



NATIONAL GENERATORS FORUM

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The Chairman
Australian Energy Market Commission
P O Box H166
Australia Square NSW 1215

14 October 2005

Dear Sir

RE: PROPOSED RULE CHANGE 2005/2 – SYSTEM RESTART ANCILLARY SERVICES

Please find attached the National Generators Forum's (NGF) submission for the proposed rule changes on System Restart Ancillary Services.

The NGF thanks the AEMC for the opportunity to provide comments to the proposed rule changes. Also, the NGF appreciates the AEMC decision to allow additional two weeks for comments given the complexity of the rule changes.

Viewed as a whole, the NGF has issues with many key parts of the package and therefore the NGF recommends rejection of the entire package for further review. As NEMMCO has the option of extending the existing system restart ancillary services contracts by one year, there should be sufficient time to properly review –preferably undertaken by AEMC- and re-introduce a new package.

Please contact the undersigned if you have any questions in relation to the contents of this submission.

Yours faithfully

John Boshier
Executive Director
National Generators Forum

**NGF RESPONSE TO THE PROPOSED RULE CHANGE
NO: 2005/2 – SYSTEM RESTART ANCILLARY SERVICES**

SUMMARY

The National Generator Forum (NGF) is the peak industry body representing market-facing generators in Australia. The NGF has fundamental concerns regarding NEMMCO's proposed rule changes associated with System Restart Ancillary Services (SRAS) due to the following reasons.

- 1 The incorrect assumption of monopoly provision and resulting failure to rely upon competitive market options;
- 2 Inefficiencies implied by using a cost-based approach rather than a competitive process;
- 3 Contradictions to market design principles as described in rule 3.1.4
- 4 The manifest injustice of requiring providers to guarantee delivery at a price below their offer and to lock in that guarantee prior to settlement of the price;
- 5 Lack of service provider access to reasonable dispute resolution;
- 6 Excessive NEMMCO discretion in applying the SRAS standard;
- 7 Excessive NEMMCO discretion in determining primary and secondary restart services;
- 8 The role of the additional secondary services premium;
- 9 The role of the AEMC in determining two premiums;
- 10 Generator exposure to increased SRAS costs resulting from "societal needs" and proposed cost recovery mechanism

The NGF is concerned that these arrangements will discourage providers from offering services, thus reducing the provider pool in areas that NEMMCO is already struggling to fully procure. This situation will inevitably lead to non-optimal long term security and price outcomes for consumers.

The NGF has issues with many key parts of the package and therefore recommends rejection of the entire package until there has been further review. As NEMMCO has the option of extending existing providers' arrangements by one year, there is sufficient time to properly conduct such a review - preferably undertaken by the AEMC - and re-introduce a new package.

It should be noted that a number of NGF members raised similar concerns to those expressed in this submission during NEMMCO's SRAS review in 2004. Also, some proposed changes such as regional cost recovery are significantly different to the conclusions reached by NEMMCO in its final report of the SRAS review. As such, this consultation represents the first available opportunity for market participants to comment.

1. Assumptions on Competition

The Allen Consulting Report¹ and the subsequent proposed rules are based upon the incorrect initial assumption that System Restart Ancillary Services (SRAS) are natural monopoly services and so require input cost-based price regulation.

In fact, system restart should be a very competitive service. All existing and new non-wind power stations can be equipped to provide this service by installing auxiliary generation. For hydro and gas-turbines the installation cost and timeframes tend to be modest. Steam plant and cogeneration can retrofit auxiliary generation, in the same manner but can also explore lower cost alternatives such as shared restart. Clearly NEMMCO could potentially receive tenders from providers far in excess of requirements.

However, NEMMCO's view is affected by its tendering experience that has struggled to achieve sufficient offers, little exploration of new supply and at least one retirement. The explanation for this is simple: each invitation to tender has required contracted providers to deliver within only a matter of weeks after execution. New-entrants are being excluded by the recruitment process. NEMMCO's intention to have an "expression of interest" process to resolve technical matters followed by contracting 12 months before delivery will overturn the assumption.

The NGF believes that the change to long lead-time and long-term contracting provides an excellent opportunity:

- for the NEM to take advantage of the efficiencies that arise from competitive market dynamics and avoid overly burdensome economic regulation; and
- to overcome the recent supply shortfall by allowing new providers to explore efficiencies brought about through clever engineering techniques, presuming there is the opportunity to profit from doing so.

