



Australian Energy Market Commission

## **RULE DETERMINATION**

### **National Electricity Amendment (Cost Recovery for Other Services Directions) Rule 2010**

**Rule Proponent(s)**

AEMO

**Commissioners**

Tamblyn  
Henderson

13 May 2010

**JOHN TAMBLYN**

Chairman

For and on behalf of the Australian Energy Market Commission

**RULE  
CHANGE**

## **Inquiries**

Australian Energy Market Commission  
PO Box A2449  
Sydney South NSW 1235

E: [aemc@aemc.gov.au](mailto:aemc@aemc.gov.au)

T: (02) 8296 7800

F: (02) 8296 7899

Reference: ERC0090

## **Citation**

AEMC 2010, Cost Recovery for Other Services Directions, Rule Determination, 13 May 2010 ,  
Sydney

## **About the AEMC**

The Council of Australian Governments, through its Ministerial Council on Energy (MCE), 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 providing advice to the MCE on matters relevant to the national energy markets. We are an independent, national body. 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.

This work is copyright. The Copyright Act 1968 permits fair dealing for study, research, news reporting, criticism and review. Selected passages, tables or diagrams may be reproduced for such purposes provided acknowledgement of the source is included.

## Summary

On 13 March 2009, NEMMCO (now the Australian Energy Market Operator (AEMO)) submitted a request to the Australian Energy Market Commission (Commission) to make a rule regarding cost recovery for “other” services directions.

The Rule Change Request is concerned with rectifying identified problems in the framework for recovery of costs for “other” services directions, specifically the appropriate regional liability for recovered costs, and the basis upon which the proportional liability of participants is calculated.

The Rule Proponent identified two key issues with the way compensation and cost recovery for directions for “other” services is currently treated under the Rules:

- The current methodology does not take into account the regions to which the benefits of the direction accrue, and consequently inappropriately allocates costs to regions that receive no benefit from a direction.
- The current methodology is inconsistent with that for energy and market ancillary services directions, and is based on a reference to the “fixed component of participant fees” which no longer has any firm relevance to current practice.

The Rule Proponent proposed that changes be made to the Rules regarding cost recovery for “other” services so that costs are recovered from:

- the regions that benefit from the direction, determined by applying the regional benefits test; and
- market customers and market generators in the affected region in proportion to their “relevant energy”, rather than in proportion to the largest single fixed component of participants fees.<sup>1</sup>

On 23 July 2009, the Commission published a notice under section 95 of the National Electricity Law (NEL) advising of its intention to commence consideration of the Rule Change Request in accordance with the standard rule change process. The first round of consultation commenced with the publication of a paper, prepared by AEMC staff, identifying specific issues or questions. This first round of consultation closed on 24 August 2009. Two additional rounds of consultation were undertaken on specific issues arising out of submissions, closing on 16 September 2009 and 4 February 2010.

A submission on the Rule Change Request from the National Generators Forum (NGF) proposed an alternative approach to the issues identified by AEMO, placing them within a broader context. The changes put forward by the NGF would introduce additional prescription in the Rules around the circumstances under which AEMO

---

<sup>1</sup> The relevant energy of a market participant is 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. Generator energy and customer energy are terms used in clause 3.15.6A for recovering ancillary service costs.

could classify a direction as a direction for “other” services. While AEMO initially expressed misgivings about specific aspects of the NGF’s alternative approach, the two parties reached an agreed position that would enable both proposals to be implemented in a manner which addressed AEMO’s concerns.

The Commission has concluded that there are problems with the manner in which the framework for "other" services directions operates, particularly with regard to the manner in which directions for services are classified. Accordingly, the Commission has determined to make a Rule. However, rather than make the Rule proposed by the Rule Proponent, the Commission has decided to make a more preferable Rule consistent with the position put forward by both AEMO and the NGF.

The Commission commenced public consultation on its Draft Rule and associated Rule determination on 25 February 2010. Having considered submissions received on the Draft Rule, the Commission has determined to make a final Rule which reflects the Draft Rule, with some minor drafting amendments. The Rule as Made introduces regionalisation of cost recovery for "other" services, as well as additional guidance around the classification of directions for services by AEMO.

The Rule as Made also replaces the reference to the "largest single fixed component of participants fees" with a measurement of "relevant energy" as the basis for determining proportional liability for recovered costs, and introduces limitations on the use of an existing bid price as the basis for determining compensation to a directed participant under clause 3.15.7(g) of the Rules.

The Cost Recovery for Other Services Directions Rule No. 5 will commence on 1 July 2011.

# Contents

<b>1</b>	<b>AEMO's Rule change request.....</b>	<b>1</b>
1.1	The Rule Change Request .....	1
1.2	Rule Change Request rationale .....	1
1.3	Solution proposed by the Rule Change Request .....	1
1.4	Background to the Rule Change Request .....	2
1.5	Commencement of Rule making process .....	5
1.6	Publication of draft Rule determination and Draft Rule .....	5
1.7	Alternative approaches to the issues identified by the Rule Change Proponent.....	5
1.8	Extensions of time.....	6
<b>2</b>	<b>Final Rule Determination.....</b>	<b>7</b>
2.1	Commission's determination .....	7
2.2	Commission's considerations.....	7
2.3	Commission's power to make the Rule .....	8
2.4	Rule making test.....	8
2.5	Other requirements under the NEL .....	9
<b>3</b>	<b>Commission's reasons.....</b>	<b>11</b>
3.1	Assessment.....	11
3.2	Rule as Made .....	12
<b>4</b>	<b>Commission's analytical framework.....</b>	<b>16</b>
4.1	General analytical framework.....	16
4.2	Application of analytical framework for the Rule Change Request .....	17
<b>5</b>	<b>Proposed approaches to the issue .....</b>	<b>19</b>
5.1	The AEMO proposal.....	19
5.2	The NGF alternative .....	20
5.3	The "AEMO-NGF position" .....	21
<b>6</b>	<b>Impact on the classification of directions.....</b>	<b>23</b>
6.1	Rule Change proponent's view .....	23

6.2	Stakeholder views .....	23
6.3	Analysis .....	24
6.4	Conclusion .....	25
<b>7</b>	<b>Impact on the quantum of compensation.....</b>	<b>27</b>
7.1	Rule Change proponent's view .....	27
7.2	Stakeholder views .....	27
7.3	Analysis .....	28
7.4	Conclusion .....	29
<b>8</b>	<b>Impact on the recovery of costs from market participants .....</b>	<b>31</b>
8.1	Rule Change proponent's view .....	31
8.2	Stakeholder views .....	31
8.3	Analysis .....	32
8.4	Conclusion .....	33
	<b>Abbreviations.....</b>	<b>35</b>
<b>A</b>	<b>Summary of issues raised in submissions .....</b>	<b>36</b>
A.1	First round of consultation .....	36
A.2	Second round of consultation.....	41

# 1 AEMO's Rule change request

## 1.1 The Rule Change Request

On 13 March 2009, NEMMCO (now the Australian Energy Market Operator (AEMO)) (Rule Proponent)<sup>2</sup> made a request to the Australian Energy Market Commission (Commission) to make a Rule regarding cost recovery for "other" services directions (Rule Change Request).

The Rule Change Request is concerned with rectifying identified problems in the framework for recovery of costs for "other" services directions, specifically the appropriate regional liability for recovered costs, and the basis upon which the liability of individual participants for these costs is calculated.

## 1.2 Rule Change Request rationale

The Rule Change Request has been prompted by the identification by AEMO of two key issues with the way compensation and cost recovery for directions for "other" services is currently treated under the Rules:

1. The current methodology does not take into account the regions to which the benefits of the direction accrue. Thus, the costs are inappropriately allocated between regions. This results in the costs being inequitably recovered from Registered participants across all regions that do not benefit from the direction. Typically, only Registered participants trading within the region involved in the direction benefit through improved system security.
2. The methodology is inconsistent with that for energy and market ancillary services directions. Given the frequency at which other services directions have been issued to date, and the materiality of such transactions, it is important that the compensation methodology used for "other" services provides an equitable recovery mechanism that is consistent with the methodology used for energy and market ancillary services directions.<sup>3</sup>

## 1.3 Solution proposed by the Rule Change Request

In the Rule Change Request, the Rule Proponent seeks to address the issues identified (and outlined above) by modifying the existing cost recovery methodology applicable to "other" services under clause 3.15.8(g), so that costs are recovered from:

---

<sup>2</sup> AEMO was established on 1 July 2009, and assumed the functions of NEMMCO. AEMO will be referred to as the Rule Proponent in this document.

