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Dear Sebastian

### DESPATCHING THE MARKET: PROPOSED TRIAL AT TUMUT NODES

Macquarie Generation does not support changes to the National Electricity Code, as proposed by the National Electricity Code Administrator and Snowy Hydro, to trial a modified constraint support pricing and contracting regime for the Tumut nodes during periods of binding congestion in the Snowy region.

Macquarie Generation believes that the proposed derogation is an inadequate and second-rate response to the intra-regional congestion problems that prevail in the Snowy region. The Corporation would support a reconfiguration of boundaries in the Snowy area to address the underlying cause of dispatch inefficiencies. NEM institutions should pursue optimal solutions to design problems not partial fixes with uncertain and possibly unintended outcomes for participants and the market.

#### **Background**

The National Electricity Code currently defines regional boundary criteria, a process for reviewing the criteria, and a process for adjusting regional boundaries through time. The boundary adjustment review process has stalled since the NEM Ministers' Forum instructed NEMMCO and NECA to cease applying the relevant Code provisions in July 2002. For market participants, the dispatch inefficiencies created by intraregional congestion in the Snowy region, which are by far the most significant and contentious in the NEM, remain a major concern.

The failure of the process for setting NEM boundaries has caused protracted and costly industry debate for many years. The most obvious sign of this problem is the controversy over constraint formulation in the NEM. NEMMCO has conducted numerous reviews and consultations in an attempt to better manage power flows in the Snowy region. However, constraint formulation alone cannot correct the underlying cause of dispatch inefficiencies.

The Ministerial Council on Energy released terms of reference for a review of the regional structure in January 2004. The MCE's consultants, Charles River Associates, published a report on regional boundary arrangements in September 2004. The MCE is yet to comment on the recommendations in the CRA report.

Macquarie Generation supports the broad thrust of the majority of CRA recommendations to improve the boundary change process, particularly the move to replace the current technical criteria with an assessment of the economic costs and benefits of a boundary reconfiguration. Under the CRA proposal, changes to the current boundary structure may take five or more years to implement given the work needed to change the market rules, undertake a full review and assessment of NEM boundaries and to implement boundary changes following a three year notice period.

Macquarie Generation recognises that market participants cannot wait five years for an effective solution to the misalignment of regional boundaries in the Snowy region, but the Corporation does not believe that the proposed derogation is the right answer nor does it provide any value as a trial of the CSC/CSP proposal.

### **The Snowy problem**

The 1,300MW nominal limit on the Murray to Upper and Lower Tumut transmission elements is a permanent feature of the NEM. There are no plans and little prospect of upgrading the transmission infrastructure in the Mount Kosciuzko national park. The Murray-Tumut constraint has bound for the following hours over recent calendar years:

- 2002 – 100 hours
- 2003 – 111 hours
- 2004 – 35 hours (33 hours in October to December period)

NEMMCO, in its draft final *Regional Boundaries Review* (February 2002), examined a number of options for configuring the Snowy boundaries and recommended the establishment of a Snowy region that encompassed the existing region and the Riverina and Canberra/Yass areas with a regional reference node at Canberra. NEMMCO never published a final report. The Ministerial moratorium on any further review has left the problem unresolved.

### **The proposed Snowy trial**

The proposed trial at the Tumut nodes may deliver some improved dispatch signals for Snowy Hydro mainly in the presence of southerly energy flows through the Snowy region. The vast majority of intra-regional congestion in the Snowy region occurs when energy is flowing in a northerly direction. In this case, the Snowy proposal is unlikely to significantly alter dispatch patterns.

The problems with the Snowy region are complicated by the fact that Murray generation is located at the regional reference node and by the presence of loop flows in the Snowy region. The Snowy proposal does not address these issues. Snowy Hydro has effectively adapted and tailored the CRA proposal to address some of the specific commercial problems that it faces when congestion occurs.

If the MCE Standing Committee of Officials does consider that there is merit it investigating the CRA concept, it should consider a trial in another part of the NEM where the arrangement has a more general application.

### **Quantifying the effects of the trial**

The MCE Standing Committee of Officials support for the proposal was contingent upon some measurement of the effects of the trial prior to its approval. NECA has indicated that it commissioned some modelling of the proposal prior to supporting the proposed derogation. NECA has not made that modelling work available to market participants.

Macquarie Generation is of the view that the ACCC must have access to detailed modelling work that can give some insight into likely market outcomes and the sensitivity of those outcomes to changes in the key assumptions. The analysis needs to be:

- Independent of Snowy or other market participants;
- Include game theory and take account of strategic contracting scenarios;
- Focus on market efficiency outcomes; and
- Calculate the extent of wealth transfers from the settlement residue auctions to Snowy Hydro.

### **Regional boundary review is the preferred solution**

The Snowy Hydro proposal for a partial trial of the CSC/CSP regime effectively introduces a dynamic regional boundary when intra-regional constraints are binding. This is a new and untested proposal that will create uncertainty for participants as to possible bidding behaviour and competitive responses, particular in the presence of loop flows and counterprice management arrangements. The creation of uncertainty in the physical market will inevitably have an effect on the derivatives contract market.

Given the deficiencies of the Snowy proposal, Macquarie Generation believes that a one-off review of regional boundaries in the Snowy area is justified to address the problems caused by Murray-Tumut congestion. The majority of submissions to the NECA consultation on the Snowy derogation agreed that a review was the preferred approach given the persistent nature of the congestion problem, as did NECA (p.5) in its report on the derogation:

... a change to the regional boundary could be a durable and effective solution to these problems. It would also be consistent with the recommendations in the CRA report of the use of CSP/CSCs as an interim measure, and of a regional boundary change for sustained and material congestion. However, a boundary change is likely to be delayed due to the current moratorium, the policy hiatus before the new institution are developed, and the processes required in the Code.

Macquarie Generation is currently considering whether to sponsor a further derogation to initiate a fast-track review of regional boundaries in and around the Snowy region. Such a review could use the existing boundary criteria and review processes. Implementation of

the review findings would be mainly dependent upon any necessary changes to IT systems and contract documentation. Given that there are very few if any contracts written against the Snowy node, it may be possible to introduce the findings well within the current 12-month notice period.

Yours sincerely

Signed 4/3/2005

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MANAGER MARKETING & TRADING