As the Allen report follows an incorrect initial assumption, the NGF believes its recommendations should not be used in developing a framework for acquiring SRAS.

The NGF recommends retaining the "competition test" in accordance with the existing rule 3.11.5(d1) where NEMMCO can only enter a "regulated acquisition" process where there are fewer than one more expression of interest than required to meet a sub-network's need. The process of the competitive acquisition of SRAS should also be reviewed and modified to encourage new entrants.

2. Cost Based Approach

The rule changes envisage a process where tenderers make an offer and, then NEMMCO has the right to inspect the providers' costs and substitute its own view of a fair and reasonable risk adjusted return. It is inconceivable that that NEMMCO would not exercise its right to inspection in all cases. The competitive process will be subsumed by an adversarial regulated price setting such as occurs for network businesses, with its overheads, perverse incentives and informational disputes.

¹ Guidelines for dealing with non-competitive tenders for System Restart Ancillary Services in the NEM dated 20 March 2004

In attempting to allocate a fair and reasonable risk adjusted return, many questions will arise that are not addressed by the proposed rule 3.11.5C and have no single answer, such as:

- What equipment in a provider's power station can be considered a part of the system restart equipment? A few auxiliary generators, or an entire power station that actually restarts the system?
- Over what timeframe should the provider recover its capital costs: the life of the contract, or the life of the plant?
- What levels of risk return should be accommodated in the reward? For example, should the provider recover a risk return to recognize that the process itself might force it to supply below its own costs?
- What operational risks are to be managed by the provider and how are these to be assessed by NEMMCO in appropriately remunerating the provider given the potential application of liquidated damages.

The concept of allocating a cost-based return will destroy and pervert efficient market-based incentives, consider:

- 3.11.5C(2) intends to provide return for "innovation in the provision of those services". This is inconsistent with a cost-based approach, because an innovator acts to achieve super-normal profits for a time. For innovation to be achieved, the price should ideally be set by competitive market dynamics.
- Providers have no incentive to promote the most efficient options. In some cases NEM providers can offer multiple services within a sub-network for varying sunk costs. The input-cost reward encourages offering only the higher-cost services.

3. Contradictions to Market Design Principles

The cost-based approach contradicts several parts of rule 3.1.4 "Market Design Principles", such as:

- (a)(1) "minimisation of NEMMCO decision-making to allow Market Participants the greatest amount of commercial freedom to decide how they will operate in the market"

in that NEMMCO will determine and impose a risk adjusted return rather than allow participants to make a willing offer.

- (a)(2) "maximum level of market transparency in the interests of achieving a very high degree of market efficiency"

in that NEMMCO will receive and impose prices upon providers within a confidential environment.

- (a) (3) "avoidance of any special treatment in respect of different technologies used by Market Participants"

in that the fair and reasonable risk adjusted return will be input-technology dependent.

- (a) (6) “ancillary services should, to the extent that it is efficient, be acquired through competitive market arrangements and as far as practicable determined on a dynamic basis. Where dynamic determination is not practicable, competitive commercial contracts between NEMMCO and service providers should be used in preference to bilaterally negotiated arrangements”

in that NEMMCO is not proposing to use *competitive* acquisition of SRAS.

4. Guaranteeing delivery at an unknown price

After resolving technical matters, the provider is required to guarantee performance against liquidated damages. Only *after* that occurs does the provider discover the price to be paid by NEMMCO. This seems manifestly unjust, because the provider can be forced to produce below its willing offer.

This will discourage participation, especially from new providers and jeopardize NEMMCO’s aim to achieve a greater depth in the market.

In all cases except clear “natural monopoly” circumstances, a provider should have the freedom to refuse to provide below a nominated price. As stated earlier, as long as sufficient lead-time is provided, there should be no “natural monopoly” situations for SRAS in the NEM.

Furthermore, any liquidated damages applicable to the service provider on failure to perform should be limited to the annual value of the contract, to avoid exposing participants to untenable risks that may only further discourage participation.

5. Dispute Resolution Process

The proposed new rule 3.11.5E raises a number of significant issues. Under the proposed amendments a dispute can only be invoked by NEMMCO if it has formed a view that the tenderer’s service is required to meet system restart ancillary services standards. By NEMMCO’s own explanation, the dispute resolution process is to be heavily biased in its favour.