<sup>3</sup> AEMO Rule Change Proposal, 13 March 2009, p. 4.

- the regions that benefit from the direction, determined by applying the regional benefits test; and
- market customers and market generators in the affected region in proportion to their “relevant energy”, rather than in proportion to the largest single fixed component of participants fees.<sup>4</sup>AEMO has proposed removal of the reference in clause 3.15.8(g) to the “largest single fixed component of participants fees” on the basis that participant fees no longer include a clearly identifiable fixed component.

## 1.4 Background to the Rule Change Request

The Rule Change Request addresses problems identified by AEMO in the existing framework for issuing directions for services under the Rules. The key elements of that framework are outlined in the following sections.

### 1.4.1 AEMO's power to issue directions

Clause 4.8.9 of the Rules gives AEMO the power to direct a registered participant to do any act or thing, if it is 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.

### 1.4.2 Classification of services

Services are only defined in the Rules in terms of their compensation and/or 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 compensated as an energy direction or a Market Ancillary Service (MAS) direction and then only in terms of the relevant cost recovery mechanism.

Directions for “other” services have included directions for:

- network support to remove a localised power system security violation that is remote from the regional reference node;

---

<sup>4</sup> The relevant energy of a market participant is 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. Generator energy and customer energy are terms used in clause 3.15.6A for recovering ancillary service costs.

- reactive power, where the delivery of reactive power and attendant change in active power is considered one all-inclusive service;
- a reduction in generation;
- manual or local frequency control; and
- an increase in scheduled load.

Between 2002<sup>5</sup> 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.<sup>6</sup> Directions for network support have made up the bulk of “other” services directions.

At the time of issuing a direction, AEMO does not specify the type of direction, only the action to be taken by the directed participant. AEMO’s *Operating Procedure for Intervention, Direction and Clause 4.8.9 Instructions* states that “when AEMO issues a direction AEMO will not advise the participant of the “type” i.e. energy or other at the time the direction is issued. AEMO will advise the participant of the physical deliverable requirement and the technical reason for the direction only”.<sup>7</sup>

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”.<sup>8</sup> The type of service, or more specifically, the cost recovery methodology to apply, is determined by AEMO after the situation which precipitated the direction is resolved.<sup>9</sup>

### 1.4.3 Calculation of compensation and liability for recovered costs

Separate methodologies have been established under the Rules for calculation of the compensation payable to directed participants, and the funding of that compensation (i.e. recovery of costs), applicable to each kind of directed service. Table 1.1 summarises these compensation and cost recovery methodologies.

---

<sup>5</sup> The current framework for directed services was introduced in 2002, following consultation by NECA and NEMMCO.

<sup>6</sup> AEMO Rule change proposal, p. 3; Compensation for Network Support directions has been predominantly in the order of \$2.1 to \$4.1 million per annum.

<sup>7</sup> AEMO, *Operating Procedure for Intervention, Direction and Clause 4.8.9 Instructions*, 2009, p. 7.

<sup>8</sup> AEMO, *Operating Procedure Glossary*, 1 July 2009, p. 9.

<sup>9</sup> 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.

**Table 1.1 Compensation and cost recovery methodologies**

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), the Directed Participant is entitled to receive compensation for the provision of a service at a price equal to the price in an existing bid or offer.</p> <p>Participants also have the opportunity to seek additional compensation under 3.15.7B of the Rules, which permits directed participants to make an application to AEMO for additional compensation in accordance with specified criteria.</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	<p>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. Participants have the opportunity to seek additional compensation under 3.15.7B of the Rules, as noted above.</p>	<p>Costs are recovered from all registered participants NEM wide in the same proportion as the largest single fixed component of participant fees.</p>

## **1.5 Commencement of Rule making process**

On 23 July 2009, the Commission published a notice under section 95 of the NEL advising of its intention to commence the Rule change process and the first round of consultation in respect of the Rule Change Request. A consultation paper prepared by Australian Energy Market Commission (AEMC) staff identifying specific issues or questions for consultation was also published with the Rule Change Request. Submissions closed on 24 August 2009.

The Commission received one submission, from the NGF, on the Rule Change Request during the first round of consultation. This consultation was extended in response to issues raised in the NGF submission. A further submission was received, from AEMO, by the close of this additional consultation on 16 September 2009. Two further submissions were received by the Commission from AEMO and the NGF on the 13th and 16th of November 2009 respectively. A summary of the issues raised in first round (and supplementary) submissions and the Commission's response to each issue is contained in Appendix A.1.

## **1.6 Publication of draft Rule determination and Draft Rule**

On 25 February 2010 the Commission published a notice under section 99 of the NEL and a draft Rule determination in relation to the Rule Change Request (Draft Rule Determination). The Draft Rule Determination included a draft Rule (Draft Rule), which was a more preferable Rule.

Submissions on the Draft Rule Determination closed on 8 April 2010. The Commission received two submissions on the Draft Rule Determination, from AEMO and the NGF. Copies of submissions received throughout the consultation process are available on the AEMC website.<sup>10</sup> A summary of the issues raised in second round submissions, and the Commission's response to each issue, is contained in Appendix A.2.

## **1.7 Alternative approaches to the issues identified by the Rule Change Proponent**

In the course of consultation on the Rule Change Request, two additional approaches to addressing the issues identified by AEMO were put forward:

- An alternative approach outlined in the initial submission from the NGF ("the NGF alternative"), which, although not submitted as a formal Rule change request, proposes the introduction of a definition for "other" services directions, in addition to the changes in the Rule Change Request.
- A position subsequently agreed between AEMO and the NGF ("AEMO-NGF position"), although this was not submitted as a formal modification to the Rule

---

<sup>10</sup> [www.aemc.gov.au](http://www.aemc.gov.au)

Change Request or as an additional Rule change request. This agreed position incorporates the changes proposed in the Rule Change Request and in the NGF alternative, plus an additional drafting change.

The three approaches to the issues raised in the Rule Change Request are summarised in Chapter 5.

## **1.8 Extensions of time**

The Commission issued notices under section 107 of the NEL extending the date for publication of its Draft Rule Determination on two occasions:

- On 29 October 2009, a notice was published extending the date for publication of the draft determination until 26 November 2009, in order to allow the Commission additional time to consider new and complex issues arising from submissions from the NGF and AEMO.
- On 26 November 2009, a notice was published extending the date for publication of the draft determination until 25 February 2010, following the receipt of additional submissions from AEMO and the NGF, in order to allow the Commission to conduct additional public consultation on a number of specific issues.

## 2 Final Rule Determination

### 2.1 Commission's determination

In accordance with section 102 of the NEL the Commission has made this final Rule determination in relation to the Rule proposed by AEMO. In accordance with section 103 of the NEL the Commission has determined not to make the Rule proposed by the Rule proponent and to make a more preferable Rule.<sup>11</sup>

The Commission's reasons for making this final Rule determination are set out in section 3.1.

The *National Electricity Amendment (Cost Recovery for Other Services Directions) Rule 2010 No [5]* (Rule as Made) is published with this final Rule determination. The Rule as Made commences on 1 July 2011. The Rule as Made is a more preferable Rule. Its key features are described in section 3.2.

### 2.2 Commission's considerations

In assessing the Rule Change Request the following were taken into account:

- the Commission's powers under the NEL to make the Rule;
- the Rule Change Request;
- submissions received during first round and second rounds of formal consultation;
- submissions received in supplementary rounds of consultation;
- previous consultation, analysis and decisions relating to the framework for directions undertaken by the National Electricity Code Administrator (NECA), NEMMCO and the Australian Competition and Consumer Commission (ACCC); and
- the Commission's analysis as to the ways in which the proposed Rule will, or is likely to, contribute to the achievement of the National Electricity Objective (NEO).

---

<sup>11</sup> Under section 91A of the NEL the AEMC may make a Rule that is different (including materially different) from a market initiated proposed Rule (a more preferable Rule) if the AEMC is satisfied that having regard to the issue or issues that were raised by the market initiated proposed Rule (to which the more preferable Rule relates), the more preferable Rule will or is likely to better contribute to the achievement of the National Electricity Objective

## 2.3 Commission's power to make the Rule

The Commission is satisfied that the Rule as Made falls within the subject matter about which the Commission may make Rules. The Rule as Made falls within the matters set out in section 34 of the NEL as it relates to regulation of:

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

Furthermore, the Rule as Made relates to matters set out in Schedule 1 of the NEL, specifically:

- Item 7 - The setting of prices for electricity and services purchased through the wholesale exchange operated and administered by AEMO, including maximum and minimum prices; and
- Item 8 - The methodology and formulae to be applied in setting prices referred to in item 7.

