

29 January 2009

Dr John Tamblyn
Chairman
Australian Energy Market Commission
PO Box A2449
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By email: submissions@aemc.gov.au

Dear Dr Tamblyn

Physical Market Cap Trigger Rule Change Proposal (ERC0075)

This submission is in response to the NGF's rule change proposal to establish a Contingency Administered Price Period (CAPP) triggered by disruptive events and incidents of the power system. The SECV provides comment on a number of the specific arguments presented in the NGF's submission, and raises some additional questions for consideration prior to a rule change.

The NEM is currently structured to provide incentives for both base load and peaking generation investment, as well as demand side participation. The market outcomes determine the appropriate price signals to either attract investment in base load or peaking generation.

The NGF Rule Change Proposal is essentially proposing a market intervention mechanism via a price cap during certain high price events. Whereas the market should determine the price signals to attract investment, the NGF's proposal intervenes in the market and reduces the incentives to invest in peaking generation and demand side participation. The SECV believes that this reduction in market efficiency runs counter to the National Electricity Objective.

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The SECV provides the following comments in respect of the NGF Proposed Rule change;

- In section 2.2 of the NGF rule change proposal, the NGF states that there is no corresponding negative revenue impact on a fully hedged retailer.
 - The SECV contends that there are already a number of risk mitigation instruments available to Market Participants to help insure them against high prices arising from non-credible contingencies, such as:Options
 - Inclusion of FM Clauses in hedge contracts
 - Interruption products and other demand-side response instruments

Accepting that such risk mitigation instruments are already available, any implementation of the proposed Rule change should take this into account, and only be implemented with sufficient long term notice so as to minimise the impact on any existing and future contracts.

- In the NGF's proposal, section 5.3 deals with the Potential Detriments of their proposed rule change to demand-side managers.

The conclusion is that any incident which satisfies the criteria of a non-credible contingency - as defined in section 4.3 of the NGF's proposal - is quite rare and therefore the financial impact of removing higher prices which arise as a result of these is likely to be immaterial.

The SECV does not agree with this statement. Demand side participation is evidence of an efficient market, and such participation relies on elevated prices as an incentive to participate. The removal of any number of high-priced future events will have a detrimental effect on such participants, and will have an adverse affect on the efficiency of the NEM.

- Under the heading "Dilutes Availability Incentives" in section 5.3 of the NGF's proposal, the NGF deals with the concern that price capping may reduce the incentives on generation and demand-side response to be available for dispatch following a serious incident.

A statement is made "Non-dispatch generation and load cannot be directed and is not eligible for compensation. However, these parties would not be expected to respond quickly to sudden, unexpected price changes in any case, and so the price capping would probably not materially affect their behaviour".

The SECV notes that there are already some large, non-dispatchable loads (e.g. aluminium smelters) that have demonstrated the capability to rapidly respond to high-price triggers, and as such price-capping would materially affect their behaviour.

- Section 6.3 in the NGF's proposal under the heading "Settlement Timescale" states:

"The proposed Rule, by capping prices, will substantially reduce the magnitude of the wealth transfers. Therefore, the impact of the proposed Rule will be beneficial for the dispatched-off generators and detrimental to the dispatch-on generator or to the retailers which hold cap contracts."

Since most generating companies own several power stations, it is possible that they may be dispatched-off at one site and dispatched-on at another, offsetting the overall impact. Furthermore, a power station which is dispatched-on in one incident may be dispatched-off in a later incident, so again the impacts may be offsetting. In the light of this, it is impossible to predict in advance who will gain and who will lose from the proposed rule. However, the reduction in the risk associated with these uncertain wealth transfer benefits all generators."

The SECV contends that demand-side participants should be included in the list of those for which the proposed rule change will have a detrimental effect, and that it is possible to predict that such participants will lose from the proposed rule change.

In addition, the reduction in the risk associated with the uncertain wealth transfers in question will not benefit peaking generators; hence the statement that all generators will benefit as a result is incorrect.

There are additional issues that require careful consideration in addressing the NGF's rule change proposal:

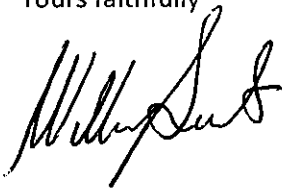
- The possible impacts on system reliability. Does the removal of high price outcomes dilute in any way the incentives to maintain and operate the system in accordance with Good Electricity Industry Practice? High price events are scrutinised more than lower price outcomes. This has been shown to improve the operation and performance of the NEM over time. Are there longer term implications that should be considered?

The possible impacts on the Secondary market. The implementation of the Rule change would decrease price volatility in the market and hence impact hedge contract markets. It could be reasoned that a decrease in volatility would have an adverse impact on liquidity. Ideally this consultation process will include the views of some secondary market participants.

In summary, the SECV disagrees with the NGF's proposed rule change on the basis that:

- The proposed Rule change unnecessarily intervenes in the efficient operation of the Market,
- Incentives for new peaking stations and demand side participants to enter the market will decrease,
- There are already a range of instruments available to all Market Participants that can be used to hedge against so called non-credible contingencies,
- A reduction in the number of high-priced events introduced via market intervention will have a detrimental effect on existing demand-side managers who are able to rapidly respond to such events

Yours faithfully

A handwritten signature in black ink, appearing to read 'William J Burt', written in a cursive style.

William J Burt

General Manager