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Ministerial Council on Energy

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Dr John Tamblyn
Chairman
Australian Energy Market Commission
PO Box A2449
SYDNEY SOUTH NSW 1235

Dear Dr ~~Tamblyn~~ ^{John},

**Arrangements for Managing Risks associated with Transmission Network Congestion
(Implementation of the Rule Change Recommendations of the CMR)**

I refer to the letter from the Hon Martin Ferguson AM MP, Chair of the Ministerial Council on Energy (MCE) of 5 November 2008 outlining the MCE's response to recommendations of the Australian Energy Market Commission (AEMC) in its Congestion Management Review - Final Report (CMR Report). The MCE has endorsed the recommendations of the AEMC in the CMR Report.

In the letter, the MCE recognised the extensive consultation undertaken by the AEMC in formulating the final CMR Report. MCE requested that the AEMC progress four proposed Rule changes to implement the recommendations arising out of the CMR Report. It was requested that these proposed Rule Changes be considered under the fast track rule change process in accordance with section 96A of the National Electricity Law (NEL).

In support of that request, please find attached further information to progress the proposed Rule changes referred to above.

I further note that the current negative settlement residue recovery mechanism, which is the subject matter of one of the proposed rules, is due to expire on 30 June 2009 and that the National Electricity Market Management Company is due to auction units for periods beyond that date. As noted in the response, the MCE considers that it would be inefficient to revert to the old recovery mechanism of auction fees. Therefore the current sunset should, if necessary, be extended until the new recovery mechanism can be implemented. This should be given effect through a savings and transitional arrangement in the Negative Residue Draft Rule.

Should you have any further enquiries, please contact Ms Kimberley Pattinson, Manager MCE Secretariat, on (02) 6213 7789.

Yours sincerely



Drew Clarke
Chair, MCE Standing Committee of Officials

16 February 2009

Rule Change Request - Further Information

Implementation of the Rule Change Recommendations of the Congestion Management Review undertaken by the Australian Energy Market Commission

December 2008

Background and context

In October 2005, the MCE directed the AEMC (the Commission) to undertake the Congestion Management Review (the Review). Under the Terms of Reference for the Review, the Commission was asked to identify and develop improved arrangements for managing both the financial and physical trading risks associated with material network congestion in the NEM. The Commission was also asked to develop draft changes to the National Electricity Rules (the Rules) to enable implementation of the proposed arrangements.

The Commission published its Final Report on the Congestion Management Review in June 2008. The Final Report recommends four Rule changes. The recommendations are based upon consultations arising from both the Draft Report on Congestion Management Review and the Exposure Drafts of the recommended Rule changes.

The MCE has endorsed the recommendations of the MCE and requests that the Commission progress the Rule changes via the fast track Rule change process in accordance with section 96A of the National Electricity Law.

The following information is provided in support of the Rule Change Request.

Rule Change Request

1. Proponent of the Rule change request:

The Ministerial Council on Energy
MCE Secretariat
GPO Box 9839
CANBERRA ACT 2601

2. Description of the Rules:

The Commission's Final Report on the Congestion Management Review recommends four Rule changes to improve the arrangements for managing financial and physical trading risks associated with transmission network congestion. The MCE requests that the Commission make all four Rules.

- Draft National Electricity Amendment (Fully Co-optimised and Alternative Constraint Formulations) Rule 2008.

This Rule change would formalise in the Rules NEMMCO's use of fully co-optimised network constraints for the purposes of dispatching generation and Market Network Service Providers.

- Draft National Electricity Amendment (Negative Inter-regional Settlements Residue Amounts) Rule 2008.

This Rule change would amend the Rules governing the funding of negative settlement residues so as to reduce uncertainty for holders of Inter-Regional Settlement Residue (IRSR) units.

