



RULE CHANGE

Australian Energy Market Commission

SECOND CONSULTATION PAPER

National Electricity Amendment (Cost recovery for “Other” Services directions) Rule 2009

Rule Proponent

NEMMCO (now AEMO)

17 December 2009

This staff paper has been prepared to facilitate public consultation on the Rule change proposal and does not represent the views of the Commission or any individual Commissioner of the Australian Energy Market Commission.

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Citation

AEMC 2009, *Cost recovery for "Other" Services Directions*, Second Staff Paper 17 December 2009, Sydney

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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Introduction

On 13 March 2009 NEMMCO (now AEMO) submitted a Rule change proposal to the Australian Energy Market Commission (Commission) seeking to modify the method of cost recovery for directions for “other” services directions.

Consultation was undertaken on the proposal under section 95 of the National Electricity Law (NEL), and closed on 24 August 2009. One submission was received from the National Generators Forum (NGF), which did not disagree with the AEMO proposal, but proposed two other possible approaches to the related wider issue of how “other” services are defined.

Additional consultation was undertaken on the alternatives proposed by the NGF, which resulted in a further submission from AEMO that was not supportive of the NGF’s alternative approaches.

Subsequently, further submissions were received by the Commission from AEMO and the NGF reflecting the outcomes of discussions held by these parties on an agreed position. This agreed position incorporates the changes initially proposed by AEMO and the NGF, with the addition of a drafting amendment affecting the operation of a specific aspect of compensation methodology.

The Commission has the power under Section 91A of the NEL to make a more preferable Rule, if it considers that a more preferable Rule would better contribute to the achievement of the National Electricity Objective (NEO). The making of a more preferable Rule would potentially allow the Commission to incorporate the changes proposed by AEMO and the NGF, if it takes the view that the issues identified are sufficiently related. To this end, the Commission considers that the additional submissions, and the agreed position reached between AEMO and the NGF, warrant further consultation on a number of specific issues prior to proceeding to a draft Rule determination.

This Consultation Paper was prepared by staff of the AEMC to facilitate additional public consultation on the Rule change proposal and the contents of the AEMO and NGF submissions. It should be read in conjunction with the original Rule change proposal submitted by AEMO, and the subsequent submissions made by the NGF and AEMO. This paper does not represent the views of the Commission or any individual Commissioner.

The Consultation Paper:

- sets out background information relevant to the original Rule change proposal, the alternative approach proposed by the NGF and the subsequent agreed AEMO-NGF position;
- summarises, at a high-level, the changes to the framework for directions for “other” services proposed by AEMO and the NGF; and

- sets out the issues arising out of the various proposals which the Commission wishes to seek stakeholder views on, including questions that stakeholders are encouraged to consider when preparing their submissions.

1. Background

This section of the paper provides some background information on

- AEMO's power to issue directions;
- the initial AEMO Rule change proposal (the AEMO proposal);
- the NGF's proposed alternative (the NGF alternative) and AEMO's response to it; and
- the position agreed by AEMO and the NGF ("agreed AEMO-NGF position").

1.1 AEMO's power to issue directions

Clause 4.8.9 of the Rules give AEMO the power to direct a registered participant to do any act or thing, if it satisfied that it is necessary to do so to maintain power system security or re-establish the power system to a secure or reliable operating state.

Similarly, under section 116 of the NEL, AEMO may direct a Registered participant to take any action it considers necessary to maintain power system security or for reasons of public safety.

Directed participants are required to comply with the direction, unless to do so would be a hazard to public safety, materially risk damaging equipment, or contravene any other law.

AEMO is required to pay compensation to the directed participant for the service provided in response to the direction, and recover the cost of that compensation from other market participants. Compensation methodologies are in place with regard to directions for:

- energy services;
- market ancillary services (MAS); and
- services other than energy or MAS ("other" services).

Energy in this context refers to the provision of electrical energy. Market ancillary services refers to services to correct an increase or decrease in power system frequency beyond system operating limits.