## 2.4 Rule making test

Under section 88(1) of the NEL the Commission may only make a Rule if it is satisfied that the Rule will, or is likely to, contribute to the achievement of the NEO. This is the decision making framework that the Commission must apply.

The NEO is set out in section 7 of the NEL as follows:

“The objective of this Law is to promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity with respect to:

- (a) price, quality, safety, reliability and security of supply of electricity;  
and
- (b) the reliability, safety and security of the national electricity system.”

Under section 91A, the Commission may make a Rule that is different (including materially different) from a market initiated proposed Rule (a more preferable Rule) if the Commission is satisfied that, having regard to the issue or issues that were raised by the market initiated proposed Rule (to which the more preferable Rule relates), the more preferable Rule will or is likely to better contribute to the achievement of the NEO.

In the case of a more preferable Rule, the Commission is required under section 99(2)(a)(ii) to include in its final determination the reasons it is satisfied the proposed more preferable Rule will or is likely to better contribute to the achievement of the NEO than the market initiated Rule request to which the more preferable Rule relates.

For the Rule Change Request, the Commission considers that the key, relevant aspect of the NEO is the efficient operation and use of electricity services for the long term interests of consumers with respect to reliability, safety and security of supply of electricity.<sup>12</sup>

The framework for directed services, which incorporates the methodology for cost recovery for “other” services directions that is the main subject of the Rule Change Request, is a significant aspect of the powers available to AEMO to intervene in order to ensure the security and reliability of the National Electricity Market (NEM). The Commission is satisfied that the proposed more preferable Rule will, or is likely to, better contribute to the achievement of the NEO for the following reasons, based on the analysis conducted in Chapters 6, 7 and 8:

- Efficiency will be promoted by the inclusion of the proposed guidance in the Rules around the circumstances under which a direction may be classified as an “other” services direction.
- Introduction of regionalisation of cost recovery for "other" services directions similarly results in an incremental improvement in efficiency by promoting a better alignment between the underlying cost of an "other" services direction and the price of supplying that direction in a specific region.
- The Rule as Made removes incentives for directed participants to engage in potentially distortionary bidding or re-bidding behaviour designed to maximise the potential compensation payable to them.
- The Rule as Made supports greater predictability in application across the three classes of direction by regionalising cost recovery for “other” services directions, in the same manner that cost recovery for directions for energy and MAS are regionalised. The promotion of predictability and transparency is a significant principle underlying good regulatory design, which in turn has implications for economic efficiency.

## **2.5 Other requirements under the NEL**

In applying the Rule making test in section 88 of the NEL, the Commission is also required to have regard to any relevant Ministerial Council on Energy (MCE)

---

<sup>12</sup> Under section 88(2), for the purposes of section 88(1) the AEMC may give such weight to any aspect of the NEO as it considers appropriate in all the circumstances, having regard to any relevant MCE statement of policy principles.

Statements of Policy Principles.<sup>13</sup> The Commission has concluded that, with regard to this Rule Change Request, there are no relevant MCE Statements of Policy Principles.

The Commission is required to have regard to, if relevant, form of regulation factors as required under section 88A of the NEL. These factors do not apply in this instance as the Rule Change Request does not relate to the making or revocation of a Rule that specifies an electricity network service as a direct control network service or confers a function or power upon the Australian Energy Regulator (AER). Furthermore, the Rule Change Request does not relate to the regulatory activities undertaken by the AER for the purpose of making or amending a distribution determination or transmission determination or making an access determination.

The Commission is also required under section 88B of the NEL to take into consideration the revenue and pricing principles outlined under section 7A of the NEL, with respect to any matter or thing specified in items 15 to 24 and 25 to 26J of Schedule 1 to the NEL. As the Rule Change Request applies to matters which fall outside these items under Schedule 1, the Commission has determined that the revenue and pricing principles are not relevant in this instance.

---

<sup>13</sup> Under section 33 of the NEL the AEMC must have regard to any relevant MCE statement of policy principles in making a Rule.

### **3 Commission's reasons**

The Commission has analysed the Rule Change Request and assessed the issues/propositions arising out of it. For the reasons set out below, the Commission has determined that a Rule be made. Its analysis of the Rule proposed by AEMO, and the proposed more preferable Rule, is also set out below.

#### **3.1 Assessment**

As noted in Section 1.2, the Rule Change Proponent is seeking to address two key issues with the way cost recovery for "other" services directions is currently treated under the Rules. These issues are regional allocation of costs associated with a direction for "other" services and consistency across cost recovery methodology for all categories of directed service. The Commission has assessed these issues in terms of the inefficient recovery of costs; proportional liability for those costs; and transparency in the application of the directions framework.

##### **3.1.1 Inefficient recovery of costs**

The Commission considers that the costs of directions should be targeted to those who benefit from them in order to promote economic efficiency. The misalignment that exists within the current cost recovery methodology is likely to contribute to inefficiencies in the use of electricity services. The Commission therefore is of the view that a Rule is necessary to address these potential inefficiencies in the application of the framework for "other" services.

The current methodology for "other" services directions inefficiently recovers costs from regions that do not benefit from the direction. Typically, only Registered participants trading within a region involved in the direction benefit through improved system security. The application of the current methodology could result in market participants in non-benefiting regions subsidising the cost of a service for participants in regions that do benefit from the direction. This could distort competitive behaviour and dispatch outcomes in the NEM as market participants in non-benefiting regions may modify their bid prices to recover these costs. In turn, this may, at the margin, reduce the efficiency of wholesale dispatch outcomes compared to the situation resulting from a more efficient allocation of the relevant costs. Distortions in competition could ultimately lead to higher prices being paid by customers.

##### **3.1.2 Determination of proportional liability for recovered costs**

The Commission has determined that, in the interests of maintaining good regulatory practice, a Rule is required to remove the reference to the largest fixed proportion of participant fees in the methodology for determining proportional liability for "other" services.

The current cost recovery methodology utilises the largest fixed proportion of participant fees as the basis for determining proportional liability. The use of this method of allocating liability between customers and generators reflects the absence of an appropriate market mechanism for allocating costs (as exists for energy and MAS directions) and a presumption that “other” services would account for the minority of directions.<sup>14</sup> AEMO participant fees no longer include a clear fixed component (and are, according to AEMO, likely to evolve further over time<sup>15</sup>), rendering this component of the formulation essentially redundant. Maintaining a reference in the Rules to a concept that is inconsistent with accepted current practice or established terminology does not serve to promote good regulatory practice.

### **3.1.3 Transparency in application of the directions framework**

The Commission has concluded that market participants would benefit from a greater degree of certainty and transparency in the Rules around the application of the existing framework for the determination of compensation, and funding of that compensation, for directed services. Introduction of greater transparency and certainty would give participants a better understanding of their obligations and potential risks, as well as their entitlements within the framework for directions.

The submission from the NGF in response to the Rule Change Request, while concurring with the issues raised by AEMO, raised the related issue of the overall operation of the framework for “other” services, and specifically the manner in which AEMO classifies directions for services, which in turn determines the applicable compensation and cost recovery methodology. The framework applicable to “other” services directions is not explicitly set out in the Rules, reflecting, in part, the original intention that the category of “other” services would be a “catch all” category that would constitute only a small proportion of issued directions. Similarly, the reliance on a non-market mechanism for calculating compensation and cost recovery for “other” services directions is also reflective of this intention. While submissions received by the Commission have not provided evidence that this framework has been inappropriately administered by AEMO, the Commission is seeking to address concerns that the lack of certainty around the application of the existing framework could give rise to disputes.

## **3.2 Rule as Made**

Having concluded above that a Rule is required to address the issues identified in the Rule Change Request and the related issues raised in the NGF submission, the Commission has determined that the Rule proposed in the Rule Change Request, while it would adequately address the issues identified by AEMO, will not be sufficient to address the broader issues raised by the NGF.

---

<sup>14</sup> See ACCC determination, *Amendments to the National Electricity Code – Review of Directions in the NEM*, 3 October 2002, p. 18; NECA/NEMMCO, *Final Report, Power System Directions in the National Electricity Market*, 19 May 2000, p. 33

<sup>15</sup> AEMO submission, 7 September 2009, p. 2

The changes put forward by the NGF would, in isolation, not be sufficient to address the issues identified by the Rule Proponent, as they do not directly address the cost recovery methodology for “other” services. The AEMO-NGF position, as articulated in the submissions received from AEMO and the NGF on 13 and 16 November 2009 respectively, would introduce changes that would address all the identified issues without resulting in deleterious effects on the calculation of the quantum of compensation.

