

24 November 2010

Mr Glenn Appleyard  
Regulator  
Office of the Tasmanian Economic Regulator  
GPO Box 770  
Hobart TAS 7001

Dear Mr Appleyard

**FCAS Pricing Investigation Draft Report**

Please find attached Hydro Tasmania's response to OTTER's Draft FCAS Pricing Investigation Report and IES's Consultation Draft.

If you have any queries, please contact the undersigned on 6230 5775 or via email at [david.bowker@hydro.com.au](mailto:david.bowker@hydro.com.au)

Yours sincerely



David Bowker  
Manager Market Regulation

# Hydro Tasmania Submission to OTTER's FCAS Pricing Investigation

## Draft Report

### Overview

Hydro Tasmania is broadly supportive of the Draft Report findings but there are some outstanding issues which require attention and resolution. We have discussed all of them below but the key issues are:

- Risk When New Supplier Enters
- Cost of Inertia not Allowed
- Cost of Regulation
- Fixed Opportunity Cost Calculation

### Risk When New Supplier Enters

When a new supplier enters the market for FCAS, Hydro Tasmania is unable to manage the risk of its FCAS contracts. This represents an untenable position and it is an issue which needs to be addressed. It is relevant to the degree of competition in the service (para. 33(2)(e)) and the financial viability of the provider (para. 33 (2)(i)).

In selecting the regulation of a standard hedge product, the Regulator is making a fundamental assumption that Hydro Tasmania is able to physically back its hedge position. Continuing with existing contracts and methodology after registration of a new supplier (not dealt with by self-provision clause) is an untenable risk for Hydro Tasmania.

With the presence of new entrants, high prices from a co-optimised outcome and the resultant exposure of Hydro Tasmania under the regulated contracts cannot be managed with bids.

Take the case where there is a new provider who has 20 MW capability bidding at the market floor. Hydro Tasmania can respond to high price by also bidding at market floor and the two providers would be enabled on a pro-rata basis<sup>1</sup>.

If this meant that the new supplier was enabled for 50% of its capability, then Hydro Tasmania's exposure would be  $(10 \text{ MWR}_6 * \text{market cap} + 10 * 1.75 \text{ MWR}_{60} * \text{market cap} + 10 * 2 \text{ MWR}_5 * \text{market cap})$  \$49.5k for a 5 minute interval. This is assuming that the new supplier does not have any liability (i.e. a market load).

This case clearly demonstrates that Hydro Tasmania would have an unmanageable risk due to the regulations. A new entrant (non generator) may be incentivised to contract away their risk (may result in a 10 MW contract with a generator). Yet, under this scenario, Hydro Tasmania is still obliged to offer to manage a competitor's entire liability even though a

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<sup>1</sup> NER 3.8.16

portion may be hedged i.e. potential to exacerbate risk even further to the example highlighted.

Further, a Determination which requires Hydro Tasmania to enter into hedges which it is not able to back, may place Hydro Tasmania in breach of the Treasurer's Instruction for Government Business Enterprises relating to Financial Arrangements. The Treasurer's Instruction prohibits Hydro Tasmania from 'entering into financial arrangements for which there is no underlying physical position' or 'by taking a leveraged position'.

Also, the possible financial consequences of Hydro Tasmania being locked into a position where it is unable to back its hedges are potentially severe. The financial viability of providing the service (reg. 33(2)(i)) and the return on Hydro Tasmania's assets (para. 33(2)(f)) could be compromised when a new entrant appears.

Recommendation: The appearance of a material new entrant in Tasmania should trigger a suspension of existing 'safety net' contracts and the removal for the requirement for new contracts while an assessment of the need to continue the regulations takes place (see next point re-materiality).

### **Materiality of new supply**

In section 2.6 of their Consultation Draft Report, IES refer to an example of a new entrant providing 100 MW of R6 giving cause for OTTER to remove the declaration. The rationale given is that this quantity would remove the dependency on Hydro Tasmania to provide the service.

Given the comments relating to new supplier noted above, Hydro Tasmania considers that materiality occurs at a much lower quantity than the threshold referred to by IES and is more commensurate with a percentage of the average contract quantity.

