



Australian Energy Market Commission

**Final Rule Determination**

**National Electricity Amendment (Cost  
Recovery of Localised Regulation Services)  
Rule 2007**

Rule Proponents  
National Generators Forum

23 August 2007

Signed: .....

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**Chairman**

For and on behalf of  
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## **About the AEMC**

The Council of Australian Governments, through its Ministerial Council on Energy, established the Australian Energy Market Commission (AEMC) in July 2005 to be the Rule maker for national energy markets. The AEMC is currently responsible for Rules and policy advice covering the National Electricity Market. It is a statutory authority. Our key responsibilities are to consider Rule change proposals, conduct energy market reviews and provide policy advice to the Ministerial Council as requested, or on AEMC initiative.

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## Summary

On 7 September 2006, the National Generators Forum (NGF) lodged a proposal with the Australian Energy Market Commission (Commission) to amend the National Electricity Rules (Rules) to provide for cost recovery of localised regulation frequency control ancillary services (FCAS) on a regional basis. Since that time, the Commission has received submissions on the NGF Rule change proposal and undertaken analysis, all of which it considered before publishing its draft Rule Determination and draft Rule. The Commission also called for submissions from interested parties on the draft Rule Determination and draft Rule.

The NGF Rule change proposal refers to FCAS. The Commission notes that the services referred to as FCAS are defined in the Rules as market ancillary services (MAS).<sup>1</sup> In order to maintain consistency between this Rule Determination, the NGF Rule change proposal and the submissions, the Commission will refer to market ancillary services as FCAS, but notes that this only reflects the current definition of market ancillary service in the Rules. The Commission notes that the introduction of additional market ancillary services in the future (by way of a Rule change) could occur, which could affect the interchangeability of the terms FCAS and MAS.

The Proposed Rule had three main elements:

- Apportioning the cost of local regulation FCAS amongst the region(s) that require regulation FCAS in a trading interval;
- Apportioning the cost of local regulation FCAS between the individual market participants who contribute to, or alleviate, the need for the regulation FCAS within the region(s) that require regulation FCAS in a trading interval; and
- Providing a procedure for determining the contribution factor of individual market participants for the purpose of apportioning individual liability for the costs of regulation FCAS.

Presently, the participant derogation in Part 11 of Chapter 8A of the Rules (Derogation) provides for localised cost recovery of regulation services in Tasmania. The NGF Rule change proposal noted that, if adopted, the Proposed Rule would remove the need for the Derogation which, in any case, is due to expire on 31 December 2008.

In making this Rule Determination and the Rule to be made, the Commission has considered the Proposed Rule and the matters raised in the submissions, including any overlap between the Rule change proposal and NEMMCO's review of the operation and effectiveness of the FCAS markets (FCAS Review). For the reasons set out in Chapter 2 of this Rule Determination, the Commission is satisfied that the NGF's Proposed Rule would promote the National Electricity Market objective (NEM Objective) and satisfy the Rule making test. Therefore, the Commission has, in

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1 See clause 3.11.2 of the Rules.

this Rule Determination, determined to approve the Proposed Rule (subject to some modifications) and, in accordance with ss 102 and 103 of the NEL, makes this Rule Determination and Rule.

# 1 NGF Rule change proposal

On 7 September 2006, the National Generators Forum (NGF) lodged a proposal with the Australian Energy Market Commission (Commission) to amend the National Electricity Rules (Rules) to require the costs of regulation frequency control ancillary services (FCAS) requirements to be recovered on a regional basis.

The Commission published the Rule change proposal in accordance with s 95 of the National Electricity Law (NEL) and called for submissions from interested parties to be lodged by 22 February 2007. The Commission received submissions from TRUenergy, Flinders Power and NEMMCO.

On 17 May 2007, the Commission published its draft Rule Determination and draft Rule and invited interested parties to make submissions by 29 June 2007. The Commission received two submissions: one from the NGF and one from NEMMCO. The Commission also invited requests for a pre-determination hearing by 24 May 2007 but no such requests were received.

On 26 July 2007, the Commission published a notice under s 107 of the NEL extending the period of time for making this Rule Determination in order that NEMMCO could provide additional information concerning the timing required to implement the Rule to be made.

This Chapter summarises the NGF's Rule change proposal and discusses the matters that the Proposed Rule sought to address.

## 1.1 Summary of the Rule change proposal

The key elements of the NGF's Rule change proposal were:

- Apportioning the cost of local regulation FCAS among the region(s) that require the regulation FCAS in a trading interval;
- Apportioning the cost of local regulation FCAS between the individual market participants who contribute to, or alleviate, the need for the regulation FCAS within the region(s) that require regulation FCAS in a trading interval; and
- Providing a procedure for determining the contribution factor of individual market participants for the purpose of apportioning individual liability for the costs of regulation FCAS.

To give effect to the proposal, the Proposed Rule suggested amendments to clauses 3.15.6A(h), (i), (j) and (k) of the Rules. The process and the drafting of the suggested amendments was based on the process for regionalisation of contingency FCAS, and on the drafting of the existing contingency FCAS Rule (Rule 3.15.6A(g)).<sup>1</sup> The Proposed Rule also included consequential amendments necessary for its effective

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1 NGF Rule change proposal, 7 September 2006, p. 2.

implementation, the most notable of which is the deletion of the derogation contained in Part 11 of Chapter 8A of the Rules (Derogation).

