Macquarie Generation

System restart ancillary services

SUBMISSION TO THE AEMC IN RESPONSE TO PROPOSED RULE CHANGES

14 October 2005

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1. Introduction

Macquarie Generation appreciates the opportunity to make this submission to the AEMC in response to the section 95 Notice for Proposed Rule No. 2005/02 – System Restart Ancillary Services and pricing under market suspension (Rule change).

Macquarie Generation is strongly opposed to the proposed arrangements for system restart ancillary services (SRAS) in the Rule change. Our opposition is at three distinct levels:

- First, at a high in-principle level, the Rule change imposes inappropriate functions on NEMMCO (see section 2);
- Second, at a substantive market impact level, the Rule change:
  - unnecessarily limits the technical characteristics of SRAS that NEMMCO may tender and contract for (see section 0); and
  - inappropriately and inefficiently seeks to quasi-regulate remuneration for SRAS (see section 4); and
- Third, at a detailed legal drafting level, the Rule change contains a number of troubling ambiguities (see section 0).

This submission develops each of these contentions and offers two efficient alternative approaches for establishing remuneration for SRAS (see section 0). Our conclusion is contained in section 0.

2. Inappropriate NEMMCO responsibilities

2.1 BACKGROUND

The Rule change effectively seeks to cap the amount NEMMCO pays and tenderers receive for SRAS. While there is nothing inherently wrong with capping the price that NEMMCO, as representative contractor for non-market ancillary services in the NEM, pays for SRAS, Macquarie Generation does have serious concerns about:

- the way this cap is set; and
- the level at which the cap is set.

Section 3 addresses our concerns about the level of the cap. This section highlights our concerns about the manner in which the cap is set, including the role of NEMMCO in that process.

2.2 NEMMCO AS ECONOMIC REGULATOR

The Rule change puts NEMMCO and ultimately the dispute resolution advisor and dispute resolution panel (DRP) in the position of economic regulator for SRAS services. The proposed clause 3.11.5C(a) states that:

"In assessing any NMAS tenders, NEMMCO must seek to acquire the relevant non-market ancillary services on terms and conditions that are consistent, to the extent practicable, with the following guiding principles:

(1) remuneration reflecting efficiently incurred long-run incremental costs of providing the non-market ancillary services;

(2) remuneration (excluding any primary service premium, if applicable) being sufficient (but need not be more than sufficient) to encourage efficient investment in the relevant non-market ancillary services and innovation in the provision of those services;

(3) remuneration (excluding any primary service premium, if applicable) for providers of the non-market ancillary services providing a return on capital adjusted for risk, that is equal to, or close to equal to, the opportunity cost of the capital employed; and

(4) the terms and conditions of the agreement to be entered should not be inconsistent with the terms and conditions of the draft ancillary services agreement annexed to the NMAS invitation to tender."

Clause 3.11.5C goes on to require the tenderer to provide detailed cost information to NEMMCO to enable NEMMCO to establish the reasonableness of the tender against its guiding principles.

Where NEMMCO chooses to dispute the tender, proposed clause 3.11.5E(c) provides the dispute resolution advisor with similar criteria for determining appropriate remuneration for

SRAS to those contained in clause 3.11.5C(a). In other words, the advisor is required to determine a long run cost-based price.

Macquarie Generation submits that these proposed clauses effectively make NEMMCO and ultimately the dispute resolution advisor and the DRP responsible for quasi-regulating SRAS remuneration. While this approach is deeply flawed from an economic perspective (discussed in section 4 below), it is also inconsistent with the institutional allocation of responsibilities in the NEM. The AER is the economic regulator of network services. If SRAS are effectively to be subject to similar economic regulation as applies to networks (a proposition with which we strongly disagree), Macquarie Generation believes that the AER is the appropriate body to undertake this role.

The DRP explicitly does not have economic regulation roles under the Rules. For example, where disputes are raised in relation to TNSPs' proposals to develop large transmission investments under clause 5.6.6, the DRP may determine factual or technical matters, such as whether the proposed investment will have a material inter-regional impact or is a reliability augmentation (5.6.6(i)(3) and (5)). However, the DRP is expressly forbidden from determining whether the investment satisfies the regulatory test (5.6.6(i)(6)). Rather, only the AER may determine whether the investment satisfies the regulatory test (5.6.6(m)) and even this is limited to non-reliability augmentations (5.6.6(l)).

