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21 March 2005

Mr Peter Adams
Code Change Panel
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Dear Mr Adams

Recovery of Negative Inter-Regional Settlement Residues

NRG Flinders offers the following comments on the above Code change proposal, issued by the Code Change Panel for comment on 17 February 2005.

Summary

The changes provide for an improvement in the process for funding negative inter-regional settlement residues that accrue in the NEM, by recovering nett negative residues from future auction proceeds paid to the relevant TNSP, rather than auction fees funded by SRA unit holders, as under the present approach.

It is acknowledged that the existing approach represents neither an efficient nor practical solution. It leaves NEMMCO potentially exposed to significant debts for a period of time, increases costs for auction participants (thereby diluting the value of SRA instruments) and relies on the inefficient 'smearing' of costs across all auction fees.

NEMMCO's proposal therefore appears to have a number of advantages:

- It arguably provides for firmer SRA units, and therefore increases certainty and value for auction participants;
- It greatly reduces the period of time and extent to which NEMMCO is currently required to bear debt, and largely eliminates the resulting debt servicing costs;
- It reduces the inefficient 'smearing' of accrued negative residues across all auction fees, and confines the funding of nett negative residues to the relevant directional interconnector, arguably increasing certainty for TNSPs, to the benefit of customers as the ultimate recipients of the auction proceeds.

NRG Flinders therefore offers its support for the concept as an improvement on the current negative residue funding process.

Auction Proceeds Estimation

NRG Flinders offers its support on the basis that the recovery of nett negative residues would be confined to the respective TNSP relevant to the particular directional interconnect concerned, as implied in the wording of the Code change.

This should reduce any uncertainty in the estimation of forward auction proceeds in the setting of transmission charges, as the established pattern of negative residue accruals on a particular directional interconnect can be readily observed.

It is noted that the improved funding approach may act to firm up SRA units and therefore increase the value of these instruments, such that auction proceeds may not necessarily decline, given that auction participants would currently be pricing a discount in the value of the units, reflecting the recovery of negative residues.

Consistency Across Timeframes

Given the strengths of the new funding approach, there would appear to be benefits in extending the funding principle to cover all negative inter-regional settlements residues, not just significant residues that exceed weekly positive residue receipts.

This could possibly be achieved by the removal or appropriate modification of clause 3.6.5(a)(4)(i)(a), which provides for initial recovery of negative residues from positive settlement residues arising in the same billing period (ie week) before any remaining negative residues are recovered via auction proceeds.

Since NEMMCO has rejected the notion of a cap for netting off initial negative residues, the removal of this provision would appear consistent with the underlying intent of NEMMCO's proposal, and would achieve a consistent negative residue funding approach across all timeframes and enhance the benefits of the proposal discussed above.

Interest Costs

It is also noted that NEMMCO proposes to exclude interest costs from debt funding from the new funding arrangement, preferring to recover these costs through auction fees. Again, NRG Flinders would argue that such costs should appropriately be recovered through auction proceeds, consistent with the underlying intent of the proposal. These interest costs arise as a consequence of negative residue accumulation. These are costs auction participants are in no position to manage, provide no direct benefit to SRA holders, and are not incurred as a result of positive settlement residues, the rights to which participants compete at auction.

Accrued Debt

NEMMCO has also noted that an existing liability of approximately \$3m currently stands, due to accrued negative residues. However, NEMMCO's proposal appears silent on the recovery of this existing shortfall. It may therefore be desirable to clarify the intended treatment of this existing debt under the Code changes proposed, preferably in line with the new methodology, to avoid deferring the benefits of the new approach for an excessive period.

Accumulation Management Policy

More broadly, once an improved method of negative residue recovery is in train, NEMMCO may wish to reconsider its constraint management policy, whereby it generally attempts to limit the accumulation of negative residues to \$10,000 in any billing period. With improved shortfall funding arrangements in place that largely eliminate the inefficiencies and distortions of the existing funding method, there may be arguments for relaxing this threshold under certain circumstances.

Conclusion

NRG Flinders is supportive of the proposed Code change, as outlined above, and considers that additional benefits may be available by:

- considering the extension of the new funding arrangement to apply across all timeframes, through the modification or removal of sub clause 3.6.5(a)(4)(i)(a);
- clarifying the intended recovery of the existing accumulated debt (preferably in line with the new funding approach).

With the benefit of a more efficient negative residue funding arrangement, NEMMCO may also wish to reconsider its existing approach to the management of negative residue accumulation.

Should you have any queries in relation to this submission, please feel free to contact the undersigned on (08) 8372 8706.

Yours sincerely

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