The current negative settlements residue recovery mechanism, which is to be replaced by this proposed Rule, is due to expire on 30 June 2009 and that NEMMCO is due to auction units for periods beyond that date. If the expiry date is not extended, then the current

negative settlement residue recovery mechanism will, under the Rules, revert to the arrangements that applied prior to 1 July 2006.

The MCE considers that it would be inefficient to revert to the old recovery mechanism of auction fees and therefore the current sunset should, if necessary, be extended until the new recovery mechanism can be implemented. This should be given effect through a savings and transitional arrangement in the Negative Residue Draft Rule.

Clauses 3.6.5(c), 11.1.1(c), and 11.1.2(b) would need to be amended to extend the expiry date of the current negative settlements residue recovery mechanism.

- Draft National Electricity Amendment (Congestion Information Resource) Rule 2008.

This Rule change would establish a new Congestion Information Resource (CIR), to be published by NEMMCO, which will consolidate and enhance existing sources of information relevant to the understanding and management of congestion risk.

- Draft National Electricity Amendment (Network Augmentations) Rule 2008.

This Rule change would clarify the Rules governing the rights of generators who fund transmission augmentations as a means of managing congestion risk, so that future connecting parties will make a contribution to those funded investments from which they benefit.

The details of the draft Rules are contained in Appendix G of the **Final Report on the Congestion Management Review by the Australian Energy Market Commission, June 2008** (the CMR Report).

3. Nature and scope of the issues that is proposed to be addressed:

As part of the Congestion Management Review, the Commission identified the need to:

- clarify and strengthen the obligations on NEMMCO in respect of how it formulates the constraints used to dispatch the market;
- improve the usefulness of the Inter Regional Settlement Residue (IRSR) units as a hedging instrument for generators, retailers and large users;
- clarify and strengthen the regulatory framework for transmission as it relates to circumstances where another party connects to the network and benefits from an existing participant-funded network augmentation; and
- improve the provision of information to the market about events affecting dispatch.

Collectively, the proposed Rules would provide greater transparency, predictability and certainty around the formulation, development and use of constraint equations and existing hedging instruments; strengthen the existing risk management instruments; clarify Rules around transmission augmentation and assist energy market participants to manage risks and make informed decisions.

4. The proposed Rules will contribute to the achievement of the national electricity objective:

The National Electricity Objective (NEO) set out in section 7 of the National Electricity Law provides the Rule making test:

“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.”

The Commission has proposed incremental changes consistent with the current National Electricity Market (NEM) design and looks to improve the provision of information and strengthen the existing risk management instruments. The proposed Rules would improve the clarity of the dispatch process and rules around transmission augmentation. Furthermore, the proposed Rules would also provide greater transparency, predictability and certainty around the formulation, development and use of constraint equations and existing hedging instruments.

The proposed Rule changes are a step towards establishing an effective congestion management regime that will promote efficient outcomes by assisting energy market participants to manage risks and make informed decisions and as such the proposed Rules contribute to the achievement of the NEO.

The extension of the expiry date of the current settlements residue recovery mechanism to an appropriate future date would provide certainty to NEMMCO and market participants on the negative settlements residue recovery mechanism that will apply before the proposed National Electricity Amendment (Negative Inter-regional Settlements Residue Amounts) Rule 2008 is made. Furthermore, extending the expiry date of the current settlements residue recovery mechanism, would avoid costs in implementing process and system changes to effect arrangements that applied prior to July 2006. As such, the extension of the expiry date contributes to the achievement of the NEO.

5. Expected costs and benefits of the proposed change and the impact of the proposed change on those likely to be affected:

The CMR Report provides the assessment of the proposed Rule changes and benefits.

The proposed Rule changes are designed to improve the arrangements for managing financial and physical trading risks associated with transmission network congestion. A summary of the benefits and costs of each of the proposed Rule changes is provided below.