For these reasons, NEMMCO and the dispute resolution advisor and DRP should not be given the roles proposed in clauses 3.11.5C and 3.11.5E of the Rule change.

3. Unnecessary limitations to technical characteristics of SRAS

The Rule change inserts a new clause 3.11.4A, which requires NEMMCO to develop and publish:

- a detailed description of each type of restart service being either a primary restart service or a secondary restart service. The description must include, without limitation, the technical and availability requirements for each type of restart service (3.11.4A(b));
- guidelines for undertaking modelling and testing of services to provide a reasonable degree of certainty that a facility is capable of delivering SRAS if required (3.11.4A (c)(1)); and
- guidelines for establishing the number, type, location of SRAS to be procured for each electrical sub-network (3.11.4A (c)(2)).

These documents are to be used in the SRAS tender process. Although these documents themselves are not (yet) the subject of consultation, Macquarie Generation seeks to highlight that the requirements for their development and publication may lead NEMMCO to an excessively narrow specification of the types of services that may be suitable for providing SRAS. In our view, NEMMCO should keep as open a mind as possible to facilitate trade-offs between offered services with different capabilities and costs.

For example, if an offered service has technical characteristics that fall just outside those specified in NEMMCO's guidelines under 3.11.4A(b) but it is being offered at a much lower price than another service that is fully within the required characteristics, it may be inefficient for NEMMCO to exclude the non-compliant service from consideration for contracting.

Macquarie Generation will reiterate these points if the Rule change is accepted by the AEMC and NEMMCO consults on the documents mentioned above.

4. Inappropriate and inefficient regulation

4.1 INAPPROPRIATENESS OF COST-BASED REMUNERATION

The Rule change effectively seeks to implement cost-based remuneration of SRAS. The sub-paragraphs of clauses 3.11.5C and 3.11.5E refer to principles such as 'efficiently incurred long run incremental costs', remuneration that is 'sufficient, but not more than sufficient' and a rate of return that is similar to the firm's opportunity cost of capital. These principles are similar to those contained in Parts B and D of Chapter 6, which govern transmission and distribution revenue and pricing requirements.

Macquarie Generation strongly contends that the economic regulation of SRAS in a similar manner to the economic regulation of transmission and distribution networks would be grossly inappropriate for a range of reasons.

SRAS does not exhibit the same natural monopoly characteristics as transmission or distribution services. Natural monopolies primarily arise due to large economies of scale and the inefficiency of duplication. The entire Part IIIA legislative framework in the *Trade Practices Act* (TPA) is based on the view that the inefficiency of duplication would allow natural monopolies, left alone, to raise prices over the long term and sustain economic profits. By contrast, neither the TPA nor the Rules prevent firms operating in contestable activities from setting 'high' prices or raising their prices.

It is also clear that the Rules and NEM market design is fundamentally based on the notion that generation is a contestable activity, where entry is (within limits) free. Indeed, if this were not the case, there would be little point in regulating access to transmission networks.

Providers of SRAS could not even properly be said to have substantial market power over the services they provide. While they may be the sole suppliers of services in the short term, they face competition from potential entrants in the longer term. The Australian law on market power under the TPA provides clear guidance on this matter.

In the High Court case of *Queensland Wire*, Mason CJ and Wilson J said:

> A large market share may well be evidence of market power… but the ease with which competitors would be able to enter the market must also be considered. It is only when for some reason it is not rational or possible for new entrants to participate in the market that a firm can have market power… There must be barriers to entry. As Professor FM Scherer has written, 'significant barriers to entry are the *sine qua non* of monopoly or oligopoly, for… sellers have little or no *enduring power* over price when entry barriers are nonexistent.' [Emphasis added][1]

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1 *Queensland Wire Industries Pty Ltd v Broken Hill Pty Co Ltd* (1989) 167 CLR 177, at pp.189-190.