Directions for "other" services have, historically, included directions for:

- network support services (to remove a localised power system security violation that is remote from the regional reference node);
- reactive power, where the delivery of reactive power and any attendant change in active power is considered to be one all-inclusive service;
- a reduction in generation;
- manual or local frequency control; and
- an increase in scheduled load.¹

Between 2002² and 2008, directions for “other” services accounted for some 90 per cent of issued directions, and approximately 99 per cent of total compensation paid. The total amount of recovered costs for directions for “other” services (predominantly for network support services and manual frequency control services) has ranged from approximately \$200,000 to \$4.4 million per annum.³

1.2 Calculation of compensation for directed participants and recovery of costs for directed services

Separate methodologies have been established under the Rules for calculation of the compensation payable to directed participants, and the funding of that compensation (ie recovery of costs), *currently* applicable to each kind of directed service. Table 1 sets out these compensation and cost recovery methodologies.

¹ AEMO Rule change proposal p3

² The current framework for directed services was introduced in 2002, following consultation by NECA and NEMMCO.

³ AEMO Rule change proposal p3; Compensation for Network Support directions has been predominantly in the order of \$2.1 to \$4.1 million per annum.

Table 1: Compensation and Cost Recovery Methodology for Directed Services

Type of direction	How compensation is calculated	How costs are recovered
Energy	<p>Calculated as the amount of energy in MWh produced as a result of the direction, multiplied by the market price. Under clause 3.15.7, market price is defined as the 90th percentile of that service over the previous 12 months.</p> <p>Alternatively, under clause 3.15.7(d), if at the time of the direction, the Directed Participant had submitted a valid dispatch bid, dispatch offer or rebid for dispatch of the requested service, the Directed Participant is entitled to receive compensation for the provision of that service at a price equal to the price in that bid or offer.</p> <p>Participants have the opportunity to seek additional compensation under 3.15.7B of the Rules, which permits directed participants, entitled to compensation under 3.15.7 or 3.15.7A, to make an application to AEMO for additional compensation in accordance to criteria outlined in 3.15.7B.</p>	<p>Costs are recovered from market customers in regions that benefit from the direction, in proportion to the amount of energy that the market customer consumes.</p>
Market Ancillary Services	<p>Methodology as above, based on MW of FCAS produced as a result of the direction.</p> <p>Participants have the opportunity to seek additional compensation under 3.15.7B of the Rules, as noted above.</p>	<p>Costs are recovered in the same way as if the market ancillary services were provided through the normal market operations. While the cost recovery methodology is slightly different for the different categories of market ancillary service that might be the subject of the direction, they are all recovered on a regional benefits basis.</p>

"Other" services	Compensation for "other" services directions is calculated, under 3.15.7A, based on a "fair payment price" as determined by an independent expert appointed by AEMO. This price has predominantly been determined on the basis of long run average costs. ⁴ Participants have the opportunity to seek additional compensation under 3.15.7B of the Rules, as noted above.	Costs are recovered from all registered participants NEM wide in the same proportion as the largest single fixed component of participant fees.
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⁴ AEMO submission, 7 September 2009, p. 3.

1.3 AEMO's Rule change proposal

AEMO has identified what it perceives to be an issue with the way compensation and cost recovery for directions for "other" services is currently treated under the Rules. Under current arrangements, costs for compensating participants directed to provide "other" services are recovered from all market participants in all NEM regions.

AEMO's Rule change proposal seeks to modify the existing methodology for recovery of costs arising out a direction for "other" services, so that costs are recovered from:

- the regions that benefit from the direction, determined by applying a regional benefits test; and
- market customers and market generators in the affected region in proportion to their "relevant energy".

These changes will also remove what is essentially a redundant reference in the Rules to the fixed component of participant fees as the basis for determining proportional liability of market customers and generators. AEMO participant fees no longer include a fixed proportion.

The AEMO Rule change does not directly seek to make any changes to the method by which the quantum of compensation owing to participants directed to provide "other" services is calculated, the classification of directions or the compensation and cost recovery methodologies applicable to directions for energy or MAS.

