

10 March 2006

John Tamblyn, Chairman
Australian Energy Market Commission
Level 16, 1 Margaret Street
Sydney NSW 2000

By email: submissions@aemc.gov.au

Dear John,

REFORM OF REGIONAL BOUNDARIES

Origin appreciates this opportunity to provide a submission on the Ministerial Council of Energy (MCE) proposed rule change regarding the process and criteria for regional boundary change in the NEM.

Our views with respect to the current consultation should be seen primarily in the context of the desire to maximise possibilities for trade and competition across the network; which for retailers entails the ability to access markets with minimum risk in all areas of the NEM and to purchase energy from a variety of suppliers at minimum cost. In this regard, we are strongly supportive of an efficient transmission investment framework and a regional spot market which provides an appropriate balance between locational price signals and liquid interregional trade. We consider that balance to be about right in the NEM with the exception of the Snowy region¹. Origin is strongly of the view that changes to regional boundaries should only occur as a last resort and on the basis of well specified and sufficiently rigorous economic criteria.

To this end we are largely in agreement with the broad principles contained within the policy statement on transmission released by the MCE in May 2005:

1. The MCE agreed that regional structure should be stable, with the giving of advanced notice of a boundary change to allow registered participants the opportunity to adjust their contract and trading positions.
2. Amendments to regional boundaries occurring only on the basis of robust economic criteria.
3. The MCE agrees that the relationship between regional boundary review, the regulatory test, congestion management and the Last Resort Planning Power (LRPP) should be clearly defined.

However, we have reservations with some of the proposed detail underlying these broad principles. The MCE requires that the economic criteria developed by CRA should form the starting point for consultation; however, we are not convinced that the criteria for justifying regional change should be any different to those currently used for calculating net market benefits under the regulatory test. Both measures essentially address the same problem: material and persistent congestion on the network and thus should be

¹ Please see our submissions to the LYMMCO and Snowy Hydro consultations on this issue.

evaluated on the same basis. Further, while we agree with the general linkage proposed by MCE for managing congestion and conferral of a LRPP on the AEMC with respect to transmission investment, we do not consider it is necessary for such a power to also exist for regional boundary reviews. This should be left to participants whom we consider to be better placed to assess whether a regional boundary change is required. With regard to the latter, we fully support the MCE proposal for participant driven regional boundary change applications provided a stringent set of rejection criteria are incorporated into the rules.

We discuss these issues in more detail below.

1. Stability of regional structure

The MCE proposes two alternative options in relation to the timing of regional boundary reviews: periodic reviews every 5 years coinciding with the revenue reset period of transmission companies; or boundary review by application. The MCE supports the latter option because it considers the former would lead to cyclical uncertainty. We agree. Participants are in the best position to determine whether a regional boundary change is needed since they bear the costs and benefits of regional change.

While this implies some potential gaming issues, the MCE considers these can be largely avoided by giving the AEMC the power to reject spurious proposals on a number of grounds, including where:

- The economic criteria are unlikely to be met
- A committed investment proposal has been shown to address the constraint
- The ANTS has not identified the constraint as material or enduring
- The congestion management regime has not identified the constraint as material or enduring and/or
- An application of the LRPP has identified a project as passing the regulatory test.

These grounds for rejection of a regional boundary proposal provide Origin with some comfort that regional boundary change would only be undertaken rarely and on the basis of clear and compelling evidence. A key criterion in this respect is the power of the AEMC to invoke its LRPP to direct an applicant or another party to undertake the regulatory test. Thus where a committed investment has not already been identified, a boundary application would provide an opportunity for the AEMC to invoke its power to request whether the constraint could not be better addressed through transmission investment. The clear advantage of such an approach is that this allows the net benefits of transmission investment and regional boundary change to be compared at the same time. However, it would therefore be important that these two alternative means of addressing congestion are valued on the same basis. A key issue we turn to in the next section.

Finally, Origin notes that the proposed rejection criteria have not been included in the rule change proposal. We would strongly urge the AEMC to include these in the rules to ensure regional boundary changes are considered in a transparent and predictable manner.

2. Economic Criteria

The MCE considers that regional boundary changes would only occur when clearly justified on the basis of a cost-benefit analysis. The test for the creation or amendment of a region would depend on whether the change is likely to result in “material and enduring net economic benefits”. While we agree with this principle we are less convinced by the proposed economic criteria, developed by CRA, that underpin it. These provide for regional change in the event of the following:

1. An increase in the economic efficiency of dispatch of at least \$1 million p.a.; or
2. A change in locational price indicators [within the new region] sustained over the review cycle such that indicative investments in generation would achieve an increase in revenue annually of at least 25 per cent of new entrant costs.

Provided that:

- A region of no less than 200MW of demand be created; and
- A separate region shall not be created where in the reasonable opinion of the relevant authority there is little prospect of market based investment within the review period.

While dispatch efficiencies are an appropriate consideration in evaluating the need for regional change, we are less convinced by the locational price indicators criterion, which appears highly arbitrary and subjective in our view. Origin also considers the \$1 million threshold value for dispatch efficiencies is probably too low given the imprecision associated with calculating forward looking benefits and costs. We would prefer to see a range of between \$5 and \$10 million as a more appropriate threshold justifying regional change.

There is also a question as to why the criteria being proposed are different to those underlying the regulatory test, when both are used to address the same problem. In particular, with the proposed facilitating role of the LRPP there appears to be no reason why addressing congestion through regional change or transmission investment cannot be done concurrently and on the basis of the same economic criteria.

