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11th April 2002

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

Delivered by e-mail to: electricity.group@accc.gov.au

Dear Michael

**National Electricity Code Changes –**
**Review of Directions in the National Electricity Market**

Snowy Hydro Trading Propriety Limited (SHTPL) appreciates the opportunity to comment on this important issue. We support the intent of the NECA code changes. We note that the latest draft of proposed code changes was not subjected to a detailed Participant consultation. Hence, there are a number of issues that require further clarification and modification to remove ambiguity in the interpretation of these code changes and to ensure that the proposed changes are internally consistent with other provisions of the National Electricity Code.

## Compensation to Directed Participants for Energy or Market Ancillary Services

SHTPL endorses the revised compensation principle (clause 3.15.7(c) and (d)) which represents a major improvement over the previous proposals. Unlike the original proposal, Directed Participants who have submitted valid bids will be paid their bid price rather than the 90th percentile price. This arrangement presents market participants with the correct price incentives for making capacity available, particularly where scarcity is anticipated. From a drafting perspective, it would perhaps have been more appropriate to set out the main principle ("pay as bid") first, followed by the exception (90th percentile pricing).

While the principle of compensation to Directed Participants in clause 3.15.7 seems clear and appropriate, we do not understand the purpose or relevance of clause 4.8.9A ("Provision of an ancillary service under a direction") and its interaction with the provisions in Chapter 3 of the Code. The introduction to the Code Change Panel's report notes that a key recommendation was that "a single and consistent arrangement should apply to the use of the power of

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direction."[1] We are therefore surprised to note the apparently unchanged provisions of clause 4.8.9A which may suggest that separate and different arrangements will continue to apply to the provision of market and non-market ancillary services provided under a direction to maintain the power system in a secure operating state.

We note that the principles for compensation to directed participants for the provision of market and non-market ancillary services under 4.8.9A(c) and 4.8.9A(d) differ substantially from the principles for compensation to Directed Participants for energy and market ancillary services set out in 3.15.7 and from compensation principles for services other than energy and market ancillary services set out in 3.15.7A. Clause 4.8.9A(d) retains the compensation principles and language of the previous regime, that is, compensation should be set at the higher of market value and cost. "Market value" is not adequately defined at all, and this lack of specificity has in the past led to extremely protracted and expensive processes to settle appropriate compensation amounts. By contrast, 3.15.7 sets compensation at bid price (or in the absence of a bid, at the 90$^{th}$ percentile of spot price) which is unambiguous.

We fail to see the reason for applying two different compensation principles to the provision of the same ancillary services under direction. It is not clear to SHTPL whether the retention of 4.8.9A is deliberate, and if so, what the policy intent behind this is, or whether a drafting error might be involved.

**Compensation to Directed Participants for Services Other than Energy or Market Ancillary Services**

Compensation for "other services" is set in an entirely different way from compensation for energy and market ancillary services: here, the compensation principle is "fair payment". "Fair payment" is to be determined by an independent expert, taking into account the matters set out in clause 3.15.7A(c)(1), provided NEMMCO is of the opinion that such an expert can be expected to determine fair payment.

Clause 3.15.7A(c)(1) sets out a number of principles and other matters that are intended to guide the expert in arriving at a determination. While NECA's intent evidently seems to be that a "fair payment price" reflects a market under scarcity conditions[2], this intent is not reflected in clause 3.15.7A(c)(1). While NECA has made some minor changes to this clause as a result of submissions during the previous round of consultation, the major problems (as discussed in detail in SHTPL's submission dated 15 June 2001) remain. In particular:

- There is no explicit requirement to take the economic efficiency principles that underpin the design of the (National Electricity Market) NEM and the codified market objectives into account.

