



Australian Energy Market Commission

DRAFT RULE DETERMINATION

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

Rule Proponent(s)

AEMO

Commissioners

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25 February 2010

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For and on behalf of the Australian Energy Market Commission

RULE
CHANGE

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Citation

AEMC 2010, Cost Recovery for "Other" Services Directions, Rule Determination, 25 February 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 policy advice covering the National Electricity Market and elements of the natural gas 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.

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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.¹

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 consultation paper, prepared by AEMC staff, identifying specific issues or questions. This first round of consultation closed on 24 August 2009. An additional two rounds of consultation were undertaken on specific issues arising out of submissions, closing on 16 September 2009 and 4 February 2010.

¹ 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.

A submission on the Rule Change Request from the National Generators Forum (NGF) proposed an alternative approach to the issues identified by AEMO in a broader context. These changes would introduce additional prescription in the Rules around the circumstances under which AEMO could classify a direction as a direction for “other” services. While AEMO initially raised concerns over the impact of the NGF’s alternative approach, the two parties reached an agreed position that would enable both proposals to be implemented while addressing AEMO’s concerns.

The Commission has considered the alternative approaches put forward by the NGF and AEMO, as well as the original Rule Change Request. The Commission agreed with AEMO’s assessment of the issues inherent in the cost recovery framework, and also concurred with the NGF’s view that there was a problem with the broader framework for the classification of directions as “other” services. The Commission has determined not to make the Rule proposed by the Rule Proponent and to make a proposed more preferable Rule based on the position put forward by both AEMO and the NGF.

In accordance with the notice published under section 99 of the NEL, the Commission invites submissions on this draft Rule determination, including a draft Rule, by 8 April 2010.

In accordance with section 101(1a) of the NEL, any person or body may request that the Commission hold a hearing in relation to the draft Rule determination. Any request for a hearing must be made in writing and must be received by the Commission no later than 4 March 2010.

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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)² 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 participants is calculated.

1.2 Rule Change Request rationale

The Rule Change Request has been prompted by the identification 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.³

1.3 Solution proposed by the Rule Change Request

In this 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:

² 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.

³ 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.⁴ 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 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 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 as part of 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 second round of formal consultation, including the publication of a second staff consultation paper, was undertaken in order to obtain stakeholder views on a range of specific issues. This second consultation round closed on 4th February 2010, with one submission received from NGF reiterating its earlier expressed position. All submissions received are available on the AEMC website.⁵ A summary of the issues raised in submissions and the Commission’s response to each issue is contained in Appendix A.

1.5 Extensions of time

The Commission issued notices under section 107 of the NEL extending the date for publication of its draft determination on two occasions:

⁴ 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.

⁵ www.aemc.gov.au

- 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.

1.6 Alternative approaches to the issues identified

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

- An alternative approach outlined in the initial submission from the NGF (“the NGF alternative”), though not submitted as a formal Rule change request, which 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”), though not submitted as a formal modification to the Rule 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.

1.7 Consultation on draft Rule determination

In accordance with the notice published under section 99 of the NEL, the Commission invites submissions on this draft Rule determination, including a draft Rule, by 8 April 2010.

In accordance with section 101(1a) of the NEL, any person or body may request that the Commission hold a hearing in relation to the draft Rule determination. Any request for a hearing must be made in writing and must be received by the Commission no later than 4 March 2010.

Submissions and requests for a hearing should quote project number “ERC0090” and may be lodged online at www.aemc.gov.au or by mail to:

Australian Energy Market Commission

PO Box A2449

Sydney South NSW 1235

2 Draft Rule Determination

2.1 Commission's determination

In accordance with section 99 of the NEL the Commission has made this draft Rule determination in relation to the Rule proposed by AEMO. The Commission has determined not to make the Rule proposed by the Rule Proponent and to make a proposed more preferable Rule based on the AEMO-NGF position.

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

A draft of the proposed Rule to be Made (Draft Rule) is attached to, and published with, this draft Rule determination. The Draft Rule is a proposed more preferable Rule.⁶ Its key features are described in section 3.2.

