). This will allow interested parties to gain an understanding of the operation of the link and the emerging price outcomes in Tasmania to inform the bidding process. It also coincides with the commencement of the first tranche of retail contestability.

One significant issue in the auction design is to ensure that the transaction costs of holding the auction are commensurate with the returns. Costs could be minimised by infrequent, large volume auctions, but this could conflict with the requirements of participants and may produce poorer market outcomes.

The Government would be able to approve the cancellation of an auction if the volumes of import IRRs available for sale were clearly insufficient to warrant the costs of the auction process.

In the event that there is no market demand for the products offered through the IRF, (due to the emergence of other firmer products), the need for the sell down process will require review. The Government will also review the appropriateness and structure of the IRF if there are wider developments in inter-regional hedging arrangements in the NEM.

CONCLUSION

The Energy Reform Framework developed by the Government as documented in the Information Paper *Meeting Tasmania's Energy Needs for the 21st Century* is pro-competitive, will deliver very significant public benefits to both Tasmania and the NEM more widely and provides an appropriate basis for the State's participation in the NEM.

Nevertheless, the Government has considered the issues raised by interested parties and the ACCC with regard to the arrangements for interstate trade and has agreed to implement additional measures within its Energy Reform Framework in response.

Arrangements will be put in place to give greater certainty as to the basis for transport bidding decisions for Basslink. The combination of the BSA and the enhancements to the Energy Reform Framework will mean that Basslink:

- is made available to NEMMCO at full capacity (within its technical envelope) in both a northwards and southwards direction;
- will not be subject to negative transport bids; and
- will be subject to zero transport bids in a southward direction, except in limited and appropriate circumstances.

With regard to inter-regional trading, the Government recognises that, while not critical, access to the import IRRs across Basslink is likely to assist in the development of competition within Tasmania, as the secondary market matures. The IRF strikes an appropriate balance in meeting a number of objectives:

- By acting as a "safety net" to ensure all of the import IRRs are made available to the market, it enhances the scope for inter-regional contracting across Basslink.
- By encouraging private arrangements, it provides the scope for the development of more effective inter-regional price risk management tools and will address the potential shortcomings of a fixed auction arrangement.
- The implementation of the reserve price provides an acceptable degree of comfort that the essential economic underpinning of Basslink remains and that Basslink remains a commercially attractive project for both BPL and Hydro Tasmania.

These enhancements to the Energy Reform Framework reinforce the already strong framework for the State's participation in the NEM and enhance the case for the authorisation of the NEM entry transition arrangements.

ATTACHMENT A: CORRESPONDENCE ON THE BASSLINK SERVICES AGREEMENT



Australian Competition & Consumer Commission

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15 November 2000

Ms Rachel Trindade
Clayton Utz
Level 18
333 Collins Street
MELBOURNE VIC 3000

Mr Baden Furphy
Freehills
101 Collins Street
MELBOURNE VIC 3000

Dear Ms Trindade and Mr Furphy

Proposed Basslink Services Agreement between the Hydro-Electric Corporation ("HEC") and National Grid International Limited ("NGI")

I refer to your recent discussions with Rod Shogren and Commission staff with respect to this proposed agreement. I would also like to take this opportunity to thank you for the submissions which have been made to the Commission in recent weeks as well as the opportunity for Rod and staff to meet with representatives of your respective clients to discuss this project.

You have sought the Commission's views on whether there is likely to be a breach of Part IV of the *Trade Practices Act 1974* ("the Act") arising out of the proposed Basslink Services Agreement ("BSA"), such that your clients may need to seek authorisation for the proposed agreement under Part VII of the Act.

While the Commission can express views on whether it believes there is a breach or possible breach of the Act, the final determination of this question is always a matter for a court. Further, the Commission believes that whether to seek authorisation for a proposed contract, arrangement or understanding is a question for the parties to the proposed agreement. While the Commission can indicate whether it intends to take action in a particular instance, in the absence of an authorisation under Part VII of the Act it is unable to confer upon the parties any immunity from a private legal action for an alleged breach of Part IV (other than s 50).

