20th January 2009

Dr John Tamblyn
Chairman
Australian Energy Market Commission
PO Box A2449
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Sent electronically to:
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Project Reference code: ERC0075

Dear Dr Tamblyn,

Supplementary Submission to:
Contingency Administered Price Cap Following a Physical Trigger Event Rule Change Proposal

This supplementary submission outlines a summary of the concerns Snowy Hydro has with the NGF proposal. Our concerns are detailed in a presentation to the AEMC presented on the 20th January 2009 and a Rule change proposal submitted to the AEMC on the 18th December 2008.

We do not wish to repeat the full details of the presentation or our alternative rule change proposal in this submission. However, we highlight that our presentation and our alternative rule change proposal are integral parts of our submission to the NGF rule change proposal and these documents should be read in conjunction with this supplementary submission.

The NGF rule proposal implies that there is a problem for generators in trying to mitigate the financial risk of significant contingency event(s) outside a generator's direct control. The NGF rule allegedly limits 'unmanageable' arbitrary financial transfers and reduces alleged inefficient spot market outcomes when certain contingency events occur.

Snowy Hydro strongly believes the NGF proposal does not resolve any of the problems it espouses to achieve through its proposed Rule change.

We believe that there is no net public policy benefit in implementing the NGF rule proposal and in fact its implementation would result in significant dis-benefits. Snowy Hydro strongly believes the financial risk that the NGF proposal has alleged needs managing can be satisfactorily managed through other means such as bilateral contracts with force majeure provisions. Additionally, Market Participants with appropriate and prudent risk arrangements in place would face undesirable sovereign risk to these arrangements by the ratification of the NGF rule change.

Snowy Hydro has experience with force majeure provisions in electricity market bilateral derivative contracts and we know of other electricity market counter parties that use similar force majeure provisions to manage the financial risk from major system contingency events. Force majeure provisions are also widely used in the gas market. Our point is force majeure provisions are used to manage financial risk and its use does not lead to distorted pricing signals in the electricity spot market.

If however the AEMC finds that there is evidence of some market failure in the existing market rules that supports the claims made by the NGF through its rule change, Snowy Hydro believes such market failure can be resolved more efficiently and in a much less distortionary manner through Snowy Hydro's alternative rule change proposal.

The following sections summaries the major concerns we have with the NGF rule change proposal.

Distorting Spot Market Outcomes

The fundamental problem Snowy Hydro has with the NGF rule change is that it would create inefficient market outcomes by distorting generator and demand side incentives to respond to the contingency event in the most efficient manner.

The Spot market relies on the spot price to signal to all Market Participants to balance the supply and demand in most efficient manner. The NGF proposal caps this Spot price under certain contingency events which by definition will alter generator, demand side response, and consumer incentives. In our view these altered incentives perversely hinders the market to reach the supply and demand balance in the fastest and most efficient manner.

Further to this:

- Because of a Spot market contingency event(s) the Spot market is at risk of being suspended. Just the risk of suspension alone will change generator incentives and demand side response which in the absence of the contingency administered price period (CAPP) would have efficiently brought the underlying supply and demand situation into balance;

- When the CAPP applies price signals are blunted and this distorts the appropriate mix of generation plant in the long run. In particular, Snowy Hydro is concerned that blunting the spot price would significantly reduce incentives on peak plant entry and demand side response which typically rely on a short duration of high spot prices to be economically viable;

- The capping of Spot prices in one region potentially leads to portfolio generators with generation in different regions shifting their pattern of generation between various sites. This may result in negative settlement residues. NEMMCO may manage these negative settlement residues by also suspending adjacent regions to the original triggered region. In effect, all market regions are at risk of market suspension and we believe such an outcome would only magnify the distortion and inefficiency of the NGF proposal; and

- The NGF proposal would blunt the driver for generators to maintain reliable plant.

The NGF proposal tries to make a distinction between efficient and non-efficient Spot prices for the purposes of new generation investment pricing signals. Snowy Hydro believes that there is no fundamental basis to such classification and to attempt to classify spot prices is simply wrong.

