NATIONAL GENERATORS FORUM

25 February 2011

Mr John Pierce
Chairman
Australian Energy Market Commission

Lodged via www.aemc.gov.au

Dear Mr Pierce

ERC0108: Network Support and Control Ancillary Service Rule Draft Determination

The NGF welcomes the opportunity to respond to the Draft Rule Determination on Network Support and Control Ancillary Services (NSCAS).

The NGF supports AEMC's draft ruling to retain the ability for AEMO to procure NSCAS for system security and reliability. The NGF also supports the Draft Rules removal of the 18 month time frame from when AEMO can act to address a system security or reliability need.

However, the NGF believes that TNSPs are not structured to have the necessary market experience and incentives to procure NSCAS that deliver market benefits. That is, the NGF believes TNSPs are not adequately equipped to assess market benefits from the dispatch of NSCAS in real time in the Spot market. The NGF advocates that it is appropriate that the accountability and responsibility for planning and procurement of network services that deliver market benefits reside with AEMO.

If the AEMC continue with the Draft Ruling that TNSPs have sole responsibility for providing NSCAS which solely deliver market benefits then there must be:

- an adequate transitionary period for TNSPs to demonstrate that they have the necessary expertise to assess and quantify market benefits that are delivered by dispatching NSCAS in the Spot market. Without this demonstrable evidence the NGF believes the transition of this function from AEMO to TNSPs is simply too risky and not in the long term interest of consumers; and
- The NGF believes specific Rule obligations on TNSPs and AEMO are required to ensure NSCAS are procured and dispatched where there are market benefits.

With respect to incentives under the proposed new arrangements, the NGF remains concerned that the AEMC has discounted the impact from potential conflicts of interest and the possibility of TNSPs favouring network assets over services offered by Market Participants.

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The NGF believes that there remain a number of material transitionary issues that must be addressed by both TNSPs and AEMO prior to the initiation of this Rule change. The NGF believes at least an 18 month period is required to address these issues prior to the commencement of the Rule change.

Are TNSPs Equipped to Procure NSCAS for Markets Benefits?

Under the existing Rules clause 3.11.4(b)(2) AEMO as the Market Operator procures and dispatches Network Control Ancillary Services to:

> where practicable to **enhance network transfer capability** whilst still maintaining a secure operating state when, in AEMO's reasonable opinion, the resultant expected increase in network control ancillary service costs will not exceed the resultant expected increase in **benefits of trade from the spot market**.

AEMO is well equipped to perform this function as the Market Operator with access to all the required market data/information to make this assessment of when to enable and dispatch NSCAS in the Spot market. There has been no indication and/or proof that AEMO and its predecessor NEMMCO have not adequately performed this trade-off between costs and spot market benefit.

Under the proposed Rule, the Draft Rule Determination states[1],

> TNSPs have sole responsibility for providing NSCAS which solely deliver market benefits;

The NGF believes that enhancing Spot market trade through the use of NSCAS is a major component of the overall market benefits. The NGF is therefore concerned that TNSPs are not equipped or have the experience to make this assessment of providing NSCAS to deliver market benefits. TNSPs simply don't have the detailed spot market knowledge to perform this function nor would TNSPs existing approved operating cost allowances include finance to allow TNSPs to procure this expertise. This could result in a significant market dislocation, as in general these network services contracted by AEMO have been targeted at supporting inter-regional flows. Step reductions in inter-regional flows could have severe impacts on inter-regional trade, and regional prices – disrupting the contract markets and ultimately impacting on customer prices. Detailed analysis would need to be conducted to understand such potential impacts, and ensure they advanced the NEM objective prior to implementation of such a fundamental change.

A number of other observations give rise to concern that the proposed new arrangements have not been comprehensively thought out:

- The draft new Rules do not explicitly require TNSPs to provide NSCAS for market benefit;
- The RIT-T has sufficient flexibility and provides TNSPs with discretion to avoid the assessment of market benefit from "enhancing Spot market trade". For instance, the AER's final Regulatory investment test for transmission (June 2010) in clause (7) states:

  > *A transmission network service provider must quantify all classes of market benefits which are determined to be* ***material in the transmission network service provider's <u>reasonable opinion</u>****.*

- TNSP's have struggled with applying the Market Benefits section of the new RIT-T. If TNSPs are struggling with quantifying market benefits for long life capital investments such as

[1] AEMC Draft Rule Determination, page 11

generators and transmission equipment then the NGF believes that TNSPs will have an even more difficult task of assessing market benefits of network services which enhance Spot market trade in the dispatch (5 minute) time frame.

In summary, the NGF advocates that it is appropriate that the accountability and responsibility for planning and procurement of network services that deliver market benefits continue to reside with AEMO.

However, if the AEMC persist with their Draft Ruling that TNSPs have sole responsibility for providing NSCAS which solely deliver market benefits then there must be an adequate transition period for TNSPs to demonstrate that they have the necessary expertise to assess and quantify market benefits that are delivered by dispatching NSCAS in the Spot market. Without demonstrable evidence that TNSPs can perform this function the NGF believes the transition of this function from AEMO to TNSPs is premature, too risky, and not in the long term interest of consumers.

