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Australian Energy Market Commission  
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Dear Dr Tamblyn

### **System Restart Ancillary Services – Proposed Rule Changes**

Frontier Economics (Frontier) understands the Australian Energy Market Commission (AEMC or Commission) is presently considering stakeholder submissions on the section 95 Notice for Proposed Rules No. 2005/02 – System Restart Ancillary Services and pricing under market suspension (Rule change).

Frontier was retained by Macquarie Generation to help prepare its submission on the Rule change (MacGen submission). We seek to directly reinforce the substantive institutional and economic arguments made in that submission with specific reference to the likely impact of the Rule change on the NEM objective.

As noted in the Commission's Revenue Requirements Issues Paper<sup>1</sup>, the NEM objective is founded on the concept of economic efficiency. The focus of the NEM objective is on outcomes for the long term benefit of consumers, with interests encompassing not just price, but quality, reliability, safety and security of supply.

In our view, the Rule change is inconsistent with the NEM objective for the key reason that it will deter market participants from offering to provide system restart ancillary services (SRAS) via the NEMMCO tender process. This will reduce reliability and security of supply.

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<sup>1</sup> AEMC, *Review of the Electricity Transmission Revenue and Pricing Rules, Consultation Program, Revenue Requirements: Issues Paper*, October 2005 (Revenue Issues Paper), chapter 2.

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Less directly, the Rule change will set potentially damaging precedents, namely:

- placing NEMMCO in the roles of economic regulator and generation developer; and
- undermining the role of prices as signals in the NEM market design.

These indirect effects could harm the overall attractiveness of the NEM investment environment with detrimental long term implications for consumers.

The following sections discuss these points in more detail.

## DETER PARTICIPANTS FROM OFFERING SRAS IN THE NEM

A key contention in the MacGen submission was that efficient remuneration for SRAS is likely to lie within a *range* bounded by the participant's opportunity cost of provision at the bottom and NEMMCO's willingness to pay at the top. The opportunity cost of provision is the risk-weighted value of compensation to the participant in the event that there is a major system disruption and NEMMCO directs that participant to provide SRAS. The MacGen submission made the point that there are good reasons for believing that the compensation for direction to provide SRAS would be based on the value of lost load (VoLL).

In our view, a rational market participant would not offer to provide SRAS through a tender process for a level of remuneration significantly below the expected compensation for direction.<sup>2</sup> Indeed, the Rule change could create perverse incentives for potential providers of SRAS to refrain from tendering and wait to be directed in the event of a major system disruption.

Therefore, a key consequence of the Rule change could be that NEMMCO has to rely on direction rather than SRAS contracts. This would provide less certainty over the availability of SRAS given that there is no guarantee that (without a contract) participants would actually be in a position to provide SRAS services in a major system disruption if and when directed to do so. This could delay the re-establishment of the power system following a major system disruption, thereby compromising system security and reliability.

Given the importance of SRAS in reestablishing the power system and the interests of consumers in overcoming a major system disruption quickly, we suggest that SRAS remuneration should be somewhat above the opportunity cost of entering into SRAS

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<sup>2</sup> Although risk aversion may encourage a participant to settle for a certain income stream that is less than the expected value of compensation, the sums involved are relatively small compared with, say, a generator's total revenues. Therefore, generators would probably not be willing to sacrifice too much expected return for a lower certain return.

contracts. Section 6 of the MacGen submission proposes two alternatives for SRAS remuneration arrangements that are much more likely to yield outcomes consistent with the NEM objective than the proposed Rule change.

## HARM TO INVESTOR CONFIDENCE IN THE NEM

In addition to jeopardising the speed and certainty of re-establishing the power system, the Rule change contains provisions that set detrimental precedents for the NEM.

First, the Rule change places NEMMCO in the position of economic regulator for SRAS remuneration. As the MacGen submission points out, this is an inappropriate role for NEMMCO, as the market and system operator. The existing Rules explicitly do not confer any economic regulatory responsibilities on either NEMMCO or the dispute resolution panel. In fact, Code changes were made in the past to *remove* NEMMCO from the role of determining whether or not a proposed regulated interconnector satisfies the Regulatory Test.<sup>3</sup>

Second, SRAS is typically provided by generators. Unlike transmission and distribution networks, generators are part of a competitive wholesale market. The barriers to entry into generation are relatively low and the overall design of the energy-only NEM is based around providing market-driven price signals for efficient generation investment and operation. Regulating the permitted remuneration for SRAS at quasi-long run average cost levels could undermine the intended market signals for generation. After all, there are no similar wholesale market price caps set at the long run average cost of generation.

Together, these precedents could harm investor confidence in the NEM, which may raise the risk premium required for investment and ultimately raise the retail price of electricity to consumers. This would clearly be contrary to the market objective.

Please contact me on (03) 9620 4488 if you would like to discuss these matters in more detail.

Yours sincerely,



Danny Price

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<sup>3</sup> ACCC, *Network and Distributed Resources, Determination*, 13 February 2002, p.5.