1.4 The NGF's alternative approach

The NGF, while it does not oppose the AEMO changes, proposed a wider set of changes to the Rules on the basis that the core problem, relating to directions for "other" services, that should be addressed is how directed services are classified by AEMO, which ultimately affects the application of compensation and cost recovery methodologies.

The NGF contends that the majority of directions determined by AEMO to be for "other" services should in fact be considered directions for energy. NGF's position is derived from two key assumptions:

- As neither energy direction or "other" service direction are defined terms, service classification should be based on the ordinary meaning of the words.

- As “other services - network support” account for the vast majority of directions, this category is the main subject of the AEMO rule change proposal.⁵

The NGF has proposed that the Rules be amended to insert a clause defining “other” services. Under the NGF’s proposed new clause, a direction would be defined as a direction for “other” services only if the direction could not have been avoided by the central dispatch process utilising “hypothetical market offers”⁶ for either energy or MAS.

The NGF also put forward a second alternative approach to the issue it has identified, under which the cost recovery for methodology for “other” services would be aligned with that for “energy”, effectively removing “other” as a discrete category for cost recovery. This represents a far more sweeping change to the current framework for directed services. Discussion in this consultation paper will concentrate primarily on the NGF’s first alternative approach.

In its submission of 7 September 2009, AEMO expressed concerns with the NGF alternative, particularly around the impact it would have on the quantum of compensation arising out of the application of clause 3.15.7(d). AEMO proposed the *deletion* of clause 3.15.7(d) as a means of addressing this concern.

1.5 The agreed AEMO-NGF position

AEMO and the NGF, subsequent to the close of additional consultation in September, have reached agreement on an approach to the issue of compensation for “other” services directions that would enable the AEMO Rule change proposal and the NGF’s alternative to be considered together.

Under the agreed position articulated in submissions from AEMO and the NGF lodged in November, AEMO has indicated that it would support the changes proposed by the NGF regarding the classification of “other” services, only if clause 3.15.7(d)⁷ were to be *modified*. This modification is the only addition to the changes proposed by AEMO in its initial proposal, and the NGF in its first submission. Accordingly, the agreed AEMO-NGF position would entail:

- the changes proposed by AEMO its initial proposal and outlined in section 1.3 above ;
- the changes proposed under the NGF’s alternative approach and outlined in section 1.4 above; and

⁵ NGF, Submission, 24 August 2009, p. 1.

⁶ “Hypothetical market offer” is not a defined term in either the NER or the NEL, or in the drafting proposed by the NGF.

⁷ As noted above, 3.15.7(d) allows a participant directed to provide energy or MAS services to use a valid bid or re-bid as the basis for calculation of compensation, rather than the 90th percentile market price stipulated under 3.15.7 (c).

- amendments to the drafting of clause 3.15.7(d) which would restrict its applicability.

AEMO’s proposed modifications to 3.15.7(d) would restrict the operation of this clause to situations where a failure of AEMO’s dispatch systems has prevented the normal dispatch of that requested service. AEMO believes that this modification would address its concerns regarding the quantum of compensation.

2. Issues for consultation

The Commission has the option to make a more preferable Rule which incorporates the agreed AEMO-NGF position, if it concludes that this would better contribute to the achievement of the National Electricity Objective (NEO), taking into consideration the issues identified by AEMO in its original Rule change proposal. In this context, implementation of the agreed AEMO-NGF position would result in the changes put forward by both parties being implemented as proposed, with the additional amendment to clause 3.15.7(d) noted above.

Consideration of the AEMO Rule change proposal, in light of the submissions from the NGF and the now agreed position between AEMO and the NGF, raises a number of specific issues that warrant further consultation. The changes put forward by both AEMO and the NGF would result in substantial modifications to the existing framework for directed services, and in particular the recovery of costs arising from “other” services directions from market customers.

This section discusses the individual effects of the AEMO proposal and the NGF alternative, as well as the implications of combining the two proposals under the agreed AEMO-NGF position.