2.2 Commission's considerations

In assessing the Rule Change Request the following was material and relevant:

- the Commission's powers under the NEL to make the Rule;
- the Rule Change Request;
- submissions received during first round consultation;
- submissions received in subsequent 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).

⁶ 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

Under the NEL, the Commission may make Rules for, or with respect to, the matters set out in section 34, or any matter or thing specified in Schedule 1 of the NEL.

The Commission is satisfied that the Draft Rule falls within the subject matter about which the Commission may make Rules. The Draft Rule 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 Draft Rule 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 draft 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.⁷

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:

- 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" direction. This guidance, which did not form part of the Rule proposed in the Rule Change Request, will result in the majority of directions being classified as directions for energy services, which has two main efficiency benefits:
 - Promotion of an 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 to determine payable compensation and cost recovery liability. This minimises the degree of intervention in market processes.
- 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.

⁷ 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.

- The Draft Rule removes incentives for directed participants to engage in bidding or re-bidding behaviour designed to maximise the potential compensation payable to them by circumscribing the application of clause 3.15.7(d). These sorts of activities can have a distortionary impact on the setting of prices, as they result in a divergence between the underlying cost (to the directed participant) of supply and the price paid (by other participants) for that supply. This behaviour can also result in participants delaying their response to a direction from AEMO, which could have a critical impact on system safety, security or reliability. Furthermore, the restriction on the operation of 3.15.7(d) reinforces 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. This aspect of the more preferable Rule did not form part of the Rule proposed in the Rule Change Request.
- The Draft Rule will lead to improvements in the clarity of the framework for directed services for market participants by introducing greater guidance regarding the circumstances under which a direction may be classified as a direction for an “other” service. This will result in 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. This aspect of the more preferable Rule did not form part of the Rule proposed in the Rule Change Request.
- The Draft Rule 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 Market Ancillary Services (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, under section 33 of the NEL, to have regard to any relevant Ministerial Council on Energy (MCE) Statements of Policy Principles.⁸ 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

⁸ Under section 33 of the NEL the AEMC must have regard to any relevant MCE statement of policy principles in making a Rule.

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.

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. Specifically, AEMO's Rule Change Request is seeking to introduce greater consistency between the methodology for "other" services directions and the methodology applying to energy and MAS directions. The Commission considers that 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 Commission therefore considers that the application of the current methodology could result in market participants in non-benefitting 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-benefitting 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.

The Commission considers that the costs of directions should be efficiently targeted to those who benefit from them and that the misalignment that exists within the current cost recovery methodology is therefore 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.

Furthermore, 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 the initial presumption that "other" services would account for the minority of directions.⁹ AEMO participant fees no longer include a clear fixed component (and are, according to AEMO, likely to evolve further over time), rendering this component of the formulation essentially redundant. The Commission has

⁹ 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

determined that, in the interests of maintaining good regulatory practice, a Rule is required to update the cost recovery methodology for "other" services as it is no longer appropriate to use the largest fixed proportion of participant fees in the methodology for determining proportional liability.

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 to the Commission have not provided evidence that this framework has been inappropriately administered by AEMO, the Commission has been made aware of concerns that the lack of certainty around the application of the existing framework could give rise to disputes.

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.

3.2 Draft Rule

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 raised by AEMO, will not be sufficient to address the broader issues raised by the NGF.

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 which incorporates the proposed changes put forward in the Rule Change Request and the NGF submission will more effectively address the issues identified. Accordingly, the Draft Rule represents a more preferable Rule.

3.2.1 Difference between the proposed Rule and the Draft Rule

The Draft Rule incorporates the Rule proposed in the Rule Change Request in its entirety, namely:

- introduction of regionalisation to the cost recovery methodology for “other” services directions through the application of the regional benefits test; and
- replacement of the reference to the fixed component of participant fees as the basis for apportioning cost recovery liability with a calculation of relevant energy (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 used in clause 3.15.6A for recovering ancillary service costs).

The Draft Rule also incorporates the amendment to clause 3.15.7(d) proposed in the AEMO-NGF position. This amendment 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.

