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Dr John Tamblyn
Chairman, Australian Energy Market Commission
PO Box A2449
South Sydney NSW 1235

By email: submissions@aemc.gov.au

Dear Dr Tamblyn,

Contingency Administered Price Period Following a Physical Trigger Event

We write in response to the Australian Energy Market Commission (AEMC) draft rule determination entitled *National Electricity Amendment (Contingency Administered Price Cap Following a Physical Trigger Event) Rule 2009* of 12 March 2009.

We wish to express our disappointment that the National Electricity Rules (Rules) change proposal was not supported by the AEMC given our belief the proposal was a practical and financially efficient solution to the issue at hand. This submission will address positions taken by the AEMC in the draft determination that we believe are incorrect.

We must also request that given the AEMC is not pre-disposed to supporting the National Generators Forum's (NGF) approach to address this issue, these matters, and the broader issue of transmission risk management, should be addressed by the AEMC directly.

Our primary contention remains: **that the current risk exposure created by the potential impact of non-credible contingency events is not appropriate** as:

- the financial risks associated with non-credible contingency events can be significant;
- there is a fundamental absence of evidence to support the view that these unpredictable events provide investment signals; and
- the risk cannot be readily managed by generators and there is an absence of viable risk management mechanisms for this risk.

For these reasons, we call on the AEMC to consider this issue as part of the Market Frameworks Review.

This submission does not represent the views of Hydro Tasmania, Snowy Hydro, and Origin Energy.

Significant financial risks associated with non-credible contingency events

There is general agreement that the occurrence of non-credible contingency events represents a significant risk to market participants in general when generating plant is tripped off-line or constrained off due to disruption on the power system.

The NGF's proposal sought to limit financial losses that a non-credible event would have on the National Electricity Market (NEM). Such an outcome would be positive for the NEM, notwithstanding it limiting the potential for some, but generally not all, peaking generators to gain revenue benefits from unique circumstances associated with a specific non-credible event from time to time. In our view, this reduced level of risk would benefit the NEM by encouraging prudent and stable investment and reduced risk for generators generally.

These unpredictable events do not provide appropriate investment signals

The NGF acknowledges the perspective that there can be direct financial benefits for incumbent generators from non-credible events and that these financial benefits may be significant under the right set of circumstances. However, this requires the perfect alignment of all event criteria for this benefit to be realised. Therefore, we contend it is not appropriate to consider that such events are drivers of investment in peaking plant.

While we agree in theory that reducing the number of very infrequent high priced events may impact a peaking generator or demand side participant's revenue; we question the thoroughness of any analysis that suggests that all high priced events are relevant to investment decisions.

Clearly, not all high priced events are identical. Such events can be categorised as: price outcomes reflective of the normal operation of the market; credible outages expected from time to time and allowed for in NEM design; or non-credible contingency events. These differing high priced events should not be considered one and the same.

High priced events below the Market Price Limit within the normal operation of the market and high priced events pursuant to credible events which are reasonably possible may result in significant returns and reflect times when peaking plant recover returns on investment costs. These events are within the normal envelope of the markets operation and can be reasonably expected depending on demand and operational issues. Expected returns from these events are directly relevant to generation investment decisions.

Conversely, non-credible events are by their very definition events which are not reasonably expected. These are events that are highly infrequent, are not planned for, are not included in reliability analysis and are events outside of the technical envelope that National Electricity Market Management Company (NEMMCO) is expected to operate the NEM within. These are events which have the potential to severely disrupt the normal flow of energy to consumers and negatively impact the integrity of the markets operation. Events which it is reasonable to expect the Rules through the technical standards seek to avoid and events which NEMMCO and market participants generally wish to avoid.

To suggest that an investor, a bank or financial consortium, would choose to invest on the basis of events that are not reasonably possible and actively avoided, and in that regard may never eventuate, is questionable. What is the basis for such an investment? What revenue streams across any given time period can be guaranteed or expected? What level of return can an investor expect?

