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AUSTRALIAN QUALITY COUNCIL

14 May 2001

Mr Michael Rawstron
General Manager, Regulatory Affairs - Electricity
Australian Competition and Consumer Commission
PO Box 1199
DICKSON ACT 2602

Dear Mr Rawstron

ACCC Draft Determination (A90742 - A90744): Ancillary Services

Integral Energy submits its response following the ACCC's pre-determination conference of 3 May 2001 in Canberra. In this submission, our comments raise new concerns following further review of the above draft determination.

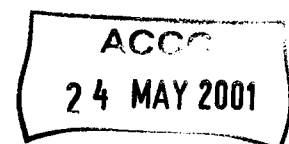
Integral Energy requested a pre-determination conference to declare its ongoing reservations about the proposed Ancillary Services (AS) Amendments. This submission is primarily focused on the proposed market arrangements for the provision of Frequency Control Ancillary Services (FCAS) and the risk management implications to be borne by retailers and our customers.

Integral Energy welcomes the ACCC's active consideration of these issues, as the establishment of effective and efficient AS arrangements is a key component of the competitive electricity market, capable of delivering real benefits to end use customers.

However, we do not believe the application of sections 90(6) and (8) of the *Trade Practices Act* has adequately taken into account the impact of these proposed arrangements on either retailers or end users. There are simply too many uncertainties at this point to justify the roll out of an FCAS spot market. Because of these uncertainties, retailers and end users are exposed to FCAS costs in a market, which is expensive, non-competitive, and the make-up of which is not transparent nor controllable.

For these parties, the draft determination on FCAS does not provide demonstrable evidence that the proposed arrangements

- foster business efficiency
- promote competition
- promote industry cost savings; nor
- foster equitable dealings in the market



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It is incumbent upon the ACCC, as custodians and enforcers of the *Trade Practices Act* to show due consideration of the impact of an FCAS spot market on all market participants - particularly end-use customers. To date, there appears to have been excessive focus on the technical minutiae of running a trial AS market and limited, if not expedient consideration of whether the broader policy underpinning an FCAS spot market is commercially workable and equitable to all market participants. This is despite quite rigorous and sustained debate by retailers over the past two years.

Integral Energy agrees that a market-based system is laudable – however, there are various ways to achieve this. In an as yet immature market, the introduction and complexity of eight spot FCAS markets is unproven, unnecessary, confusing and not as yet quantifiable in a cost-benefit sense. We are not convinced there is an efficient market for Ancillary Services and it is therefore premature to introduce a spot market for Ancillary Services.

Price volatility in the FCAS spot market will continue to be caused by market manipulation. Passive tolerance of this unacceptable market behaviour is symptomatic of the absence of a comprehensive policy on market surveillance responsibilities in the conduct of Ancillary Services markets. A case in point is the bidding and rebidding strategies by generator participants in the FCAS market. The absence of a robust policy on market power in the AS market will further foster opportunistic behaviours to the detriment of other participants.

Problems with Proposed FCAS Spot Market

There are a number of problems with the current FCAS proposal. Firstly, a contract for FCAS includes the additional ‘hidden’ costs such as:

- uplift payments
- terms and conditions
- constraint payment (which equates to the opportunity cost of constraining back a generator from providing energy in order to provide FCAS)

These elements create additional complexities and negotiation uncertainties and should be explicit and regulated. The risk from a generator’s decision to constrain from providing energy to provide FCAS should NOT be passed on to retailers and end users.

Secondly, there are limited contracts available. Greater market certainty is necessary by offering AS contracts for longer than the one month proposed by some generators. The absence of appropriate financial instruments further exacerbates contract illiquidity.

Thirdly, there is a review pending of the standards by the Reliability Panel. If requirements are in a probabilistic manner, rather than absolute, this will reduce the need for Ancillary Services. This casts further doubt over the logic of introducing a complex system, unproven in any way, with such uncertainty in the market.

Fourthly, FCAS should be on an individual dispatch unit basis. Poorer performing dispatch units should not be concealed through this current 'loophole'.

All of these factors carry significant Trade Practices implications and uncertainty about the *real* public benefit. There are benefits for some participants but large exposures for others. Generators benefit and retailers and end use customers are exposed.

Why have an FCAS spot market anyway? - Problems for Retailers

The justification for creating a complex FCAS spot market becomes spurious if the need for FCAS decreases due to:

- relaxation of the deviation standards
- impact of QNI
- limited participation by generators to supply FCAS

It is therefore too premature to have an FCAS spot market given the significant uncertainties. Retailers bear the risk of additional modification/indirect operating and resourcing costs to participate in FCAS – and yet this could all dissipate in the medium term if the requirement for FCAS decreases.

There are too many uncertainties to make this **commercially** workable, and there is unreasonable market risk being passed down the line to retailers and end users. As it stands, one part of the market will be benefiting to the detriment of another. This is not a desirable policy objective - and surely, this casts doubts as to whether the public benefit test has been appropriately satisfied.

We do not know if there will be more participants in the market – it depends on the incentives. If there are increased transaction costs as NECA has inferred then that could lead to fewer participants.

In summary, the significant uncertainties still unresolved are:

- Increased economic efficiency from 8 FCAS markets - **unproven**
- Appropriate hedge instrument - **non existent**
- Reliability Working Group view on FCAS standards - **unresolved**
- Cost/benefit analysis of implementing new arrangements - **not done**
- Decrease in need for FCAS due to QNI - **unproven**
- Greater number of participants competing to supply FCAS – **unproven**

Integral Energy's Recommendations

We believe there is a need to defer the introduction of FCAS spot market until there is a robust cost/benefit analysis that can demonstrate public benefit across the whole of the market - not just some parts, at the expense of others.

Before the final decision is made to proceed with the proposed FCAS arrangements, Integral Energy recommends the following steps be undertaken as critical decision inputs:

1. The ACCC must develop a robust policy on market power in the NEM with due consideration to provision of Ancillary Services;
2. The ACCC must institute regular, stringent market monitoring regime for FCAS;
3. FCAS market to be a regulated monopoly market through NEMMCO;
4. Implement transparent, competitive tender contact processes to provide FCAS by market participants with NEMMCO oversight - and minimal barriers to entry;
5. Develop financial instruments for offering longer-term contracting arrangements to retailers for greater certainty to hedge against risk;
6. Foster greater price certainty; no **incremental** capping of FCAS prices; they should be fixed for a period (akin to the VoLL concept) and then reviewed down the track when there is greater maturity in the AS market.
7. Conduct a full cost/benefit analysis to assess the commercial viability of FCAS market and the input costs (direct /indirect) to participate;

8. The Reliability Panel must complete its review of FCAS standards, which may in turn create less exposure, lower demand for FCAS and reduce the need for a premature expedient solution such as a complex spot market without prudent risk management practices yet in place.

I thank you for the opportunity to submit a response.

Should you have any questions please contact our Regulatory Compliance Manager, Ms Ro Coroneos on 02 9853 6904, or by email at corone@integral.com.au.

Yours faithfully



Richard Powis
Chief Executive Officer