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7 September 2009

Dr John Tamblyn
Chairman
Australian Energy Market Commission
PO Box A2449
SYDNEY SOUTH NSW 1235

By direct submission to the AEMC website

Dear John

Re | Cost Recovery for Other Services Directions ERC0090

I refer to the NGF's submission on the above Rule change proposal dated 24 August 2009. In the submission, the NGF proposes amendments to the original Rule change to address concerns related to the classification of directions and the apportioning of recovery costs between the Customer and Generator participants.

There are some significant market implications and outcomes that follow as a consequence of the NGF's proposal should it be integrated into the current Rule change consultation. The attachment to this letter outlines these issues so that they may be considered as part of the draft determination.

If you wish to discuss any of the matters identified please do not hesitate to contact John Wormald on (02) 9239 9107.

Yours sincerely

Brian Spalding

Brian Spalding
Executive General Manager Operations

Attachment

ATTACHMENT

Cost Recovery for "Other Services" Directions ERC0090

Introduction

The original AEMO proposal was a simple approach to achieving regionalisation of recovery costs for "other services" directions, as well as moving away from the current participant fee basis of cost allocation to an energy-based cost allocation, while preserving the current distribution of cost recovery across participant classes. The thrust of the AEMO Rule change proposal was to introduce regionalisation of the recovery for directions for "other services" (consistent with current energy and FCAS compensation recovery), and to move away from the participant fee allocation towards an energy based allocation as AEMO participant fees no longer have a clear fixed cost element and are likely to evolve further over time.

The AEMO proposed changes would have significant implications on the recovery cost allocation, as indicated in the NGF proposal. AEMO is making this submission to outline the market and recovery impacts of the NGF proposal.

Funding of Compensation

The NGF states that the recovery of compensation costs for ancillary service directions is carried exclusively by market customers. The Rules[1] provide that these costs are recovered on the same basis as the market costs for these services ie market customers pay for directions related to lower services, generators pay for raise services and both share the costs of directions for regulation services in accordance with the causer pays factors.

The concept of leaving scheduled plant (ie scheduled loads and MNSPs as well as scheduled generators) in the same position as if the direction had not occurred has some basis in the Rules relating to affected participants and intervention pricing[2]. 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.

Outcomes from the NGF Proposal

The NGF is proposing a test on the classification of directions for "other services" which would lead to directions for "network support" being classified as directions for energy, and compensation would be determined under Rule 3.15.7, rather than Rule 3.15.7A. It is important to consider the financial outcomes, in terms of the quantum of compensation, that arise from such a change.

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[1] See NER clause 3.15.8(f)
[2] See NER clauses 3.12.2(a)(1), (c)(1) and (c)(2)

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Rule 3.15.7A requires AEMO to appoint an independent expert to determine a fair payment price based on the market price for the service that would have prevailed under similar demand and supply conditions. Determinations have consistently relied on long run average costs of the directed plant as the best indicator of the fair payment price.

Rule 3.15.7 requires AEMO to determine the compensation quantum as the product of the directed quantity of the relevant service (ie amount of FCAS in MW or energy in MWh that was produced as a result of the direction) multiplied by the market price (in $/MW/h for FCAS or $/MWh for energy). In Rule 3.15.7 the market price is deemed to be the 90th percentile price of that service for the previous 12 months. However, the operation of clause 3.15.7(d) is such that if the directed participant had in place a valid dispatch bid or offer just prior to the direction, then the market price for the compensation is set to the price in that dispatch bid or offer. Effectively the directed participant is able to set the market price of an anticipated energy direction through the dispatch offer or bid, and this could be as high as the market cap price of $10,000/MWh.

AEMO recognises that if a valid bid or offer is in place, then the need to direct should not occur. There is an obligation[3] on the scheduled participant 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. The practical reality is that AEMO is forced to direct promptly in these situations to restore system security within prescribed time limits[4], and there is little time for the formal replacement of a dispatch offer to which the generator does not comply.

AEMO submits that the consideration of the NGF proposal to have network support directions classified as energy directions and be priced as such must address the compensation quantum issue arising from Rule 3.15.7(d). Removal of that clause would, in our view, resolve the issue satisfactorily. It would simplify the Rules, with the compensation price being paid as energy set at the historical 90th percentile value, ie well above average volume-weighted "valid bid" prices. A claim for additional compensation[5] could be made if the direct costs incurred by the directed participant exceeded the value calculated using the 90th percentile price.

Outcomes from the NGF Alternative Proposal

The NGF has suggested an alternative proposal to change the recovery for other directions to that specified for directions for energy. An outcome of this would be that directions for manual frequency control, reactive support and any other services would also be recovered from customers only. The alternative proposal thereby represents a more sweeping change to the framework for allocation of compensation costs than does the original NGF proposal.

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[3] See NER clause 3.9.7
[4] See NER clause 4.2.6(b)
[5] See Rule 3.15.7B

The allocation of costs is an important economic issue and any changes should be consistent with a high-level framework. Principles for the allocation framework were developed and presented in the review of power system directions available on the NECA website[6]. Those principles include[7] the following themes:

- If compensation arises from a direction for a market service (energy or FCAS), then the costs should be recovered in the same way that they would have been recovered from that market. Thus energy direction costs are recovered from market customers, and FCAS direction costs are recovered from market customers or market generators or both, depending on the directed service.
- If compensation arises from a direction for a non-market "other service", then there may not be a corresponding relevant basis for recovery of these costs. The default basis was to spread the costs widely through some measure of the level of interaction between the participants and the market, leading to the choice of fixed participant fees.

The NGF alternative proposal would be inconsistent with these themes, replacing them with the concept that generators should be exempt from all compensation cost recovery, and significantly altering the balance of recovery cost allocation between the participant categories for "other service" directions.

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[6] Final report on Power system directions in the National Electricity Market dated 19 May 2000 http://www.neca.com.au/Files/R_Final_Report_%20Review_of%20_Power_System_Directions.zip
[7] See page 33