Therefore, whether a firm has an ability to raise prices in the short term does not imply it has market power. The Federal Court judgment in *AGL* reinforced the view that a transient ability to increase price did not amount to market power.[2] In that case, French J found that barriers to entry in generation were low so that despite lags in the development of new generation and the ability of existing generators to temporarily spike the price (with an impact on forward prices), they did not have market power under the TPA.[3]

In this context, it is also worth reiterating that clause 3.1.4(b) of the Rules explicitly provides that the Rules is not intended to regulate 'anti-competitive behaviour by Market Participants', which is regarded as a matter for the TPA and other instruments. Note that while the term 'Market Participants' includes generators, it does not include transmission or distribution network service providers. Thus, the Rules make a clear distinction between generators and retailers on the one hand (which are 'regulated' by the market) and networks on the other (which are not).

Therefore, while it is indeed the case that regulation is instituted under the Rules to limit monopoly rents in the provision of transmission and distribution services, such controls were explicitly not considered for limiting the returns of market participants. The only limit on prices is the market price cap, VoLL, and the administered prices arrangements that apply in prolonged events.

Consequently, from a policy and market design perspective, Macquarie Generation believes it is inappropriate to introduce cost-based remuneration provisions for the procurement of SRAS.

4.2 INEFFICIENCY OF REMUNERATION PROPOSALS

Leaving aside the inappropriateness of imposing cost-based remuneration provisions for SRAS from a policy and market design perspective, Macquarie Generation believes that the proposed provisions will have detrimental effects on the efficiency of market outcomes and hence, the achievement of the NEM objective. There are several arguments that underlie this view.

4.2.1 Costly process

The Rule change requires SRAS tenderers (primarily generators) to provide detailed cost information to NEMMCO on request, in order for NEMMCO to clarify the 'reasonableness' of the tender. This suggests a very 'heavy handed' approach to establishing costs and remuneration, which is likely to be costly for NEMMCO to undertake. As market and system operator, NEMMCO is not equipped to analyse this information and would either need to retain or contract appropriate expertise. Such costs will be ultimately borne by the market.

2 *Australian Gas Light Company v Australian Competition and Consumer Commission (No 3)* [2003] ATPR 41-966, at [456].

3 At [493].

4.2.2 Ignores generator opportunity cost

A cost-based remuneration approach may deter potential SRAS providers from submitting tenders to NEMMCO, to the detriment of the long term interests of consumers and the market overall.

There is nothing in the existing Rules or the Rule change that forces parties to provide expressions of interest or tenders for the provision of SRAS. Yet SRAS are extremely valuable to market participants and end-users of electricity. In a system black of even a major supply disruption, generators will not be able to supply electricity and (most) consumers will not have access to electricity supply. Under these circumstances, if NEMMCO directed market participants to help restore the system under clause 4.8.9 of the Rules, those participants would be paid in accordance with 3.15.7A(c) of the Rules. Such remuneration therefore represents participants' opportunity cost of tendering for SRAS. A rational potential provider of SRAS would not voluntarily contract for the provision of SRAS if the risk-adjusted remuneration from direction were higher than the remuneration available from contracting. Consequently, it is relevant to consider what compensation the Rules provide should be payable by NEMMCO where it directs a market participant.

Compensation for direction

Clause 3.1.5.7A provides that in the case of non-market ancillary services, NEMMCO must (if appropriate) appoint an independent expert to determine a fair payment price taking into account:

- Other relevant pricing methodologies in Australia and overseas, including but not limited to:
  - Other electricity markets;
  - Other markets in which the relevant service may be utilised; and
  - Relevant contractual arrangements which specify a price for the relevant service; and
- The following principles:
  - (A) the disinclination of Scheduled Generators, Market Non-Scheduled Generators, Scheduled Network Service Providers or Market Customers to provide the service the subject of the direction must be disregarded;
  - (B) the urgency of the need for the service the subject of the direction must be disregarded;
  - (C) the Directed Participant is to be treated as willing to supply at the market price that would otherwise prevail for the directed services the subject of the direction in similar demand and supply conditions; and
  - (D) the fair payment price is the market price for the directed services the subject of the direction that would otherwise prevail in similar demand and supply conditions.

Focussing on the relevant principles, the key point is that the 'fair payment' price is equated to what the market price would have been if the market were operating normally.

