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Manager – Energy Market Reform Team
National Energy Market Branch
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Dear Sir

NEM Regional Structure Review

Thank you for the opportunity to participate in the region structure review. The comments provided herein are solely my own, and they have not been prepared on behalf of or discussed with any of the main stakeholders in the NEM. Nevertheless, I trust the SCO will still give them due consideration before finalising its recommendations to the MCE.

The report and its conclusions and recommendations need to be assessed within the very tight policy constraints and quite restricted terms of reference under which they have been prepared. As such, the report advances the thinking about how to manage network congestion in the NEM considerably; but a more liberal policy setting framework for undertaking the work may have led to a quite different outcome.

The issue being addressed here is essentially about how to manage network congestion in the NEM – either using region boundaries to deal with it directly in the spot market or using some out-of-the-market means of managing it as an intra-regional problem. Provided each approach is effective in its own right, the criteria that one then applies for setting the region boundaries, and the frequency with which they are reviewed and revised becomes less critical.

Nevertheless, the recommendations are a paradigm shift in thinking since the initial NEM market design was put together more than 10 years ago – At that time, a somewhat dynamic approach to setting region boundaries was proposed initially with the expectation that the market would evolve eventually to full nodal pricing when it was politically and commercially palatable to do so. In contrast to this, CRA's recommendations if implemented, would lock in highly static and inflexible regional boundaries within the current NEM regulatory and policy framework, but introduce complementary intra-regional congestion management mechanisms to address the worst features of a market with fixed region boundaries. Within the current policy and regulatory settings, this will probably be seen as a reasonably pragmatic and enlightened solution. But are the current policy and regulatory settings valid and is this the best long-term solution? This issue deserves to be addressed more broadly and objectively before locking into the proposed recommendations and spending a lot of time and effort developing and implementing the proposed CSP/CSC regime.

Like all market design questions, in the CSP/CSC regime, the devil is in the detail. Trying to design and implement a CSP/CSC regime within a very constrained policy and regulatory framework is likely to create a whole new set of controversial issues and problems that will take considerable time and participant involvement to resolve.

And, in any event, in most cases, it is reasonable to expect that rather heavy-handed regulatory intervention will be needed to apply whatever detailed CSP/CSC solution framework is finally implemented because:

- ⊗ the CS contracts will probably need to be imposed on those who will bear the constraint costs;
- ⊗ the constraint costs themselves as measured by nodal price differences and network flows will often be open to manipulation, in which case, the arrangements should probably incorporate market power mitigation provisions which also hedge the cost of the constraint when it occurs; and
- ⊗ arguably, generators behind the constraints should not be expected to bear the full cost of intra-regional network constraints under all circumstances.

The cost of network constraints, both inter-regional and intra-regional, can be affected quite significantly by TNSP and/or NEMMCO decisions and actions, errors and omissions. Yet the regime as proposed would not hold either of those parties accountable for any of the intra-regional constraint costs they impose on the market – these would be borne by selected generators. A simpler solution to implement would be to merely allocate all intra-regional constraint costs to the relevant TNSP(s) to manage within their regulated monopoly business. The TNSPs could then decide on a case by case basis within the current economic regulation framework whether to:

- ⊗ enter into contracts with generators or others to relieve the constraint and/or minimise or hedge its costs;
- ⊗ invest in network augmentation; and/or
- ⊗ press for a change to the region boundaries.

This would:

- ⊗ help to clarify the scope of each TNSP's regulated network business compared with current practice where the situation remains quite confused,
- ⊗ in the absence of any material changes to the current network access arrangements, allocate the cost of intra-regional constraints to consumers which is consistent with current practice;
- ⊗ "appoint" the TNSPs to the role of managing such constraints and incentivising them to minimise overall intra-regional network costs (excluding losses) rather than allocating part of the problem to NEMMCO with no commercial or regulatory drivers to maximise economic efficiency;
- ⊗ ensure that intra-regional congestion management, as part of the TNSP's regulated business, would be subject to regulatory supervision;
- ⊗ avoid the need for complex changes to the Code and allocate the task of developing an efficient CSC regime and modifications to current network charges directly to the TNSPs, with the onus on them to justify their approach to the regulator before it could be implemented and applied;
- ⊗ be heading in the right direction in terms of developing more commercially sustainable network access arrangements for market participants overall; and
- ⊗ facilitate consistency between the way in which TNSPs offer "firm" network capability to market participants for intra-regional network transfer capability, and NEMMCO, presumably with TNSP backing, eventually offers firmer inter-regional hedging capability up to the design capability of the interconnectors.

November 15, 2004

Page 3

CRA have suggested TNSP involvement in the CRC proposal “*would, however, be a significant regulatory development and is not expected in the short term, but would be necessary to create fully firm risk instrument.*” The proposition that it would be a significant regulatory development is at best arguable because:

- ⊗ the current TNSP economic regulation framework can and already does accommodate regulated costs other than investment in and operation and maintenance of traditional network assets, and
- ⊗ when the expected costs of any enduring intra-regional constraint exceed \$1M per annum, it would be grounds for establishing a new region boundary. Therefore the cost to the TNSPs of absorbing this responsibility should have a minimal impact on their Maximum Allowable Revenue and their network prices.

TNSPs will no doubt argue that the current WACC on which their MAR is based makes no allowance for the additional risk to them of assuming responsibility for intra-regional constraint costs. However, if the TNSPs manage the constraints judiciously, including entering into hedging arrangements where prudent to do so, the added risk to their business should be minimal. If this is not the case, then the proposed criteria for establishing a new region boundary need further refinement.

In summary, while the role of the MCE is intended to be one of setting broad policy parameters for the NEM, for this project, the MCE has specifically excluded any meaningful policy debate and the project merely focuses on how to tinker with current NEM implementation arrangements to ameliorate some of its worst shortcomings. Implementing CRA’s recommendations as proposed has the potential to achieve that rather modest objective. However:

- ⊗ the recommendations involve value transfers for some market participants and consumers, the implementation of which may prove to be no less difficult or contentious than past attempts to apply the current Code provisions governing region boundary changes have been;
- ⊗ as is usually the case in such matters, the “devil is in the detail”, and there is a real risk that compromises and other design expediencies in the detailed implementation will reduce the anticipated benefits of the proposals; and
- ⊗ it would defer indefinitely the development of a more robust and commercially sustainable set of policy parameters for the NEM, which involved less reliance on ongoing regulatory involvement.

Rather than adopting CRA’s recommendations, I would suggest the MCE either:

- ⊗ focus its attention on the broader policy and regulatory settings and leave the detailed implementation issues to the AEMC to address in due course; or alternatively
- ⊗ defer a decision pending confirmation of the feasibility, practicality and overall effectiveness of the total package of recommendations by completing the detailed design work..

Sincerely,

Jim Gallagher
Director