The Commission has carefully considered the material submitted on behalf of your clients as well as the matters raised in the discussions. The Commission has also sought the views of other market participants on certain aspects of the Basslink proposal on a restricted basis.

E X E C U T I V E O F F I C E

After considering this matter, the Commission believes that the entry into the BSA by your clients would not be sufficiently likely to contravene Part IV of the Act to warrant any action by the Commission. This conclusion is predicated upon the link being operated in the manner conveyed to the Commission and upon Tasmania becoming a region in the National Electricity Market. It should also be noted that this conclusion is based on the Commission's understanding of the material put before it and the Commission reserves the right to take action in the future if it believes that the circumstances have changed sufficiently to justify it.

While the Commission does not currently propose to take any action with respect to the BSA, it does not believe that it can be said with certainty that there is no possibility of a court finding that a contravention of Part IV could exist. Specifically, the Commission gave close attention to:

- clauses 8.1 and 9.1(e), which have the effect of limiting the capacity of link when importing into Tasmania to 300 MW; and
- clause 2.1, which requires NGI to pay to HEC the Inter-regional Revenues generated by the flow of electricity over the link.

The Commission believes that it is at least arguable that either of these provisions could give rise to a possible breach of s 45 of the Act (or, in relation to clause 2.1, s 47). Whether a breach does in fact exist would depend to a significant degree on a court's assessment of the likely future of the relevant market in Tasmania with and without the impugned provisions.

The Commission also notes that any analysis of the likely impact of the BSA is, to a degree, speculative, in that it may not be possible to accurately measure the effect of the BSA on competition until the link is in operation. However, legal action in the future (either by the Commission or a third party) could be warranted if it appeared at that time that the parties to the BSA were giving effect to a provision of a contract in a manner that had the purpose, effect or likely effect of substantially lessening competition.

The Commission believes that your clients should give careful consideration to applying for authorisation of the BSA. Under Part VII of the Act the Commission has the power to grant immunity from legal proceedings with respect to a contract, arrangement or understanding that might otherwise involve a contravention of the Act. However, for authorisation to be granted it would be necessary for your clients to satisfy the Commission that the public benefits from the proposed arrangement outweigh any anti-competitive detriment that will result from it.

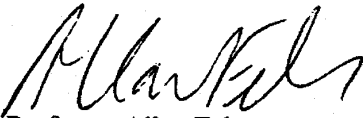
The authorisation process is a public one, in which interested persons are given the opportunity to make comments on the proposed arrangement. You should also be noted that Commission often elects to authorise only parts of a proposed arrangement, and may grant authorisation for a lesser period than the term of the agreement. While the possibility of an authorisation for 25 years cannot be excluded, this would be an unusually long period. If authorisation was granted, it may also be subject to conditions relating to the conduct of the parties.

Further, I note that it is currently proposed that some of the arrangements necessary for Tasmania to enter the National Electricity Market (in particular, derogations from the

National Electricity Code), will need to be submitted to the Commission for authorisation. When the Commission makes its assessment of the likely anti-competitive effects and public benefits of any such proposals, the manner in which the Basslink will be operated under the BSA can be expected to feature in the Commission's assessment, as it will be crucial to the nature of competition in the relevant market in Tasmania.

The Commission would be pleased to meet with your clients to discuss its views as well as the authorisation process if this would be of further assistance.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Allan Fels', written in a cursive style.

Professor Allan Fels
Chairman

Fax from : 0362385454

BASSLINK PROJECT

21/12/00 00.20 19.2



Basslink

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Hydro Tasmania

the renewable energy business

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20 December 2000

Professor Allan Fels
Chairman
Australian Competition & Consumer Commission
470 Northbourne Avenue
DICKSON ACT 2602

By Fax (02) 6243 1122

Dear Professor Fels

Hydro Tasmania and Basslink Pty Ltd wish to thank the Commission for its letter of 15 November 2000 regarding the Basslink Services Agreement ("BSA").

We appreciate the willingness of the Commission to meet with us and our legal advisers, to allow us an opportunity to brief the Commission on the BSA and to assess the submissions we put to the Commission through the examination and market consultation process conducted by Commission staff.

