Hydro Tasmania
the renewable energy business

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Dr John Tamblyn
Chairman
Australian Energy Market Commission
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Sydney South NSW 1235

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Dear Dr Tamblyn,

Contingency Administered Price Cap Following a Physical Trigger Event

Thank you for the opportunity to comment on this Rule Change proposal made by the NGF.

Hydro Tasmania has a number of concerns with the current rule change proposal to intervene in the market under a non credible contingency event trigger event. These concerns surround the following issues:

i) Management of market risk;
ii) Intervention in the market – loss of market signal;
iii) Trigger levels - Material Impact on Dispatch;
iv) Ability of NEMMCO to implement as defined;
v) Technological and locational investment signals; and
vi) Creation of new unforeseen risks.

i) Management of market risk

The rule change proposal states "market intervention is only justified following a power system disruption where risks would otherwise be both substantial and unmanageable". There are a number of ways market participants, including generators, may manage risks in the market including, but not limited to:

- location of generation in the system;
- reliability and availability of plant;
- diversification of generation mix in the system;
- demand side management (inter-ruptability products);
- contracting portfolio (composition and level);
- force majeure provisions in contracts;
- Inter-regional settlement residues;
- weather derivatives;
- risk sharing arrangements (co-insurance); and

- Cumulative Price Threshold (CPT) arrangements.

There is a trade-off each participant undertakes in balancing its assessment of the risks and rewards. There is a range of options for participants to mitigate various risks, whether one is prepared to pay the market premium is a question for each participant to assess. One would expect any assessment to incorporate the risks associated with non credible contingency events.

The NGF paper states "the litmus test for intervention should be that the risk is both substantial and genuinely unmanageable." It highlights "if the risk is manageable market intervention creates moral hazard". Hydro Tasmania supports this conclusion. Hydro Tasmania believes there are numerous options open for prudent market participants to manage risks associated with non credible contingency events. Managing these risks may create other risks, however, that is a decision for each market participant to assess. However, market participants that have invested in generation and/or physical/financial products to manage this risk should not be penalised.

It would appear an extreme proposition for any market participant that the risks based upon the proposed thresholds (section (iii) trigger levels – material impact on dispatch) are substantial and unmanageable.

ii) Intervention in the market – loss of market signal

The current proposal highlights a number of efficiency improvements as a result of the proposed rule. Hydro Tasmania seriously questions these conclusions as any intervention in the market results in the loss of a market signal with the potential to distort market outcomes. The concept of efficiency improvements is extremely questionable given the following;

i) There would appear to be significant quantities of demand (inter-ruptable load) available in the NEM that have the ability to respond to price signals. This response, while evident in the market, is not bid into the market and often happens at price signals in excess of the current price cap. This incentive may be foregone under a range of scenarios under the current proposal reducing the reliability and efficiency of electricity supply.

ii) The incentive for some peaking plant to quickly respond may also be foregone should the cap trigger be implemented. While NEMMCO may direct plant, the incentive for individual participants to respond in a timely manner may be lost. This may lead to additional market intervention with directions to participants to make generation available.

iii) The loss of the market signal (capping at $300 per MWh) based upon the currently proposed intervention is not dependent upon any unserved energy trigger. In fact the loss of 300 MW of generation in a region such as South Australia has the ability to effectively cap prices in all regions, should all inter-connector flows separating a region be toward South Australia. ie there is the potential for Queensland price to be capped at $300 per MWh (may have previously trading at $9,900 per MWh) without any change on dispatch in this region as a result of the rule change.

iv) There is the potential for this capping to apply for a period of 2 hours (the minimum allowed) even though any impact may only be for 5 minutes duration, or less if it happens to be incorrectly implemented.

The current proposal also identifies efficiency improvements as a result of a more "orderly" dispatch process in the aftermath of non credible contingencies that cause power system disruptions. The paper states, p27, "a disorderly spot market in the aftermath of a serious incident could delay power system restoration. This may mean higher levels of unserved energy as load restoration is delayed, or higher generation costs where lower cost generation remains constrained off for longer...the proposed market intervention to mitigate these risks directly should avoid or at least moderate this disorder." Given the loss of market signal it is just as feasible, if not more likely, to believe the contrary. A response on the demand side or supply is not forthcoming resulting in unserved energy that may have been avoided with no market intervention and appropriate price signal.

iii) Trigger levels and Material Impact on Dispatch

To trigger a CAPP, the impact of the non credible contingency event is defined to have a material impact on dispatch. Hydro Tasmania would question the need for regional differentiation between thresholds, particularly as any neighbouring region with interconnection flowing into a capped region also becomes capped. The proposed thresholds currently range between 300 MW and 600 MW. The stated objective of the rule is to limit risks that are seen as unmanageable. While Hydro Tasmania may accept there is an element of debate surrounding whether all non credible contingency events are manageable it certainly doesn't accept that the risks are unmanageable for a prudent market participant at the thresholds proposed. The report even highlights the thresholds selected broadly correspond to the impact of more serious credible contingencies. It is hard to comprehend then that the risks are at unmanageable levels for any prudent generator.