One formula for calculating this quantity would be 50% of the average liability, as assumed by IES in section 3.3.11, which would equal 5 MW of R6. An alternative formula would be the average Tasmanian requirement minus average Hydro Tasmania liability.

Recommendation: OTTER devise a formula for determining materiality. This threshold is then used to trigger contract suspension and a review of the need for regulation.

### **New supply in regards bundling**

While it is considered prudent to include all FCAS raise contingency services as a 'bundled' product with regards to supplies provided by Hydro Tasmania, it is conceivable that a new entrant may provide only one or two of the services. This could potentially create the situation where one or more of the services may need to be treated differently to the others.

Recommendation: OTTER acknowledges this potential and agrees that ‘self provision’ and ‘new supplier’ impacts can be applied to each service individually if necessary.

### **Cost of inertia**

This is relevant to the cost of providing the service (para. 33(2)(a)). The Regulator has concluded that the costs of inertia be excluded from FCAS costs based on IES’s view that these costs are primarily incurred through Hydro Tasmania pursuing its own commercial interest.

Provision of inertia increases Basslink flow by reducing the requirement for excessive quantities of raise contingency services. This is a least cost approach that enables the least cost market solution to be dispatched for the benefit of all electricity consumers.

Hydro Tasmania acknowledges that this is of sizeable benefit to its own commercial interests and has always accepted its share of the cost. A proportional allocation of these costs, commensurate with the respective liability of generators for the FCAS costs avoided, is considered fair and reasonable. Note that this is not a substantial contributor to the overall cost. In the case where inertia costs are disallowed, then FCAS quantities should be calculated based on ‘no additional inertia’ cases.

Recommendation: OTTER seek advice from AEMO on the technical substitutability of inertia and FCAS, and then possibly reconsider its decision to exclude the cost of inertia. These costs should be removed if and when an alternative ‘direct’ cost recovery mechanism is in place in the NEM.

### **Liability following concept**

Hydro Tasmania is generally accepting of the liability following under the cap concept (assuming the ‘new supplier’ issue discussed earlier is addressed). However, as we can not determine our exposure in advance, a risk premium should therefore be applied.

It is standard practice in the NEM for premiums to be applied for this type of flexibility. A possible solution to this issue is to use a fixed value, say 30%.

Recommendation: Pricing is amended to allow a liability following risk premium of 30%.

### **Cost of regulation**

There has been no provision for the cost of regulation to be recovered. Both the costs of the initial regulation process and ongoing administration costs of regulation should be fully recoverable (reg. 33(2)(n)).

The Draft Report suggests that these costs should somehow not be allowed because of Hydro Tasmania’s prior behaviour. This is entirely contrary to principles of natural justice, as it purports to penalise Hydro Tasmania without any adverse finding – especially in light the ACCC’s conclusion that there is no case to answer. It is also entirely at odds with standard regulatory practice and there is no other regulated business in Australia which is not permitted to recover its costs of regulation.

On a minor issue, IES suggest that REC costs are sourced from the NextGen publication at a cost of \$1500/annum. Similar information can be sourced from AFMA for no additional cost.

Recommendations:

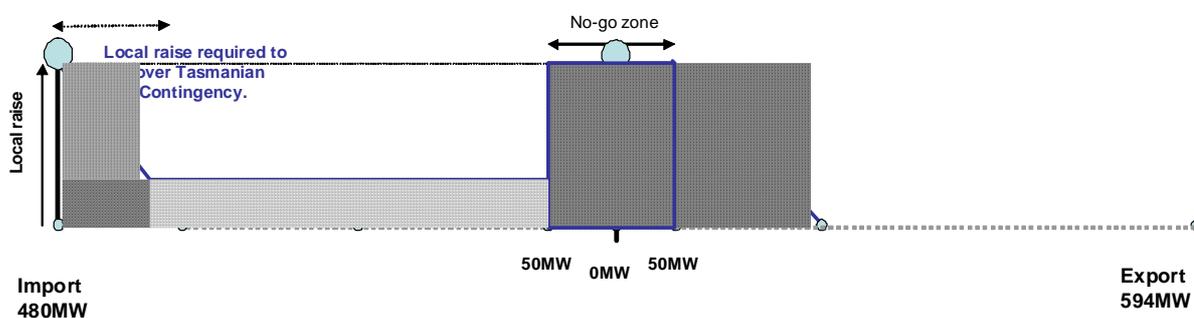
- Full cost recovery is included.
- Utilise AFMA weekly average REC price (Hydro Tasmania has access to this source) in place of NextGen.

