

17 November 2004

Manager- Energy Market Reform Team
National Energy Market Branch
Department of Industry, Tourism and Resources
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Dear Sir/Madam

NATIONAL ELECTRICITY MARKET: REGIONAL STRUCTURE REVIEW

Origin appreciates the opportunity to provide some comments on the draft report prepared by Charles River Associates (CRA), NEM - *Transmission Region Boundary Structure*, for the Ministerial Council on Energy (MCE).

We generally support the broad recommendations of the report:

- no change to the current boundaries at this time
- an incremental change approach to region boundary changes, based on clear economic principles
- increased lead time for changes to allow the market to adjust and a defined period where boundaries are stable.

However, Origin is concerned with some of the detail surrounding these recommendations, particularly in relation to the timing of regional boundary changes and the arbitrary nature of some of the economic criteria proposed by CRA for altering them.

These concerns have been outlined as part of submissions prepared by the key industry working groups: the Electricity Retailers Association of Australia (ERAA), the National Generators Forum (NGF) and a group of participants who refer to themselves as 'The Group'. Origin is an active member on all these groups and largely supports the views expressed in their submissions.

Notwithstanding this, where Origin differs, and we felt this to be of sufficient importance to ultimately withdraw our support for the submission provided by *The Group*, was on the way congestion ought to be managed in between region boundary reviews. We do not believe the current approach of using counter price flow restrictions to manage congestion is adequate in this respect. In our view, this approach does not impart effective discipline on participants to either recognise or manage their impacts on congestion, nor does it lead to a satisfactory allocation of access to market for participants when constraints bind. The latter issue, in particular, is of central importance to Origin, as we consider it deters new investment and new entry.

For these reasons Origin is more amenable to CRA's Constraint Support Pricing/Constraint Support Contract (CSP/CSC) mechanism as a way of addressing intra-regional congestion. However, and we strongly agree on this point with *The Group*, the envisaged efficiency benefits of this approach depend heavily on having the CSCs appropriately defined and allocated. Unfortunately CRA have had little to say on this important point.

In this regard, and pre-empting to an extent the second stage of consultation, Origin makes some suggestions on what it considers might be an efficient allocation methodology for CSCs, which we hope will set the stage for constructive debate on this issue in forthcoming months.

We discuss these issues in more detail below.

The problem with maintaining the status quo

Some argue that material congestion should only be addressed through region boundary change or network investment, on the basis of strict economic criteria. Congestion that falls short of this threshold should be managed as it is currently, with an Option 4 constraint formulation plus a mechanism that constrains counter price flows.

However, Origin believes that congestion can impose substantive commercial impacts on participants yet not justify region boundary change or network investment to remove it. Indeed, congestion may persist for a considerable period of time before it can be addressed through these measures (likely to be 5 years in the case of region boundary change). This creates considerable uncertainty for participants in respect of their access to market and consequently acts as significant barrier to investment and new entry.

As such, Origin considers that there will be a requirement for congestion to be managed in a more rigorous manner between region boundary reviews to allay this uncertainty. Simply restraining counter-price flows is insufficient in our view because it does not address the causes of congestion, the associated problem of distorted bidding behind constraints, nor does it provide a systematic way of allocating access when constraints bind.

In contrast, a CSP/CSC regime addresses the causes of congestion directly by providing financial penalties and bonuses to those who are in the best position to do something about it, which should encourage a reduction in congestion over time. Fixing the price distortions inherent in the current regime resolves the anticompetitive bidding issue. Further, if the right allocation methodology is adopted for CSCs, generators will know how their dispatch will be treated in the event of a constraint and degree of access they will have to market.

It should be noted that the CSP/CSC approach provides largely the same price signals as regional boundary change, arguably obviating the need for the latter to occur. Consequently this approach may provide greater certainty for participants because it would largely remove the need to predict and adjust to a continual process of region boundary change. Further, when congestion diminishes, the pricing regime naturally dissolves, avoiding the need for a realignment or deletion of regions.

This kind of certainty is crucial for new entrants considering entering the market and who, in the absence of appropriate transmission access rules under scarcity, may be concerned about how their substantial capital investments are going to be affected by the unpredictable impacts of constraints.

Options for allocating CSCs

Notwithstanding the potential benefits of a CSP/CSC regime however, the critical foundation on which the workability this regime would ultimately rest is the allocation methodology adopted for CSCs.

However, CRA provides little guidance on this matter, leaving it as a policy issue for jurisdictions to decide upon. This omission by CRA is crucial because the definition and allocation of CSCs will have a significant bearing on issues such as the level of risk to which participants are exposed, barriers to entry, and incentives for the exercise of market power.

Origin makes some suggestions on a possible allocation which addresses these issues. First, though, we highlight our concerns with what we expect will be the most likely alternative allocation proposals to be considered by the MCE.

Grandfathering to incumbents

Origin is concerned that grandfathering would provide incumbents with more rights over the network than they have currently, undermining the principles of open access and raising barriers to new entrants.