“Unlike existing Rules provisions, there is no opportunity for a prospective service provider to invoke a dispute. NEMMCO has clear obligations to conduct an assessment process that is as transparent as possible and it would be inappropriate for NEMMCO to be placed in a position where it was forced to contract with a party NEMMCO considers unable to provide an effective restart service.”²

The change to a “one-way-only” dispute process was not envisaged in earlier consultations and is not explained beyond this paragraph. In the absence of other explanation the change appears oppressive and involves a clear loss of participant rights, leading to further discouragement of prospective service providers.

² NEMMCO rule change attachment 1 Pg13. Explanation to changes to 3.11.5E

The NGF believes the removal of a participants' right to raise a chapter 8 dispute upon NEMMCO contravenes a fundamental principle of the National Electricity Law.

The NGF strongly recommends reviewing the rules related to dispute resolution process so that equitable approach is guaranteed for both parties. This would also cater for the rare 'natural monopoly' situations, providing a more fair and even-handed process designed to deliver a mutually acceptable outcome.

6. System Restart Service Standard

According to the proposed rule changes, the Reliability Panel is to determine the system restart service standard. However, the NGF is concerned about the prescriptive nature of how this system restart service standard is to be set. For instance, proposed Rule 8.8.3 (aa) states:

(aa) The purpose of the system restart service standard is to provide a benchmark against which the adequacy of procurement options for restart services can be assessed. The system restart service standard must at least:

- (1) be such that it can be used to guide the procurement of restart services;*
- (2) be capable of being applied to electrical sub-networks; and*
- (3) require restoration outcomes in terms of restoring a certain percentage of the supply capability of an affected electrical sub-network's peak demand from the transmission network within a specified number of hours of a major supply disruption occurring, the percentage and number of hours to be determined by the Reliability Panel on the advice of NEMMCO (emphasis added).*

The NGF believes that the Reliability Panel should be given complete independence to decide a national and consistent service standard for SRAS. This is a complex issue involving detailed modeling and it would be premature for NEMMCO to assume the form of the standard before the analysis is undertaken. For instance, it may be concluded by the Reliability Panel that a standard based on the percentage of restored load is more appropriate than a standard based in terms of a certain percentage of supply capability.

NEMMCO's role in the service standard mechanism should be limited to technical advice and NEMMCO should not dictate the process or outcome.

The NGF is concerned about the level of discretion proposed by NEMMCO, TNSP's and Jurisdictional Planning Bodies to procure additional services beyond that set by the Reliability Panel. By definition, a SRAS output standard set by the Reliability Panel should meet certain requirements within a set of stated assumptions. It then follows that if NEMMCO were to procure services that meet this standard, additional services would not be warranted. Hence NEMMCO's discretion to purchase additional services beyond the required service standard cannot be justified. This view is consistent with the general market consensus that NEMMCO's discretion to operate the system should be minimised to reduce operational risk for Market Participants and avoid any perception that NEMMCO may be driving market outcomes or favouring particular participants.

Furthermore, any costs resulting from an increase to the standard “for social policy reasons”³ is irrelevant to, and should not be borne by, commercial generators.

7. Definitions of Primary Restart Sources and Secondary Restart Services

The definitions of the above terms as proposed in the Chapter 10 - Glossary of the National Electricity Rules are as follows.

Primary Restart Service

A restart service that is highly likely to perform in the manner intended if called upon to do so, and that meets the technical availability requirements of a primary restart service specified by NEMMCO pursuant to clause 3.11.4A(b)

Secondary Restart Service

A restart service that is more likely than not to perform in the manner intended, if called upon to do so, and meets the technical availability requirements of a secondary restart service specified by NEMMCO pursuant to clause 3.11.4A(b)

It is not appropriate to use words like “highly likely” and “more likely than not” in a definition as they are vague and subject to interpretation. As the contents of the contracts will be confidential, market participants in general would not be able to determine the reliability of the system restart services NEMMCO has procured. Also, this will give NEMMCO an unlimited flexibility in determining the categories of primary and secondary.

Therefore, NGF recommends that the terms must be clearly defined.

8. Additional Secondary Services

According to the proposed Rule 3.11.5G, NEMMCO can procure additional secondary restart services over and above the restart services required to meet the system restart service standard set by the Reliability Panel. It is not clear why NEMMCO wish to procure more sources beyond the standards, as noted above. Also, this raises a question as to why a service standard is necessary.

The NGF recommends that clear conditions to be included in the Rules where NEMMCO could procure more sources beyond the set standards, to the extent that this is necessary at all.

