

Australian Energy Market Commission
PO Box H166
Australia Square, NSW 1215

Submission by email: submissions@aemc.gov.au

Dear Sir/Madam,

Regarding: PROPOSED RULE NO. 2005/2 – SYSTEM RESTART ANCILLARY SERVICES AND PRICING UNDER MARKET SUSPENSION

Snowy Hydro appreciates the opportunity to respond to the proposed Rule changes. We have some serious concerns on a number of issues with the package of Rule changes.

Summary

In summary our main issues are:

Assumptions on competition

- The proposed rules have been written on the assumption that System Restart Ancillary Services (SRAS) are monopoly services. As such, the pricing principles for these services reflect this assumption. Snowy Hydro believes that this principle is manifestly false or highly questionable. On the other hand, it is undisputable that NEMMCO is a monopoly buyer.
- The guidelines to determine contracting outcomes are achieved on “reasonable terms and conditions” may have been developed under the untested premise that there is a lack of competition for these services.

System Restart Service Standard

- NEMMCO has been overly prescriptive on the form of the output standard.

Tender Process

- The tender process is one sided (favours NEMMCO) and overly prescriptive. It gives too much discretion to NEMMCO. Consequently this introduces additional risk to service providers and may ultimately undermine NEMMCO’s objective of procuring sufficient SRAS to meet a set standard in an economically efficient manner.

Regional cost recovery

- The logic of regional SRAS cost recovery is flawed. We believe if the Reliability Panel were to independently set the SRAS output standard then this standard would be applicable on a national basis. From this perspective it would be appropriate to leave the current cost recovery mechanism unchanged. Any increase in the standard as specifically imposed by a Jurisdiction should be paid by customers on Jurisdictional boundary basis.

Assumptions on Competition

The proposed rules have been written on the assumption that SRAS are monopoly services. As such, the pricing principles for these services reflect this assumption. Snowy Hydro believes that this principle is untested. We believe that incumbent generators can in fact make modifications to auxiliary equipment to supply SRAS services, thereby increasing the existing competition for these services.

NEMMCO should be asked the question of how they can improve the competition for these services. For instance,

- Is the tendering process itself deterring new suppliers;
- The expression of interest process to address any technical issues that may prevent new entrants should improve supply;
- Are the prices accepted by NEMMCO simply do not cover a risk adjusted return for supplying these services, hence deterring supply offers.

In our view, the guidelines to determine contracting outcomes are achieved on “reasonable terms and conditions” were developed under the untested premise that there is a lack of competition for these services.

As highlighted in the Allen report¹, appropriate remuneration for SRAS could lie somewhere in the following range:

- *at a minimum, ‘the avoided costs of providing the service plus a reasonable commercial margin’; and*
- *at a maximum, ‘the value customers are willing to bear to avoid the consequences of not having the service available’.*

There is a very large range where the determination of a reasonable return would need to at least account for the following factors:

- The cash flow from SRAS contracts is inherently risky. The relatively short contract periods mean that SRAS providers would need to factor in over what timeframe should the provider recover capital costs. In our view the proposed rule changes explicitly places more risk on non renewal of a SRAS contract and hence three probable outcomes are likely:
 - Any capital costs would need to be covered during the expected life of the contract; or
 - Providers will simply not invest in capital to maintain SRAS capability; or
 - Providers would simply not tender because the returns are not commensurate with the inherent risks.
- What other “intangible” risks not explicitly recognised or compensated for by NEMMCO are pertinent to a prospective service provider. For instance:
 - Operational risks; and
 - Reputation risk of non-conformance in the event of a system restart.

¹ The Allen Consulting Group, Guidelines for dealing with non-competitive tenders for System Restart Ancillary Services in the NEM, 30 March 2004, page 3.

Hence, under the proposed Rules, it should be recognized that there is a legitimate wide range of remuneration for these services. The adoption of the Allen Consulting Group's guidelines may not achieve an efficient and sustainable long-term outcome for these services.

We believe, NEMMCO should encourage competition for these services in the first instance, and in the event that there are insufficient services to meet the SRAS standard, there needs to be an independent assessment of remuneration for services procured on essentially a "regulated" basis.

System Restart Service Standard

The Rule changes envisage the Reliability Panel determining the system restart service standard. Snowy Hydro is concerned about the prescriptive nature of how this service standard is to be set. For instance, Clause 8.8.3 (aa) mandates the Reliability Panel to:

(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).