Taking these considerations into account, the Commission has determined that a more preferable Rule consistent with the proposed changes put forward in the Rule Change Request and the NGF submission will more effectively address the issues identified. Accordingly, the Rule as Made represents a more preferable Rule.

The Rule as Made:

- introduces regionalisation of cost recovery for "other" services directions through application of a regional benefits test, as per the Rule Change Request;
- introduces a formula in clause 3.15.8(g) for determining proportional liability for recovered costs based on the calculation of "relevant energy"<sup>16</sup>, replacing the existing reference to the "largest single fixed component of participants fees", as per the Rule Change Request;
- puts in place guidance regarding the classification of "other" services directions by AEMO in clause 3.15.7A(a1); and
- introduces a limitation on the operation of clause 3.15.7(d) to situations where there has been a failure of the central dispatch process.

### **3.2.1 Differences between the proposed Rule and the Rule as Made**

The Rule as Made maintains the proposed Rule in its entirety, namely the regionalisation of cost recovery for "other" services and removal of the reference to the fixed component of participant fees.

The Rule as Made incorporates a new clause 3.15.7A(a1) introducing specific guidance to AEMO on the application of the category of “other” services. This functions by ensuring that AEMO may only classify a direction as an “other” services direction if the need for the direction could not be met by a valid dispatch bid, dispatch offer or re-bid at the location, had such a bid or offer been made. The introduction of this guidance regarding classification of "other" services was proposed as part of the NGF alternative.

---

<sup>16</sup> Where the relevant energy of a market participant is 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. Generator energy and customer energy are terms defined in clause 3.15.6A in relation to ancillary service transactions. These definitions have been carried over into the Rule as Made.

The Rule as Made also incorporates an amendment to clause 3.15.7(d), which restricts the circumstances in which clause 3.15.7(d) can be invoked in order to allow compensation to directed participants to be based on an existing bid. Under this revised clause, participants are only entitled to receive compensation for the provision of a service at a price equal to the price in an acknowledged dispatch bid, dispatch offer or rebid where a direction was issued because AEMO was prevented from dispatching the Directed Participant's plant in accordance with that dispatch bid, dispatch offer or rebid due to a failure of the central dispatch process. This amendment was proposed in the AEMO-NGF position.

### 3.2.2 Difference between the Draft Rule and Rule as Made

The Rule as Made maintains the Draft Rule, with two minor drafting amendments in clause 3.15.7A(a1) designed to provide additional clarity regarding the intent of the clause. Clause 3.15.7A(a1) has been redrafted to include the following:

#### 3.15.7A Payment to Directed Participants

(a1) In this clause 3.15.7A, a *direction* is a *direction* for services other than *energy* and *market ancillary services* to the extent that the need for the *direction* could not have been avoided by the *central dispatch* process had there been a valid ~~using a dispatch bid, or dispatch offer~~ which AEMO has acknowledged as valid in accordance with clause 3.8.8(a) or rebid as accepted in accordance with clause 3.8.22(e) or rebid for dispatch of the plant subject to direction in accordance with clause 3.8.8 made consistent with the requirements of clauses 3.8.6, 3.8.6A, 3.8.7, 3.8.7A or 3.8.8(d) (whichever is applicable) for dispatch of plant relevant to that direction for one or more of the following services:

- (1) *energy*; and
- (2) any *market ancillary service*.

This drafting change will ensure that a direction is defined by reference to the kind of service it is replacing (i.e. a service that could be "hypothetically" offered), rather than replacing an actual offer in place. The amendment to the draft Rule was made in response to concerns raised by the NGF and AEMO in their second round submissions regarding the reference in the Draft Rule to bids, offers or rebids "acknowledged by AEMO in accordance with clause 3.8.8". The NGF commented that this expression may be interpreted as a reference to an actual bid or offer, rather than to a "hypothetical" bid or offer applying at the location of the directed plant. This position was echoed by AEMO, though the use of the term "hypothetical" was not supported.

### **3.2.3 Implementation and transitional arrangements**

The Rule as Made will commence on 1 July 2011 in order to allow AEMO sufficient time to make the necessary changes to its operating systems and processes.

Compensation and cost recovery processes arising out of directions issued prior to the commencement date will be reconciled in accordance with the framework under the current Rules. Specifically, the new clauses 3.15.7(d), 5.15.7A(a1) and (a2), and 3.15.8(g) will not apply to any process initiated under the Rules or action taken with reference to clause 3.15.7(d) or clause 3.15.8(g), and not completed by the commencement date.

## 4 Commission's analytical framework

This chapter describes the analytical framework that the Commission has applied to assess the Rule Change Request in accordance with the requirements set out in the NEL (and explained in Chapter 2).

### 4.1 General analytical framework

As noted in section 2.4, the Commission may give such weight to any aspect of the NEO as it considers appropriate in all the circumstances. For this Rule Change Request, the Commission considers it appropriate to give weight to the following aspect of the NEO: the efficient operation and use of electricity services for the long term interests of consumers with respect to reliability, safety and security of supply of electricity.

Economic efficiency is a concept central to the NEO. As the Commission has discussed in relation to previous Rule change requests, economic efficiency is commonly considered to have three elements:

- Productive efficiency - e.g. the electricity market should be operated on a least cost basis given the existing and likely network and other infrastructure;
- Allocative efficiency - e.g. electricity generation and consumption decisions should be based on prices that reflect the opportunity cost of the available resources; and
- Dynamic efficiency - e.g. ongoing productive and allocative efficiency should be maximised over time. Dynamic efficiency is commonly linked to the promotion of efficient long-term investment decisions.

In the context of regulated energy markets, a relevant consideration is the extent and form of market intervention. Interventions in the operation of the market should be minimised. This enables resources to be allocated primarily on the basis of prices established through market mechanisms, hence supporting productive, allocative and dynamic efficiency.

The Commission also seeks to apply principles of good regulatory design and practice as it considers that the NEO has implications for the means by which the regulatory arrangements operate (in addition to their ends). In applying these principles, the Commission seeks to have regard to the need, where practicable to:

- promote stability and predictability - market Rules should be stable, or changes to them predictable, so that participants and investors can plan and make informed short and long-term decisions; and
- promote transparency - to the extent that intervention in the market is required, it should be based on, and applied according to, transparent criteria.

## 4.2 Application of analytical framework for the Rule Change Request

In the present circumstances the application of this analytical framework has involved focusing on the following issues:

- The current framework for directions including recovery of costs, perceived problems with the existing cost recovery methodology and their implications for outcomes that may be inconsistent with the NEO.
- The changes to the cost recovery methodology for “other” services proposed by AEMO and the impact of these changes on the overall framework for directions for services.
- The changes to the cost recovery methodology put forward in the alternative approach proposed by the NGF and the position agreed by AEMO and the NGF, and the overall impact of these changes on the framework for directed services.
- The likely impact of the proposed changes on economic efficiency, and in particular the efficiency of the cost recovery methodology for "other" services, having regard to the implications of the proposed changes for:
  - the classification of directed services;
  - the quantum of compensation paid to directed participant; and
  - the recovery, from market participants, of costs arising from the payment of compensation.

The Commission has focused on this set of issues because:

- These issues represent constitutive elements of the framework for directions for services.
- While it is a discrete element, the recovery of costs for “other” services directions forms an intrinsic part of the function and impact of the overall framework for directions for services under the Rules.
- Accordingly, while it would be possible to examine the methodology for cost recovery for “other” services in isolation, any change to this process will potentially have flow on effects for the operation of the overall framework, particularly if alternative approaches to the issues identified by AEMO are considered.
- The issues listed above represent the key areas where a change to a specific element of the framework (namely the manner in which the recovery of costs is determined) is likely to have an impact.

In addition to the elements of the statutory Rule change process adhered to by the Commission, the application of the Commission’s analytical framework in this instance has involved the following tasks and methods:

- Additional public consultation, including the publication of a second staff consultation paper, in order to ensure that stakeholders have the opportunity to publicly comment on specific issues arising from the various submissions made by AEMO and the NGF, and in particular the agreed position reached by both parties.
- Reference to previous analysis, consultation and decisions on the framework for directions by NECA, ACCC and NEMMCO.