The AEMC's position in the draft determination suggests there exists a view that any actions which reduce the potential for non-credible contingency events (be they technical advancements or operational improvements) would somehow undermine the operation of the market and undermine reliability and credibility as non-credible events are a necessary feature of the NEM.

This assumes the market is currently balanced with an appropriate level of non-credible events guaranteeing the appropriate returns for peaking generators. We are unclear what drives this line of reasoning and the implications of this line of reasoning are of concern.

As such the NGF believes the AEMC's rationale implies that potentially large wealth transfers which may coincide with the occurrence of a non-credible contingency event are an efficient part of the operation of the NEM. The NGF would like to further understand the AEMC's thoughts that lead to this conclusion.

The NGF is also concerned that no quantitative evidence has been provided in submissions to support the claim that revenue arising from non-credible contingency events is used in the basis for investment decisions nor does it appear has the AEMC sought to underpin their arguments with any quantitative analysis.

Without any evidence in support, the NGF contends that the argument advanced by the AEMC, that a sound investor in electricity generation would positively consider and expect a return from events that cannot be reasonably expected to occur lacks rigour.

Such a conclusion, indicating that non-credible contingency events can be reasonably expected, would indicate a failure of either the Rules to correctly define non-credible events or the planning of Transmission Network Service Providers to correctly ensure their networks are maintained to the standards assumed in the NEM.

The NGF also contends that the impact of this risk on an investment decision may increasingly be negative as lenders become more sensitive to unmanageable risks following the Global Financial Crisis.

Willingness to attribute unmanageable risks to base-load generators

We understand that the Rules and the operation of the market do not favour one form of generation over another. The NGF is wholly supportive of this approach.

In that regard, we have some concerns that the arguments presented in the draft determination are underpinned by assumptions that the possible benefits of non-credible contingency events to some peaking generators, despite the possibility of those events not eventuating or at least never positively impacting the operation of every peaking generator, are of greater value than managing the significant financial exposure these events may have on generators as a whole.

While the draft determination acknowledges the significance of these risks to generators it encapsulates a view that the downside, being financial failure of significant generation capacity and the allocation of significant risks against exposed generators is somehow acceptable if some peaking generators have a positive exposure to potential revenue flows from a non-credible contingency event. This questionable assumption shared by a small number of opportunistic interests fails to acknowledge the implications for system security and reliability should a non-credible contingency event result in financial failure of a major generator.

Furthermore, peaking generators are also exposed to unmanageable windfall gains and losses from non-credible contingency events. The peaking generator community views are not unanimous with the many peaking generators supporting the proposal developed by the NGF.

Additionally, it is important to consider that the allocation of network risk to generators was not a consequence of a conscious decision by the AEMC but rather an outcome of a position inherited at the commencement of the NEM. In this regard, it is not appropriate to assume this allocation is appropriate or sustainable in the longer term.

AEMC logic undermines Cumulative Price Threshold and Market Price Limit

The Cumulative Price Threshold and Market Price Limit represent valuable tools to manage risk exposures for market participants. These tools reflect a belief that while in some instances individual participants may forego revenue opportunities there exists an overall benefit to the market by reducing extraordinary financial risks.

The AEMC's logic, that unique, highly infrequent, extremely variable, non-credible contingency outages provide a benefit to peaking plant and steps to reduce the negative impacts of these events (which are outside of the technical envelope) would undermine investment signals is more appropriately applied to use of the Market Price Limit and Cumulative Price Threshold than the CAPP proposal.

However, it is widely accepted that the Market Price Limit and Cumulative Price Threshold are necessary interventions in the NEM to manage risk and price volatility. While there are varying views on the actual thresholds applied to these tools, it is widely acknowledged that management of normal events which arise within the normal operation of the market is necessary to ensure appropriate reliability and stability in the NEM consistent with the National Electricity Objective. Therefore, the NGF is not convinced by the argument that extraordinary risks outside the normal operation of the market should be left unmanaged.

There is an absence of risk management mechanisms for this risk

It is generally accepted that generators rarely have direct control over the occurrence of non-credible contingency events. The events generally arise within the transmission network and it was the unmanageable financial impacts of these rare transmission events that the Rules change was intended to mitigate.