The Draft Rule also incorporates a new clause 3.15.7A(a), proposed in the NGF alternative, 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 cannot be met by an acknowledged dispatch bid, dispatch offer or re-bid.

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 quantum of compensation paid to directed participants;
 - the recovery, from market participants, of costs arising from the payment of compensation; and
 - the classification of directed services.

The Commission has focused on this set of issues because:

- These issues represent constitutive elements of the framework for services directions.
- 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 The current framework for directions and its identified shortcomings

In undertaking an analysis of the impact of the Rule Change Request on directions for “other” services, it is necessary to set out the existing framework for directions and the issues with this framework identified in submissions. This is particularly appropriate given the Commission’s consideration of a more preferable Rule in response to the position agreed between AEMO and the NGF. Examining the overall framework for directions in this manner allows the Commission to look at the individual components of the framework for directions, as well as consider the interaction between those elements.

The following sections set out this framework for directions for services.

5.1 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.

5.2 Payment of compensation to directed participants

AEMO is required to pay compensation to the directed participant for the service provided in response to the direction, and recover the cost of that compensation from other market participants. Compensation methodologies are in place with regard to directions for:

- energy services;
- MAS; and
- services other than energy or MAS (“other” services).

Energy in this context refers to the provision of electrical energy. Market ancillary services refers to services to correct an increase or decrease in power system frequency beyond system operating limits.

5.3 Classification of types of services directions

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 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;
- 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 2002¹⁰ 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.¹¹ 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".¹² 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". The type of service, or more specifically, the cost recovery methodology

¹⁰ The current framework for directed services was introduced in 2002, following consultation by NECA and NEMMCO.

¹¹ AEMO Rule change proposal, p3; Compensation for Network Support directions has been predominantly in the order of \$2.1 to \$4.1 million per annum.

¹² AEMO, *Operating Procedure for Intervention, Direction and Clause 4.8.9 Instructions*, 2009, p. 7

to apply, is determined by AEMO after the situation which precipitated the direction is resolved.¹³

5.4 Calculation of compensation for directed participants and recovery of costs for directed services

Separate methodologies have been established under the Rules for calculation of the compensation payable to directed participants, and the funding of that compensation (ie recovery of costs), applicable to each kind of directed service. Table 1 sets out these 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), if at the time of the direction, the Directed Participant had submitted a valid dispatch bid, dispatch offer or rebid for dispatch of the requested service, the Directed Participant is entitled to receive compensation for the provision of that service at a price equal to the price in that bid or offer.</p> <p>Participants have the opportunity to seek additional compensation under 3.15.7B of the Rules, which permits directed participants, entitled to compensation under 3.15.7 or 3.15.7A, to make an application to AEMO for additional compensation in accordance with criteria outlined in 3.15.7B.</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.
Market Ancillary Services	Methodology as above, based on MW of FCAS	Costs are recovered in the same way as if the market

¹³ 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.

Type of direction	How compensation is calculated	How costs are recovered
	<p>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>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>

5.5 Rule Change proponent's view

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" 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.

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.

5.6 Stakeholder views

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.¹⁴

5.7 Analysis

The Commission considers that 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 Commission therefore considers that the application of the current methodology could result in market participants in non-benefitting regions subsidising the cost of a service for participants in regions that directly benefit from the "other services" direction. This could result in distortions to competitive behaviour and dispatch outcomes within the NEM as market participants in non-benefitting regions modify their bid prices to recover these costs, potentially reducing productive efficiency at the margin. From an allocative efficiency perspective the Commission considers that this outcome is undesirable. In particular, the Commission considers that the prices of electricity faced by consumers should reflect the efficient costs of the resources used in delivering that supply. Distortions that involve departures from cost reflective prices can encourage less efficient resource allocation and consumption patterns, which result in higher prices in the longer term being paid by customers.

“Other” services currently account for the majority of directions for services. As “other” services are the least clearly defined of the three categories of direction, there exists a greater degree of uncertainty and risk for directed participants that must be priced. In this instance, that risk rests in the determination of a compensation price by a third party, subject to the exercise of AEMO’s discretion to classify a direction.