We recognise and appreciate the extent to which the Commission has responded to our shared concern regarding the level of regulatory comfort we require in order to proceed with this significant project. As the Commission is aware, we believe that the BSA is a pro-competitive means of enabling the Basslink Interconnector to be built. We are of the view that it would not give rise to any contravention of Part IV of the Trade Practices Act 1974 and that it does not require authorisation.

In the light of the views expressed by the Commission and the advice of our respective legal advisers, Hydro Tasmania and Basslink Pty Ltd confirm that it is not proposed to seek authorisation of the BSA.

Yours sincerely

Geoff Singleton
Chief Executive Officer
Basslink Pty Ltd

G.L. Willis
Chief Executive Officer
Hydro Tasmania

CC Gavin Fox 02 6243 1260

ATTACHMENT B: INTER-REGIONAL PRICE RISK

The establishment of regions within the NEM means that participants in one region wishing to deal with those in another are faced with higher risks relative to intra-regional trades due to price differences between regions. These price differences arise from a number of factors, including:

- the physical limitation of the link to transfer energy from one region to another;
- unplanned generation and transmission outages in either region;
- the manner in which transmission loss factors are accounted for in determining prices; and
- interventions in the market that interfere in the setting of the spot market price.

These combine to create a level of risk for parties contracting across regions. Parties facing these risks can seek to:

- identify an instrument that covers their risk on a trade by trade basis; or
- maintain a portfolio approach to risk management by offsetting countervailing risks and positions within the organisation or between parties with natural countervailing risks⁹.

It is noted that the general practice in Australia is to adopt a portfolio approach to risk management.

Submissions to the ACCC on the Tasmanian NEM entry authorisations raised the role of import IRRs accruing to Basslink in hedging these risks. The Government recognises that import IRRs may be a useful but incomplete risk management tool for inter-regional trade. There are a number of factors that can impact on the effectiveness of IRRs as a hedge instrument in inter-regional trade, including:

- IRRs are generated only when the link is operational and is constrained. Accordingly, IRRs provide no hedge protection through forced and unplanned outages of the link. At those times, the price risk is greatest to the interstate participant but the IRR hedge value is zero.
- The market generally recognises contracts for fixed hours (eg peak and off-peak). IRR's are flow based and correlate poorly with fixed times.
- The import IRRs do not allow for the transmission losses which may leave an exposure to an interstate participant when the link is importing.

⁹ A detailed analysis of the approaches to risk management in the energy market is contained in a report by Trowbridge Consulting of Deloitte Touche Tohmatsu for VENCORP at www.energy.net.au.

- There is often a timing imperfection between the acquisition of the IRR as a hedge instrument and entering into a CFD between parties. This may be a function of the sale process (eg. a 3 monthly auction system).
- There may be a volume imbalance between the volume of IRRs available, which is capped to the capacity of the link, and the volume of inter-regional contracts. Accordingly, it is not a perfect match and there is likely to be a supply/demand imbalance related to the perception of the firmness of the IRR.
- The IRRs do not provide a complete hedge between the Victorian and Tasmanian pool prices, as the IRRs are calculated by reference to the two connections points (Loy Yang and George Town), rather than the two regional reference nodes (although George Town will be the regional reference node in Tasmania).

In addition, observation of the NEM suggests that the level of inter-regional trade has increased as the contestable customer base has increased and the use of vesting contracts has declined. Contestable customers are attracted to new innovative products offered by new entrant retailers which in turn sponsors the development of alternative risk transfer products in the wholesale market. An outline of products used to manage inter-regional risks is detailed in following Table. It shows that there is a range of products available in the market, but no one product will provide the panacea against inter-regional risk. Accordingly participants usually adopt a portfolio of products and natural counter parties to contract across regions.