The next issue is to estimate what the market price would be but for a direction to a market participant to provide system restart services. Although the market would probably be suspended in such circumstances (see clause 3.14.3), a system black is analytically equivalent to a situation where load is shed – available supply cannot meet demand at any price, up to VoLL. Under these circumstances, the market price would be at VoLL (presently, $10,000/MWh). Therefore, according to the Rules, a 'fair price' would be VoLL. This approach is supported by NECG's November 2003 report for NEMMCO in relation to the directions of 11 and 12 December 2002.[4] In that report, NECG examined a wide range of options for the determination of compensation. These options included, amongst others, the marginal cost of the relevant generator, the average cost of the generator and VoLL. With respect to VoLL, NECG said:

> Whilst efficient, the adoption of such an approach will not (at least in the short term) constrain the local monopoly power of generators. As such, it is unlikely to be consistent with a fair outcome, at least in ordinary circumstances. Nevertheless, it is conceivable that circumstances could arise where the payment of VoLL for a directed generator could be consistent with a fair payment price. Such a circumstance could arise, for example, where a generator is subject to a direction following the failure of more than one element of the transmission network. After all, the loss of several generation units in a region could reasonably be expected to result in relatively high spot prices at the regional reference node.[5]

While we do not endorse all of the sentiments expressed in this passage – for example, we would not necessarily equate a 'fair outcome' with 'constraining the local monopoly power of generators' nor even accept that a term like 'local monopoly power' has any meaning in the NEM – we note that NECG did accept the potential use of VoLL to determine compensation where several elements of the transmission system failed. By extension, in a system black situation, we suggest that there would be an even stronger case for a fair payment price to be based on VoLL, given the likely degree of unmet demand for electricity in such a situation.

In relation to other pricing methodologies for pricing system restart services in Australia and overseas, while we have not at this stage undertaken independent research into such methodologies, we do not believe such methodologies would or should constrain compensation for direction to below a VoLL price. In this context, we note that the NECG report considered ancillary service pricing in US markets (PJM and ERCOT) and England and Wales. However, NECG pointed out that the design of these markets was substantially different from the NEM, making direct comparisons of pricing approaches inappropriate. For example, PJM operates an installed capacity market, which ensures that there is sufficient capacity to meet demand. By contrast, there is no such market or payment for capacity in the energy-only NEM.

Restricting compensation for ancillary services provided under direction would reduce generators' returns and potentially harm incentives to invest. Another way to look at this issue is to consider that there is no 'average cost' cap of NEM spot prices when there is a

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4 NECG, *NEMMCO – Independent Export Report for Directions of 11and 12 December 2002, Final Report under clause 3.15.7A of the National Electricity Code*, November 2003 (NECG report).

5 NECG report, p.36.

tight demand/supply situation, even though many generators may at such times effectively have the ability to obtain high prices or substantially raise prices. There is no robust basis for limiting prices for provision of system restart services when the same generators may bid up to VoLL in the spot market operating prior to a system black condition.

Perverse incentives

In light of the discussion above, Macquarie Generation believes that the Rule change would create perverse incentives for potential providers of SRAS to refrain from tendering and wait to be directed in the event of a system black or major system disruption.

In these circumstances, NEMMCO would have much lower confidence that the relevant plant would be technically capable of providing SRAS compared to a situation where SRAS was contracted in advance. This suggests that an efficient level of remuneration for SRAS would, ***at a minimum***, be the expected risk-weighted value of compensation for direction to the relevant participant.

Expected compensation for direction, as the tenderer's opportunity cost for contracting, will typically not represent a unique efficient level of SRAS remuneration. It will generally represent the ***bottom of a range of efficient prices***. The top of this range is defined by the maximum willingness to pay of the market (or NEMMCO on the market's behalf) for contracted SRAS. Where within this range SRAS remuneration should be set is discussed further in section 0.

4.2.3 Primary service premium

An odd aspect of the Rule change is the provision for a 'primary service premium' in proposed clause 3.11.5G, to supplement the cost-based remuneration paid for SRAS availability, testing and usage.

The stated purpose of the primary service premium is to encourage entry into, and competition for, the provision of highly dependable primary restart services. NEMMCO argued that if remuneration for primary services only reflected costs and a reasonable margin, potential providers would have little incentive to "strive for status as a highly dependable primary service provider".[6] NEMMCO also believed that the premium should be an absolute amount rather than a percentage of the tendered price to avoid padding of initially tendered prices.

Clause 3.11.5G requires the AEMC to determine the premium, following consultation with the Minister for each participating jurisdiction.

