

19 December 2005

Dr John Tamblyn
Chairman
AEMC
PO Box H166
Australia Square NSW 1215

Dear John

Reliability safety net extension Rule change request

This National Electricity Rule change request is made by the AEMC Reliability Panel whose offices are located at level 16, 1 Margaret Street, Sydney NSW 2000. NEMMCO is joined as a proponent of this Rule change request insofar as the proposal amends the participant derogation contained in Part 7 of Chapter 8A of the National Electricity Rules. NEMMCO's offices are located at level 12, 15 William Street, Melbourne, VIC 3000.

Background to Rule proposal

As you are aware, the Reliability Panel has been requested by the AEMC to undertake a comprehensive and integrated review of key high level National Electricity Market (NEM) standards and parameters including the following:

- the Tasmanian reliability and frequency standards as part of Tasmania's entry into the NEM;
- the NEM reliability standard;
- the level of VoLL, market floor price and cumulative price threshold; and
- whether the reliability safety net should be allowed to expire or alternative arrangements put in place.

The review addresses the clear need to provide NEM stakeholders with greater medium-term certainty in relation to these fundamental market signals. The AEMC has asked the Panel to complete its report by 31 March 2007.

In submitting this Rule change proposal, the Panel notes that the reliability safety net provisions (as they existed in the previous National Electricity Code) have been extended twice since market start. The first was for two years from 30 June 2003 to 2005 and the second for a further one year until 30 June 2006. The rationale expressed for these

extensions was to provide time to undertake the extensive review of the reliability safety net that was always intended but was not feasible, most recently due to changes in the NEM governance arrangements. With the new governance arrangements in place from 1 July 2005, the full review of this matter is now capable of proceeding. The Panel considers that commencing the review now and completing it by 31 March 2007 is feasible and will provide the certainty sought by the market in respect of this important issue.

Statement of the issue with the existing Rules

The issue concerning the existing National Electricity Rules (Rules) that is to be addressed by the proposed Rule change is as follows.

The reliability safety net comprises NEMMCO's power to contract for reserves and to issue directions to maintain or re-establish the power system in a reliable operating state. Under the current Rules the arrangements for the reliability safety net will expire on 30 June 2006. Consideration of the future appropriateness of the safety net, or an alternative mechanism, is a key component of the integrated review since the need for, and nature of, those arrangements depends on the incentives on market participants to meet the specified reliability level.

Importantly, the Panel notes that NEMMCO has been required to rely on its reliability safety net powers in 2004 and has commenced a tender process in 2005 due to projected supply shortfalls in the summer period. While some participants in the NEM have questioned the value of the mechanism in the last year, the Panel is not currently able to be assured that allowing the existing Rules to lapse would not expose consumers to a higher risk of supply shortfalls that they may be less well placed than NEMMCO to manage. The Panel is therefore seeking to enable the market operator to be in a position to mitigate projected shortfalls in reserves pending the outcomes of the review.

The proposed Rule and how it addresses the issue

To address this issue, the Panel seeks a Rule change that will allow the Panel sufficient time to carry out and complete its review in accordance with the AEMC terms of reference and to fully consult with interested stakeholders. The Panel considers that once the results of the review are known, decisions can then be made as to the appropriateness or otherwise of the reliability safety net regime in the Rules. The Panel therefore requests that the Commission amend the relevant Rules as necessary to extend the operation of the reliability safety net for a further 24 months.

The 24 month extension would mean that the reliability safety net would lapse during the 2008 winter, rather than during the prior and subsequent summer peaks. By that time market participants will have had sufficient notice of the Panel's recommendations on the proposed way forward, the opportunity to contribute to any subsequent Rule-making process and to implement any changes that result.

Description of the proposed Rule

The proposed Rule incorporates amendments to Chapter 3 and to Part 7 of Chapter 8A of the Rules. The proposed change to Chapter 3 involves replacing the date '1 July 2006' with '1 July 2008' in clause 3.12.1(a) and (b).

NEMMCO's ability to contract for non-scheduled reserves is provided by the participant derogation contained in Part 7 of Chapter 8A of the Rules¹. That derogation currently provides for its own expiry on 30 June 2006. The draft Rule change provides for the derogation to be extended for a further 24 months so that it continues to mirror the timing in clause 3.12. Thus, the proposed change is to replace '1 July 2006' with '1 July 2008' in clause 2(f) and '30 June 2006' with '30 June 2008' in clause 3 of Part 7 of Chapter 8A. The effect of the change would be that the participant derogation expires on 30 June 2008.

The Panel has provided a draft of a proposed Rule (see attachment).

Explanation how proposed Rule contributes to NEM objective

The NEM objective, set out in section 7 of the National Electricity Law, states:

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

The Panel considers that the proposed Rule will or is likely to contribute to the NEM objective as follows.

The reliability safety net was used in 2004 and has been commenced in 2005 due to projected supply shortfalls over the summer period. If the safety net was allowed to expire prior to a full consideration of the need for it and of any potential alternatives, end users may be exposed to a higher risk of supply interruption during the period in which the review will be carried out and implemented.

¹ In authorising the original derogation, the ACCC stated on page 3 of its determination *Amendments to the National Electricity Code - Safety Net Provisions and Reserve Contracting* dated 27 November 2002 that it may only do so if the applicant satisfies the relevant tests in subsections 90(6) and 90(8) of the *Trade Practices Act 1974* (Cth). It states that these tests are essentially the same. Subsection 90(6) provides that the ACCC shall grant authorisation only if it is satisfied in all the circumstances that:

- the provisions of the proposed contract, arrangement or conduct would result, or be likely to result, in a benefit to the public; and
- that benefit would outweigh the detriment to the public constituted by any lessening of competition that would, or would be likely to result from the proposed contract, arrangements or conduct.

In that determination, the ACCC went on to state, on pages 7-8, that:

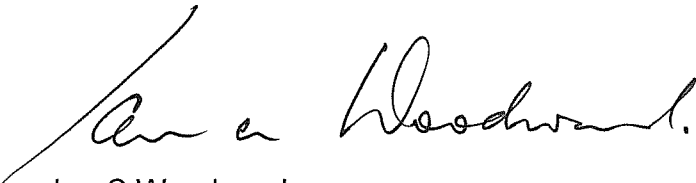
The [ACCC] considers that the proposed derogation will improve the operation of the safety net and reserve contracting provisions by:

- providing additional sources of reserve capacity ensuring NEMMCO has a greater opportunity to meet reliability standards;
- increasing competition amongst reserve contract and non-scheduled reserve contract suppliers, potentially lowering the total costs incurred by NEMMCO when activating the reserve trader; and
- promoting demand side management as a means of alleviating supply scarcity situations.

Further, the Panel is of the view that the most appropriate long term arrangement for the reliability safety net (if any) must be determined in conjunction with the other major market parameters such as the value of VoLL. This is because the safety net is required to operate only when the market fails to deliver all necessary supply options to meet the reliability standard. Assessing these matters as a package is the only way constructive interaction between these mechanisms can be designed into the final outcome.

For the two reasons stated above, the Panel considers that the reliability of supply in the short term, and delivery of a properly integrated reliability mechanism for the longer term, are best delivered by maintaining the current reliability safety net while the comprehensive review is being carried out. The Panel is therefore of the view that it is in the long term interests of consumers for expiry of the current safety net mechanism to be extended for the period while the review is carried out and its recommendations implemented by market participants and that doing so will advance the NEM objective.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Ian C Woodward', written in a cursive style.

Ian C Woodward
Chairman

Attachment

Draft Rule change