The criteria proposed by CRA also appear to be somewhat limiting. The regulatory test values a range of costs and benefits including: dispatch costs, reductions in losses, deferred or avoided capital expenditures, competition benefits and any other benefits that can be quantified. The latter points to one of the strengths of the regulatory test; that it does not limit the types of benefits that may be included. This may be important in relation to regional boundary changes where financial market and trading impacts must also be incorporated into the cost benefit calculation; not just dispatch costs or locational factors.

If the same criteria were to apply in each case then investment and region boundary change can be compared on an equivalent basis with the highest net-benefit option given precedence for addressing a congestion issue. The LRPP would provide a key facilitative role by allowing the AEMC to invoke a regulatory test review at the same time as a regional boundary change application. This would appear to be a more efficient approach to dealing with a serious congestion in the NEM.

3. Linkage to Regulatory test, Congestion Management and LRPP

The MCE proposes that a congestion management regime is initially implemented to address material points of congestion (to ensure price signalling is initially correct) and if on the basis of improved price signals congestion persists (as flagged in the latest two ANTS) and has not been addressed by investment, then it may be appropriate for the AEMC to invoke its LRPP. However, if upon invocation of the LRPP no investment has been committed within the following two years, it may invoke a regional boundary review.

Origin is relatively comfortable with the linkages proposed by the AEMC. In general, we agree that a CSP/CSC arrangement is likely to be the lowest cost option for dealing with a serious intra-regional constraint in its initial stages. It is a flexible mechanism that would improve the price signalling around substantive constraints for generators; encouraging more efficient behavioural responses and discouraging distorted bidding and consequential negative residues (and thus NEMMCO intervention to curb such residues). The CSP/CSC arrangement would also introduce a better mechanism than currently exists for apportioning access to constrained capacity (although the detail of the allocation mechanism will matter here) and, significantly, would interfere less with market trading liquidity compared with regional change, for two principal reasons:

First any regional boundary change may change the size, pricing and subsequent trading dynamics and risks in all regions adjacent to the new or amended region; whereas the effects of a CSP/CSC regime are much more localised and impose lower transaction and system costs. Second, the price signalling effect of a CSP/CSC arrangement is focused on generators rather than retailers whom are better placed to respond to such signals. Retailers will continue to observe more stable regional reference prices (the effective price retailers hedge around is not directly affected), which again implies there is less impact on hedging arrangements, system and transaction costs. This should ensure more liquid inter-regional trading and less disruption to financial markets.

A further important benefit of the CSP/CSC arrangement is that where congestion diminishes the arrangement effectively dissolves; which contrasts with the introduction of a new region which will be much more difficult to remove once congestion is eliminated.

Origin notes that no threshold trigger has been provided for the introduction of a CSP/CSC regime; rather this will be assessed on a case by case basis as the need may arise. We believe a simple trigger, such as some specified value of constraint costs, may be appropriate however, though we leave our more detailed comments regarding this issue to the congestion management review to commence shortly.

The MCE envisages that following the implementation of a CSP/CSC regime, if congestion persists and no participant has been forthcoming with a regional boundary change or a transmission investment proposal, the AEMC will invoke its LRPP. The latter appears to reflect a concern that the regulatory investment framework provides insufficient incentives for projects to be put forward which address other than strict reliability requirements. We tend to agree with this perspective and support the LRPP as a facilitative mechanism in this regard.

However, we are less convinced that AEMC itself should be able to invoke a review of region boundaries. Presumably, if no participant has come forward with a regional boundary change proposal then the market does not perceive the need for one to occur;

and in this context any inclination for the AEMC to substitute its own judgement for that of the market is inappropriate. We are inclined to the view that boundary reviews should be initiated by participants only, since they are the ones impacted by such a review. This contrasts with regulated transmission investment where the needs of the market and those of transmission companies may not always coincide (that is, those undertaking the investment and those impacted by it are not the same). A regulatory backstop in this context may be more appropriate.

Thus we consider that in the absence of a participant application for a regional boundary change the invocation by the AEMC of the LRPP with respect to the regulatory test should be the end of the matter; a further ability to invoke a regional boundary review subsequent to this appears unnecessary. In our view, if congestion is serious yet no investment project has been forthcoming then an affected participant will surely come forward to request a regional boundary change. The current participant proposals put forward in respect of the Snowy region, the only area currently in the NEM experiencing significant congestion, are testimony to this fact.

Conclusion

Origin is strongly supportive of the principle that regional boundary change should occur infrequently, with the review process driven by participants rather than imposed externally by the regulator. However, rigorous rejection criteria are essential to ensure gaming of the process does not occur. We consider those proposed by the MCE to be appropriate although to ensure greater transparency and clarity they ought to be included in the rules.

The economic criteria proposed by the MCE appear somewhat arbitrary and unnecessary. The case for the creation, amendment or deletion of a region should occur on the basis of comprehensive net-market benefits test that compares transmission investment with regional boundary change on an equivalent basis; we can see no conceivable reason why these should involve different processes. In this context, the conferral of a LRPP on the AEMC can ensure that the timing of regional boundary proposals and transmission investments can be matched and that, as a consequence, congestion on the network is addressed in the most cost effective manner.

Finally, we support the linkage of congestion measures proposed by the MCE though we do not support a capacity for the AEMC to invoke regional boundary reviews. The need for the LRPP in respect of transmission investment effectively arises out of different incentives applying to transmission companies and participants; the former are not subject to the market impacts of their proposals and thus may not be fully focused on ensuring investment proposals are put forward when needed by the market.

If you wish to discuss any of these matters further please do not hesitate to call Con van Kemenade on 8345 5278

Yours Sincerely,

Michael Hayes
Manager, Portfolio Strategy & Regulation