## 5 Proposed approaches to the issue

In its Rule Change Request, AEMO identified a number of problems with the existing approach to recovery of costs for “other” services directions, which fall out of the framework for directions for services. Specifically, AEMO stated that:

- The existing framework for cost recovery for “other” services directions inefficiently allocates costs to participants in regions that do not actually benefit from the direction (ie costs are recovered from participants in all regions in the NEM).
- The current formula for calculating the individual cost liability of market participants is based, in part, on the concept of “fixed proportion of participant fees”. This concept is no longer appropriate, as participant fees do not include a clear fixed component, and the structure of participant fees is likely to evolve over time.

The Rule Change Request, the submissions received from the NGF during consultation, and supplementary submissions from AEMO proposed a number of changes to the existing methodology for cost recovery for “other” services, and to the framework for directions more broadly. As noted previously, there are three separate approaches to addressing perceived shortcomings in the framework for directed services that are the subject of the Commission’s analysis:

- the AEMO proposal (the Rule Change Request);
- the NGF alternative; and
- the “AEMO-NGF position”.

In order to assess the Rule Change Request, the Commission has considered the impact of the three approaches put forward as part of its overall analytical framework. The following sections outline these three approaches. Subsequent chapters address the impact of these approaches on the specific elements of the directions framework, namely:

- the classification of directions by AEMO;
- the quantum of compensation payable to a directed participant; and
- the recovery of the costs arising out of that compensation.

### 5.1 The AEMO proposal

In its Rule Change Proposal, AEMO proposed two key changes to the cost recovery methodology for “other” services directions:

- 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 clearly identifiable fixed component. This would be replaced by the concept of "relevant energy" as the basis for determining proportional liability.

Relevant energy is defined 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.<sup>17</sup>"

In its subsequent submissions, AEMO did not directly address the NGF's argument that the substantive issue at question is the approach to classification of services, but instead limited its commentary to issues arising out of the changes proposed by the NGF.

## 5.2 The NGF alternative

The NGF, while it did not disagree with the solution put forward by AEMO regarding cost recovery for "other" services directions, argued that the core issue that should be addressed is how directed services are classified by AEMO. This classification in turn determines the application of compensation and cost recovery methodologies. On this basis, the NGF proposed a wider set of changes to the Rules than those included in the original Rule Change Request.

The NGF contends that the majority of directions determined by AEMO to be for "other" services should in fact be considered directions for energy, and compensated as such. NGF's position is derived primarily from the assumption that as neither "energy direction" or "other services 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, NGF is of the view that this category is the main subject of the AEMO rule change proposal.<sup>18</sup>

The NGF proposed an alternative approach to the issues arising out of the application of the framework for "other" services directions. Under this alternative approach, the Rules would be amended to insert a new clause 3.15.7A(a1) defining the circumstances under which a direction could be classified by AEMO as direction for an "other" service. A direction would be defined as a direction for "other" services only if the

---

<sup>17</sup> NEMMCO (now AEMO) Rule change proposal, 13 March 2009, p. 4

<sup>18</sup> NGF Submission, 24 August 2009, p. 1

direction could not have been avoided by the central dispatch process utilising, in the NGF's terminology, a "hypothetical market offer".<sup>19</sup>

### 5.2.1 The NGF's "second alternative"

The NGF also put forward a second alternative approach to the identified issue, under which the cost recovery methodology for "other" services would be aligned with that for "energy", effectively removing "other" as a discrete category of cost recovery.

The NGF's second alternative approach, while ostensibly addressing the issues raised by AEMO regarding the operation of the cost recovery methodology for "other" services, represents a far more sweeping set of changes to the entire framework for directed services. By utilising the same cost recovery mechanism for energy and "other" services, the NGF's second alternative would effectively remove "other" services as a cost recovery category.<sup>20</sup> The Commission is of the view that this approach would be inconsistent with the initial intention behind establishing a separate cost recovery methodology (as noted in AEMO's 7 September submission). The methodology for "other" services was intended to be used where no existing market mechanism could be utilised.

Furthermore, the Commission concurs with AEMO's assessment that the proposed alignment of cost recovery methodology for "other" services directions with that for energy services would result in generators being largely exempt from cost recovery arising of out directions, including directions for manual frequency control and reactive support.<sup>21</sup>

The Commission has concluded that the changes proposed in the NGF's second alternative, and in particular consideration of the impact of removing "other" services as a discrete category of cost recovery, are outside the scope of the Rule change proposal and accordingly has determined not to consider it alongside the other approaches.

## 5.3 The "AEMO-NGF position"

The position put forward jointly by AEMO and the NGF (the AEMO-NGF position), articulated in submissions from AEMO and the NGF lodged in November, incorporates:

- the changes proposed by AEMO in its Rule change proposal and outlined above; and

---

<sup>19</sup> Hypothetical market offer was not defined in the NGF's submission.

<sup>20</sup> As the categories of directed service are only defined in the Rules in terms of their cost recovery methodology, this alignment of methodology for "other" and energy services directions would arguably also have the effect of removing "other" as a differentiated category of direction.

<sup>21</sup> Generators would still be liable for recovered costs relating to Contingency (raise) FCAS or a proportion of Regulation FCAS, in accordance with established market mechanisms.

- the changes proposed under the NGF's alternative approach outlined above.

In addition, the AEMO-NGF position would introduce amendments to the drafting of clause 3.15.7(d)<sup>22</sup> which would restrict its applicability to situations where a failure of AEMO's dispatch systems has prevented the normal dispatch of that requested service.

---

<sup>22</sup> As noted previously, 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).

## 6 Impact on the classification of directions

The applicable methodology for recovery of costs arising out of the payment of compensation to directed participants is determined as a result of AEMO's classification of a direction. Changes to the classification of directions will have an impact on the application of the cost recovery methodology. Similarly, changes to the cost recovery methodology may have flow on effects for the operation of the overall framework for directions for services.

### 6.1 Rule Change proponent's view

The Rule Change Request did not directly address the manner in which directions are classified. In its submission of 7 September, made in response to the NGF's initial submission, AEMO largely remained silent on the manner in which directions are classified, but did express concern that the NGF alternative would have a deleterious impact on the quantum of compensation.

AEMO's 13 November submission offered support for the inclusion of the changes proposed by the NGF to the classification of "other" services directions, with the caveat that the operation of 3.15.7(d) be circumscribed.<sup>23</sup>

### 6.2 Stakeholder views

#### 6.2.1 First round submissions

In its submissions made during the first and supplementary consultation rounds, the NGF has argued that the classification of services as the core issue of the Rule Change Request, and in particular, given the proportion of directions that have been classified as "other" services to date, the classification of "other" services. In its 24 August submission, the NGF stated that the categorisation of the majority of directions as "other" services through the application of the existing framework for cost recovery "has not been in accordance with the intention of the Rules".<sup>24</sup> The NGF proposed the introduction into the Rules of a clarification of the circumstances in which AEMO may classify a direction as an "other" service as a means of addressing this related issue.

#### 6.2.2 Second round submissions

The second round submission from the NGF raised concerns regarding the drafting of clause 3.15.7A(a1) in the Draft Rule, which determines the circumstances under which AEMO may classify a direction as an "other" services direction.<sup>25</sup> NGF believes that

---

<sup>23</sup> AEMO initially took the position that this clause should be deleted. AEMO submission, 7 September 2009, p. 3.

<sup>24</sup> NGF submission, 24 August 2009, p. 2.

<sup>25</sup> NGF Second Round Submission, 31 March 2010, p. 1

the Draft Rule, by referring to bids, offers or rebids “acknowledged by AEMO in accordance with clause 3.8.8”, may be interpreted as a reference to an actual bid or offer, rather than to a “hypothetical” bid or offer applying at the location of the directed plant.

In the NGF’s view, the existence of an actual offer or bid at the location would avoid the need for the direction in the first instance, as this bid or offer would be dispatched by AEMO. Classifying a bid with reference to a “hypothetical market offer” ensures that the direction is defined by reference to the kind of service it is replacing (i.e. a service that could be hypothetically offered), rather than replacing an actual offer that has been made and acknowledged by AEMO. AEMO, in its submission of 8 April 2010, supported the NGF’s position on this issue, though raised concerns that use of “hypothetical” may “make the Rule unintentionally broad”.<sup>26</sup>

## **6.3 Analysis**

### **6.3.1 Impact of the AEMO proposal**

The AEMO proposal does not directly address the classification of directed services, but focuses on what it considers to be an issue with the cost recovery methodology applicable to “other” services. The Rule Change Proposal would not alter the current approach to classification of directions.