In Macquarie Generation's view, the primary service premium is a contrivance designed to overcome the over-zealous quasi-regulatory approach in the Rule change to determining SRAS contract remuneration. It reflects the point made in the preceding section that potential SRAS providers may not find it worthwhile to tender if only cost-based remuneration is offered. While we agree, as noted above, that the community is likely to value the provision of SRAS more than tenderers' opportunity costs, and well above the actual costs of provision, the creation of supplements to cost-based pricing is the wrong way to facilitate better remuneration arrangements.

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6 NEMMCO, *Review of system restart ancillary service arrangements – Final report*, 8 July 2004 (Final Report), Volume 1, p.53.

To understand why this is the case, consider a stylised example (in Figure 1) with two SRAS sub-regions where the market's willingness to pay (WTP) for SRAS is identical. The example assumes a 'bilateral monopoly' situation where NEMMCO seeks one provider and only one provider exists. The tenderer in sub-region A has low costs of provision while the tenderer in sub-region B has high costs of provision. The premium is a fixed amount added to tenderers' costs of SRAS provision.

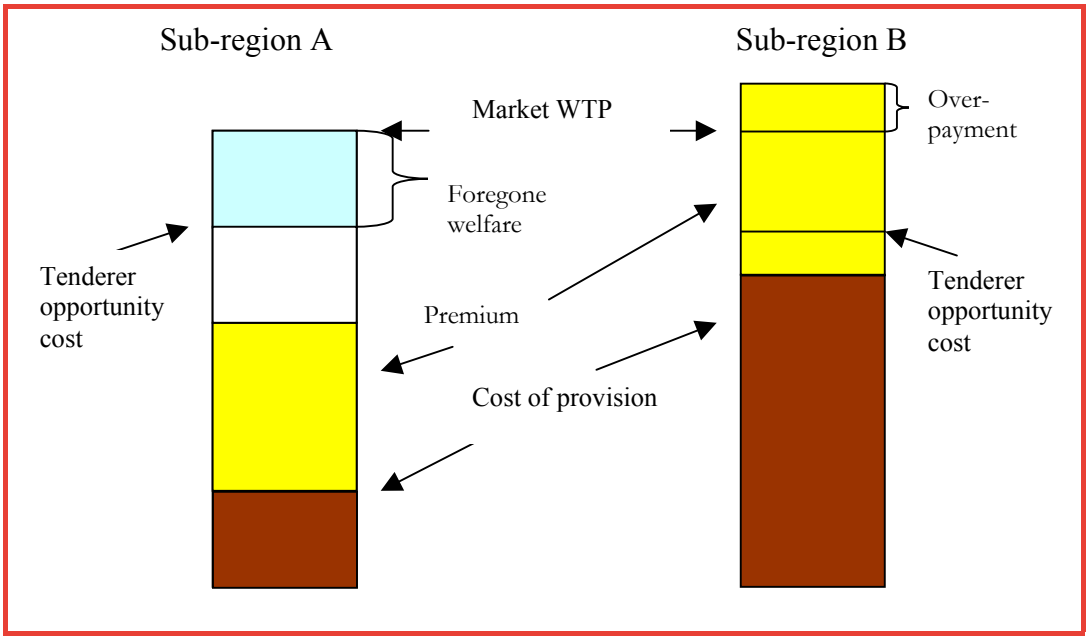

Figure 1: SRAS primary service premium

The AEMC will be able to consult with the jurisdiction(s) over the maximum willingness to pay for SRAS. However, unless the costs of SRAS provision are identical across tenderers, the premium the AEMC determines may be either insufficient or excessive. For example, in sub-region A, remuneration even with the premium is less than the tenderer's opportunity cost of provision while in sub-region B, remuneration with the premium exceeds the market's WTP. Both scenarios lead to inefficient outcomes because in sub-region A, no SRAS are contracted, while in sub-region B, the tenderer is (inadvertently) paid more than the market values the services. We consider that the sub-region A situation is far more likely to occur in practice and that the primary service premium is an arbitrary response to the problem.

4.3 NEMMCO FACILITY TENDERING

Another potentially harmful provision in the Rule change is contained in proposed clause 3.11.5H. This provides for NEMMCO to directly tender for facilities to provide SRAS following an unsuccessful tender process. The implication appears to be that if NEMMCO cannot attract tenders at cost-based prices, it will develop its own SRAS assets.