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1 NECA (February 2002): Code Change Panel: Review of Directions in the National Electricity Market, p.1

2 NECA (February 2002): Code Change Panel: Review of Directions in the National Electricity Market, p.4

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- There are no explicit economic criteria that the "fair payment" determination must comply with; (e.g. SRMC; contract compatibility; incentive compatibility; willingness-to-pay).
- There is no explicit requirement to consider specifically any contracts for the same or similar services that the directed party has with NEMMCO, or indeed, to accord primacy to any such contracts; instead, reference is made to "relevant contractual arrangements", a very open-ended definition which may or may not include contracts that NEMMCO has with other parties. As experience has shown, this particular ambiguity can result in vast differences in the assessment of compensation by experts.
- The clause retains the principles of disregarding both the disinclination of a directed party to provide the service, and the urgency of the need for the service. (3.15.7A(1)(ii)(A) and (B)). As discussed in SHTPL's earlier submission, these principles are entirely inappropriate and imply that no premium value should be attached to scarce capabilities in an emergency response situation.
- Two new principles have been inserted (3.15.7A(1)(ii)(C) and (D)), which are perhaps intended to signal that "fair payment" is a market price under scarcity conditions ("similar demand and supply conditions"), and thus, that a premium value should attach to the service. However, this would appear to conflict with the principle of disregarding urgency of the need for the service. Moreover, the clauses leave considerable room for interpretation (and dispute) about what constitutes a "similar" condition (and we note again that past experience has shown vastly different expert assessments about what constitutes similar conditions). This is particularly significant because there may not be any similar supply/demand conditions for services under consideration here (non-energy and non-market ancillary services, including such services as system restart).
- There is no explicit provision for consequential losses arising as a result of complying with a direction for services other than energy and ancillary services to be included as part of the compensation. For instance, assume that SHTPL is required to reduce its output in the energy market in complying with a direction to supply a service other than energy or market ancillary services. It is unclear that this reduction in energy can be included as part of the compensation methodology. Hence, this issue on consequential losses requires further clarification.

While SHTPL supports NECA's intent that payment to directed parties should reflect a market under scarcity conditions, we are concerned that the current draft fails to signal this intent clearly and unambiguously. The principles and guidelines for the independent expert, as they stand at present, are too vague and ill-defined to provide market participants with any degree of certainty that they will receive adequate compensation for non-energy and non-market ancillary services provided under direction, nor is there any guarantee that determinations pursuant to these guidelines will be consistent with the principles and objectives of the NEM.

SHTPL also notes that the principles set out here do not appear to be consistent with the compensation principles for apparently the same directed non-market ancillary services as set in clause 4.8.9A(c) (essentially the higher of market value or costs). As discussed above, we

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do not know whether this conflict is deliberate, what the policy reasons for it might be, or whether a drafting error is involved.

SHTPL is also concerned that there is yet another compensation principle that may come into play for non-energy and non-market ancillary services. In the event that NEMMCO is of the opinion that an independent expert *cannot* be expected to determine the fair payment price, then the Directed Participant may make a submission to NEMMCO claiming loss of revenue, additional net direct costs, and a reasonable rate of return on capital employed (see clause 3.15.7B(a1). It is not clear at all what circumstances NECA has in mind here, and why yet another set of compensation principles will be employed. The criteria to be employed by NEMMCO in determining whether an expert can or cannot be expected to make a determination are not specified (but NEMMCO may develop guidelines for that purpose, see clause 13.5.7A(b)).

However, the existence of the option of bypassing the expert determination process and restricting compensation to revenue losses, cost, plus return on capital employed is of serious concern. It is highly likely that any compensation on this basis is far lower than market prices under scarcity conditions, and it also would appear to shift the burden of determining compensation from NEMMCO to the market participant. Thus, NEMMCO will be incentivised to choose this option in preference to the more expensive and complex expert determination route. It is also conceivable that this option might deter NEMMCO from contracting for the provision of emergency services which are currently not traded in the market (for example, back-up facilities for system wide frequency control owned and maintained by generators); if no market contracts exists, NEMMCO might consider that an expert cannot be expected to determine market prices.