The very purpose of a Spot market is to allow Market Participants to respond to the Spot price both for dispatch, consumption, and in the long run for investment decisions. In particular, for new generation investment and demand side response what matters is the price irrespective of whether it was brought about from a non credible contingency or as a result of more general tight supply and demand balance.

The CAPP would be an arbitrary mechanism that would affect the Spot price by distorting the both the price and the distribution of prices. Snowy Hydro believes that it is the distortion in the distribution of Spot prices which may have the most significant impact on the appropriate mix of base, intermediate, and peaking generation and demand side response in the NEM thereby increasing the risk that the wrong type of investment is committed into the market. In the long run this is not in the interest of consumers.

Problems in Triggering and ceasing the CAPP in real time

The NGF proposal relies on increased NEMMCO discretion to determine Spot market outcomes since triggering the CAPP is totally reliant on NEMMCO. NEMMCO in turn must execute a complex procedure at a time when they are likely to be under stress trying to manage the system in the secure and reliable manner. We believe this is not fair or practical to impose on NEMMCO as this complicates system stress management for NEMMCO and may therefore create the need for directions and subsequent compensation.

The procedure to trigger the NGF's CAPP and determine when the CAPP should cease is very complex. This is demonstrated by a series of complex flow diagrams.

NEMMCO is required to trigger the CAPP in real time based on incomplete system data relating to the system contingency event and interpretation of very complex procedures. For NEMMCO to correctly trigger the CAPP it must have all necessary information and perfect foresight to ascertain whether a CAPP should be applied. Snowy Hydro believes this is both unreasonable and unpractical to impose on NEMMCO as the Spot market operator particularly in a time where NEMMCO system operators are likely to be under high stress.

The Reliability Panel's annual NEM Performance Review summates the number of Non Credible Contingency Events and multiple contingencies occurring each year. The NGF states that, "According to these reports, there were a total of 47 such incidents in the four years to 2007: about one per month[1]".

According to this statistics it is possible under that NGF proposal that the Spot market could be suspended once per month. This is potentially a very high level of market intervention and compromises the very reason for a Spot market, that is, to provide a transparent price signal for Participants to respond to underlying supply and demand balance.

Some of these Non Credible Contingency Events may not have a material impact on dispatch and therefore not result in the CAPP being applied. However, to some extent this is irrelevant as the risk of administered prices (ie. market suspension) is sufficient to change Market Participants behaviour and incentives and hence the NGF proposal could result in a greater level of market distortion than envisaged by the number of time the CAPP is actually triggered.

Snowy Hydro believes that under the NGF proposal that there is a high probability that NEMMCO may incorrectly trigger the CAPP when analysis of the facts after the contingency event conclude that the trigger was unwarranted or alternatively NEMMCO should have triggered the CAPP but did not. In both situations we believe that there are strong grounds for Market Participants to claim compensation for NEMMCO's incorrect interpretation of the CAPP trigger procedures.

[1] NGF Physical Cap Trigger Rule Change Proposal, page 24.

Increases the risk of further NEMMCO market interventions

Capping the Spot market at times of system stress financially prevents appropriate supply and demand side response. This complicates system stress management for NEMMCO, and as a result increases the risk that further market interventions are required to bring the Spot market back to balance. This may mean that NEMMCO is required to direct Market Participants.

Directions under these circumstances would be an artificial requirement brought about by the intervention of the CAPP in the first instance. If these directions were to occur than there is further resources and time required to determine subsequent compensation. Snowy Hydro believes such outcomes would be inefficient and not in the long term increase of consumers.

Smearing of Financial Risk

The NGF rule proposal smears the financial exposure to all Market Participants and in effect socialises the risk management cost of participation in the NEM. As a result this may reduce the incentive to address the root cause to the problem which triggered the CAPP in the first instance since the pain is not incurred by one or a Group of Participants who in the absence of the CAPP would have a greater incentive to ensure that the problem never occurs again.