By shifting the bulk of directed services to the energy category, under which the calculation of compensation is more clearly defined in the Rules, greater certainty is

¹⁴ NGF Submission, 24 August 2009, p. 1.

provided to generators and a potential source of the risk identified above is reduced. Over time, this reduction in risk in turn should reduce costs for participants, consistent with promoting productive efficiency in the NEM.

The Commission has concluded that, overall, the framework in place for energy directions represents a more efficient approach to determining compensation and the funding of that compensation, in comparison with the framework for "other" services, as it :

- aligns the cost of providing the directed service with the cost recovery price paid by the beneficiaries of a direction;
- places the burden of funding compensation for a direction on the main beneficiaries of that direction;
- utilises a market derived price as the basis for determining compensation, as opposed to a price determined by an independent expert.

5.8 Conclusion

Both AEMO and the NGF, while they differ in their approach, have identified issues with the manner in which the costs arising out of compensation for "other" directions is recovered from market participants. These issues do have implications for the efficient functioning of the overall framework for directions for services.

The Commission has taken the view that, given the current predominance of "other" services directions, maintaining the existing approach which allocates costs to non-benefitting regions is unlikely to result in efficient pricing outcomes for the market. This is due to the existence of a mismatch between the underlying cost of providing a direction in a specific region and the charges ultimately levied on participants for that direction. The Commission therefore considers that the approach utilised in the cost recovery methodology for energy services (ie regionalisation of cost recovery) is more likely to result in efficiency gains. In particular, the Commission considers that aligning the recovery of costs for "other" services directions with the participants in the regions that benefit from them should promote efficient cost targeting. For the reasons outlined above, the Commission considers that this should promote competition and therefore, the efficient use of electricity services.

The current framework for directions is open to a degree of ambiguity due to the absence of clear definitions or guidance in the Rules regarding the different categories of direction. While it is necessary for AEMO, as the market operator, to have a degree of discretion when determining the classification of a direction, it is also important for market participants to have some certainty regarding the likely compensation they would receive, or be expected to fund, in the event of a direction. Some uncertainty is inherent in the current framework due to a combination of what is actually written in the Rules and AEMO's application of the framework. Ensuring a greater degree of certainty for participants, without compromising AEMO's ability to manage the directions framework, would be consistent with good regulatory practice.

6 Proposed changes to the existing methodology

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 changes to 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 changes put forward as part of its overall analytical framework. This chapter examines the overall impact of the various changes proposed in the Rule Change Request, and the alternative approaches put forward by the NGF. Later chapters address the impact of these changes on the specific elements of the directions framework, namely the quantum of compensation, recovery of the costs arising out of that compensation, and the classification of directions.

6.1 Rule Change proponent’s view

The changes proposed in AEMO’s Rule Change Request would alter the cost recovery mechanisms applicable to “other” services through two key changes:

- 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 will 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.¹⁵”

¹⁵ NEMMCO (now AEMO) Rule change proposal, 13 March 2009, p. 4

6.2 Stakeholder views

In response to the changes put forward by AEMO, the NGF proposed that the Rules be amended to insert a new clause 3.15.7A(a1), defining “other” services in order to address the broader issue of classification of services (in turn providing additional clarity of the appropriate cost recovery methodology that would be applied). Under the NGF’s proposed new clause, a direction would be defined as a direction for “other” services only if the direction could not have been avoided by the central dispatch process utilising, in the NGF’s terms, “hypothetical market offers”¹⁶ for either energy or MAS.

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

In its submission of 7 September 2009, AEMO expressed concerns with the NGF alternative, particularly around the impact it would have on the quantum of compensation arising out of the application of clause 3.15.7(d), which allows directed participants to utilise the price contained in an existing offer as the basis for calculated compensation.¹⁷ AEMO proposed the deletion of clause 3.15.7(d) as a means of addressing this concern.