In its submission on the draft Rule Determination and the draft Rule, the NGF proposed certain revisions to the draft Rule to refine the process for determining individual contribution factors.<sup>2</sup> The key changes proposed were the deletion of clause 3.15.6A(h)(3) and an amendment to clause 3.15.6A(j)(2). These changes are discussed in further detail in Chapter 2.

## 1.2 Context of the Proposed Rule

The NGF Rule change proposal refers to FCAS. The Commission notes that the services referred to as FCAS are defined in the Rules as market ancillary services (MAS).<sup>3</sup> NEMMCO has addressed this discrepancy in its FCAS Review Final Report, stating that:

“Strictly speaking, the Rules refer to ‘market ancillary services’. However, frequency control ancillary services are the only ancillary services currently procured through markets. All other ancillary services are currently procured through contracts. Consequently, market ancillary services are synonymous with FCAS.”

In order to maintain consistency between this Rule Determination, the NGF Rule change proposal and the submissions, the Commission will refer to market ancillary services as FCAS, but notes that this only reflects the current definition of market ancillary service in the Rules. The Commission notes that the introduction of additional market ancillary services in the future (by way of a Rule change) could occur, which could affect the interchangeability of the terms FCAS and MAS.

FCAS enable NEMMCO to control the frequency of the power system and ensure the system meets the frequency standards prescribed by the Reliability Panel. There are eight types of FCAS, which can be grouped into two categories: six types of contingency FCAS and two types of regulation FCAS.

Contingency FCAS (comprising *fast*, *slow* and *delayed*, each having a *raise* and *lower* service) are used to restore the prescribed frequency of the power system after a major disturbance, such as the unplanned outage of a large generator or a random failure in the transmission network. Major disturbances of this kind are rare.

Regulation FCAS (*raise* and *lower*) are used to control minor variations in frequency around the Australian standard of 50Hz. Minor variations occur continually, and are typically the result of forecasting errors or generators not meeting their dispatch targets. Regulation FCAS are dispatched at five minute intervals to account for these continuous frequency variations.

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2 The Commission notes that “contribution factor” is the term used in clause 3.15.6A(k) of the Rules but that the term “causer pays factor” is also used to describe these factors. See, for example, the NEMMCO procedure made in accordance with clause 3.15.6A(k) of the Rules, “Causer Pays: Procedure for determining contribution factors ‘Causer Pays Procedure’”.

3 See clause 3.11.2 of the Rules.



When NEMMCO determines the quantity of regulation and/or contingency FCAS in accordance with the dispatch algorithm, NEMMCO must determine the required quantity that:

- May be sourced from any region within the NEM, which is known as a “global market ancillary service requirement”;<sup>4</sup> and
- Must only be sourced from one or more nominated regions, which is known as a “local market ancillary service requirement”.<sup>5</sup>

Local market ancillary service requirements, or local FCAS requirements, are required in abnormal circumstances where only local market participants have the technical capability to provide FCAS. This is most often the case when a region becomes isolated – or “islanded” – due to planned and/or forced outages of transmission elements. A region that has become islanded can also be described as operating asynchronously from other regions within the NEM.

Currently, there is a disparity between the way that local regulation FCAS requirements are paid for compared to local contingency FCAS requirements. The Issues Paper published by NEMMCO as part of its FCAS Review summarised the current cost recovery mechanism for each requirement:<sup>6</sup>

“Whenever local contingency FCAS requirements are set, the costs of those local contingency requirements are recovered solely from market participants within the local region or regions. This is on the basis that only the local market participants benefit from the local FCAS requirements, and that only the local market participants can influence the local FCAS prices. ...

Whenever local regulation FCAS requirements are set in Tasmania, the costs of those local requirements are recovered solely from Tasmanian participants under a participant derogation in the Rules. ... Whenever local regulation FCAS requirements are set on the mainland, the costs of those local regulation requirements are recovered from all mainland participants, i.e., including from participants who are outside the region(s) in which the local requirement is set.”

The impact of the existing cost recovery mechanism for local regulation FCAS requirements on market participants is most clearly observed where a region is islanded from the remainder of the NEM. As the NGF Rule change proposal explains:<sup>7</sup>

“Thus at that time [when Tasmania announced it would join the NEM before the completion of the Basslink interconnector] the cost of FCAS regulation services was being recovered on a NEM wide basis without any recognition

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4 Clause 3.8.1(e2) of the Rules.

5 Id.

6 NEMMCO, FCAS Review Issues Paper, December 2006, pp. 29-30.

7 NGF Rule change proposal, 7 September 2006, p. 2.

that a part or parts of the NEM may have a local requirement such as may occur when a region becomes islanded away. Under such circumstances the islanded part may have extremely high FCAS regulation supply costs however the cost recovery would be from all parts of the NEM based on specific causer pay factors for generators and a common causer pays factor for most consumers. ...

In the event of high FCAS regulation supply costs in Tasmania then the cost would be mainly recovered from mainland participants including generators who had FCAS regulation capability available but could not use it to offset their cost obligations. Conversely, any high FCAS regulation supply costs on the mainland would be recovered in part from Tasmanian participants.”