- *Draft National Electricity Amendment (Fully Co-optimised and Alternative Constraint Formulations) Rule 2008.*

This Rule change will improve the clarity of the dispatch process. It will provide greater transparency and predictability around the formulation, development and use of constraint equations. Constraint equations have a significant commercial impact as they can directly affect how generation and load are dispatched. By “hardwiring” the constraint form in the Rules and requiring a high degree of transparency and predictability around the development and use of constraint equations through the Constraint Guidelines, this Rule change will ensure that market participants have greater certainty as to how these factors will impact on their own dispatch.

The use of the fully co-optimised constraint formulation is a policy position endorsed by the MCE. This particular formulation gives NEMMCO control over the most number of dispatchable variables (e.g. generator output), which improves its ability to manage power system security and supply reliability and to utilise more fully the network during the dispatch process. There are certain circumstances under which NEMMCO considers a

constraint formulation that is not fully co-optimised (an Alternative Constraint Formulation or ACF) will deliver greater security in the power system. While it is important for the system operator to have a level of flexibility in the Rules to use an ACF, participants must also have certainty around what constraint formulation NEMMCO will use in dispatch. The proposed Rule change ensures that NEMMCO only uses an ACF in exceptional circumstances, and that those exceptions are explicitly identified beforehand in the Constraint Guidelines.

This Rule change would formalise in the Rules NEMMCO's use of fully co-optimised network constraints for the purposes of dispatching generation and Market Network Service Providers.

The main costs involved with this Rule change arise from the implementation of the proposed Rule. The main costs are:

- Costs associated with NEMMCO publishing and when required, amending network constraint formulation guidelines and ensuring compliance with the guidelines; and
 - Costs associated with the Commission commencing a review 3 years after the implementation of this Rule where it is to consider the efficiency of NEMMCO's intervention policy for managing accumulation of negative settlement residues.
- *Draft National Electricity Amendment (Negative Inter-regional Settlements Residue Amounts) Rule 2008.*

The proposed Rule seeks to improve the usefulness of the IRSR unit as a hedging instrument for generators, retailers and large users. The proposed Rule would, instead of netting-off the negative settlement residues against the positive settlement residues which occur in the same billing week, implement arrangements for the direct funding of the negative settlement residues.

The removal of intra-week netting-off of positive and negative settlement residues means that unit holders will retain the full value of residues accumulated from other events during a week, which will thereby improve the IRSR as a risk management instrument. The value of IRSR units will no longer be diluted because of events resulting in negative settlement residues.

The direct billing of the relevant Transmission Network Service Provider (TNSP), who will then recover these costs through charges to its customers, is a more direct and transparent way to recover negative settlement residues rather than through auction proceeds following the netting-off process, as is currently the practice. However, the net impact is broadly the same. This direct billing arrangement also gives NEMMCO the flexibility to recover negative settlement residues in a timely manner rather than having to wait for the quarterly auctions.

These changes, coupled with an increase in the dispatch intervention threshold to manage the accumulation of negative settlement residues, will improve the value and usefulness of the IRSR unit as a mechanism for managing inter-regional basis risk. The redesign of the Settlement Residue Auction (SRA) to sell units up to three years in advance will improve their flexibility and usefulness for participants seeking hedge cover for their longer-term contract positions. It will potentially make secondary trading more likely, and thereby improve liquidity in the range of risk management tools available in the NEM.

This Rule change would amend the Rules governing the funding of negative settlement residues so as to reduce uncertainty for holders of IRSR units.

The extension of the expiry date of the current settlements residue recovery mechanism to an appropriate future date would provide certainty to NEMMCO and market participants on the negative settlements residue recovery mechanism that will apply before this Rule is made, and help avoid costs associated with implementing interim process and system changes.

The main costs with respect to this Rule change are related to:

- the requirement on the AER publish and where necessary amend a determination identifying which TNSP will be responsible for payments with respect to negative settlements residue; and
 - process and system changes by NEMMCO to implement this Rule.
- *Draft National Electricity Amendment (Congestion Information Resource) Rule 2008.*

The availability of information plays an important role in enabling market participants to understand, and therefore manage, the risks associated with congestion. This Rule change would establish a new Congestion Information Resource (CIR), and require NEMMCO to develop and publish a resource that provides information in a cost effective manner to market participants to enable them to understand the patterns of network congestion and make projections of market outcomes in the presence of network congestion. This will include information on planned network events. The development of the CIR is to be continuous and incremental.