Additional submissions were received by the Commission from AEMO and the NGF (on 13 and 16 November respectively) reflecting an agreed position in relation to the Rule Change Request. This agreed position (the “AEMO-NGF position”) incorporates the changes initially proposed by AEMO in its Rule Change Request and those contained in the NGF’s alternative approach, with the addition of an amendment to 3.15.7(d) proposed by AEMO limiting the circumstances in which this clause would apply. AEMO’s proposed amendment would limit the applicability of this clause to situations where a failure in AEMO’s dispatch process has prevented the dispatch of the directed participant’s plant.

6.3 Analysis

The Proposed Rule would not change the manner in which the amount of compensation is determined for participants directed to provide “other” services. The proposal does, however, move from recovery of costs from all market participants across the NEM to recovery from participants in the regions that benefit from the

¹⁶ “Hypothetical market offer” is not a defined term in either the Rules or the NEL, or in the drafting proposed by the NGF.

¹⁷ 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).

direction. This would be achieved through application of a regional benefits test. This is consistent with the methodology applicable to directions for energy and MAS, and should help to ensure that the costs of "other" services directions are more efficiently targeted to those that benefit from them. The concept of "relevant energy" utilises existing terms established in clause 3.15.6A for the calculation of costs arising out of ancillary services transactions, and has a much more direct relationship to the functioning of the market than the term it replaces.

The methodology for recovery of costs for energy services directions, by virtue of it being more clearly defined in the Rules, also promotes transparency and predictability in the operation of the NEM. In the event that an intervention – in this case a direction – in the market is required, cost recovery should be based, as much as is possible on, and applied according to, transparent criteria and methodology.

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. 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 out of directions, including directions for manual frequency control and reactive support.¹⁸

The AEMO-NGF position would result in the changes to the cost recovery methodology for "other" services proposed by AEMO in the Rule Change Request, as well as the introduction of a definition for "other" services put forward by the NGF. The AEMO-NGF position would not change the basic operation of either the AEMO proposal or the NGF alternative, as discussed above.

6.4 Conclusion

The changes proposed in the Rule Change Request would address the issues identified by AEMO by putting in place regionalisation of cost recovery. It would also remove the now redundant reference to the fixed component of participant fees, promoting good regulatory practice.

¹⁸ 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 NGF alternative, while it would not alter the existing methodology for cost recovery for “other” services, would ensure that only a minority of directions were classified as “other” services. This would result in the majority of services no longer being subject to the existing cost recovery methodology for “other” services directions, but instead being treated as energy directions.

The AEMO-NGF position would put in places both sets of changes as proposed, addressing the issues identified by both parties.

The NGF’s second alternative would result in the inappropriate application of the cost recovery methodology for energy services to services that should be considered, and compensated as, directions for “other” services in the absence of an appropriate market mechanism. The Commission has determined not to adopt the NGF’s second alternative as part of its draft Rule.

The Commission has concluded that the Rule changes proposed will, on balance, result in incremental improvements in economic efficiency for the following reasons:

- An incremental improvement in allocative efficiency should be promoted through the introduction of regionalisation of cost recovery for “other” services directions, as this will ensure that the costs of "other" services directions are more closely aligned with those that benefit from them, regardless of the category of direction and regardless of the region in which the direction occurs.
- Productive efficiency should also be promoted by shifting the bulk of directed services to the energy category. The calculation of compensation for energy directions is more clearly defined in the Rules, resulting in greater certainty to generators and reduction of a potential source of risk (namely the classification of a directed service and the determination of a compensation price) which must be priced by generators. This should in turn reduce costs to consumers.

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 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.

AEMO's response to the NGF's alternatives 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.¹⁹ 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.

7.2 Stakeholder views

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.

The NGF, in its 16 November 2009 submission, expressed support for AEMO's amendment to clause 3.15.7(d). This amendment would have implications for the calculation of payable compensation to directed participants.

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

¹⁹ AEMO submission, 7 September 2009, p. 3

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.

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.

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 ordinarily be classed as directions for “other” services changing due to the effect of clause 3.15.7(d). 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, however, ensure that compensated is calculated on the basis of an efficient market price.

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

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.²⁰ 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 of supply (in this instance, as the result of a direction) and the price for that supply (calculated through compensation methodology). 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

²⁰ See AEMO submission, 7 September 2009, p. 3.