To address concerns about inequitable recovery of local regulation FCAS requirements between market participants operating in Tasmania and those operating on the mainland, and to overcome difficulties in amending the then National Electricity Code, the Australian Competition and Consumer Commission (ACCC) approved a participant derogation on 9 March 2005.<sup>8</sup> The Derogation, which requires NEMMCO to recover Tasmania’s local regulation FCAS requirements from Tasmanian market participants, was to expire on 31 December 2006 but was extended by the AEMC until 31 December 2008.<sup>9</sup>

While the NGF’s analysis set out above was offered as background to the introduction of the Derogation, the NGF acknowledged that there is “the possibility of other regions or parts thereof becoming separated into an island thus requiring a more general solution”.<sup>10</sup>

The Commission understands that the Proposed Rule had two primary objectives:

- To replace the Derogation with a permanent solution; and
- To implement a NEM-wide solution that enables the cost of local regulation FCAS requirements to be recovered from those markets participants who had both the capacity and the ability to mitigate their liability at the time the requirements were needed.

Using the cost recovery mechanism that currently applies to local contingency FCAS requirements as a starting point, the NGF Rule change proposal:<sup>11</sup>

- Required the cost of the local regulation FCAS requirements to be apportioned amongst the region(s) that require the regulation FCAS in a trading interval;

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8 Australian Competition and Consumer Commission, Applications for Authorisation: Amendments to the National Electricity Code: Tasmanian Ancillary Services - Chapter 8 Derogation - Determination, 9 March 2005.

9 National Electricity Amendment (Extension of Cost Recovery of Regulation Services in Tasmania) Rule 2006 No. 20.

10 Id.

11 NGF Rule change proposal, 7 September 2006, p. 3.

- Modified the existing methodology for determining contribution factors to take account of the apportionment of cost between regions or sets of regions; and
- Required the contribution factors (as modified) to be used to divide the cost between participants within the region(s) that require regulation FCAS in a trading interval.

The NGF Rule change proposal submitted that the Proposed Rule had the following advantages:

- “It is able to deal with both partial and total localisation of services (note that partial localisation of regulation service is a common occurrence across Basslink);
- The localisation of cost allocation is driven by the localisation of the NEMMCO FCAS regulation supply requirement, thus avoiding problems of definition;
- It carries across to the regulation services an established process used for all other market ancillary services, giving advantages in both consistency and implementation cost;
- Both the settlement processes and the proposed rule changes are simple extensions from the existing Rules”.

The Commission’s analysis of the Proposed Rule and the submissions made during the first and second rounds of public consultation is set out in Chapter 2.

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## 2 Rule Determination

The Commission has determined, in accordance with s 103 of the NEL, to make the Proposed Rule subject to certain amendments to refine the process for determining individual contribution factors. The Proposed Rule has also been amended to ensure consistency in the use of terms defined in the Rules and to correct typographical errors. Under s 103 of the NEL, the Rule will commence on 1 January 2009. The Rule to be made is attached to this Rule Determination at Attachment A.

In accordance with s 102 of the NEL, this Rule Determination sets out the Commission's reasons for making the Rule to be made. In making its decision, the Commission has taken into account:

- The Commission's powers under the NEL to make the Rule to be made;
- The NGF's Rule change proposal and Proposed Rule;
- The submissions received during the first and second rounds of public consultation;
- The scope and timing of NEMMCO's FCAS Review, including the final report published as part of that Review; and
- The Commission's analysis of how the Rule to be made will or is likely to contribute to the promotion of the NEM Objective so that it satisfies the statutory Rule making test.

This chapter sets out the Commission's powers to make the Rule and the objective of the Rule to be made.

### 2.1 Commission's power to make the Rule

The Commission has considered the subject matter of the Rule change proposal submitted by the NGF and is satisfied that it falls within the scope of the Commission's Rule making powers as set out in s 34 and Schedule 1 of the NEL. Specifically, the Proposed Rule is a Rule that is for, or with respect to:

- The operation of the national electricity market; and
- The operation of the national electricity system for the purposes of the safety, security and reliability of that system; and
- The activities of persons participating in the national electricity market or involved in the operation of the national electricity system.

The Proposed Rule also falls within the matters referred to in Item 7 (The setting of prices for electricity and services through the wholesale exchange) and Item 8 (The methodology and formulae to be applied in setting prices referred to in Item 7) of Schedule 1.

### 2.1.1 The Rule making test and the NEM Objective

The Rule making test set out in s 88 of the NEL requires the Commission to be satisfied that a Rule that it proposes to make will, or is likely to, contribute to the achievement of the NEM Objective. The NEM Objective, which is set out in s 7 of the NEL, provides:

“The national electricity market objective is to promote efficient investment in, and efficient use of, electricity services for the long term interests of consumers of electricity with respect to price, quality, reliability and security of supply of electricity and the reliability, safety and security of the national electricity system.”

The NGF submitted that its Proposed Rule “will ensure that the parties that bear the cost of regulation services are those that have the possibility of influencing that requirement for service.”<sup>12</sup>

In order to satisfy itself for the purposes of s 88, the Commission has undertaken its own analysis of whether the Proposed Rule will, or is likely to, contribute to the achievement of the NEM Objective.

The Commission considers it likely that benefits will flow to the NEM from the Proposed Rule. Firstly, it will promote consistency in the way that the costs of FCAS services are recovered across the NEM and across different forms of FCAS. Currently, the Rules permit the costs of localised contingency FCAS requirements to be recovered from market participants on a regional basis. With the exception of Tasmania (due to the Derogation), the costs of localised regulation FCAS requirements are recovered from participants across the NEM with the effect that market participants may be required to contribute to costs incurred other than by reason of their conduct. The Commission has not been able to identify a sound operational or policy rationale for maintaining the divergence in the current approaches and therefore considers it is appropriate that the discrepancy be addressed. Further, the Commission considers that improving the correlation between the contribution of a market participant to frequency deviations and liability for the cost of localised regulation FCAS requirements will promote more effective and efficient use of the power system, and provide clearer investment signals to existing and potential market participants.