Apart from these major concerns, there is a procedural aspect relating to the independent expert determination which needs to be resolved. Clause 3.15.7A(e) provides that a published expert determination also determines the fair payment price for that service for *future* directions over the following 12 months. While there are obvious merits in using precedent for future determinations, it is not clear what happens if a new, separate, direction for the same service is issued *prior* to the date of publication of the expert report. In principle, it would appear that compensation for such a direction must be determined by a separate independent expert. This in turn raises the question of what the status of that second report will be, once it is published, and how this affects the precedent value of the first expert's report.

It is also not entirely clear whether the precedent "fair payment price" refers to an absolute price in dollar terms, or whether the precedent is set by the *methodology* employed by the expert.

In summary, we believe the proposed code changes on compensation to Directed Participants for services other than energy or market ancillary services (3.15.7A) should be rewritten to espouse clear economic principles to guide the independent experts' determination of a fair payment price that reflects a market under scarcity conditions and to address the concerns raised in the preceding paragraphs on this issue.

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**Clause 3.8.22A: Variation Of Offer, Bid Or Rebid**

It is our understanding that the ACCC are in the process of considering NECA's proposed code changes in relation to bidding and rebidding. It therefore appears inappropriate and premature that NECA's proposed Directions Code changes refer directly to the proposed bidding and rebidding code changes which have not, or not yet, been authorised by the ACCC.

Furthermore, SHTPL strongly objects to Clause 3.8.22A. This clause explicitly contains a presumption of guilt, that is, a presumption that market participants submit their offers and bids in *bad faith* unless they can prove that they acted in good faith. This is entirely contrary to the established legal doctrine of the presumption of innocence unless proven guilty. We see no good reason for reversing the burden of proof for the purposes of bids in the NEM. In addition to this, there will be immense uncertainty surrounding the interpretation of what constitutes acting in "good faith".

**Clause 3.15.10C(c)(1)**

SHTPL notes that the effect of Clause 3.15.10C(c)(1) is that a Directed Participant must merely repay any compensation received, together with interest if the Directed Participant is found to be in breach of 3.8.22B. We understand that the ACCC are currently considering the authorisation of Clause 3.8.22B and if and when this does occur, clause 3.15.10C(c)(1) is inadequate. The conduct in question can be extremely costly to the market and other market participants, and will result in significant transaction costs associated with determining compensation payments for all affected participants. We would have expected that any market participant who intentionally or recklessly causes such damage to the market should not only have to repay any "ill-gotten gains", but also pay costs to NEMMCO, NECA and other affected participants, as well as perhaps some form of penalty or fine. In the absence of liability for damages for such conduct, market participants are in fact incentivised to act in a manner prejudicial to the market, as they can only gain but not lose.

**Recovery of Compensation Amounts from Market Participants**

A key determinant in the formula for calculating appropriate compensation amounts to be paid by Market Customer is the "Regional Benefit", as determined by NEMMCO (3.15.8(b)). However, the "regional benefit directions procedures", which will determine such regional benefits, do not appear to exist to date; clause 3.15.8(b2) charges NEMMCO with the development of such procedures, and sets out some factors to be taken into account. However, there is no timeline for the development of these procedures. Therefore, it is not entirely clear whether the compensation recovery formula can at present operate at all, or what modification needs to be made in the interim. Furthermore, it is not possible at this point to assess what the full economic implications of the compensation recovery method will be, and whether they will raise any competition policy issues that should be brought to the attention of the ACCC.