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.²¹”

Ensuring that directed participants are not able to engage in activities designed to maximise compensation would also remove significant potential market distortions and allow participants to better manage their exposure to the cost of a direction issued by AEMO.²²

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

7.4 Conclusion

Individually, the AEMO proposal and the NGF alternative do not directly alter the calculation of the quantum of compensation. However, the NGF alternative does 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. As the 2000 commentary from NECA, NEMMCO and the ACCC indicates, this is contrary to the intention of the Rules. Classifying the majority of directions as energy will also ensure that the price used as the basis for calculating compensation is derived through a market mechanism.

While AEMO’s suggestion in its 7 September submission that clause 3.15.7(d) be deleted would address the creation of incentives for generators to attempt to maximise compensation, the Commission believes that the solution proposed in the AEMO-NGF position is a more appropriate response, as there will be situations where directed participants should have recourse to clause 3.15.7(d).

The Commission considers that a draft Rule should minimise the incentives for generators to engage in behaviour designed to maximise compensation arising out of a direction, in order to reduce the possibility of distortionary pricing effects, as there is an identifiable efficiency benefit in ensuring that prices for supply reflect as much as possible the cost of that supply. The draft Rule, by removing incentives to engage in this sort of bidding or re-bidding behaviour, should also minimise incentives for directed participants not to respond promptly to an AEMO direction. Furthermore, the restriction on the operation of 3.15.7(d) reinforces the principle that compliance with

²¹ NECA/NEMMCO Final Report, *Power System Directions in the National Electricity Market*, 19 May 2000, p. 35

²² NECA noted in its final report 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”,

directions is an obligation placed upon participants in the interests of maintaining system security rather than an opportunity for generating profits.

8 Impact on the recovery of costs from market participants

The Rule Change Proposal, and subsequent submissions, raises 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”.²³

In response to the NGF’s alternative approach to the issue, AEMO questioned the NGF’s statements regarding customers exclusively carrying the recovery of compensation costs for ancillary services, and that pricing and compensation in the event of a market intervention are based on the concept of leaving generators unaffected by the intervention.

8.2 Stakeholder views

In its 24 August submission, the NGF argued that that the outcome of the application of the existing framework for cost recovery – namely the vast majority of directions being considered as “other” services – “has not been in accordance with the intention of the Rules”.²⁴ 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. This guidance, which would result in the bulk of directions classified as directions for energy, would shift responsibility for funding compensation from generator and customers to solely customers. The NGF contends that this shift to recovery solely from customers 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).

²³ AEMO Rule Change Proposal, p. 5

²⁴ NGF submission, 24 August 2009, p. 2.

- 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 benefitting from the direction (ie market customers in the benefiting region) are expected to pay.²⁵

8.3 Analysis

The AEMO proposal, on its own, 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 the regionalisation.

Conversely, participants in non-benefitting 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.”²⁶

Adopting the changes proposed by AEMO will remove the inefficient allocation of costs to participants in non-benefitting regions, as currently exists under the Rules, for the reasons outlined above, the inefficient allocation of costs to participants in non-benefitting regions can lead to distortions in competition, and inefficient pricing outcomes to the detriment of consumers.

The proposed use of “relevant energy” utilises existing terms established in clause 3.15.6A for the calculation of costs arising out of ancillary services transactions, in place of the current use of the largest fixed component of participant fees as the basis for determining proportional liability. The existing approach was originally adopted as a “least worst” option, given 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 largely maintains the current distribution of cost recovery across participant classes. Under current arrangements, generators have paid 43 per cent of recovered costs for “other” services

²⁵ NGF submission, 24 August 2009, p. 2.

²⁶ NEMMCO/NECA final report, p. 35

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.

The use of “relevant energy” as the basis for proportional liability would result in market generators having to pay a slightly greater proportion of costs than they currently do. Combined with the introduction of regionalisation (ie the move away from smearing costs across all regions), generators in benefitting regions will pay a greater proportion of an overall larger cost liability, though equally, generators (and customers) in unaffected regions will have no liability.