The Proposed Rule also eliminates the need for the Derogation. The Derogation was always intended to operate as a temporary measure until a NEM-wide solution could be developed and implemented. The Commission considers that amending the Rules in the way proposed by the Proposed Rule accords with the policy objective that existed at the time the FCAS market was introduced.

Further, the continued operation of the Derogation prolongs the differences between Tasmania and the mainland in relation to the mechanisms by which the costs of local regulation FCAS are recovered. Given the intention of the energy market reforms to reduce the instances of jurisdictional-specific regulation, removing the Derogation in

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12 NGF Rule change proposal, 7 September 2006, p.3

favour of a NEM-wide approach will help to promote regulatory consistency and efficient use of the system.

The Commission has applied the Rule making test to the Rule to be made and is satisfied that it is likely to promote the NEM Objective. Chapter 3 of this Rule Determination sets out the Commission's analysis of the issues raised by the Rule change proposal and the submissions, and how the Rule change proposal satisfies the NEM Objective and the statutory Rule making test.

## **2.2 NEMMCO FCAS Review**

NEMMCO is required under the National Electricity Rules to undertake a review of the operation and effectiveness of the spot market for ancillary services market, and recommend any improvements.<sup>13</sup> The Rules require NEMMCO, in conducting the review, to consider:

- Simplification of the FCAS markets;
- Better determination of FCAS requirements; and
- The introduction of an FCAS usage market.

NEMMCO released an Issues Paper in mid-December 2006, setting the scope of the review and calling for submissions from interested market participants. The Issues Paper indicated that one of the matters to be considered as part of the FCAS Review was whether "regional recovery of regulation FCAS costs [should] be introduced to all regions of the NEM".<sup>14</sup>

The Issues Paper anticipated that the draft report would be released on 20 April 2007. To enable the Commission to consider NEMMCO's draft report as part of its analysis of the NGF Rule change proposal and submissions received during first round consultation, the Commission extended the period of time for making the draft Rule Determination.

NEMMCO published its final report on 31 July 2007. Its conclusion about the introduction of regional recovery of regulation FCAS costs is that:<sup>15</sup>

"The costs of local regulation FCAS requirements should be regionally recovered, subject to a final decision on the appropriate causer pays factors to use. Resolution of this issue would be best managed through the AEMC Rule change process already underway."

The Commission notes that NEMMCO's position on this issue is unchanged from the draft conclusion expressed in its draft report.

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13 National Electricity Rules, clauses 3.1.4(a1)(2) and (3)

14 NEMMCO, FCAS Review Issues Paper, December 2006, p. 35.

15 Ibid., p. 37.

### **2.3 Consultation process**

On 21 December 2006, the Commission published a notice under s 95 of the NEL commencing initial consultation on the NGF Rule change proposal. Interested parties were invited to provide submissions by 22 February 2007.

The Commission received a submission from:

- TRUenergy;
- Flinders Power; and
- NEMMCO.

On 5 April 2007, the Commission issued a notice under s 107 of the NEL extending the time for making its draft Rule Determination and draft Rule.

On 17 May 2007, the Commission published its draft Rule Determination and draft Rule under s 99 of the NEL. Interested parties were invited to provide submissions by 29 June 2007. Submissions were received from:

- The NGF; and
- NEMMCO.

On 26 July 2007, the Commission issued a notice under s 107 of the NEL extending the time for making its Rule Determination.



### 3 Commission’s analysis of the Proposed Rule

The Commission received a submission on the Rule change proposal at the first round of consultation from each of:

- TRUenergy;
- Flinders Power; and
- NEMMCO.

In the second round of consultation, the Commission received a submission from each of:

- The NGF; and
- NEMMCO.

This chapter addresses the issues raised in submissions made in response to the Proposed Rule, to the draft Rule Determination and draft Rule, and sets out the Commission’s analysis and its reasons for its decision.

#### 3.1 Regional cost recovery

As detailed in Chapter 1 of this Rule Determination, the NGF’s Proposed Rule repeals the Derogation allowing local regulation FCAS costs to be recovered in Tasmania and implements a NEM-wide process requiring the cost of regulation FCAS to be recovered on a regional basis.

The submissions received during the first round of consultation were broadly supportive of the Proposed Rule. TRUenergy observed<sup>16</sup>:

“It was the intention shortly after the creation of FCAS markets in 2001 that all services, including regulation, should move towards regionalised recovery where regionalised requirements exist. This was driven by the advantages listed in the proposal and by its potential to facilitate secondary markets in the various services.

It is now appropriate for regulation services to be brought into line with the contingency services and for a single generic solution to be proposed rather than a ‘Tasmania only’ approach.”

NEMMCO’s first round submission also expressed support for the principles behind the NGF’s Rule change proposal.<sup>17</sup>

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16 TRUenergy, 16 February 2007, p. 1.

17 NEMMCO, 22 February 2007, p. 1.

Flinders Power considered that while the Rule change proposal was not without merit, it was preferable not to proceed with the Rule change proposal at this time.<sup>18</sup> Flinders Power's concerns were that introducing regional recovery for regulation FCAS would:

- Allow the distortions caused by the lag in the current regulation FCAS cost apportionment arrangements to persist, thereby continuing to allow generators to escape their portion of the costs by varying output; and
- Exacerbate the differences between the commercial drivers for contingency FCAS compared to regulation FCAS.