This is a complex issue requiring detailed modeling. To date this modeling and detailed analysis has not been undertaken. Hence, in our view it is inappropriate for NEMMCO to:

- Prescribe the form of the output standard; and
- To oversee the role and independence of the Reliability Panel.

The Reliability Panel should be given complete independence to derive a national and consistent service standard for SRAS.

Throughout the 2004 SRAS Review, NEMMCO have not accepted Participants concern that the definition of the Primary Restart Service and Secondary Restart Service were vague and lacked definition. For instance, refer to the following definitions,

Primary Restart Service

*A restart service that is **highly likely** to perform in the manner intended if called upon to do so (emphasis added),...*

Secondary Restart Service

*A restart service that is **more likely than not** to perform in the manner intended, if called upon to do so (emphasis added),....*

These definitions are vague and do not attempt to quantify the measurement of reliability of the SRAS.

Snowy Hydro believes the lack of recognition and the importance of reliability of a SRAS source is encapsulated in these definitions. This view is incorrect as the value of system restart sources decreases exponentially with decreasing start reliability.

The following table shows the number of sources required to provide 99% reliability for restart reliabilities ranging from 0.99% to 0.30%. The table also shows the relative value of each source.

Reliability of each source	Number of source	Relative value of each source
0.99	1	100%
0.9	2	50%
0.8	2.87	35%
0.7	3.83	26%
0.6	5.03	20%
0.5	6.65	15%
0.4	9.02	11%
0.3	12.92	8%

Since the number of SRAS required to meet a 99% reliability target dramatically increases with decreasing source reliability, the analysis demonstrates that the Reliability Panel needs to consider amongst other considerations the affect of different SRAS source reliability in deriving an output standard.

Tender Process

Snowy Hydro believes the tender process is one sided (favouring NEMMCO) and overly prescriptive. The tender process also gives too much discretion to NEMMCO. Consequently this introduces additional risk to service providers and may ultimately undermine NEMMCO's objective of procuring sufficient SRAS to meet a set standard in an economically efficient manner.

For instance,

Clause 3.11.5C (a) states:

- (4) the terms and conditions of the agreement to be entered should not be inconsistent with the terms and conditions of the draft ancillary services agreement annexed to the NMAS invitation to tender.

The (4) point is concerning because it is unclear what being "inconsistent with the draft agreement" means.

If NEMMCO wishes to have an aspect of the tender clarified, it issues a notice of clarification to the tenderer under 3.11.5C (b), who must then provide NEMMCO on a confidential basis within 5 business days "sufficiently detailed information" to enable NEMMCO to establish the "reasonableness" of the tender. The issue with this part of the process is that:

- first it might be difficult to get the information together in 5 business days, and
- secondly Service Providers may not want to provide this information to NEMMCO since it may be commercially sensitive.

Clause 3.11.5D (c) & (g) effectively means the service provider after lodgment of their tender can be left in the dark about NEMMCO's assessment and likely acceptance of their tender offer price for the service. Thirty (30) days after the tender closing date upon NEMMCO delivering a NMAS notice of intention to contract, the Tenderer cannot withdraw its tender.

In our opinion, this process with its inherent risk of being mandated to deliver a service below a required risk adjusted rate of return will only serve to discourage participation in the tender process.

Regional Cost Recovery, Clause 3.15.6A

It should be noted that the proposed regional cost recovery clause 3.15.6A represents a significant change from the conclusion that NEMMCO derived in the 2004 SRAS Review.

In the Final report², NEMMCO recommended:

NEMMCO recommends that SRAS costs continue to be allocated and recovered across the entire market on the basis of 50% to customers and 50% to generators using energy as the metric. Costs would not be allocated on a regional or electrical sub-network basis.

NEMMCO's rationale for this recommendation³ was:

... NEMMCO is of the view that SRAS cost recovery should not be recovered on either a sub-network or regional basis, but costs should be allocated uniformly across the market. Given it is recommended that a uniform *system restart service standard* would apply across the whole NEM, the benefits to the market of restoring the system are unlikely to differ across sub-network or regions. Furthermore, in the case of a *black system* in a single *electrical sub-network*, it is likely that other sub-networks could assist in restoring supplies. This support may be available because adjacent sub-networks restart first, or are not in *black system* condition. It is contended that these arguments support a case for sharing the restart procurement costs across the whole market.