### **6.3.2 Impact of the NGF alternative**

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.

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 at that location could not conceivably have a bid or offer in place for energy or MAS that could fulfil the technical needs of the direction. This approach would reinforce the intention that compensation and cost recovery of directions should be determined through market mechanisms in the first instance, leaving “other” services as a category of last resort. 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 mechanism.<sup>27</sup>

---

<sup>26</sup> AEMO Second Round submission, 8 April 2010, p. 1

<sup>27</sup> On page 18 of its determination dated 3 October 2002, the ACCC noted that the proposed methodology for cost recovery for “other” services under 3.15.8(g) is a “catch all” to ensure that “if

The NGF alternative would ensure that a greater level of clarity and certainty applies to directions for energy and “other” services. This will in turn provide additional certainty for participants who may be subject to compensation and/or cost recovery mechanisms and reduce the likelihood that a market participant will enter into a dispute with the market operator over the classification of a directed service (and consequently, the compensation and cost recovery methodologies applied). This clarity will also reduce the risks associated with uncertainty over the classification of directions, and the costs attached to those risks.

The existing approach to classification carries with it an inherent risk for generators, as remuneration associated with complying with a direction can vary depending on how AEMO ultimately classifies a direction. This risk, however small, will be priced accordingly by generators, and reflected in offer and contracts prices more generally. Reducing or removing this risk, by ensuring a greater degree of certainty and transparency for directed participants, will reduce this risk and consequently reduce costs for generators and promote productive efficiency.

### **6.3.3 Impact of the AEMO-NGF position**

The AEMO-NGF position would introduce into the Rules a definition for “other” services directions as suggested by the NGF, as well as an amendment to 3.15.7(d) which would reduce the incentives for directed participants to engage in profit maximising bidding behaviour. The drafting amendment to 3.15.7(d) suggested by AEMO would not affect the functioning of the definition suggested by the NGF.

## **6.4 Conclusion**

The Commission has concluded that the introduction of guidance regarding classification of services, which would result in the majority of directions being classified as directions for energy services, has two key efficiency benefits, which will better promote the achievement of the NEO:

- Promotion of an efficient alignment between the beneficiaries of a direction and the recovery of costs arising out of that direction, by ensuring that only those participants that directly benefit from a direction are expected to contribute to its cost and that the prices charged to those participants reflect the underlying cost within that region.
- Promotion of good regulatory practice and efficient use of electricity services by ensuring that where a direction for a service replaces a service that would ordinarily be provided through the market, existing market mechanisms are used

---

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”. Contrary to this principle, 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.

to determine payable compensation and cost recovery liability. This minimises the degree of intervention in market processes.

The Commission has also concluded that introduction of greater guidance regarding the circumstances under which a direction may be classified as a direction for an “other” service will lead to greater regulatory certainty and predictability for directed participants and market participants, which in turn places a downward pressure on costs associated with managing risk and regulatory compliance and promotes productive efficiency benefits.

## **7 Impact on the quantum of compensation**

Changes to the framework for directions that affect, or have the potential to affect, the total quantum of compensation payable to directed participants have a number of implications for market participants. Accordingly, when assessing the changes proposed in the Rule Change Request, and those contained in the NGF alternative, the impact on the calculation of compensation is an important consideration.

### **7.1 Rule Change proponent's view**

AEMO's Rule change proposal did not directly address the methodology for the calculation of the compensation payable to directed participants under the Rules. The changes contained in the Rule Change Request would not directly affect the quantum of compensation for any of the categories of directed service.

### **7.2 Stakeholder views**

#### **7.2.1 First round of consultation**

The NGF did not directly propose changes to the manner in which compensation for directed participants is calculated. Similarly, the NGF did not offer a view on the existing compensation methodology, other than to note that the classification of directions ultimately affects the calculation of both compensation and the funding of that compensation.

AEMO's response to the NGF alternative raised concerns about the resulting changes to the potential quantum of compensation, particularly in situations where a directed participant utilises an existing bid and re-bid as the basis for calculating the prevailing market price under clause 3.15.7(d). AEMO was of the view that consideration of the NGF alternative must "address the compensation quantum issue arising from Rule 3.15.7(d)", and proposed that this clause be removed in order to resolve this issue.<sup>28</sup> The subsequent submission from AEMO on 13 November 2009 (in which it confirmed its support for the AEMO-NGF position) proposed an amendment to 3.15.7(d) that would restrict its operation, rather than providing for its complete deletion. The NGF, in its 16 November 2009 submission, expressed support for AEMO's amendment to clause 3.15.7(d).

#### **7.2.2 Second round of consultation**

The calculation of compensation to directed participants was not directly addressed in second round submissions.

---

<sup>28</sup> AEMO submission, 7 September 2009, p. 3

## **7.3 Analysis**

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 Rules. 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 the price for that service over the previous 12 months.

### **7.3.1 Impact of the AEMO proposal**

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.

### **7.3.2 Impact of the NGF alternative**

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 shift would result in the potential quantum of compensation for what would, to date, have been classed as directions for “other” services changing due to the effect of clause 3.15.7(d).<sup>29</sup> This clause allows directed market participants who have a valid bid, offer or rebid for 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 shift to utilisation of the energy category would ensure that compensated is calculated on the basis of an efficient market price. This change in methodology may, however, create additional incentives for directed participants to engage in inappropriate behaviour which would maximise their received compensation, to the possible detriment of the rest of the market and network security.

### **7.3.3 Impact of the AEMO-NGF position**

The AEMO-NGF position, by implementing aspects of 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, the AEMO-NGF position would also restrict the circumstances under which clause 3.15.7(d) could operate, effectively limiting payable compensation to the formulae 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

---

<sup>29</sup> Noting that, to date, “other” services directions have accounted for 90 per cent of issued directions.

for determining compensation, as allowed under 3.15.7(d), except in situations where there has been a failure of AEMO's dispatch processes.

Restricting the application of 3.15.7(d) would remove incentives for particular kinds of bidding or re-bidding behaviour designed to maximise compensation arising from a direction, which can result in an inefficient divergence between the underlying cost (to the directed participant) of supply and the price paid (by other participants) for that supply. This reflects the intention contained in the final report from NEMMCO and NECA arising out of the 2000 review of directions:

“The methodology by which “fair payment” is determined will be clearly laid down in the Code in advance, and will aim to provide a payment to at least restore the pre-direction position of the participant, while also aiming to guarantee that no abnormally high profits can be gained through being directed.<sup>30</sup>”

Ensuring that directed participants are not able to engage in activities designed to maximise compensation would remove significant potential market distortions and allow participants to better manage their exposure to the cost of a direction issued by AEMO.<sup>31</sup> The proposed amendment to 3.15.7(d) would also address the issues raised by AEMO in its submission of 7 September 2009 regarding incentives for generators to react slowly to dispatch instructions in situations where their short run average costs are greater than the market settlement at the regional reference price.<sup>32</sup> Furthermore, restriction of the operation of 3.15.7(d) would reinforce the principle that compliance with directions is an obligation placed upon participants in the interests of maintaining system security rather than an opportunity for rent seeking behaviour.

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

## 7.4 Conclusion

The Commission has concluded that the restriction on the application of clause 3.15.7(d) proposed under the AEMO-NGF position would place an appropriate limit on the possible quantum of compensation payable, consistent with the overall intention that compensation should reflect a fair market price based on the cost of providing the service. This restriction would remove incentives for directed participants to engage in bidding or re-bidding behaviour designed to maximise the potential compensation payable to them. This removal of incentives has an identifiable

---

<sup>30</sup> NECA/NEMMCO *Final Report, Power System Directions in the National Electricity Market*, 19 May 2000, p. 35.

<sup>31</sup> NEMMCO/NECA noted that “Distortion will occur if the balance of risk and reward under direction provides an incentive for participants who can reasonably participate in the market at a time when they are likely to be directed to re-enter and receive a higher effective return”. See NEMMCO/NECA, *Joint Market Direction Review: Issues and Principles*, November 1999, p. 7.

<sup>32</sup> See AEMO submission, 7 September 2009, p. 3.

efficiency benefit in ensuring that prices for supply reflect as much as possible the cost of that supply. Accordingly, with regards to the calculation of compensation, the AEMO-NGF position is more likely to contribute to the achievement of the NEO than the approach put forward individually in the Rule change proposal and the NGF alternative.

## 8 Impact on the recovery of costs from market participants

The Rule Change Proposal, and subsequent submissions, raise the issue of how the costs associated with compensation for directed participants, and in particular directions for “other” services, are recovered from the market. This is an important consideration as it has potential implications for all market participants.