Flinders Power and NEMMCO also noted that, at the time first round submissions were lodged, NEMMCO was undertaking a review of the operation and effectiveness of the spot market for ancillary services, and on the potential for future implementation of a usage market for these services.<sup>19</sup>

The Commission addresses each of these matters below.

### **3.1.1 Distortionary effects of NEM-wide regional recovery**

Flinders Power submits that the current mechanism to apportion the cost of regulation FCAS does not allow costs to be reflected in "real time".<sup>20</sup> Rather, there is a delay of up to seven weeks from the date the data used to calculate contribution factors is first collected, to the date the contribution factors based on that data are applied.

Flinders Power submits that the first consequence of this delay is that low output plant can "inefficiently escape their portion of costs purely through the variability of their output patterns."<sup>21</sup> Using the example of a peaking generator, Flinders Power submitted that a market participant may operate with unfavourable deviations during one period and manage out the financial effects of those deviations in the subsequent period.

The Commission notes the matters raised by Flinders Power's analysis. However, it also notes that the ability for a generator to engage in such conduct stems predominantly from the current arrangements that govern the calculation and application of the contribution factors which are not the subject of the current Rule change proposal. The Commission has determined that the Rule to be made will introduce new factors for the purposes of implementing the policy behind this Rule change. However, the Rule to be made does not remove or detract from any of the contribution factors in the current Rules.

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18 Flinders Power, 21 February 2007, p. 2.

19 Ibid., and NEMMCO, 22 February 2007, p. 1.

20 Flinders Power, 21 February 2007, p. 1.

21 Ibid.

### 3.1.2 The effect of regional recovery on the contribution factors

The NGF's Rule change proposal notes that the Proposed Rule required "a slight modification to the causer pays calculation" in clause 3.15.6A(h) to enable regional recovery. NEMMCO noted that:<sup>22</sup>

"scaling up the existing causer pays factors is a pragmatic and sufficiently accurate approach to regional recovery of regulation FCAS in the event of regional islanding."

Based on the Commission's acceptance of regional recovery of regulation FCAS at a policy level, the Commission understands the need for the Rules to be amended in order to implement it. The Commission has amended the drafting proposed by the NGF to ensure consistency with the remainder of the Rules.

During the first round of consultation, Flinders Power submitted that until cost recovery for regulation FCAS can move closer to a real time cost recovery arrangement, implementing regional cost recovery will exacerbate the distortions of the current scheme.<sup>23</sup>

As noted above, the Commission considers that issues regarding the current arrangements for calculating contribution factors during the settlement process are not the subject of the current Rule change proposal. Accordingly, for the reasons set out at section 3.1.1 above, the Commission has determined the Rule to be made will not remove or detract from the principles that NEMMCO is currently required to take into account in preparing a procedure for determining contribution factors during the settlement process. As noted above, additional principles have been included to account for the regional recovery of the costs of regulation FCAS.

The submissions made during the second round of public consultation identified two practical matters concerning the calculation and use of contribution factors under the draft Rule that required clarification. The first matter, canvassed by the NGF, is that clause 3.15.6A(h)(3) of the draft Rule is not properly part of the process for regional allocation of regulation FCAS costs and was inadvertently included in the NGF's Proposed Rule. The NGF noted that clause 3.15.6A(h)(3) is inappropriate because it has the effect of allocating the cost of regulation FCAS requirements on a regional basis:

- To those customers who have metered data for causer pays calculations; and
- Before FCAS regulation costs are allocated to individual participants.<sup>24</sup>

The NGF noted that these effects were inconsistent with the intention of the Proposed Rule to "allocate localised regulation costs as much as possible to causers

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22 NEMMCO, 22 February 2007, p. 1.

23 Flinders Power, 21 February 2007, p. 1.

24 NGF, 28 June 2007, p. 1.

of localised regulation services.”<sup>25</sup> Accordingly, the NGF submitted that clause 3.15.6A(h)(3) should be deleted.

The Commission has reviewed the practical consequences of clause 3.15.6A(h)(3) and accepts the NGF’s submission. Accordingly, this clause has been deleted from the Rule to be made.

NEMMCO’s second round submission noted that the cumulative effect of clauses 3.15.6A(j)(2) and (k)(3) of the draft Rule required it to determine contribution factors for every potential region, or set of regions, prior to an islanding event.<sup>26</sup> Given the large number of possible regions that could result from an islanding event, NEMMCO submitted that it is more practical to determine the actual regional contributions during the settlement process as and when required. NEMMCO also suggested that the clause obliging it to undertake this process this be contained within clause 3.15.6A(i).

The NGF agreed that requiring NEMMCO to publish the contribution factors for each region in advance of an islanding event may not be practical.<sup>27</sup> However, the NGF submitted that it would assist market participants to manage their risks in real time if NEMMCO were to publish information to enable each participant to estimate the cost of its regulation FCAS requirement once a region begins operating asynchronously (ie, becomes islanded).

The Commission accepts NEMMCO’s submission that requiring it to prepare contribution factors for each theoretical region or set of regions before an islanding event has occurred is inappropriate. Accordingly, clause 3.15.6A(j)(2) of the Rule to be made has been amended so that NEMMCO is only required to calculate the factors after an islanding event occurs.