In our view, NEMMCO has not justified the case for regional cost recovery. We believe that on balance, the probability is that SRAS from another sub-network could and would assist in the restoration of a single electrical sub-network. This supports the case for allocating the cost uniformly across the market as originally recommended by NEMMCO.

It then follows that NEMMCO's primary 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" (emphasis added).

Snowy Hydro believes that generators compete in a very competitive spot market. At the margin, applying additional Jurisdictional policy related cost could affect the efficiency of the wholesale market as it distorts the merit order of generation supply.

² NEMMCO, Review of system restart ancillary service arrangement – Final report, page 56.

³ *ibid*

More specifically, NEMMCO's proposal for regional recovery of SRAS cost has no logical basis. Market regions are meant to reflect material congestion points in the transmission network. The price associated with a market region provides potential investors with a pricing signal for investments. By recovering SRAS costs based on market regions, an additional sovereign risk is added to investor's decision-making. Ultimately this creates uncertainty to investment decisions and may therefore deter investments.

Existing market region boundaries reflect jurisdictional boundaries with the exception of the Snowy region which is fully situated in the NSW jurisdiction boundary. As explained, market regions are meant to reflect material transmission congestion pinch-points and hence there is no guarantee that they will continue to be aligned with Jurisdictional boundaries.

With the dynamic nature of the market and the disconnect between criteria used to determine market regions and sub-electrical networks, the fundamental flaws in the logic for region cost recovery for SRAS are:

1. The criteria for the determination of region boundaries and sub-electrical networks are different. Region boundaries are determined under the Rules clause 3.5.1, whereas the boundary for sub-electrical networks depend on the number and strength of transmission corridors; electrical distance between groups of generation; and the amount of generation and load in an area. The extent of this difference in criteria may give rise to inefficient and distortionary recovery of SRAS costs.
2. The pre-assumption that market regions will align with a jurisdictional boundary;
3. The pre-assumption that sub-electrical networks will align with Jurisdiction boundaries; and
4. For a market region with predominantly generation and little or no load, the regional cost recovery is distortionary.

With regards to the fourth point above, the Snowy region is comprised of approximately 3760 MW of generation and little or insignificant customer load. In NEMMCO's own regional boundary reviews, they conclude that the Snowy region should not exist and instead the two major generation centers of Tumut and Murray should be re-defined to another market region. Further to this, CRA's report⁴ on transmission and regional boundary structure, for the Ministerial Council on Energy recommends that a market region should not exist for a region with less than 200MW of load. This means the Snowy market region should not exist.

It can be concluded that prescribing SRAS cost on the basis of market regions is distortionary and may adversely affect market efficiency. The risk of distortion occurring under the proposed Rules is magnified with market dynamics constantly changing, increasing demands across the market, and the potential for major congestion pin-points to appear unexpectedly thereby requiring market region changes.

⁴ CRA, NEM – Transmission Region Boundary Structure, Sept 04, page 49.

However, Snowy Hydro acknowledges that under the current cost recovery, local jurisdictions could demand higher local standards or smaller sub networks with little regard to costs. This therefore supports some regionalizing of the customer payments where jurisdictions are able to vary the level of procurement.

In conclusion, on the basis that an independent Reliability Panel should set a uniform national standard for all sub-electrical networks, Snowy Hydro recommends the cost allocation methodology as proposed by the NGF. That is,

- (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.

Conclusion

Snowy Hydro has serious concerns about some fundamental aspects of the proposed Rule changes. These concerns relate to:

- Untested assumptions on competition to supply SRAS services;
- The prescriptive form of the SRAS standard;
- The one sided and overly prescriptive tendering process; and
- The flawed logic for regional SRAS recovery.

We acknowledge that NEMMCO had attempted to undertake a comprehensive review of SRAS in 2004 but it is our view NEMMCO have ignored some fundamental Participant concerns raised as part of this process. It should be noted that NEMMCO is a monopoly buyer of SRAS. NEMMCO is also in charge of reviewing SRAS, setting the procurement process, and making other recommendations. With these intermingled functions and responsibilities it is questionable whether competitive market Participants would have a fair representation on all aspects associated with procuring SRAS. We believe an independent third party such as the AEMC should undertake another review of SRAS to ensure that there is a balanced view on this issue.

Snowy Hydro appreciates the opportunity to respond to the proposed Rule changes. I can be contacted on (02) 9278 1862 if you require clarification on any issue with respect to this submission.

Yours faithfully,

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