**Basslink import definition**

The initial declaration was intended to place regulations on the Tasmanian local requirement for raise contingency services. The determination of a local requirement is dependant on the output of National Electricity Market Dispatch Engine (NEMDE), which is the co-optimised outcome of participant’s bids and constraints within the spot market.

IES have addressed this issue by the use of a Basslink import definition to determine how often a local requirement is enabled. This is used for the purposes of calculating the contract price. The definition chosen by IES (+50 MW) is not fully representative of the periods when a local requirement is enabled. The Tasmanian requirement may exist until Basslink flow is greater than the no-go zone limit plus the actual requirement (I.e.  $Y = 50 + X$ ) as shown in the diagram below.

**Local FCAS Requirements for Tasmania  
Raise Contingencies**



In another section of their report, IES suggest that 130 MW is representative of a maximum Tasmanian requirement, therefore, for the purposes of these regulations  $Y = 180$  MW.

Recommendation: Basslink import is defined as +180 MW for the purposes of the 'safety net' contract. Customers may stipulate their own definition of Basslink import for variation to the safety net contract.

### **Basslink import – settlement**

The contract should be settled on terms that reflect the cost calculation and associated risk profile. Therefore any periods where the Basslink import definition is not satisfied (i.e. when exports are above Y) no liability is covered by the contract.

Recommendation: The safety net contract should be updated to reflect this methodology.

### **Calculation dates**

Specific dates for determining input values should be determined. Historical data should be referenced to the previous corresponding period. For example, the data for the 1<sup>st</sup> half of 2010 should reference the 1<sup>st</sup> half 2011).

Recommendation: The average price over the week containing or nearest to 15<sup>th</sup> December for 1<sup>st</sup> half calendar year contract and average price over the week containing or nearest to 15<sup>th</sup> June for 2<sup>nd</sup> half calendar year contract.

### **Energy price reference:**

"IES favours using the price for a one year Victorian peak swap contract starting from the next quarter". Keeping in line with the six month pricing principles, the forward price for the applicable period should be used (i.e. two quarters rather than full year).

Recommendation: That the energy price reference should be based on the price for two quarters, not the full year.

### **Fixed opportunity cost calculation**

Section 3.3.10 of the IES Consultation Draft Report implies that there is a correlation between a generator's maximum exposure and high Tasmanian requirements. While this may be true, there is potentially a much stronger correlation between a generator's output and low Tasmanian demand with high imports on Basslink.

For instance, a generator's output of 200 MW, Tasmanian demand of 1000 MW and Basslink import of 400 MW would create a 33% liability for that particular generator. In this example a 75 MW requirement would mean a 25 MW liability.

Recommendation: The divisor (Y) in this calculation should be an average or median requirement rather than a maximum. This number could be devised from historical data.

### **Clarity of Liability**

The Regulator proposes that: “The contract quantity for each dispatch interval will be based on the generator’s actual fast raise FCAS MW liability (based on the generator’s output for the dispatch period) capped by a maximum requirement or requirements”.

It is important to be clear that the regulation only covers the Tasmanian local requirement and not the global requirement. This distinction is lost or is not explicitly expressed in several statements of the Draft Report.

This lack of distinction could leave Hydro Tasmania exposed should global prices go high, as was the case on January the 16<sup>th</sup> 2007 when MPC pricing occurred for r6,r5 and r60.

Recommendation: That OTTER’s Final Report explicitly states that safety net contracts only cover the Tasmanian local requirement.

### **Commencement date**

In order to provide sufficient time for Hydro Tasmania to place all relevant information on its website and price the first six month safety net contract, a commencement date of 31<sup>st</sup> January 2011 is considered achievable.

Recommendation: That 31 January 2011 be the determination commencement date