The Commission considers that publishing an estimate of the contribution factors for those market participants affected by islanding once the islanding event has occurred will assist participants to manage the financial risks associated with localised regulation FCAS requirements, for example, by adjusting generation output in response to a sudden increase in FCAS costs. The Commission understands that NEMMCO is able to determine approximate cost allocation factors for use in the dispatch timeframe for the duration of an islanding event and that the publication of these estimated factors would assist market participants to mitigate risks associated with regulation FCAS requirements. Clause 3.15.6A(nb) of the Rule to be made therefore requires NEMMCO to calculate and publish real time estimates of the contribution factors for market participants in a region that is operating asynchronously.

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25 NGF, 28 June 2007, p. 1.

26 NEMMCO, 29 June 2007, p. 1.

27 NGF, 28 June 2007, p. 2.

### 3.2 Abolition of the Derogation

Presently, Part 11 of Chapter 8A of the Rules contains a derogation that provides for the transitional arrangement for market ancillary services for Tasmanian entry into the NEM. The Derogation replaces clause 3.15.6A(a) of the Rules for regulation services only. It requires NEMMCO to determine cost recovery for regulation services on a regional basis, similar to the other types of FCAS, and then determine the costs for the Tasmanian region with the balance of costs being averaged for all other regions combined.

The Derogation was due to expire on 31 December 2006 but was extended in late 2006 until 31 December 2008 in response to a Rule change proposal from NEMMCO.<sup>28</sup>

Although the NGF's Rule change proposal was received prior to the extension of the Derogation, its observations regarding the need for a permanent solution remain relevant:<sup>29</sup>

"... there is a need to implement a permanent solution for Tasmanian islanding. Further there is the possibility of other regions or parts thereof becoming separated into an island (due to planned and/or forced outages of transmission elements) thus requiring a more general solution. In addition it is now apparent that limitations on the operation of BassLink necessitate a local requirement for FCAS regulation services under some power transfer conditions."

TRUenergy's first round submission expressed support for the abolition of the Derogation for the reason that the Derogation was only ever intended as a short-term solution:<sup>30</sup>

"While contingency services had regionalised recovery implemented shortly thereafter, regulation services were initially overlooked as their incidence of separation was lower and their resolution more complex. However the entry of Tasmania necessitated an urgent response and so the current 'Tasmania only' derogation was implemented."

The Commission has considered the policy rationale underlying the introduction of the Derogation. The Commission is satisfied that the Derogation was intended to apply temporarily and that subsequent steps were to be taken to identify and implement a permanent solution. Further, the Commission is satisfied that the Rule to be made provides a practical resolution of the issues.

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28 The Derogation was extended on 7 December 2006. Further information about NEMMCO's Rule change proposal and the consultation process followed by the Commission is available from the Commission's website at [www.aemc.gov.au](http://www.aemc.gov.au).

29 NGF Rule change proposal, 7 September 2006, p. 2.

30 TRUenergy, 16 February 2007, p. 1.

The Commission considers that it is also appropriate to address the broader discrepancy between the mechanisms for, on the one hand, recovering the costs of local contingency FCAS requirements and, on the other, recovering the costs of local regulation FCAS requirements. Therefore, the Commission has decided that the Derogation shall be removed by the Rule to be made.

In its draft Rule Determination, the Commission noted that it may be necessary to extend the Derogation beyond 31 December 2008 as a transitional measure depending on the time required by NEMMCO to implement systems changes required by the adoption of the Proposed Rule. The Commission understands that, based on its present expected future workload, NEMMCO is able to implement the Rule to be made by late 2008. Therefore, the Commission does not propose that the Derogation be extended.

### **3.3 NEMMCO FCAS Review**

NEMMCO is required under the Rules to undertake a review of the operation and effectiveness of the spot market for market ancillary services, and recommend any improvements (FCAS Review).<sup>31</sup> The Rules require NEMMCO, in conducting the Review, to consider:

- Simplification of the FCAS markets;
- Better determination of FCAS requirements; and
- The introduction of an FCAS usage market.

NEMMCO's Issues Paper foreshadowed a number of potential changes that were likely to improve the operation of the FCAS markets. NEMMCO sought submissions<sup>32</sup> on the appropriateness of the potential changes, and called for other possible changes that may be suitable. In relation to the regional recovery of regulation FCAS costs, the Issues Paper stated:<sup>33</sup>

“The costs from local contingency FCAS requirements are covered regionally, on the basis that only local market participants are the beneficiaries of the local FCAS requirements, and only local market participants are able to influence the local FCAS price. This principle has been applied temporarily to Tasmanian regulation FCAS costs. However, the principle has not yet been extended to the recovery of regulation FCAS in general.”

In its first round submission on the NGF Rule change proposal, NEMMCO noted:<sup>34</sup>

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31 National Electricity Rules, clauses 3.1.4(a1)(2) and (3).

32 The period for making submissions closed on 23 February 2007.

33 NEMMCO, FCAS Review Issues Paper, December 2006, p. 3.

34 NEMMCO, 22 February 2007, p. 1.

“... the regional recovery of regulation FCAS costs is a likely prerequisite for any co-optimisation of regulation and delayed FCAS. The potential co-optimisation of regulation and delayed FCAS is currently being considered as part of NEMMCO’s review of the FCAS markets, as well as being the subject of a current Hydro Tasmania Rule change proposal.”

