



9 May 2003

electricity.group@acc.gov.au

Dear Electricity Group

Re: Code Change Proposal for Regional Pricing of Ancillary Services

Thank you for the opportunity to comment on the code change proposal submitted by the code change panel. Please find TXU's comments enclosed. TXU also endorses the submission to these changes prepared by the National Generators' Forum.

I was invited to participate in the focus group convened by the code change panel, attended by Charles River Associates, which considered the mechanism of implementing regional settlement. This approach of using consultancy and industry expertise to work together towards a mechanism that is robust and likely to get industry and regulatory support should be commended and used more frequently.

TXU strongly supports the code changes that were considered by this process, however we object to the changes in section 3.14, which were not considered by the focus group.

I would welcome any questions on (03) 8628 1280.

Yours sincerely

Ben Skinner
NEM Policy Manager

Regional Settlement

The cost smearing approach to frequency control ancillary services has proved to be an unexpectedly severe limitation to the efficient application of the causer pays principle and has made hedging of ancillary services so difficult that negligible contracts have been written. This lack of hedging has both increased the risk burden to the market and exaggerated the market power of providers during short-term regional events.

We strongly endorse the intent of the Eraring code change, whilst recognising that the code change has been enhanced through the focus group process.

Localised cost recovery

In its earlier paper, the panel claimed that regional settlement had a potentially adverse impact by allocating extreme price events to a smaller group of payers, and might be a barrier to entry to generators who do not provide the services. TXU feels these arguments have the following flaws:

- As the cost impact is equal on all generators, they pass through the cost of these by raising bid prices as soon as they are exposed to the increased FCAS cost.
- It is the lack of hedging that creates the conditions for generators to offer ancillary services at very high prices. With regional settlement facilitating a hedge market, extreme prices would be very rare.

Cumulative Price Threshold and administered price cap

This mechanism has been included by the panel into the code change without detailed consideration of the need or its potential impacts. It was not part of the Eraring code change nor the work of the focus group nor its consultant. TXU is concerned that it has seriously harmful effects upon the energy market.

The mechanism caps the energy markets as well as ancillary services market, and can potentially cap the entire NEM. Although the trigger price is apparently the same as that for energy, the volume of procured services in FCAS is much smaller, so an event which otherwise had very small market impacts can trigger an energy price cap with very large impacts.

TXU is concerned regarding irrational market outcomes during periods of administered pricing on energy, having experienced such a period in January and February 2000. It is likely to have the following distortions:

- Important investment signals from a period of tight/supply demand balance can be lost.
- Generators see no incentive in maintaining availability, even scheduling maintenance during a period of shortage as it has least financial risk.
- NEMMCO is likely to have to intervene to maintain plant availability, causing large compensation payments that cannot be mitigated by market customers.
- Demand-side response sees no incentive to participate.
- Participants using inter-regional trading strategies become unfairly exposed. If hedging load in an uncapped region with positions in a capped region the position will become unhedged, even if holding settlement residue instruments if interconnector flows are low.
- The inter-regional flow mechanism that switches the cap on and off in adjacent regions can be gamed by generators and MNSP's.

We therefore urge great caution in recommending any new trigger to an administered price cap on energy prices. Such a suggestion needs consideration as least as thorough as was undertaken upon the Eraring request for regional settlement.

Better ways to cap FCAS prices

TXU is not averse to the concept of a cumulative price threshold triggered cap on ancillary services, but we feel it is possible to suggest a mechanism without the serious side-effects of that proposed here.

We should attempt to limit the cap only to the services that need to be limited. Ideally this would be the particular service and region that triggered the CPT, however as the energy market and other services are co-optimised against it, we accept that one or all ancillary services cannot be simply capped in isolation.

A better mechanism would be, for example, to simply cap the ancillary service prices at the regional energy price *plus* the administered price threshold.

Trigger Level

The cumulative price threshold was proposed to limit the extent of systemic financial risk in the market such that a major market event would not trigger a chain of financial collapse. As the volume of ancillary services purchased in the NEM is less than one-twentieth that of energy, it follows that the implied level of systemic financial risk upon participants caused by an FCAS price event is also much lower.

Following the logic that created the CPT, this suggests the trigger level for FCAS should be increased by the relative volume difference against energy.

Separability

The changes recommended to section 3.14 stand alone from the regionalised settlement changes. They can be deleted without affecting the benefits of the rest of the authorisation.

Recommendation

The commission should authorise these code changes subject to the condition that changes to section 3.14 be deleted. The commission should invite NECA to consult and consider more thoroughly mechanisms for limiting periods of extreme prices on ancillary services and then re-propose new code changes for authorisation.