The NGF alternative would result in the majority of directions currently compensated as “other” services – and specifically network support services, which account for the bulk of “other” services directions – being treated as energy directions, which are already subject to the regional benefits test. Significantly, this would shift the cost recovery burden from all market participants (as applies currently to “other” services directions, which have historically accounted for the bulk of directions) to benefitting market customers only (as applies to energy directions), presuming that the majority of directions are treated as energy directions.

As a result, customers would pay more for directed services overall, due to the majority of services now being recovered as energy services. Directions for energy services are recovered from market customers, whereas “other” services directions are recovered proportionally from customers and generators (and would continue to do so under the AEMO proposal). Cost for all directed services, other than contingency FCAS (raise), would be recovered solely from market customers in the benefitting region. Regulation FCAS would continue to be recovered from customers (54 per cent) and generators (49 per cent).

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 (certain categories of FCAS are recovered from generators), 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.²⁷”

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.

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 and 7.4 above), but otherwise would result in the previously noted effects of the AEMO proposal and the NGF alternative remaining unchanged.

8.4 Conclusion

The Rule Change Request, in isolation, would result in a change to the way in which cost recovery for "other" services directions is calculated, which addresses the issues identified by AEMO. While it would shift the cost recovery burden to benefitting regions only (resulting in participants being required to pay more with regard to some “other” services directions, but nothing with regard to those directions where they do not benefit), this would be an appropriate shift in the cost recovery burden as it ensures that the costs of "other" services directions are more efficiently targeted to those participants that benefit from them.

The NGF alternative, by 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 believes 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.

²⁷ NEMMCO/NECA Final Report, 2000, p. 35

9 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.

9.1 Rule Change proponent's view

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

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.

9.2 Stakeholder views

The NGF sees 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.

9.3 Analysis

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 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.

Services are only defined in terms of their 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 an energy direction or a MAS direction and then only in terms of the relevant cost recovery mechanism.

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 mechanism²⁸; however, 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.

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.

9.4 Conclusion

The AEMO proposal would not directly alter the existing approach to classification of directions for service. Conversely, 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 did not 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.

The AEMO-NGF position would introduce into the Rules the definition suggested by the NGF alternative, as well as an amendment to 3.15.7(d) which will 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.

This guidance will ensure a greater level of clarity and certainty applies to directions for energy and “other” services. This will in turn provide greater 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.

²⁸ 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 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”.

Abbreviations

ACCC	Australian Competition and Consumer Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
Commission	Australian Energy Market Commission
MAS	Market Ancillary Services
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

Stakeholder	Issue	AEMC response
AEMO	The current methodology does not take into account the regions to which the benefits of the directions accrue. Thus, the costs are inappropriately allocated between regions. (AEMO Rule Change Proposal, 13 March 2009, p. 4)	Agree that current methodology does not do this, resulting in costs being recovered from participants in all regions. Appears to be an inefficient approach and inconsistent with other directions.
AEMO	[existing] 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. (AEMO Rule Change Proposal, 13 March 2009, p. 4)	The AEMO-NGF position should increase regulatory certainty with respect to calculation of compensation for "other" services directions with consequential productive efficiency benefits
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 ie market customers pay for directions related to lower services, generators pay for FCAS raise services and both share the costs of directions for regulation services in accordance with the causer pays factors. (AEMO submission, 7 September 2009, p. 2)	Analysis supports AEMO's assessment regarding compensation costs being borne solely by customers as some FCAS is clearly funded by generators.
AEMO	The concept of leaving scheduled plant (ie scheduled loads and MNSPs as well as scheduled generators) in the same position as if the direction	Analysis supports AEMO's assessment. It is unclear to what the NGF is referring regarding leaving generators unaffected, though

Stakeholder	Issue	AEMC response
	<p>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)</p>	<p>NECA/NEMMCO do refer to generators being left "no worse off" with regard to obeying a direction (see NECA/NEMMCO Final Report, May 2000).</p>
AEMO	<p>AEMO recognises that if a valid bid or offer is in place, then the need to direct should not occur. There is an obligation 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, and there is little time for the formal replacement of a dispatch offer to which the generator does not comply. (AEMO submission, 7 September 2009, p. 3)</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, as this could result in a delay in responding to an AEMO direction.</p>
AEMO	<p>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</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>