Specific Rules Obligations Required

The proposed Rule was intended to clarify the roles between AEMO and TNSPs. However, the draft Rules lack specific obligations on both AEMO and TNSPs to fulfil this intention. There is no specific Rule obligation on TNSPs to procure NSCAS for market benefits. There is also no specific Rule obligation for AEMO to dispatch NSCAS procured by TNSPs where there are net market benefits.

The NGF therefore believes two explicit Rules obligations are required in the Rules:

1. A Rule obligation for TNSPs to procure NSCAS which solely deliver market benefits; and
2. A Rule obligation for AEMO to dispatch NSCAS procured by TNSPs where there are net market benefits.

Additional Implementation Concerns

Implementation of the proposed arrangements is of critical importance to ensure an efficient outcome in the long term interest of consumers. The objective of NSCAS (an NSCAS need) is required to:

- maintain power system security and reliability of supply of the transmission network in accordance with the power system security and reliability standards; and

- maintain or increase the power transfer capability of that transmission network so as to **maximise the present value of net economic benefit** (empathise added) to all those who produce, consume or transport electricity in the market.

The second part of the NSCAS need would presumably require TNSPs to apply the new RIT-T which to date has been largely untried. As outlined later in this submission, TNSPs may have an inherent bias towards their own network solutions. Therefore, how do Market Regulators (the AER) and the AEMC as the Rule Making Body ensure that there will be an unbiased assessment of options amongst a range of regulated and competitive Service Providers?

For instance, how would TNSPs conduct the RIT-T to compare a network asset investment such as a capacitor bank (which TNSP can invest in) compared to a reactive power ancillary service (RPAS) offered by a generator in generator mode or synchronous condenser mode. Key assumptions that would need to be justified in any meaningful comparison between a network asset service offer (ie. Capacitor bank) and a generator service offer would be inputs like:

- What assumed level of utilisation of generator RPAS would be applied?
- What investment time frame and level of utilisation would be applied on the capacitor bank?
- When TNSPs assesses a competitive service offer does it take into account the uncertainty of income for the Service Provider? This is especially relevant for a synchronous condenser service which under existing AEMO arrangements only receives revenue when enabled. Uncertainty of revenue may also be caused by the contract duration and the potential for stranding risk associated with capital spent on asset maintenance and investment. All these factors will influence the price a Service Provider places on its service offer.

The AEMC states in the Draft Determination that[2],

Some relevant aspects of the revenue and pricing principles relate to:

> … ;
>
> • providing a reasonable opportunity to service providers to recover efficient costs and ensuring that prices should allow for a **return commensurate with the regulatory and commercial risks** in providing the service;
>
> … ;

The NGF strongly agrees with this revenue and pricing principle. It would be critical for TNSPs to be aware of the actual risk Service Providers have in making their services available. As mentioned above, under current arrangements RPAS services offered through Synchronous Condenser mode are only paid if the service is enabled. That is, there is no availability payment. Hence, the risk of recouping sufficient revenue from the offered service is entirely with the Service Provider. In the absence of a change to the payment structure for these services, it would be expected that Service Providers factor this risk into their service offers. If TNSPs don't factor this risk into their assessment of the prospective tender offers in comparison to what they themselves can provide through the Regulated Asset Base then such an outcome would both be inequitable and inefficient.

It has been highlighted by the NGF in a past consultations on the RIT-T that TNSPs have a lot of discretion in the input assumptions in an application of the RIT-T. Currently, Service Providers face procedural and regulatory barriers that reduce the effectiveness of competing with TNSPs within this process. Hence, an open and transparent consultation on how TNSPs will conduct and assess NSCAS tenders is clearly needed prior to the commencement of this Rule change.

These are the sought of implementation issues which remain unanswered. Similar implementation concerns are also relevant with AEMO's potential involvement in the procurement process under the situation where TNSPs do not purchase the required amounts of NSCAS. Without an understanding of how TNSPs and AEMO would practically implement this Rule change, the NGF is concerned that the most efficient outcome in the long term interest of consumers would not be attained.

The NGF recommends that the date of effect of this Rule change is **<u>NOT</u>** initiated until these implementation issues have been resolved through consultation by AEMO and TNSPs with Market Participants. This recommendation is consistent with principles of regulatory certainty and predictability.

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[2] AEMC Draft Rule Determination, page 8

NSCAS contracts expire July this year. The following is a list of key implementation / transition issues that need to be addressed by either or both AEMO and TNSPs:

- TNSPs demonstrating sufficient expertise to assess market benefits from enhancing Spot market trade;

- Tendering guidelines for non-registered Participants;

- AEMO and TNSPs to sort out tender provisions and outline how they plan to assess tenders on a competitively neutral basis; and

- AEMO to establish Regional Benefits calculations.

The NGF believes there needs to be at least an 18 month transitionary period prior to the commencement of this Rule change to address the above implementation / transition issues. At the expiry of this period there needs to be an independent assessment that TNSPs are adequately prepared for this transition.