In a sense the NGF rule proposal creates moral hazard whereby generators rely on the market to provide “free” insurance instead of ensuring their risks are managed prudently.

The smearing of risk under the NGF proposal would adversely impact the secondary market and its regular Participants such as brokers and financial intermediaries. This class of market Participants rely on market volatility and their services are tied to managing the risk of market volatility and providing liquidity.

If the overall level of market volatility is distorted under the NGF proposal then the risk is this important class of Market Participants would become less viable. In the medium to long term this becomes an undesirable outcome as these entities provide an important function to an efficient secondary market for financial contracts.

Finally, the NGF proposal results in arbitrary financial transfers which are dependent on the Market Operator triggering the CAPP in real time. Depending on the individual Market Participants contract position it could be a winner or a loser.

Technology Biased

The NGF Rule change proposal is not technology neutral. That is, peaking generators and demand side response don’t have start up problems similar to coal generators. Thereby, in the absence of market suspension the response from peaking generators and demand side response may ameliorate the risks associated with the system contingency event.

Bias towards a number of generators in close proximity and gaming concerns

The NGF Rule change proposal is designed to favour generators in a highly concentrated location at the expense of generation that is not concentrated (eg. Favours the Latrobe Valley generators). This is because the probability of a contingency affecting multiple stations is much higher in an area with a high concentration of generators.

The NGF CAPP proposal also creates gaming opportunities for portfolio generators with generation in different locations to optionally trigger market suspension when the Spot price does not suit their current exposure.

Snowy Hydro's alternative Rule change proposal

As stated earlier in this submission Snowy Hydro believes the problem the NGF proposal aims to fix is currently being managed through other much more efficient and non distortionary mechanisms such as force majeure provisions in financial contracts. We believe there is no net public benefit in implementing the NGF proposal as there is no market failure of the electricity rules that prevents such risks from being managed.

However, should the AEMC find evidence of some market failure that warrants closer inspection of the NGF proposal, Snowy Hydro has proposed a Spot Market Insurance Fund as an alternative and much more efficient solution.

The Snowy Hydro proposed Rule would establish a Spot Market Insurance Fund whereby participating Market Participants would be eligible to claim compensation for Spot market contingency events(s) which have a low probability of occurring but when it does occur result in high financial impact. The Spot Market Insurance Fund addresses all of the problems outlined in the NGF proposal without the major problems associated with the NGF proposal.

The Spot Market Insurance Fund is proposed to be administered by the AER. The AER in consultation with Market Participants and NEMMCO would develop:

- Trigger conditions for compensation;
- The form of the Fund; and
- Membership and Costs.

The major difference and advantage of the Snowy Hydro proposal compared to the competing NGF proposal is that the Spot market is not suspended during the relevant spot market contingency event(s). The assessment of compensation is determined after the contingency event(s) when all relevant parties have the time, resources, and all necessary data to determine whether compensation is warranted. Snowy Hydro's alternative proposal correctly avoids NEMMCO having to make difficult market suspension decisions at times of system security stress when NEMMCO's focus should correctly be on maintaining the system in a secure and reliable state.

Summary

In summary, Snowy Hydro has serious concerns with the NGF rule change proposal. We believe the NGF proposal is fundamentally flawed as it distorts Spot market pricing signals and relies on NEMMCO market intervention at a time when NEMMCO's focus is on system security and reliability. We strongly believe the NGF rule change proposal should be rejected.

Snowy Hydro believes there is no evidence of market failure to support the NGF proposed rule change. However, should the AEMC finds some market failure through the existing rules, Snowy Hydro has submitted a competing and alternative rule change proposal which addresses the concerns of the NGF but does not have the problems inherent in the NGF proposal.

Snowy Hydro appreciates the opportunity to respond to this consultation. Please contact Kevin Ly, Manager Market Development and Strategy on (02) 9278 1862 if you would like to discuss any issue associated with this supplementary submission.

Yours sincerely,

Roger Whitby
Executive Officer, Trading