Flinders Power also observed that the matters sought to be addressed by the NGF’s Rule change proposal were the subject of the FCAS Review. In its first round submission, Flinders Power stated:<sup>35</sup>

“It is also noted that a broad review of the operation of the FCAS markets in the NEM is currently underway, being undertaken by NEMMCO. This review might potentially result in a number of changes to current FCAS arrangements, including service requirements, market operation, and cost recovery arrangements. It is expected that any Rule change proposals which emerge from this review would be presented to the AEMC by the end of September 2007.

Whilst the current Rule change proposal is not without merit, Flinders Power believes in view of the current distortions, it would be preferable not to proceed with this change at this time, and to await the outcomes of the FCAS review before implementing changes to the current cost recovery arrangements.”

As noted above, NEMMCO released its draft report on 3 May 2007.<sup>36</sup> With respect to local recovery of regulation FCAS, NEMMCO said:

“To make things clear for the AEMC consultation, this report favours extending the regional cost recovery principle to regulation FCAS costs, subject to the resolution of the appropriate causer pays factors to be used. NEMMCO considers it appropriate to maintain a ‘placemaker’ in the FCAS review for the regional recovery of regulation FCAS costs, but agrees with the NGF and Stanwell that the issue can be adequately resolved through the AMEC Rule change process already underway.”

On the basis of the clear exposition of NEMMCO’s position, the Commission did not consider it appropriate to defer consideration of the NGF’s Rule change proposal until after the conclusion of the FCAS Review.

NEMMCO published its final report on 31 July 2007. NEMMCO’s position remained that the costs of local regulation FCAS requirements should be regionally recovered (subject to a final decision on the appropriate contribution factors use to use) and

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35 Flinders Power, 21 February 2007, p. 2.

36 NEMMCO, FCAS Review Draft Report, May 2007, p. 37.

that this issue would be best managed through the Rule change process already underway.<sup>37</sup>

### 3.4 Analysis of the Rule to be made

The Commission assessed the drafting of the Proposed Rule against the Derogation and clauses 3.15.6A(f) and (g) of the Rules, which provide for local recovery of FCAS contingency costs. Based on its understanding of the NGF's objectives in putting forward the Proposed Rule, the submissions received during the public consultation processes and the operation of the Rules and the Derogation, the Commission has made several amendments to the Proposed Rule. For the benefit of interested stakeholders, this section of the Rule Determination outlines the nature of, and rationale for, the drafting amendments made by the Commission.

The purpose of clauses 3.15.6A(h) and (i) of the Rule to be made is to enable the costs of regulation FCAS to be recovered on a regional basis throughout the NEM. To ensure the clauses in the Rule to be made do not unnecessarily or unintentionally alter the process that currently applies in Tasmania, the Commission has assessed the Rule to be made against the Derogation.

Sub-paragraphs (1) and (2) of clause 3.15.6A(h) of the Rule to be made mirror paragraphs (b)(1) and (2) of the Derogation. The allocation mechanisms contained in paragraphs (b)(3) and (4) of the Derogation have been adapted to facilitate NEM-wide recovery of the costs of regulation FCAS and are set out in clause 3.15.6A(i) of the Rule to be made.

The formulae contained in clause 3.15.6A(i) of the Rule to be made are substantially similar to those contained in paragraphs (b)(3) and (4) of the Derogation and in clauses 3.15.6A(h) and (i) of the current Rules. The Commission notes that the formula in clause 3.15.6A(i)(2) of the Rule to be made has been amended from the draft Rule to better facilitate the process of allocating the regional recovery of the costs of regulation FCAS. In order to facilitate NEM-wide regional recovery, modifications have also been made to the definitions of the inputs to the formulae.

Paragraph (b)(5) of the Derogation is not replicated in the Rule to be made because it will become redundant once the Rule commences.

The Rule to be made also amends clauses 3.15.6A(j) and (k) of the current Rules. The insertion of sub-paragraph (j)(2) clarifies that NEMMCO is subject to a positive obligation to determine contribution factors for regulation FCAS on a regional basis. In response to the second round submissions, sub-paragraph (j)(2) has been amended to clarify that this obligation exists only after an event has occurred that causes a region to operate asynchronously.

The Rule to be made also inserts a new clause 3.15.6A(nb) into the Rules. This clause requires NEMMCO to publish an estimate of the contribution factors for individual market participants operating within a region that is operating asynchronously. It is

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<sup>37</sup> NEMMCO, FCAS Review Final Report, July 2007, p. 37.



intended that the estimates published under clause 3.15.6A(nb) are for the information of market participants and do not bind NEMMCO for the purposes of the settlement process conducted pursuant to clauses 3.15.6A(h)-(k) of the Rules.

To guide NEMMCO in developing a procedure for determining contribution factors, the Rule to be made inserts new principles at sub-paragraphs (3) and (6) of clause 3.15.6A(k) that NEMMCO must take into account. The inclusion of these principles is to ensure that matters specific to the regional recovery of the cost of regulation FCAS are addressed in NEMMCO's procedure.

The new clauses for insertion into Chapter 11 of the Rules introduce savings and transitional measures designed to ensure that the actions taken by NEMMCO prior to the Rule commencing for the purposes of implementing the Rule are valid.