This is a provision that has real potential for creating economic inefficiency. As we have shown above, cost-based remuneration, even with a primary service premium, is not likely to meet a tenderer's opportunity cost of providing SRAS due to the likely compensation the participant

would get paid in the event of direction. This could lead to a situation where mutually beneficial contracts between NEMMO (as market representative) and generators do not go ahead. Instead, clause 3.11.5H could lead to the market funding *additional new plant* to meet NEMMCO's requirements. This expenditure would represent an efficiency loss to the market as a whole, because investment costs that could have been avoided by contracts in relation to existing facilities would be incurred. The market as a whole would be better off if NEMMCO simply paid a SRAS price that induced (existing) potential SRAS providers to tender.

5. Drafting ambiguities

This section highlights a number of drafting ambiguities in the Rule change. These ambiguities should be addressed if the Rule change is, in spite of this submission, approved.

- ***Technical standards*** – the fact that the technical standards will be set out in several different documents developed by different entities[7] may result in uncertainty for service providers if the standards do not complement each other and address any inconsistencies between the various documents.
- ***Payment for services – Basis of costs*** - The payment for SRAS is to be based on some estimate of the costs of providing the service plus a primary services premium if a primary service is provided. As noted above, clause 3.11.5C sets out relevant guidelines for NEMMCO's SRAS contracting. Whilst these guidelines are more expansive than the guidelines currently set out in the Rules, they still leave significant room for uncertainty.
- ***Payment for services - Primary services premium*** – As noted above, SRAS providers who provide a primary service will receive a premium determined by the AEMC to provide competition and encourage providers to strive for status as a highly dependable primary service provider.

  Clause 3.11.5G requires the AEMC to determine an amount or methodology for establishing the primary services premium in accordance with subclause (a) and requires the AEMC to consult with the Ministers for each participating jurisdiction. Subclause 3.11.5G(e) states that the AEMC may from time to time review and amend the premium. The proposed Rule changes appear only to shift the responsibility of determining part of the overall charges for SRAS from NEMMCO to the AEMC and give little real guidance to the AEMC on how the premium is to be determined. An additional concern is created by the uncertainty in subclause (e) – is it intended that the premium could change part way through a contractual term for SRAS?
- ***Payment for services – additional secondary services allowance*** - The Rules referring to the additional secondary service allowance in clause 3.11.5G are unclear. Is this simply authority to acquire additional services over and above the requirements in the guidelines, or will an additional premium be payable to the entity providing the additional services?
- ***Definitions of primary and secondary restart services*** - The definitions of "primary restart service" and "secondary restart services" include references to performance as "highly likely" and "more likely than not" which are vague and uncertain. It is not clear whether these references will be defined further by the guidelines to be issued by NEMMCO pursuant to clause 3.11.4A(b).
- ***Confidentiality*** - The reference to the system restart plan being confidential does not make it clear whether this plan will nevertheless be released to SRAS providers.

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7 The four documents comprise: (1) a description of the services (determined by NEMMCO), (2) guidelines for procurement and assessment/testing guidelines (determined by NEMMCO), (3) service standards (determined by the Reliability Panel) and (4) standards set out in the Ancillary Services Agreement (drafted by NEMMCO).

6. Proposed SRAS remuneration arrangements

Macquarie Generation proposes two options for determining efficient SRAS remuneration that we believe are vastly superior to the arrangements proposed in the Rule change. These can be loosely described as:

- 'Splitting the benefits'; and
- 'Pool of money'.

Both options are explained in more detail below.

6.1 'SPLITTING THE BENEFITS'

Section 0 above explained how the tenderer's opportunity cost of contracting for SRAS should be considered the ***bottom*** of the efficient range of remuneration.

The top of the range of efficient remuneration for SRAS is NEMMCO's willingness to pay, on behalf of the market, for these services. There are good reasons why the market may be willing to pay more for SRAS contracts than a potential provider's opportunity cost.

If NEMMCO were to rely on its power of direction to require generators to act or do certain things during a system black condition or major supply disruption, there is no guarantee that the services would actually be available at that time. Without contractual obligations to guide its decision-making, a participant may not have or maintain the capability to provide necessary system restart services at the time required. For example, a generator may mothball or reduce maintenance on certain units in a way that meant those units were not capable of providing system restart services. The Rule change effectively acknowledges the value of contracting through the (deeply flawed) primary service premium concept.