9. AEMC’s role in determining premiums

According to proposed rules 3.11.5G, the AEMC is to determine the primary services premium and the additional secondary services premium. It is unclear to the NGF whether the AEMC is the appropriate body to deal with pricing matters and on what basis these premiums are to be determined.

³ NEMMCO, NEMMCO rule change attachment 2 page 1

10. Issues with Regional Cost Recovery

NEMMCO's justification for changing the cost allocation methodology is based on the premise that the, "costs of delivering acceptable levels of restart service could differ substantially between sub-networks – inequities could be magnified should **jurisdictions** seek to have different standards applied for social policy reasons"⁴.

The NGF believes that this might be a legitimate concern of Jurisdictions, however to the extent that the cost recovery of these policy decisions lead to costly complications in implementation and affect the efficiency of the wholesale market, this becomes a major concern for competitive market participants.

The number of providers would be expected to have a direct impact upon the time taken to restore the network and subsequently the market. The 50/50 generator/customer funding provision was originally justified by NECA on the basis that both generators and customers benefit from the prompt restoration of the market⁵. However when assessing the relative benefits of a marginal increase in the number of providers, the NGF argues that customers are clearly the greater beneficiaries.

For customers, the benefit in prompt restoration is in the order of several tens of thousand's of \$/MWh interrupted. However generators' benefit from prompt restoration is in the order typical market prices, i.e. around \$40/MWh. Hence, the benefit to customers is in the order of 1000 times more than generators. This would imply that customers should pay the full cost of SRAS, and certainly the incremental cost of any increase above a national standard.

Generators see themselves as competitive participants in a National Market, rather than a local jurisdiction. The social policy objectives of the jurisdiction in which they are located are therefore incidental.

The energy based-levy upon generators will be reflected in their offers to the market. At the margin, having different levies upon generators located in different jurisdictions could result in inefficient market outcomes due to a distortion to the market's merit order.

At the same time, the NGF recognizes why NEMMCO suggested regionalizing the recovery. If it was to remain smeared, local jurisdictions could demand higher local standards-or smaller sub networks-without regard to costs. Therefore the NGF supports some regionalizing of the customer payments where jurisdictions are able to vary the level of procurement.

Market regions are intended to reflect congestion points in the transmission network rather than jurisdictional boundaries. Currently, it is true that existing region boundaries reflect jurisdictional boundaries with the exception of the Snowy region which is fully situated in the NSW jurisdiction boundary, but there is no guarantee that they will continue to be aligned with Jurisdictional boundaries.

⁴ NEMMCO, NEMMCO rule change attachment 2 page 1

⁵ Note that TNSP's and DNSP's also benefit, yet they do not fund SRAS.

The flaws in the logic for energy region-based recovery are:

- The criteria for the determination of region boundaries and sub-electrical networks are different. The extent of this difference may give rise to inefficient and distortionary recovery of SRAS costs.
- The pre-assumption that market regions will align with a jurisdictional boundary;
- The pre-assumption that sub-electrical networks will align with Jurisdiction boundaries; and
- For a region with predominantly generation, the cost recovery is distortionary.

Therefore, the NGF recommends:

- (a) That SRAS recovery revert to a 100% customer basis; and
- (b) Customer recovery is achieved on a jurisdictional basis.

Failing that:

- That the generator component be set to recover 50% (or the percentage allocated to generators) of only the component of SRAS costs that result from meeting a National Standard set by the Reliability Panel and **not** any additional costs due to higher local standards;
- That the generator component be shared by generators across the NEM;
- That the customer component be regionalized, preferably on a jurisdictional basis rather than by energy-regions.

If, however all jurisdictional, TNSP and NEMMCO discretion were to be removed from setting the standard and size of electrical sub networks and transferred to the Reliability Panel, then the NGF would also recommend national smearing of SRAS costs.

Care would also need to be taken in any regionalised cost recovery approach not to violate contractual confidentiality and disclose individual generator cost information, given the limited number and known identities of service providers in certain sub-networks.

CONCLUSION

Viewed as a whole, the NGF has issues with many key parts of the package and therefore recommends rejection of the entire package for further review. A number of aspects as highlighted in this submission appear to raise additional risks and uncertainties for participants, potentially discouraging participation and undermining the benefits of the proposals.

As NEMMCO has the option to extend existing SRAS providers' arrangements by one year, there is sufficient time to properly conduct such a review - preferably undertaken by the AEMC - and re-introduce a new package.