

18 March 2005



Mr Peter Adams  
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Dear Peter

### **Consultation – Proposed Changes to Settlement Residue Auction Clause 3.6.5**

The ERAA supports NEMMCO's proposal to recover negative residues from auction proceeds rather than auction fees for the following reasons:

- It will reduce NEMMCO's cost to recover negative residues.
- It does not impact the performance SRA instruments.

The reasoning behind this position is detailed below.

#### ***No case to materially alter market design.***

It is noted that in the Attachment 3 "Options to fund negative residues" a large number of options are detailed, many of which would alter significantly the nature of the SRA instruments. It is the ERAA's strongly held position that in seeking to improve the efficiency of administering the SRA auction process, NEMMCO has not detailed a case to alter materially market design per se.

#### ***Assessment of options must align with Code objectives.***

Although NEMMCO has come to what we believe is the correct conclusion with regard to the options considered, we are somewhat concerned about the reasoning applied. Specifically, NEMMCO's focus on identifying impacts on the various market sectors tends to suggest that NEMMCO's objectives are:

- Avoidance of (contentious) wealth transfers.
- Minimisation of NEMMCO's costs.

The ERAA is of the position that assessment of any proposal to alter market design should be aligned with the long term efficiency objective of the Code/Rules. This suggests that the following aspects should be explicitly considered:

- Static efficiency- does the market design give the correct signals for utilisation of existing capital and resources?
- Allocative efficiency- are costs allocated the parties best able manage them?
- Dynamic efficiency- does the market design give correct signals for long term deployment of capital. Particularly pertinent to spot market design are the following considerations:
  - i) Change of static signals pose a risk to investors, which in turn adds a risk premium to cost of capital. Hence the conflicting objectives of maximising static efficiency while minimising cost of capital must be carefully considered.
  - ii) Static signals that reduce competition will result in increased capital being deployed to mitigate wealth transfers. This is perhaps the most important factor in design of inter-regional hedging instruments.

***Does the NEMMCO proposal represent the best solution to the problem at hand?***

NEMMCO’s objectives appear to be limited to addressing the issue of un-necessary administrative costs and “cost to carry” of negative residues between time of accumulation and time of recovery.

These costs are simply in-efficient as the market receives no benefit in return for the additional costs incurred by NEMMCO. As such the objective should be to minimise these costs by recovering negative residues as quickly and cleanly as practical.

The question of recovery via auction fee’s and auction proceeds is indeed simply a question of minimising these costs. The reasoning for this is explained below:

Any increase in auction fees will result in a corresponding decrease in auction proceeds as potential purchasers value units as per the following equation:

$$\Sigma \text{Auction proceeds} = \Sigma \text{SRA unit value} = \Sigma \text{Anticipated Value of units} - \Sigma \text{Auction fees.}$$

So Auction proceed recipients receive:

$$\Sigma \text{Anticipated Value of units} - \Sigma \text{Auction fees}$$

As such both the recipients of auction proceeds and purchasers of SRA units are indifferent as to the point of recovery as the net auction proceeds is not effected.

Testing this proposal against the long term efficiency objective:

- Static efficiency: Net costs to the market are reduced with no corresponding reduction in benefits. Hence static efficiency is enhanced.
- Allocative efficiency: There is no change in allocation of costs hence no impact on this aspect.
- Dynamic efficiency: There is no change in dynamic efficiency as static signals see by potential investors are unchanged, and no wealth transfers occur.

On this basis the ERAA believes that the NEMMCO proposal to shift recovery from auction fees to auction proceeds with the objective of minimising the cost of managing negative residues is fundamentally sound.

Yours sincerely,

*Transmission by e-mail*

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**Energy Retailers Association Australia (ERAA)**