On the basis that the ability to direct participants is a poor substitute for contracting for system restart services in advance, NEMMCO's willingness to pay for system restart services could be well above the expected opportunity cost of provision. In fact, it could be argued that NEMMCO's maximum willingness to pay for these contracts should be based on the expected value of unserved energy avoided by having SRAS contracts in place. This could be as high as the value of customer reliability (VCR), well above the NEM's VoLL. CRA estimated VCR for VENCorp in 2002 at $29.60/kWh.[8] In 1998, the Monash University Centre for Electrical Power Engineering derived a figure of $20.56/MWh for NSW.[9] Allowing for inflation between 1998 to 2005, a current figure of $25,000/MWh for NSW would seem a reasonable maximum valuation.

8 CRA, *Assessment of the Value of Customer Reliability (VCR)*, December 2002, p.42.

9 Centre for Electrical Power Sector Engineering, *Report on Consultancy, Value of Lost Load Study for TransGrid*, July 1998, p.21.

Obviously, to convert these values to contracted SRAS remuneration levels would involve allowing for the expected probability of a system black or major supply disruption and the expected period of duration and quantity of the service that would be required.

The final step is determining where within the range of efficient prices should be considered 'appropriate remuneration' for the provision of SRAS under contract. One way of looking at this question is to acknowledge that the value created by having SRAS contracts in place is due both to NEMMCO's tender process as well as to the tenderer's entry into those contracts. That is, the economic surplus or benefit created by the contracts is due in equal part to NEMMCO and the tenderer. Neither party could create the value independently, nor could it be said that one party is more important to the creation of that value than the other.

To take a different example, if a landowner develops a boat jetty (say at zero cost) and a boat owner uses the jetty and is willing to pay $1,000 for that use, both parties are essential to the creation of the $1,000 value from that transaction. Neither the landowner nor the boat owner could claim to deserve the entire $1,000.

Therefore, one reasonable and arguably equitable way to determine an appropriate price would simply be to divide the range of efficient prices in half – hence the 'splitting the difference' label for this approach. Although it may seem simplistic or arbitrary, there is no economic case for any other level of remuneration within the efficient range to be selected instead.

6.2 'POOL OF MONEY'

Another approach to determining appropriate SRAS contract remuneration is for NEMMCO to notionally set aside, on the advice of the jurisdictions, a pool of money that represented the relevant jurisdiction's maximum willingness to pay for SRAS in that jurisdiction, divided amongst sub-regions as the jurisdiction saw fit.

NEMMCO could then tender for SRAS as it does now, but on the basis that tenders would be accepted so long as their proposed remuneration was no more than the notional pool of money set aside for the sub-region. There would be no need for NEMMCO to disclose the size of the pool, which would help promote more equal bargaining positions. In sub-reigns where there was only one potential provider, it could tender for and earn potentially the entire pool. However, in other sub-regions, the cheapest bid would be awarded the contract and the remainder of the pool would not need to be recovered from the market. This would provide similar market-like incentives for new entrants into SRAS provision where competition was initially weak.

Conceptually, this approach is similar to VENCorp's approach to network planning, with the VCR providing the maximum that VENCorp is willing to pay on behalf of consumers to avoid a given expected amount of unserved energy.

This approach has the benefit of simplicity and imposes the least informational requirements on NEMMCO and other parties. All that is required is for NEMMCO to seek advice from

the jurisdictions as to their willingness to pay to avoid unserved energy and the probability and amount of SRAS contracts being called upon.

7. Conclusion

The Rule change proposed by NEMMCO has a number of severe shortcomings. It puts NEMMCO in the position of economic regulator of an essentially contestable service. More practically, it increases the risk that efficient contracts for SRAS will not be struck and that the market will either be forced to rely on the second-best option of NEMMCO direction or even that NEMMCO may inefficiently develop SRAS facilities itself. The Rule change also contains a number of drafting ambiguities.

This submission proposes two options for determining efficient levels of SRAS remuneration. The 'splitting the difference' approach requires NEMMCO to have more information but incorporates an explicit judgement as to the distribution of value from the contracts. The 'pool of money' approach is simply and informationally undemanding. It is also conceptually similar to VENCorp's approach to network planning. Either of these two approaches would constitute a substantial improvement on the Rule change proposed by NEMMCO.