2.1 Overall impact of the AEMO and NGF proposals on compensation and cost recovery

The AEMO proposal would alter the cost recovery mechanisms applicable to “other” services through two key changes:

- Introduction of regionalisation of cost recovery, based on the application of a regional benefits test, as currently applies to energy and MAS directions.
- Removal of what is effectively a redundant reference in clause 3.15.8(g) of the Rules to the fixed component of participant fees as the basis for determining proportional cost recovery for “other” services. AEMO participant fees no longer include a fixed component. This will be replaced by the concept of “relevant energy” as the basis for determining proportional liability.

Relevant energy is described by AEMO as:

“the sum of the generator energy and (the absolute value of) the customer energy recorded in the metering data for that participant in the period of the direction.” ...

...“The relevant energy of Market Customers and Market Generators in a region is approximately equal. The main cause of variation is the net import or export of power that may occur at the time of the direction. Thus if the region is a net exporter, the share of recovery costs for a direction in that region will be up to 55% for market generators, and down to 45% if the region is a net importer.”⁸

This proposal does not change the manner in which the amount of compensation is determined for participants directed to provide “other” services. The proposal does, however, move from recovery of costs from all market participants in the NEM to recovery from participants in the regions that benefit from the direction.

The NGF alternative, by defining the circumstances under which AEMO could classify a direction as a direction for “other” services, would likely result in the majority of directions (based on experience to date) being compensated as directions for energy rather than “other” services. This would affect the amount of compensation payable to the directed participant, as well as the recovery of the costs associated with that compensation from other market participants, when compared with the existing process.

The agreed AEMO-NGF position would result in the changes to the cost recovery methodology for “other” services proposed by AEMO, as well as the introduction of a definition for “other” services put forward by the NGF. The agreed position would not change the basic operation of the AEMO proposal and the NGF alternative, as discussed above.

2.2 Quantum of compensation to directed participants

The total amount of compensation payable to a directed participant is determined in accordance with sections 3.15.7, 3.15.7A and 3.15.7B of the NER. In general, directions for energy and MAS are compensated according to formulas set out in 3.15.7, while compensation for directions for “other” services is determined by an independent expert appointed by AEMO. The formula under 3.15.7 restricts the price applicable to energy or MAS directions to the market price, defined as the 90th percentile of that service over the previous 12 months.

The AEMO proposal would not alter the quantum of compensation, as it does not change the manner in which compensation is determined for “other” services, and does not change the compensation methodology applied by AEMO to energy or MAS directions.

Based on the nature of directions issued since 2002, the NGF alternative would result in the majority of directions being defined as energy services. This change would result in the *potential* quantum of compensation for what would ordinarily be classed as directions for “other” services changing due to applicability of clause 3.15.7(d), which allows directed market participants who have a valid bid, offer or rebid for

⁸ NEMMCO (now AEMO) Rule change proposal, 13 March 2009, p. 4.

dispatch of that service (i.e. energy) in place to be compensated at a price equal to the price in that bid, offer or rebid.

The agreed AEMO-NGF position, by implementing the AEMO proposal and the NGF alternative, would not result in a change in the quantum of compensation determined for “other” services directions, but would result in the majority of directions being treated as energy directions (based on the nature of directions since 2002) and compensated accordingly.

However, it would also restrict the circumstances under which clause 3.15.7(d) could operate, effectively limiting compensation to the formula set out in the Rules under 3.15.7. Participants directed to provide energy or MAS services would not have the option to utilise an existing bid or re-bid as the basis for determining compensation, as allowed under 3.15.7(d), except in situations where there has been a failure of AEMO’s dispatch processes.

This would also seem to address the issues raised by AEMO in its submission of 7 September 2009 regarding incentives for generators to react slowly to dispatch instruction in situations where their short run average costs are greater than the market settlement at the regional reference price.⁹ Restricting the application of 3.15.7(d) would act as a disincentive for particular kinds of bidding or re-bidding behaviour, designed to maximise compensation arising from a direction.