Stakeholder	Issue	AEMC response
	<p>historical 90th percentile value, ie well above average volume-weighted "valid bid" prices. A claim for additional compensations could be made if the direct costs incurred by the directed participant exceeded the value calculated using the 90th percentile price. (AEMO submission, 7 September 2009, p. 3)</p>	
AEMO	<p>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. (AEMO submission, 7 September 2009, p. 3)</p> <p>The NGF 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.</p>
AEMO	<p>AEMO considers that there is merit in using the accepted offer price in the rare circumstance</p>	<p>This appears to be appropriate given the preferred reliance on using existing market mechanisms as</p>

Stakeholder	Issue	AEMC response
	<p>where an IT failure of the dispatch systems has occurred that prevents the normal dispatch of that service. Amendment of this clause, as suggested below, would allow the benefit of this clause to be retained and would ensure that the NGF's proposal does not introduce the detrimental outcomes identified by AEMO regarding the issue with the current operation of clause 3.15.7(d) of the NER. (AEMO submission, 13 November 2009, p. 1)</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>the basis for determining a fair price – this would 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.</p>
AEMO	<p>The reference to "valid bid" has been replaced with "acknowledged bid" to make it clear that only bids or offers validated under clause 3.8.8 would qualify. The words "dispatch offer" have been included 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 NGF does not oppose the Rule change that has been proposed by NEMMCO but believes that a further change beyond that now proposed would be desirable.</p> <p>The issue that concerns us relates to the classification of directions as either for the "provision of energy or market ancillary services" or alternatively for "services other than energy and</p>	<p>There is an argument supporting a relationship between the two issues as classification determines cost recovery methodology.</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</p>

Stakeholder	Issue	AEMC response
	<p>market ancillary services". It is this latter classification that is the subject of the Rule change now under consideration by the Commission. This classification process, which in practice is conducted by the market operator, affects both the calculation of compensation and funding of that compensation. (NGF submission, 24 August 2009, p. 1)</p>	<p>discretion.</p> <p>This has been addressed in draft Rule by incorporating amendments to classification framework.</p>
NGF	<p>We note that directions in this category [network support] incurred 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 Rule (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>We submit that within the ordinary meaning of the words, such a direction is clearly a direction for energy. We note in particular that no activity other than the production of energy is required of the directed participant.</p> <p>We contend that the classification of a direction should be based on the nature of the dispatch outcome that it substitutes for, if it does substitute for a possible dispatch, and that the "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>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 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 and is supported by the principles outlined by NECA and NEMMCO.</p>

Stakeholder	Issue	AEMC response
NGF	<p>The primary aim is to restore the funding arrangements for directions to the state that we contend was the clear intention of the current Rules.</p> <p>We propose that this be done by inserting a new clause defining the “other” classification and clarifying the consequences of assigning a direction to this classification. A draft to this effect is attached as an appendix. (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. This has been incorporated into the draft Rule.</p> <p>However, it will have an impact on the quantum of compensation.</p>
	<p>...much of the intended outcome could be achieved by aligning the cost recovery provisions for directions in the “other” category, with the cost recovery already specified for directions for energy or market ancillary services.</p> <p>In particular, this would lead to cost recovery from market customers only, which would then be consistent with the way in which different market participants benefit from the application of direction. In other words, it would lead to the beneficiaries paying. We submit that this outcome has already been judged to be consistent with the national Electricity Objective, as evidenced by its inclusion in the current Rules.</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, though it does apply in some instances. NECA/NEMMCO addressed this in 2000 in response to calls in submissions for a general beneficiary pays approach for directions and concluded it 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)	
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 February 2010, p. 1)</p>	<p>It is unclear on what basis NGF reaches this conclusion, as there are categories of FCAS that are clearly recovered from market generators. The comment regarding provisions for “other” service being non-specific as possible is borne out by previous NECA/NEMMCO and ACCC documents (as noted in the draft determination).</p>