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Secondly, clause 3.15.8(g) provides for the recovery of any residual compensation amounts that have not been recovered from Market Customers and Affected Participants pursuant to 3.15.8(b) and (e). Such residual compensation is recovered from Code Participants on the basis of fixed participant fees. There are two problems with this approach:

- Firstly, fixed fees are currently set on the basis of historical capacity (for generators), and of the previous year's load (for market customers). There does not appear to be a good economic reason for linking the recovery of compensation for current directions in the market to historical capacity or load; the choice of fixed fees as a basis seems to be merely a device for recovering residual compensation amounts from large market participants. The NEM is an energy only market and to link compensation to capacity is inconsistent with the design of the market. This issue is of particular concern for high capacity but low energy plant such as SHTPL's generation assets. SHTPL continues to advocate that where there are no mechanisms to recover the full costs of a direction, the charge to Participants must be on an energy (i.e. $/MWh) basis.
- Secondly, the fee structure itself can change drastically from time to time; a future fee structure may not have any fixed fees, or may set fixed fees on an entirely different basis, and therefore, recover residual compensation amounts from very different parties. As you are aware, there is currently a dispute between NEMMCO and the National Generator Forum relating notably to the determination of fixed participant fees. SHTPL believes that it is unwise to link the recovery of residual compensation for directions to a factor that may change substantially and result in a very different, and perhaps unintended, recovery allocation.

**Other Issues**

- Throughout the consultation process it has been widely accepted and espoused that directions should be used as a last resort. Directions should also only be used where the normal market mechanisms, including spot markets and contracts are not available or are not functional. SHTPL believes that since these principles are widely endorsed that they should be explicitly codified.

- We note that the wording of clause 3.12.11(c) could be improved somewhat: as it stands, that clause states that an affected participant (respectively market customer) may make a submission claiming that the amount calculated by NEMMCO is greater than, less than, **or equal to** the correct amount. This implies that such a submission is optional and at the discretion of the participant. However, clause 3.12.11(c2) states that if a participant does not deliver such a submission, it shall cease to have an entitlement to compensation under 3.12.11, which, in practice, means that making a submission is compulsory even if the party concerned agrees with the amount calculated by NEMMCO. It appears to us that what is intended here is that an affected participant or a market customer either: confirms in writing their acceptance of the amount calculated by NEMMCO, or makes a submission as to why that amount should be different.

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- It is unclear as to why clauses 3.12.11 (d) 1 (iv) to (vii) relating to compensation for Affected Participants have been deleted when clauses 3.15.7B (a3) (iv) to (vii) (which are substantiatively the same as 3.12.11 (d) 1 (iv) to (vii)) relating to additional compensation for Directed Participants have been included.

**General Comments on Drafting**

As a general observation, the current draft (together with the host of amendments made on previous occasions) would benefit from a rigorous clause by clause audit and a substantial editing job. There are numerous instances of clauses that appear to address substantially the same matters but that are drafted inconsistently, using different terms and/or different concepts, which makes interpretation difficult and the assessment of the likely impacts uncertain. Additionally, drafting is unnecessarily complex and legalistic in some places, and clause numbering has become very complex and difficult to follow.

**Conclusion**

In conclusion, SHTPL is supportive of the intent of NECA's code changes. The current code changes in principle address the majority of the objectives of the review of directions in the NEM. Specifically, SHTPL endorses:

- The compensation methodology for energy and market ancillary services
- The inclusion of SRA holders as affected parties able to claim compensation

However, because these latest code changes were not subjected to Participant consultation prior to being submitted to the ACCC for authorisation, there remain some significant issues requiring further clarification and modification to remove ambiguity and uncertainty in the interpretation of these code changes and to fully meet the codified market objectives. These issues where we still have concerns are:

- The purpose and relevance of clause 4.8.9A. This may be a drafting oversight.
- The proposed code changes on compensation to Directed Participants for services other than energy or market ancillary services (3.15.7A) and the clauses related to when an independent expert could not reasonably be expected to determine a fair payment price (3.15.7B (a1)) should be rewritten to espouse clear economic principles and to ensure that the fair payment price reflects a market under scarcity conditions.

If you have any enquiries in relation to this submission then please contact myself on (02) 9278-1862.

Yours sincerely,

Kevin Ly
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