Participants would still have the option to make a claim for additional compensation in accordance with section 3.15.7(B) of the Rules under either the AEMO proposal or the NGF alternative.

2.3 Payment of costs by market participants

The AEMO proposal, on its own, would maintain the existing approach in the Rules which divides liability for recovery of the total compensation amount for an “other” services direction between customers and generators; however, the total amount payable by participants in a *specific* region would increase as a result of the introduction of the regionalisation. Conversely, participants in non-benefitting regions will no longer be obliged to contribute to the recovery of compensation costs.

AEMO contends that the move to basing proportional allocation on relevant energy would result in a split between generators and customers that largely maintains the current distribution of cost recovery across participant classes. Under current arrangements, generators have paid 43 per cent of recovered costs for “other” services directions, and market customers 57 per cent (reflecting, proportionally, the fixed component of participant fees). According to AEMO, the relevant energy of market customers and market generators is approximately equal, but does vary depending on whether a region is a net importer or exporter at the time of the direction. The share of recovery costs applicable to generators for a direction in that region will be up to 55 per cent if a region is a net exporter, and down to 45 per cent if the region is a net importer.

⁹ See AEMO’s supplementary submission, 7 September 2009, p. 3..

The use of relevant energy as the basis for proportional liability would result in market generators having to pay a slightly greater proportion of costs than they currently do. Combined with the introduction of regionalisation (ie the move away from smearing costs across all regions), generators in benefitting regions will pay a greater proportion of an overall larger cost liability, though equally, generators (and customers) in unaffected regions will have no liability.

The NGF alternative would result in the majority of directions currently compensated as “other” services being treated as energy directions, which are subject to the regional benefits test. Significantly, this would shift the cost recovery burden from all market participants (as applies currently to “other” services directions, which have historically accounted for the bulk of directions) to benefitting market customers only (as applies to energy directions).

As a result, customers will pay more for directed services overall, due to the majority of services now being recovered as energy services. Directions for energy services are recovered from market customers, whereas “other” services directions are recovered proportionally from customers and generators (and would continue to do so under the AEMO proposal). Cost for all directed services, other than contingency FCAS (raise), would be recovered solely from market customers in the benefitting region. Regulation FCAS would continue to be recovered from customers (54 per cent) and generators (49 per cent).

In its August submission, the NGF contends that this shift to recovery solely from customers is appropriate, on the basis that:

- The Rules provide for recovery of MAS to be carried exclusively by customers, reflecting the fact that directions are generally for the benefit of customers only (ie by avoiding the need for load shedding).
- Pricing and compensation provisions in the Rules are based on the concept of leaving generators “unaffected by the intervention”.
- This change would be consistent with the beneficiary pays principle, as only those participants benefitting from the direction (ie market customers in the benefitting region) would be expected to pay.¹⁰

The agreed AEMO-NGF position, by introducing a limitation on the applicability of clause 3.15.7(d), would circumscribe the ability of directed participants to increase the amount of received compensation (as noted in section 2.2 above), but otherwise would result in the effects of the AEMO proposal and the NGF alternative remaining unchanged, as discussed above.

¹⁰ NGF submission, 24 August 2009, p. 2.

2.4 Classification of directed services

The AEMO proposal does not specifically address the classification of directed services, but focuses on what it considers an issue with the cost recovery methodology applicable to “other” services.

The NGF’s alternative is primarily concerned with the definition of “other” services, and proposes the introduction of a definition for “other” services, where currently such a definition does not exist. This would have the consequential effect of altering the compensation and cost recovery methodology that would apply to the majority of directions in the NEM.

Services are only defined in terms of their cost recovery mechanisms. While *energy* and *market ancillary service* are defined terms in the Rules, “energy direction” and “market ancillary service direction” (or similar) are not defined. Furthermore, “other” is only defined by virtue of it not being an energy direction or a MAS direction and then only in terms of the relevant cost recovery mechanism.