It is also accepted that the financial costs of those events are borne solely by affected generators even though generators are not able to take steps to further reduce the possible occurrence of non-credible contingency events. In stating this the NGF requests that the AEMC take particular notice of the fact that Transmission Network Service Providers, as the market participants responsible for transmission impacts in the NEM, bear no responsibility or liability in the event that their network fails to deliver the required transmission outcomes.

It is also not possible for generators to fully consider the potential for non-credible events that would result in financial failure within the wholesale contracts market. These events cannot be predicted or planned for. Furthermore, these events cannot be priced into contracts even if such events could be reasonably forecast. In simple terms: how can a generator price contracts to avoid a one-off event that would constrain a single generator and result in financial failure? Even if an event was known in advance with reasonable certainty the risk premium to overcome such failure would make contracts on offer uncompetitive.

Additionally, this matter is of concern to incumbent generators who have no control over locational decisions and hence the benefit of such signals is not relevant. Even for new connections we question the merits of this argument given the unique, unplanned and irregular occurrence of non-credible events.

The NGF is also concerned that an insurance scheme of the type indicated in other submissions does not currently exist for the NEM and as indicated in our letter of 10 March 2009 (incorrectly dated 10 March 2008) such a scheme is clearly not viable.

Therefore it should be recognised that there is an absence of risk management tools available to manage the risk of such an event. Neither insurance, force majeure provisions, inter-regional settlement residues, or weather derivatives et al are viable options to resolve our genuine concerns (see NGF proposal dated October 2008). If these tools were readily available, given the significance of the issue, we would encourage the AEMC or other proponents of such mechanisms to work with industry to develop these mooted solutions. However, these mechanisms are not viable and inaction to date supports our view on these proposals.

Nevertheless, it is important to consider that even if a financially sustainable risk management tool was made available, which we consider highly unlikely, such an instrument would not address the ongoing and inappropriate allocation of transmission risk to generators which is beyond the control of generators. Consistent with risk management fundamentals a risk should lie with the party best placed to manage that risk. In this instance the NGF contends that this is clearly not generators.

The market should not reward participants where they perform poorly; however, in this instance the current arrangements penalise generators where transmission performance is poor and is outside the generators control or responsibility. This disbenefit should be addressed with mechanisms established that appropriately incentivise responsible parties.

NEMMCO Market Operations during Contingency Events

The NGF is genuinely concerned with AEMC citing the workload of NEMMCO staff as a key reason behind refusing to instigate the contingency administered price period as a practical risk management tool.

The NGF contends that NEMMCO is paid a significant amount of revenue by participants to operate the NEM. Operating the NEM should not only include managing the system security and reliability impacts during a contingency event but also ensuring the NEM continues to operate in a financially efficient manner. The NGF believes the question to NEMMCO should not be “*can you implement this change to the NEM*” but “*what would NEMMCO need to implement this change in the NEM*”. The NGF specifically requests that the AEMC raise this question with NEMMCO to ensure appropriate consideration of this proposal.

The NGF also contends that in some circumstances changed bidding incentives may well lead to greater input by NEMMCO staff than would otherwise be required if the *Contingency Administered Price Cap Following a Physical Trigger Event* was approved to manage system security outcomes.

Conclusion

In this case, the AEMC has shown an unwillingness to seek a practical resolution to the ongoing financial risk the NGF believes is incorrectly borne by generators as a consequence of non-credible contingency events they have no direct control over. The reasoning for this decision as provided by the AEMC within the draft determination is contested by the NGF.

We request that the AEMC consider the matters raised in this submission prior to final determination and in the absence of a final determination in the positive the NGF requests the AEMC take steps to holistically consider the issue of transmission risk as part of the Market Frameworks Review. Please advise the next steps to be taken by the AEMC in writing to:

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National Generators Forum
GPO Box 1301
Canberra ACT 2601**

Yours faithfully,

Alex Cruickshank
Chair, Market Working Group