TNSP Potential Conflict of Interest and Incentives Under New Arrangements

Under the Draft Rule Determination TNSPs will have the primary responsibility for procuring NSCAS in accordance with their existing obligations with respect to reliability and security of supply (page 10); and TNSPs has sole responsibility for providing NSCAS which solely deliver market benefits (page 11).

As highlighted earlier in this submission, there is no specific Rule obligation for TNSPs to procure NSCAS which deliver market benefits. The NGF has therefore recommended a specific Rule obligation on TNSPs to fulfil the intent of the proposed Rule change.

To meet the requirements of the Rules TNSPs can either themselves invest in network assets or procure NSCAS from other Service Providers. The NGF assumes that for practical purposes where TNSPs procure these services from other Service Providers that it would be in the form of an Invitation to Tender.

The NGF continues to be concerned with AEMO's proposed Rule change and the AEMC Draft Rule Determination which intends to allow TNSPs to conduct a tender process where they are conflicted since they can provide a competing service through their Regulated Asset Base.

The key concern is what incentives do the TNSPs have to procure NSCAS from other Service Providers? The NGF asserts that TNSPs may inherently favour their own network solutions for a number of reasons:

- TNSPs are not actively involved in the competitive market and would therefore be more familiar with network/capital solutions;

- The cost of NSCAS procured by TNSPs would be recovered by transmission network charges to their customers and expensed in the current year that it is procured. The costs of these services have been volatile and TNSP customers are concerned with the volatility and variability of these transmission charges. For instance, there were a number references by User Groups and large Market Customers who are concerned with the variability and predictability of transmission charges in submissions to the Dual Marginal Loss Factors rule change first stage consultation.

> In contrast, if TNSPs were to invest in meeting a NSCAS need through their own regulated investment, the cost recovery of this asset would be a charge that is amortised over the economic life of the network asset. This charge would be a lot smoother and more predictable than a service provided by other competitive Service Providers. Hence, TNSPs are more likely to favour their own capital investment which has a more known cost profile over the life of the asset versus over services offered by Market Participants whose cost would be more variable and unpredictable.

The AEMO Rule change will improve information provision of the NSCAS requirements in the NEM. The Rule change has made it clear that TNSPs have a key role in the provision of NSCAS. The required publication of the NSCAS need in the National Transmission Network Development Plan (NTNDP) and the requirement for TNSP's to outline how they plan to source their own requirements is expected to sharpen the incentives on TNSPs to procure an efficient amount. It is therefore unclear to the NGF how the proposed TNSP administration of the tender process will sharpen these incentives. Given, the potential for conflict of interest and the incentives on TNSP businesses to invest in their own network assets, the NGF strongly recommends that the AEMC re-consider their Draft Ruling that would allow TNSPs to be the primary entity in procuring NSCAS.

Non-registered Participants

The Commission is interested in comments from stakeholders on whether non-registered participants should be able to provide NSCAS under the AEMO proposed arrangements or, alternatively, whether a new classification should be created under the Rules for such NSCAS providers.

The NGF believes that all Service Providers (including non registered participants) must be required to meet the requirements of the Rules. Under the proposed arrangements both TNSPs and AEMO may tender with non registered participants. Hence, the NGF believes **BOTH** TNSPs and AEMO must consult on the obligations and standards to apply to the tender offers.

It remains uncertain the actual costs AEMO will incur in this obligations and standards consultation process. It is also uncertain what resource and costs AEMO must direct to the administration of non-registered participants who may be successful in the tendering process. A new classification under the Rules for these currently non-registered participants would allow AEMO to re-coup these costs through their Participant fees. Given the uncertainty in these new arrangements, and the unknown potential uptake of non registered participants, the NGF supports a new classification for these Service Providers.

Conclusion

The NGF believes TNSPs are not adequately equipped to assess market benefits from the dispatch of NSCAS in real time in the Spot market. If the AEMC continue with the Draft Ruling that TNSPs have sole responsibility for providing NSCAS which solely deliver market benefits then there must be an adequate transitionary period for TNSPs to demonstrate that they have the necessary expertise to assess and quantify market benefits that are delivered by dispatching NSCAS in the Spot market. Further to this, the Rules must have specific Rule obligations on TNSPs and AEMO to procure and dispatch NSCAS where there are market benefits.

With respect to incentives under the proposed new arrangements, the NGF remains concerned that the AEMC has discounted the potential for conflicts of interest and the possibility of TNSPs favouring network assets over services offered by Market Participants.

The NGF has highlighted a number of material transitionary issues that must be addressed by both TNSPs and AEMO prior to the initiation of this Rule change. The NGF believes at least an 18 month transitionary period is required prior to the commencement of this Rule change.

The NGF appreciates the opportunity to respond to the Draft Rule Determination. If you any queries in respect of this submission, please contact Kevin Ly on (02) 9278 1862.

Yours sincerely,

M. Roberts

Malcolm Roberts
<u>Executive Director</u>