This appears to be consistent with concept of the “other” category as a catch-all for services that did not easily fit into the other two categories or could not be met through an existing market mechanism¹¹; however, directions for “other” services have accounted for some 90 per cent of issued directions and approximately 99 per cent of total compensation paid since 2002.

At the time of issuing a direction, AEMO does not specify the type of direction, only the physical deliverable requirement and the technical reason for the direction. AEMO’s operating procedures glossary explicitly states that there is “no distinction between reliability or security directions, or whether the direction is for energy, FCAS or any other service”. The type of service, or more specifically, the cost recovery methodology to apply, is determined by AEMO subsequent to the issuing of a direction.¹²

The AEMO proposal would not alter the existing approach to classification of directions for service.

Conversely, the NGF alternative would prescribe the classification of “other” services on the basis of whether the directed service could be avoided by the central dispatch process utilising “hypothetical market offers” for either energy or MAS. A directed service would only be considered an “other” service if a participant did not have a bid or offer in place for energy or MAS that could fulfil the technical needs of the

¹¹ On page 18 of its determination dated 3 October 2002, the Australian Competition and Consumer Commission noted that the proposed methodology for cost recovery for “other” services under 3.15.8(g) is a “catch all” to ensure that “if there is compensation not recoverable under the main provisions of clause 3.15.8, then there remains a mechanism for its recovery.” The ACCC also noted NECA’s statement that the issue of directions “is most likely related to the energy or ancillary services markets”.

¹² For example, AEMO advised Registered Participants that directions in South Australia of 17 and 18 June 2009 were considered as directions for “Other Service - Network Support” in NEM Communication 3436, issued on 29 June 2009. AEMO’s report on the direction was issued on 22 July 2009.

direction. The implications of this classification for AEMO operating procedures have not been addressed in the NGF proposal.

The agreed AEMO-NGF position would introduce into the Rules the definition suggested by the NGF alternative. The drafting amendment to 3.15.7(d) suggested by AEMO would not affect this definition.

3. Questions for consultation

The questions below are intended to facilitate consultation, and stakeholders are encouraged to consider these questions when preparing submissions in response to this consultation paper.

- Are there broader ramifications of defining directions for “other” services in the Rules, as proposed under the NGF alternative, particularly considering the absence of definitions for either energy or MAS directions?
- Is it appropriate to recover costs arising from the compensation of directed participants primarily, or even solely, from market customers, as suggested by the NGF on the basis of a beneficiary pays framework?
- Does the operation of clause 3.15.7(d) create incentives for directed participants to engage in bidding or re-bidding behaviour designed to profit from AEMO directions for energy or MAS? Does the change to that clause proposed AEMO as part of the compromise position address these incentives? Does this change have wider implications for market participants?

4. Consultation

The Commission invites written submissions in response to this consultation paper by 5pm (Australian Eastern Standard Time) on 4 February 2010. Submissions may be lodged online or by mail in accordance with the following requirements.

Submissions should be submitted, where practicable, in accordance with the Commission’s Guidelines for making written submissions on Rule change proposals. The Commission publishes all submissions on its website, subject to a claim of confidentiality.

All enquiries on this project should be addressed to Nathan Martin on (02) 8296 7800.

Lodging a submissions electronically

Comments must be lodged online via www.aemc.gov.au. The submission must be on letterhead (if submitted on behalf of an organisation), signed and dated.

Upon receipt of the electronic version of the electronic version of submission, the Commission will issue a confirmation email. If this confirmation email is not

received within 3 business days, it is the submitter's responsibility to ensure successful delivery of the submission has occurred.

Lodging a submission by mail

The submission must be on letterhead (if an organisation), signed and dated by the respondent. The submission should be sent by mail to:

Or mail to:
Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

Or by Fax: (02) 8296 7899.

The envelope must be clearly marked with the project reference code: "ERC0090".

Except in circumstances where the submission has been submitted electronically, upon receipt of the hardcopy submission the Commission will issue a confirmation letter. If this confirmation letter is not received within 3 business days, it is the submitter's responsibility to ensure successful delivery of the submission has occurred.