The CIR will provide information to participants to help them understand how the network's available network capability may change due to planned network events such as outages. This is an important factor in strengthening the value of IRSR units by improving the reliability and predictability of transmission capability. If participants can accurately predict interconnector transfer limits, then with a high degree of certainty they can determine the required number of IRSR units necessary to hedge an inter-regional position.

The CIR Rule also requires NEMMCO to publish information on the incidence of congestion using historical data on mis-pricing. It also clarifies the definition of mis-pricing, based on comments made in submissions.

Understanding patterns and trends in the incidence of congestion is also relevant to policymakers.

The main costs on this Rule change are associated with the requirements on:

- NEMMCO to consult on and publish the "congestion information resource guidelines" and the "congestion information resource"; and
 - Transmission Network Service Providers to provide information to NEMMCO in accordance with the "congestion information resource guidelines".
- *Draft National Electricity Amendment (Network Augmentations) Rule 2008.*

Negotiated transmission services are an important element of the overall congestion management regime because they provide locational signals to generators considering investment options. The direct cost of connection provides one form of signal. The scope for generator-funded network augmentations provides another. This has relevance where the quality of access required by the generator is greater than can be supported by network investment consistent with satisfying the Regulatory Test.

A potential barrier to efficient responses to these signals is the risk that a generator who funds a network augmentation does not realise the full benefits of the augmentation because another generator connects subsequently.

The proposed Rules provide for this contingency in two ways. First, they allow a generator to negotiate an explicit level of transmission network user access with a TNSP; for example, the generator could stipulate compensation payments if the level of service was reduced. Second, they allow costs to be recouped (or charges reduced) in the event that another user's connection impacts on the service being provided to the generator.

While the current provisions in the Rules already allow for such responses to subsequent connections to a generator -funded augmentation, these provisions can be stated more clearly and directly. This includes making explicit the requirement that recouped costs (or reduced charges) should be negotiated between a generator and a TNSP, and not unilaterally imposed by a TNSP. This clarification will provide greater certainty for generators, thereby improving the overall effectiveness of the locational signal.

This Rule change would clarify the Rules governing the rights of generators who fund transmission augmentations as a means of managing congestion risk, so that future connecting parties will make a contribution to those funded investments from which they benefit.

Since this Rule change is a clarification to existing requirements, no costs are involved.

6. Summary of consultations on the Congestion Management Review and the Exposure Drafts of Rule changes:

This Rule change request is made by the MCE under sections 91(1) and 96A(1)(b) of the National Electricity Law. The CMR Report documents the following consultations that were undertaken leading up to the recommended Rules:

1. an Issues Paper (March 2006) that outlined the Commission's understanding of the Terms of Reference and the impacts of congestion on the market;
2. a Statement of Approach (June 2006) that set out the process the Commission intended to take in progressing the Review and related issues;
3. a revised Statement of Approach (December 2006) that updated the process for progressing the Review and related issues;
4. a Directions Paper (March 2007) that presented some preliminary findings on materiality and a discussion of the options the AEMC considered worth closer examination;
5. a Draft Report (September 2007) that presented the Commission's proposed recommendations for improving congestion management arrangements in the NEM; and
6. Exposure Drafts (March 2008 and May 2008) that presented legal drafting to implement the changes to the Rules that the Commission recommended in the Draft Report.

Throughout the Review process the Commission also liaised directly with stakeholders through bilateral meetings, workshops and industry forums.

The matters raised by stakeholders in submissions on the Draft Report and the Exposure Drafts of the Rules have been noted, assessed, decided upon in the CMR Report.