### 8.1 Rule Change proponent's view

The Rule Change Request addresses the recovery of costs from market participants by introducing regionalisation of cost recovery for “other” directions. In AEMO’s view, this establishes a more appropriate degree of consistency between the three categories of direction, and “promotes a more appropriate allocation of compensation costs between regions and ensures costs are passed through to Market Participants who benefit directly from consequences of the direction”.<sup>33</sup>

### 8.2 Stakeholder views

#### 8.2.1 First round submissions

As noted previously, the NGF questioned the historical categorisation of the majority of directions as “other” services<sup>34</sup> and proposed greater prescription around the classification of a direction as an “other” service by AEMO. This guidance, which would result in the bulk of directions classified as directions for energy, would leave customers solely responsible for funding compensation. The NGF contends that this shift is appropriate, on the basis that:

- The Rules provide for recovery of costs arising out of energy or MAS directions 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 relating to market interventions are based on “the concept of leaving generators unaffected by the intervention”.
- This change would be consistent with the current funding provisions that apply to energy and MAS directions, wherein only those participants benefiting from the direction (ie market customers in the benefiting region) are expected to pay.<sup>35</sup>

AEMO questioned the NGF’s statements regarding customers exclusively carrying the burden of recovery of compensation costs for ancillary services, and that pricing and

---

<sup>33</sup> AEMO Rule Change Proposal, p. 5.

<sup>34</sup> NGF submission, 24 August 2009, p. 2.

<sup>35</sup> NGF submission, 24 August 2009, p. 2.

compensation in the event of a market intervention are based on the concept of leaving generators unaffected by the intervention.<sup>36</sup>

## 8.2.2 Second round submissions

The issue of recovery of costs arising out of payment of compensation to directed participants was not directly addressed in second round submissions.

## 8.3 Analysis

### 8.3.1 Impact of the AEMO Proposal

The AEMO proposal 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 regionalisation (through the application of a regional benefits test). Conversely, participants in non-benefiting regions will no longer be obliged to contribute to the recovery of compensation costs. This is consistent with the approach in place for directions for energy and MAS, and with the general principle outlined in work undertaken by NECA and NEMMCO establishing the current framework for directions:

“Where the direction is made solely for the benefit of one region, then the funding should be limited to the participants in the affected region, rather than all market participants.<sup>37</sup>”

The proposed use of “relevant energy”, in place of the current reference to the largest fixed component of participant fees as the basis for determining proportional liability, utilises existing terms established in clause 3.15.6A for the calculation of costs arising out of ancillary services transactions. The existing approach was originally adopted by NECA and the ACCC in the absence of an appropriate market mechanism. AEMO contends that the move to basing proportional allocation on “relevant energy” would result in a split between generators and customers that is consistent with the current distribution of cost recovery across participant classes, though it would result in generators, overall, bearing a slightly larger proportion of costs.<sup>38</sup>

---

<sup>36</sup> AEMO Submission, 7 September 2009, p. 2.

<sup>37</sup> NEMMCO/NECA, *Final Report, Power System Directions in the National Electricity Market*, 19 May 2000 p. 35.

<sup>38</sup> 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). Based on information provided by 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 a 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. Combined with the introduction of regionalisation, generators would, overall, pay a greater proportion of an overall larger cost liability, though equally, generators (and customers) in unaffected regions will have no liability.

### 8.3.2 Impact of the NGF alternative

The NGF alternative would result in the majority of directions currently compensated as “other” services being treated as energy directions. This would shift the bulk of the overall cost recovery burden from all market participants in all regions, as applies currently to “other” services directions, which have historically accounted for the bulk of directions, to benefiting market customers only.<sup>39</sup> As a result, market customers would bear greater responsibility for funding of directed services overall.

While the NGF’s argument that the Rules provide for costs relating to energy or MAS directions to be recovered exclusively from customers is not borne out, as certain categories of FCAS are recovered from generators<sup>40</sup>, there is a case in support of the view that customers are the main beneficiaries of directions, primarily through the avoidance of load shedding. The expectation that customers, as the main beneficiaries, should bear the costs associated with a direction also reflects the general principle that the same party that would pay for the service under normal market conditions (ie the dispatch of energy) should be the one to pay where a similar service is directed:

“Payments to directed parties and compensation to third parties should be funded from the sector(s) of the market that would normally meet the costs of the service concerned. Where no normal market mechanism exists for the directed service, payments should be funded using the same methodology used for allocating the fixed component of pool fees.<sup>41</sup>”

The NGF alternative does not propose changes to the existing methodology for recovery of costs relating to “other” services, instead offering support for the Rule Change Request on that specific issue.

### 8.3.3 Impact of the AEMO-NGF position

The 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 7.3.3), but otherwise would result in the effects of both the AEMO proposal and the NGF alternative on the calculation of compensation, as noted above, remaining unchanged.

## 8.4 Conclusion

The existing inefficient allocation of costs to participants in non-benefiting regions can lead to distortions in competition and inefficient pricing outcomes to the detriment of consumers. The Commission has concluded that the introduction of regionalisation of cost recovery for “other” services directions as proposed by AEMO (and included in the

---

<sup>39</sup> Energy directions are already subject to a regional benefits test.

<sup>40</sup> Costs for contingency FCAS (raise) is recovered from market generators, and regulation FCAS is recovered from customers (54 per cent) and generators (46 per cent).

<sup>41</sup> NEMMCO/NECA, *Final Report, Power System Directions in the National Electricity Market*, 2000, p. 35.

AEMO-NGF position), would result in an incremental improvement in efficiency. This improvement would be achieved through the promotion of a better alignment between the underlying cost of an "other" services direction and the price of supplying that direction in a specific region. Ensuring that the majority of directions are classified as energy services would also result in a shift in the current cost recovery burden predominantly to market customers. The Commission has concluded that, taking into account the main beneficiaries of a direction, this would be an appropriate shift which would also reflect the original intention of the framework for directions for services.

The Commission is also of the view that regionalisation of cost recovery for "other" services directions, in the same manner that cost recovery for directions for energy and MAS are regionalised, supports greater predictability in application across the three classes of direction. The promotion of predictability and transparency is a significant principle underlying good regulatory design, which in turn has implications for economic efficiency.

## Abbreviations

ACCC	Australian Competition and Consumer Commission
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
Commission	Australian Energy Market Commission
MAS	Market Ancillary Service
MCE	Ministerial Council on Energy
NECA	National Electricity Code Administrator
NEL	National Electricity Law
NEM	National Electricity Market
NEO	National Electricity Objective
NGF	National Generators Forum

## A Summary of issues raised in submissions

### A.1 First round of consultation

Stakeholder	Issue	AEMC response
NGF	<p>The NGF does not oppose the Rule change but believes that a further change beyond that now proposed would be desirable.</p> <p>NGF is primarily concerned about classification of directions as either for the “provision of energy or market ancillary services” or alternatively for “services other than energy and market ancillary services”. The classification process affects both the calculation of compensation and funding of that compensation. (NGF submission, 24 August 2009, p. 1)</p>	<p>Agree that classification of services is relevant to Rule change proposal.</p> <p>Analysis of the Rules and the operation of the classification framework suggests an absence of clarity which would be open to possible dispute , though AEMO needs to retain a degree of discretion.</p> <p>This has been addressed in Rule by incorporating amendments to classification framework.</p>
NGF	<p>NGF notes that network support directions account for a large fraction of the total cost incurred in compensation for directions. Hence this disputed category is the main subject of the NEMMCO Rule change proposal. (NGF submission, 24 August 2009, p. 1 )</p>	<p>Network support has been the most frequent “other” service to date; however focusing specifically on a particular type of direction (ie on a technical basis) may not be appropriate when determining changes to the overall framework as it is not possible to guarantee that this will be the case into the future. It is more appropriate to take a higher level approach to analysis.</p>
NGF	<p>NGF submits that within the ordinary meaning of the words, majority of directions involve no activity other than the production of energy by the directed participant.</p>	<p>Agree that there is a lack of clear definition in the Rules around these terms; however it is not entirely clear that an “ordinary meaning” interpretation would be appropriate as it would not</p>