## **3.5 Implementation and timing of the Proposed Rule**

### **3.5.1 Implementation**

In its first round submission, NEMMCO's raised concerns about the lead time required to implement the changes required by the NGF's Rule change proposal if the proposed abolition of the Snowy region proceeds. While NEMMCO's development cycle typically takes about 9 months (including 3 months to develop functional requirements and 6 months to develop, test and implement software), NEMMCO was of the view that the development cycle may be under particular pressure if the proposed abolition of the Snowy region proceeds. NEMMCO noted that it could "provide firmer comments on the timeframes once a draft determination is published."<sup>38</sup>

As NEMMCO's second round submission did not discuss the timelines that it may require, the Commission requested that NEMMCO provide this information. NEMMCO has subsequently advised the Commission that it expects to implement the Rule to be made by late 2008.

The Commission is concerned to ensure that the Rule to be made, which differs from the draft Rule, does not have any unforeseen adverse technical implications for NEMMCO that would delay the implementation of the Rule. To mitigate this risk, the Commission sought confirmation from NEMMCO that the Rule to be made does not present any technical obstacles to implementation. The Commission notes that its approach to NEMMCO occurred after the Commission had settled the policy rationale underpinning the changes it required to the draft Rule and the nature of the amendments. NEMMCO has advised that the Rule to be made is unlikely to affect NEMMCO's ability to implement it by late 2008.

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38 NEMMCO, 22 February 2007, pp. 1-2.

### **3.5.2 Timing of commencement and transitional arrangements**

As discussed above, the Derogation will cease to apply on 31 December 2008. On the basis of NEMMCO's advice that it expects to implement the Rule to be made by late 2008, the commencement date for the Rule is 1 January 2009.

In its draft Rule Determination, the Commission sought feedback from interested stakeholders on the appropriateness of the savings and transitional provisions. No submissions were received that addressed this point.

### **3.6 Miscellaneous amendments**

In the course of evaluating the Proposed Rule, the Commission noted that clauses 3.15.6A(f) and 3.15.6A(g) of the Rules refer to "local requirements" or "local ancillary service requirements" in italics, indicating that the term is defined in the Rules. It appears that the use of such terms as defined terms is an error and the appropriate term to use in these clauses is "local market ancillary service requirements". Accordingly, the Rule to be made makes this amendment.

## 4 Differences between the Proposed Rule and the Rule to be made

The Commission has largely adopted the drafting of the Proposed Rule subject to some modifications and enhancements.

The key differences between the Proposed Rule and the Rule to be made are that the Rule to be made:

- Amends clause 3.9.2A(b) to extend the application of the clause to the regulating raise service and regulating lower service;
- Amends clause 3.15.6A(h)(1) to require the allocation under clause 3.15.6A(a) to be undertaken for each of the regulating raise services and regulating lower services (rather than “or”);
- Deletes clause 3.15.6A(h)(3), which inappropriately allocated regulation FCAS costs;
- Deletes the words “requirement” and “requirements” from the defined terms used in the formulae in clauses 3.15.6A(i)(1) and (2), and inserts additional wording in clauses 3.15.6A(i)(1) and (2) to enable the calculation of liability for each global market ancillary requirement and each local market ancillary service requirement;
- Amends the formulae in clause 3.15.6A(i)(2) and the definition of TCE to enable the calculation of liability for each global market ancillary requirement and each local market ancillary service requirement;
- Amends clause 3.15.6A(j) to require NEMMCO to prepare regional contribution factors after a region begins to operate asynchronously;
- Inserts new principles at sub-paragraphs (3) and (5) of clause 3.15.6A(k), thereby providing additional guidance to NEMMCO in the development of its procedure for determining contribution factors; and
- Inserts additional wording in clause 3.15.6A(k) that reflects NEMMCO’s discretion to prepare estimates under clause 3.15.6A(nb);
- Italicises the words “region” and “regions” to reflect that they are a defined term in the Rules (clauses 3.15.6A(k)(3) and (6));
- Amends clause 3.15.6A(na) to refer to clause 3.15.6A(j)(1), an amendment required as a consequence of the amendments to clause 3.15.6A(j);
- Inserts a new clause 3.15.6A(nb), which requires NEMMCO to publish an estimate of the contribution factors for the information of market participants when a region or set of regions is operating asynchronously; and
- Provides for transitional and savings provisions.

The Rule to be made also makes minor editorial amendments to the Proposed Rule.

The Rule to be made also amends clauses 3.15.6A(f) and 3.15.6A(g) to refer to “local market ancillary requirements”.

The key differences between the draft Rule and the Rule to be made are that the Rule to be made:

- Deletes clause 3.15.6A(h)(3), which inappropriately allocated regulation FCAS costs;
- Inserts additional wording in clauses 3.15.6A(i)(1) and (2) to enable the calculation of liability for each global market ancillary requirement and each local market ancillary service requirement;
- Amends the formulae in clause 3.15.6A(i)(2) and the definition of TCE to enable the calculation of liability for each global market ancillary requirement and each local market ancillary service requirement;
- Amends clause 3.15.6A(j)(2) to clarify the scope of NEMMCO’s obligation to prepare regional contribution factors after a region begins to operate asynchronously;
- Amends clause 3.15.6A(na) to refer to clause 3.15.6A(j)(1), an amendment required as a consequence of the amendments to clause 3.15.6A(j);
- Inserts additional wording in clause 3.15.6A(k) that reflects NEMMCO’s discretion to prepare estimates under clause 3.15.6A(nb);
- Inserts a new clause 3.15.6A(nb), which requires NEMMCO to publish an estimate of the contribution factors for the information of market participants when a region or set of regions is operating asynchronously.