It is important to note that under the current regime generators do not have a guaranteed level of fixed access to market when intra-regional constraints bind; rather, the firmness of any such access hinges, inter alia, on new entry. Where new generation is sited along side existing generation behind a constraint the level of access to that constrained capacity is concomitantly reduced for existing generators.

Under a strict grandfathering arrangement, such access rights would remain fixed for incumbents regardless of new entry, providing them with an essential property right over transmission which they do not in fact own¹.

New entrants on the other hand would be exposed to the full price risk of a CSP regime, which therefore acts as a competitive disadvantage to such entry. The potential for such an allocation to deter dynamic competition may therefore be inappropriate if consumers, who pay for the network, justifiably expect that any allocation of contracts should maximise competition across it. This would clearly provide the best prospect for effective discipline on the delivered prices they pay.

Auctioning rights

In Origin's opinion, allocating contracts on the basis of an auction, while more acceptable than grandfathering, may not resolve the issue described above, since once contracts have been auctioned they would establish a transmission property right for the term of the contract, to an extent therefore implying the same problems for new entrants as do grandfathered rights.

¹ Generators only pay connection charges, not the costs of the actual transmission lines themselves which is paid for by customers

This could be addressed through creation of some form of secondary market; however, it seems unlikely that holders of property rights would ever wish to sell them if they have any value, unless they are forced to sell at some point down the track. A requirement to sell, however, would greatly reduce the value of such contracts and impose significant uncertainty over the access of long lived generation assets to market.

As a result, a key problem under an auction mechanism is the term over which contracts should be allocated and the basis on which they should subsequently be transferred.

A further potential problem with any auctioning of CSCs is that they may amplify the market power of generators who are able to influence the value of contracts they have purchased or those purchased by others (by congesting or de-congesting a link). Clearly this would enhance their attractiveness to these generators and may therefore lead to a concentration of CSCs in the hands of generators with the most market power, hardly a desirable state of affairs².

This issue is well documented in relation to FTRs and it is not immediately apparent that this would be any different under the contracting arrangements proposed by CRA. This would need to be examined closely in any forthcoming consultation.

Origin view on CSC allocation

As a consequence of the problems likely to be encountered with the allocation methodologies described above, Origin proposes an alternative allocation that does not discriminate between incumbents and new entrants, provides greater certainty for participants, and deals with the market power concerns inherent in any auction process. While the details of such a regime will need refining, to be sure, the basic idea follows.

Long term contracts could be allocated to participants competing for access to scarce transmission capacity which reflect some form of sharing of such access³. Shares or contracts may be allocated to each generator on the basis of their available capacity contesting a particular constraint, as a proportion of the total capacity contesting the constraint. It is likely that an allocation will also need to be made to an interconnector in the case of most significant intra-regional constraints⁴.

It is acknowledged that the firmness of such 'shared' access to the RRP depends on the overall level of transmission capability existing at the time, and that this may vary. Contracts to constrained capacity will therefore need to reflect this fact by being scaled down accordingly, in proportion to whatever capability is available at the time. While this implies a level of uncertainty with respect to the level of the absolute access to scarce transmission capacity at various times, participants at least will know *ex ante* the proportion of scarce transmission that will fall to them when a constraint binds.

Perhaps the key aspect of this arrangement is that where a new entrant locates near an incumbent generator it would obtain a share of access to constrained capacity, and thus effectively lower the contract level for all existing generators contesting that constraint (contracts would therefore need to be redefined to reflect this fact). This is crucial from Origin's perspective to ensure that the price and volume risk inherent in the CRA

² Bushnell, J (1999), *Transmission rights and market power*, University of California Energy Institute, Berkeley.

³ Note that this would occur only once bids have been taken into account.

⁴ This sharing proposal was first put forward by Delta and Macquarie Generation.

constraint management approach is shared among incumbents and new entrants over time (which grandfathering does not achieve).

In addition, such a contract allocation process would expose all generators behind a constraint to an incrementally greater level of price risk over time as new entry occurs, and thereby provides important incentives for addressing congestion going forward.

Moreover, generators behind a constraint may be encouraged to a greater extent under this approach to collectively pay for augmentation (with a straightforward methodology for working out respective funding contributions) or lobby the relevant jurisdiction to do so, if they wish to maintain or enhance their level of access over time.

Conclusion

Origin supports the development of rigorous economic based criteria for determining new regions, and endorses the concerns raised by the various industry working groups in this regard.

We also support the implementation of a CSP/CSC regime to address significant congestion in between boundary reviews, but only to the extent that an acceptable allocation methodology can be developed for CSCs

A CSP regime combined with the allocation methodology we have proposed provides a coherent and systematic framework for addressing congestion and determining access to scarce transmission capacity when constraints bind. It creates certainty for participants in respect of how congestion will impact them commercially, while at the same time ensuring competitive neutrality between incumbents and new entrants over time.

Origin looks forward to meeting with you in person, if required, to discuss these issues further. Please free to contact Con Van Kemenade on 02 8345-5278 in the first instance.

Yours sincerely,

Signed

Tony Wood
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