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Chairman
Australian Energy Market Commission
PO Box A2449
South Sydney NSW 1235

By email: submissions@aemc.gov.au

Dear Dr Tamblyn

Physical Market Cap Trigger Rule Change Proposal (ER0075)

We write to provide a submission to supplement the abovementioned rule change proposal (the NGF proposal).

The NGF proposal sought to reduce the financial risks to generators of extreme non-credible transmissions events on the basis that generators have no control over transmission events.

This submission has two purposes, it:

1. advises the AEMC of the ongoing discussions between the NGF and NEMMCO to address implementation issues and matters arising from NEMMCO's submission in response; and

2. responds to assertions made in certain other submissions received by the AEMC in response to the NGF proposal.

This submission is not supported by Hydro Tasmania, Origin Energy or Snowy Hydro, who are members of the NGF but have made separate submissions in response to the NGF proposal.

Discussions with NEMMCO

The NGF proposed Rule change was developed over a substantial period, commencing shortly after a market disturbance in January 2007. Several times during this development phase the NGF consulted with NEMMCO officers in order to ensure that our proposal would not make unreasonable demands on NEMMCO staff. This consultation then extended to include a meeting one week before the closing date for submissions.

Despite these efforts, a number of concerns in relation to implementation issues were raised in the NEMMCO submission.

The NGF has since met with NEMMCO to discuss these implementation issues. The discussions focussed on possible clarifications and changes in the drafting of the proposal which would simplify the implementation of the proposal for NEMMCO.

These discussions are not yet complete, and we do not seek to speak for NEMMCO, but we believe that we are likely to be able to agree on changes which would make NEMMCO comfortable that the proposal could be implemented without adverse consequences to other NEMMCO responsibilities.

Is insurance an alternative to the NGF proposal?

Some submissions assert that insurance in some form constitutes an alternative to the NGF proposal. This is not the case.

The NGF proposal is designed to reduce the costs of financial risks imposed on some participants by an extreme and unforeseeable market disturbance. An insurance product does not do this.

An insurance product has the effect of converting the aforementioned risk into a stream of premium payments for a generator; however, the risk of an event having a significant financial impact remains. It is just that in these instances an insured generator, pursuant to the stream of premium payments, will have managed that risk through a risk transfer process. This means that the full financial impacts of an event will still be present but the distribution of the costs associated with the realisation of a risk will have been altered via the use of insurance as a risk transfer tool.

Therefore, over the long-term, premium payments must cover the costs of all claims, including a prudential margin and cash reserve to deal with the extreme variability of all events, even at the aggregate level. Additionally, administration costs and in the case of a commercial provider, a margin in the expectation of profit in return for assumption of the identified risks.

Thus insurance, while transferring the impact of costs, both over time and between participants, does not fundamentally reduce the existence of the financial risks associated with such events or their impacts on generators as a group of market participants.

We believe that mitigation of the costs to participants of extreme market disturbances is appropriate because:

- the relevant events are rare and do not provide a useful market signal in the context of reliability of supply, and
- network events are best managed by the network owners and operators and therefore the associated costs of a risk eventuating should not fall on other participants.

The Snowy Hydro insurance proposal is considered further in an appendix to this submission.

We also note that the other means of managing these risks proposed in some submissions amount to incorporating an insurance element in another transaction. While in some cases this might be possible, it will inevitably be priced into the transaction, with an insurance premium thus appearing in some other guise.

Again such proposals crystallise the cost of the risk; they do not mitigate it.

Statements on the frequency of a price cap

Some submissions have sought to associate the frequency of price capping with the frequency of non-credible contingency events (i.e. about once per month).

However, the NGF, in formulating this proposal has recognised that the great majority of non-credible contingency events do not result in any material disturbance to the market. The further requirements to be satisfied before the price cap is applied greatly reduce the frequency of its application.

The data provided in the NEMMCO submission is a useful clarification here. NEMMCO identified 6 potentially relevant events in a 2-year period.

Having regard to recent changes in NEMMCO processes on re-classification, we believe that 4 of these 6 events over 2 years would lead to price capping under our proposal. However, of these 4 events the uncapped prices that eventuated were below the Administered Price Cap, and hence the application of the price cap would not affect market outcomes in any way. Therefore, based on the NEMMCO data it is reasonable to expect that the NGF proposal will impact market prices for a limited period on, typically, one occasion per year.

As such, based on the frequency data provided by NEMMCO, it is evident that the fears expressed in relation to the perceived loss of market signals are significantly overstated.

If you have any questions in relation to the comments provided by the NGF please contact me on telephone (02) 6243 5120.

Yours faithfully,

JFBoshier

John Boshier
Executive Director

Appendix

Comments on Snowy Hydro proposal for a Spot Market Insurance Fund

In the body of our submission we note that while insurance provides a mechanism to transfer risk and distribute costs across insured market participants it is not an alternative to the NGF proposal. The NGF is also concerned that the proposal made by Snowy Hydro may be putting obligations on NEM bodies that are beyond their capacities.

Specific comments are:

- The use of the NER to set up a voluntary scheme seems neither necessary nor desirable. A voluntary insurance arrangement could be set up by any market participant or insurance company and would not require the force of the NER.

- Moreover the opportunity to set up such a scheme, in the absence of NER direction, has existed since market inception, and yet no such scheme has emerged to date. We are not aware of any entities that have considered such a scheme viable and acted on that belief.

- The market entities proposed to have an active role in the scheme, namely NEMMCO and AER, have no experience in the provision of insurance nor the necessary accreditation or capital to act as a prudential body. We strongly believe the participant compensation fund does not qualify as insurance in this context because the provisions for contributions and claims are all defined in the NER and hence their role is basically mechanical, not decision-making.

- The risks to be managed vary over a wide range between participants (unlike the risks of dispatch error). This makes setting of insurance premiums difficult. Neither NEMMCO or the AER, are currently equipped to discriminate between participants on the basis of relative risk levels. While expertise of this nature could be obtained by either body it does not represent core business and does not compliment either organisation's roles as impartial regulatory bodies.

- Nevertheless, if premiums were set, and those premiums were set without regard to relative risk levels, then the scheme would become unstable with those participants at the lower end of the risk spectrum among current members always subject to an incentive to exit the scheme (because the premium cost would necessarily relate to the higher risks faced by the other current members). This process of adverse self-selection would undermine the viability of the scheme and require the use of prohibitively high premiums given the relatively small number of participants when compared with other insurance arrangements.

- The conditions for the payment of claims would be much more critical than the conditions for application of a price cap under the NGF proposal. This is because if a price cap were applied contrary to the intent of the NGF proposal, it would in many cases have no effect in the market (as demonstrated by the data provided by NEMMCO). In contrast, under the Snowy Hydro insurance scheme every entitlement to claim would result in a financial drain on the scheme, whether that was intended in the design or not.

- We note that both these critical issues of premium determination and the basis of a claim remain undefined in the Snowy Hydro proposal. They are arguably the key determinants of the viability of individual insurance products.