Stakeholder	Issue	AEMC response
	<p>NGF contends that the classification of a direction should be based on the nature of the dispatch outcome that it substitutes for. "Other" category should apply only when the direction does not substitute for the dispatch of energy and/or market ancillary services. (NGF submission, 24 August 2009, p. 3)</p>	<p>take into account all the characteristics of the circumstances precipitating a direction.</p> <p>Utilising the idea of substitution as a basis for determining classification appears to have merit. The NGF's proposal reflects principles outlined by NECA and NEMMCO in the previous review of the directions framework.</p>
NGF	<p>NGF is primarily concerned with restoration of funding arrangements for directions in keeping with "the clear intention of the current Rules."</p> <p>NGF proposes that this be done by inserting a new clause defining the "other" classification and clarifying the consequences of assigning a direction to this classification. (NGF submission, 24 August 2009, p. 3)</p>	<p>Drafting proposed by NGF would introduce additional clarity regarding classification of directions, without unduly restricting AEMO discretion.</p> <p>However, it will have an impact on the quantum of compensation.</p> <p>NGF proposal has been incorporated into the draft Rule.</p>
NGF	<p>Cost recovery provisions for "other" category should be aligned with the cost recovery already specified for directions for energy or market ancillary services.</p> <p>This would lead to cost recovery from market customers only, which would be consistent with beneficiary pays model.</p> <p>This change would also reduce the consequences of the market operator deciding to classify a direction one way or the other, since the cost recovery process would then be independent of this classification. (NGF submission, 24 August</p>	<p>Beneficiary pays, while appropriate in some circumstances, is not a consistent theme throughout the Rules. This picks up one of the points in the NECA/NEMMCO report, which concluded a beneficiary pays approach was not always appropriate, particularly in relation to "other" services where it may not be possible to clearly identify a beneficiary.</p>

Stakeholder	Issue	AEMC response
	2009, p. 4)	
AEMO	The NGF states that the recovery of compensation costs for ancillary service directions is carried exclusively by market customers. The Rules provide that these costs are recovered on the same basis as the market costs for these services. (AEMO submission, 7 September 2009, p. 2)	Analysis supports AEMO's assessment that compensation costs are not borne solely by customers as some FCAS is clearly funded by generators.
AEMO	The concept of leaving scheduled plant in the same position as if the direction had not occurred has some basis in the Rules relating to affected participants and intervention pricing. However there is no "concept of leaving generators unaffected by the intervention". The compensation recovery arrangements for "energy", "ancillary service" and "other service" directions are all different. (AEMO submission, 7 September 2009, p. 2)	Analysis supports AEMO's assessment. It is unclear to what the NGF is referring regarding leaving generators unaffected, though the previous NECA/NEMMCO analysis does refer generators being left "no worse off" with regard to obeying a direction (see NECA/NEMMCO Final Report, May 2000).
AEMO	<p>AEMO recognises that if a valid bid or offer is in place, then the need to direct should not occur.</p> <p>Scheduled participants are obliged to follow dispatch instructions and be constrained on without compensation if network security demands it. However, some scheduled generators can be slow in following dispatch instructions to generate if their short run average costs are more than the market settlement at the regional reference price. AEMO is forced to direct promptly to restore system security within prescribed time limits - there is little time for the formal replacement of a dispatch offer to which the generator does not comply. (AEMO</p>	<p>Agree that this is a valid issue. Incentives for generators to engage in bidding activities (eg the replacement of a bid) designed to maximise profits should be minimised in this context, as this could result in a delay in responding to an AEMO direction.</p> <p>Final Rule incorporates a provision to minimise incentives for this kind of behaviour in response to a direction.</p>

Stakeholder	Issue	AEMC response
	submission, 7 September 2009, p. 3)	
AEMO	<p>Consideration of the NGF proposal must address the compensation quantum issue arising from Rule 3.15.7(d). Removal of that clause would resolve the issue satisfactorily and would simplify Rules. A claim for additional compensations could be made by the directed participant.. (AEMO submission, 7 September 2009, p. 3)</p>	<p>The NGF proposal would result in greater recourse to 3.15.7(d) (as this clause applies to energy directions, but not “other” services directions). Combined with the shift the bulk of cost recovery burden to customers as a result of the majority of directions being treated as energy, this has implications for the quantum of compensation.</p> <p>Amendment to 3.15.7(d) to limit its application has been incorporated into Rule.</p>
AEMO	<p>The NGF's [2nd] alternative proposal represents a more sweeping change to the framework for allocation of compensation costs than the original NGF proposal. (AEMO submission, 7 September 2009, p. 3)</p> <p>The NGF [2nd] alternative proposal would be inconsistent with the principles for the allocation framework developed by NECA.</p> <p>This would also introduce the concept that generators should be exempt from all compensation cost recovery, significantly altering the balance of recovery cost allocation between the participant categories for "other service" directions. (AEMO submission, 7 September 2009, p. 4)</p>	<p>The NGF's second alternative would effectively remove “other” services as a cost recovery category. This does not take into account circumstances in which “other” services remains the appropriate classification, and assumes that a market mechanism would exist for all forms of direction. This is a more significant change than those contemplated in the Rule change proposal, or in the NGF's alternative approach.</p> <p>Commission has concluded that this change is outside the scope of the Rule change proposal.</p>
AEMO	AEMO considers that there is merit in using the accepted offer price in the rare circumstance where an IT failure of the dispatch systems has	This appears to be appropriate given the preferred reliance on using existing market mechanisms as the basis for determining a fair price – this would

Stakeholder	Issue	AEMC response
	<p>occurred that prevents the normal dispatch of that service. Amendment of clause 3.15.7(d) would ensure that the NGF's proposal does not introduce detrimental outcomes regarding compensation.</p> <p>AEMO supports the inclusion of NGF's proposed clause only if an amendment to clause 3.15.7(d) is made. AEMO has proposed minimal changes to the drafting of clause 3.15.7(d) to address its concerns. (AEMO submission, 13 November 2009, p. 1)</p>	<p>be prevented where AEMO's processes fail.</p> <p>Restricting the application of 3.15.7(d) would reduce the possibility of inappropriate incentives for generators to respond to a direction in any manner other than promptly.</p>
AEMO	<p>AEMO suggests removing reference to "valid bid" with "acknowledged bid" to make it clear that only bids or offers validated under clause 3.8.8 would qualify. AEMO has also included "dispatch offer" in the last line because "price" in isolation is not a defined term. (AEMO submission, 13 November 2009, p. 2)</p>	<p>This is an appropriate distinction for the removal of doubt over what constitutes a valid bid – this is reflected in the draft Rule.</p>
NGF	<p>The provisions for cost recovery in the case of direction for energy or a MAS show clearly that NECA believed that market customer should pay the costs in this case. On the other hand, the provisions for cost recovery for "other" directions appear to be deliberately as non-specific as possible while still retaining an orderly and predictable process.</p> <p>This supports the concept that NECA did not envisage that this category would be much used, and could not form a clear view as to what class of participant might cause the need for such a direction or benefit from it. (NGF submission, 8</p>	<p>It is unclear on what basis NGF reaches this conclusion regarding payment by customers, as there are categories of FCAS that are clearly recovered from market generators.</p> <p>The comment regarding provisions for "other" service being non-specific is reflected in the previous NECA/NEMMCO and ACCC documents (as noted in the Rule determination).</p>

Stakeholder	Issue	AEMC response
	February 2010, p. 1)	

## A.2 Second round of consultation

Stakeholder	Issue	AEMC response
NGF	Reference in Draft Rule to bids, offers or rebids "acknowledged by AEMO in accordance with clause 3.8.8" runs the risk of being interpreted as a reference to an actual offer in place, which would render the provision irrelevant. (NGF 2nd round submission, 31 March 2010, p.1)	This is a valid observation - the intention of the draft Rule was to establish that a bid that could be made at the location of directed plant (ie a "hypothetical" bid) must meet the criteria for a valid bid, rather than referring to a bid that is actually in place.  This has been amended in final Rule.
NGF	Draft Rule should make clear that the "hypothetical" bid or offer is to be considered as applying at the location of the directed plant. (NGF 2nd round submission, 31 March 2010, p.1)	Agree that this should be included in final Rule for the avoidance of ambiguity.
AEMO	Notes and agrees with NGF position that draft 3.15.7A(a1) is likely to be interpreted as a reference to an actual bid or offer. AEMO does not agree with use of "hypothetical" in drafting, as it may make Rule unintentionally broad. (AEMO 2nd round submission, 8 April 2010, p. 1)	See above
AEMO	Also agrees with NGF point that assessment of a direction should be made at the location of directed plant. (AEMO 2nd round submission, 8 April 2010,	See above

Stakeholder	Issue	AEMC response
	p. 1)	