Product Type	Natural counter parties	Pros	Cons and similarity to IRRs
Inter-regional Pool Price Swaps	Generators, Retailers, Traders	Provides a perfect hedge for a firm volume	There is an exposure if the retail volume is different to the hedged volume.
Load following inter-regional swaps	Generators, Retailers, Traders	Provides a perfect hedge	Impractical to find counter-parties willing to enter into financial contracts as the volumes in both regions do not move in sync.
Caps and Captions	Generators and Traders	Provides a good hedge above strike prices for a fixed volume.	There is residual exposure to the cap price and there is exposure if the retail volume is different to the hedged volume. In this they are similar to IRRs
IRR	Link operators and holders of IRR	Works well when the link is constrained and the physical capacity is equal to the notional capacity.	Firmness is related to the firmness of the link, the loss factors on the link, link availability
Modified Capacity Based Swaps	Generators	Generator is compensated if there is a link constraint.	No compensation if the link is unconstrained and is dependent on the counter party's generating units. Similar to IRRs.

Product Type	Natural counter parties	Pros	Cons and similarity to IRRs
Co-insurance arrangements	Generators	Generators compensated if there is a link constraint	No compensation if the link is unconstrained. If link is constrained and generators have coincident outages the value will move to zero. Similar to IRRs.
Weather hedges	Specialist derivative operators. Useful for systems dependent on hydro Generation	Cover tailored to requirements and price outcomes reasonably predictable and transparent	Imperfect correlation between weather and inflows and pool prices. Provides no cover against link outages. Similar to IRRs.

ATTACHMENT C: RESERVE PRICE DETERMINATION

1. PURPOSE

The purpose of this attachment is to set out the arrangements and processes that must be followed in determining the reserve price for each tranche of import IRRs.

2. OBJECTIVE

The objective of the Reserve Price Setter (which may be the auctioneer under the IRF) is to establish a fair and reasonable reserve price for each tranche of import IRRs made available for sale via the auction process.

The reserve price for each tranche is to reflect the expected cash value of the import IRRs accruing to Basslink over that period.

3. PROCESS

The Reserve Price Setter must follow the following process:

- (1) an independent expert (with appropriate skills and experience) must be engaged to estimate the expected cash value of the import IRRs accruing to Basslink in each sell down period;
- (2) the estimation must take into account the outcomes of scenarios across the full range of the probability distribution;
- (3) the estimation must be based solely on publicly available information;
- (4) the independent expert will provide the Reserve Price Setter with a draft valuation report specifying:
 - a single probability-weighted average expected cash value of the import IRRs in each period for which the value is being estimated; and
 - the range of scenarios modelled, including the material assumptions made.
- (5) the draft valuation report is to be provided to Hydro Tasmania four weeks before the auction. Hydro Tasmania will have two weeks in which to provide comment on the draft report to the Reserve Price Setter.
- (6) The Reserve Price Setter must consider any comment made by Hydro Tasmania on the draft valuation report and must liaise with the independent expert in this regard.

- (7) The independent expert must take into account the matters raised by the Reserve Price Setter under (6) and provide the Reserve Price Setter with a final valuation report, specifying:
 - a single probability-weighted average expected cash value of the import IRRs in each period for which the value is being estimated; and
 - if the final valuation is different from the draft valuation, the variations in assumptions made.
- (8) The Reserve Price Setter must set the Reserve Price for each tranche at the value contained in the final valuation report.

4. DURATION OF RESERVE PRICE SETTINGS

The Reserve Price Setter must not vary the Reserve Price for a tranche of import IRRs between valuations, unless there is a significant change in market conditions. Valuations must be undertaken at least annually.

5. RESPONSIBILITIES

In setting reserve prices, the Reserve Price Setter must:

- (1) keep all material provided by the independent expert confidential (save for the draft valuation report, which must be disclosed to Hydro Tasmania);
- (2) not disclose the reserve price to any party;
- (3) act independently;
- (4) comply with the process outlined in this paper, taking into account the factors set out in this paper and not take into account other factors;
- (5) act with due skill; and
- (6) require that the independent expert does likewise

6. VARIATIONS IN THESE ARRANGEMENTS

These arrangements may be varied with the agreement of the Australian Competition and Consumer Commission and the Tasmanian Government in consultation with Hydro Tasmania.