The extremely low levels of thresholds proposed has the potential to result in capping in regions, through inter-regional flows, where there may be no material impacts on dispatch and the loss of a transparent market signal as a result.

iv) Ability of NEMMCO to implement as defined

The proposed rule has the potential to be very challenging to implement as intended in real time given the combination of the stressful conditions and the complexity associated with the varying scenarios that may or may not require implementation of a price cap and its release. This is the case for a number of reasons including:

- There has been the occurrence of a non-credible contingency;
- Issuing of market notices;
- The system may be insecure;
- Instances of load shedding and load restoration;
- Developing network constraints;
- Developing Frequency control Ancillary Service requirements;
- Monitoring of constraints equations to assess MIOD; and
- Monitoring on any generation impacted – ability to synchronise

History shows there are examples during significant system events where it has proved challenging for NEMMCO to assess the physical situation and implement various processes with the precision it may have under other conditions, given the real time pressures and unique characteristics of each scenario. This is not unexpected given the

real time pressures. Many participants as a result, as well as NEMMCO themselves, are reluctant to have discretionary decisions to be made impacting the market outcomes if they can be avoided. The increased work-load and complexity associated with the proposed rule change only increases the potential for error. The primary aim of NEMMCO will be to ensure the system remains in, or returns to, a secure state. The ability to correctly implement such a complex rule change as intended may be unrealistic as a result. The market impacts of incorrectly implementing may be substantial on participants. Not the least it will imply an increased level of implementation risk and potential unintended market price capping at times and uncapped prices during intended periods.

It should be noted that the incorrect implementation, either in commencing or completing can have material impacts, particularly as the cap can only be invoked once for a particular non credible contingency event.

The submission acknowledges "A degree of operational decision making will unavoidably be required by the market operator to trigger and conclude the mechanism." Given the range of real time pressures the operator will be managing during the events it would be realistic to expect error in the implementation of the proposal on a number of occasions. This is particularly concerning given the four year period to 2007 averaged a non credible contingency event about once a month on average

v) Technology and location investment signal

The NGF paper purports to contribute to the NEM objective by creating efficiency improvements for generation investment as a result of mitigating unmanageable financial risks for future generators. Hydro Tasmania questions this conclusion and believes the rule change will in fact lead to inefficiencies in the market outcome. The loss of clear market signal is likely to result in delays in appropriate investment in peaking plant and demand side management. Peaking generation obtains a level of its premium during market volatility some of which may be expected during non credible contingency events. The capping of the market will suppress the "real" value of this premium, leading to a delay in the investment of peaking plant. This is exacerbated by the potential for capping of the market in a number of regions that are unaffected by the non credible contingency event in dispatch. This will almost certainly result in inappropriate plant mixes in the future resulting in energy disruptions that would have otherwise been avoided.

The rule change proposal is designed to favour generators in a highly concentrated location at the expense of those diversified in the network. Similarly, any future incentive to appropriately assess location within the network may be lost with the advent of the rule. A participant will discount locating in an area where the risk may be higher of being impacted under a non credible contingency event.

vi) Creation of new unforeseen risks

The rule change is very complex and by its nature it is hard to envisage all the various scenarios and market incentives and responses that may eventuate should it be implemented. The NGF highlights the occurrence of non credible contingency events at approximately one per month, "there were a total of 47 such incidents in the four years to 2007". The proposed rule is very complex and Hydro Tasmania would not be surprised if there are scenarios that participants can behave in a manner to manage risks or create opportunities that have not currently been anticipated. The implementation of the rule will drive different behaviours and incentives to that which currently exist. The greater the intervention the higher the potential. Hydro Tasmania has significant concerns about the

ability of participants to utilise the proposed rule to their commercial advantage in a manner that is not intended under the current rule proposal.

Conclusion of Expected Costs and Benefits

The NGF states "there is a systematic effect of the proposed Rule in reducing the financial risks arising from serious incidents. Whilst in the short term, the main beneficiaries of this will be generators, in the medium and longer term the benefits will be passed through to retailers and customers".

Hydro Tasmania would seriously question this conclusion for reasons outlined in this submission, including the:

- the loss of market signal;
- impact on future investment in peaking plant and demand side management;
- competitor responses – short and long term; and
- the high implementation risk of the proposed rule.

Based upon issues discussed in this paper it is very difficult to envisage a net benefit from the proposed rule change.

If you have any queries please contact David Bowker on 62305775 or via email on david.bowker@hydro.com.au.

Yours sincerely

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