



14 April 2009

Dr John Tamblyn
Chairman
Australian Energy Market Commission
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By email: submissions@aemc.gov.au

Dear Dr Tamblyn

NEM Reliability Settings: VoLL, CPT and Future Reliability Review

This submission is presented on behalf of the Loy Yang Marketing Management Company Pty Ltd and International Power in response to the draft rule determination on National Electricity Market reliability settings specifically the proposed increases to Value of Lost Load (VoLL) and the Cumulative Price Threshold (CPT).

Whilst it is appreciated that the draft determination has received some support from industry participants, particularly peaking generators who would benefit from such an outcome, this submission outlines a number of concerns regarding the proposed increase in VoLL and CPT. These concerns arise in part from:

- a failure to consider the risk implications for generators, especially those that are contracted;
- an under appreciation of the importance of VoLL as a risk management tool and a failure to manage the implications of non-credible contingency events via an alternative mechanism;
- the AEMCs assumption that increasing VoLL and the CPT will increase investment remains untested;
- a belief that it would be prudent to await the outcomes of the AEMC's Market Frameworks Review before progressing any changes to VoLL and CPT;
- the significant reduction in contract liquidity pursuant to the introduction of the Carbon Pollution Reduction Scheme and the resultant cash flow implications suggest any changes that exacerbate cash flow risks would not be appropriate at this time;
- a belief that current regulatory uncertainty and impediments to investment within the market are the primary factors impeding investment and that those factors

require redress prior to any changes to National Electricity Market reliability settings.

AEMC Market Frameworks Review

We hold a number of legitimate concerns regarding the proposal. These concerns have been enunciated below. However, in our view the underlining question is: what drives investment in the National Electricity Market?

The proposed change to National Electricity Market reliability settings are being addressed in isolation of a wider and holistic consideration of National Electricity Market investment drivers. We suggest changing this policy lever in isolation can not be expected to generate appropriate investment signals and therefore we believe it would be appropriate to consider changes to VoLL and CPT as part of a wider review of investment incentives and impediments.

In that regard, we note the comments of the Australian Energy Regulator (30 October 2008, response to Reliability Panel Exposure Draft) that it would be prudent to await the outcomes of the AEMC Market Frameworks Review prior to this rule change proposal proceeding.

We support this position on the basis that a holistic consideration of investment drivers and incentives should underpin much of the analysis within the Market Frameworks Review. Therefore, a decision to increase VoLL and CPT may not encourage the investment expected by the AEMC, and when seen in light of the concerns outlined below, may only exacerbate risks and act as a disincentive to investment.

A failure to consider the risk implications for generators, especially those that are contracted

The risk analysis undertaken by Concept Economics which focuses on price volatility and does not sufficiently take into account the position of generators who are contracted. In assessing the increased price volatility as the consequence of raising either or both VoLL and CPT the risk implications for retailers were noted but the adverse impacts on generators were not adequately investigated.

Importance of VoLL as a risk management tool

Hence our concern that the analysis undertaken to date fails to appreciate the importance of VoLL as a risk management tool and has instead focused on the possible benefits of an increase in price volatility. VoLL provides stability for retailers and generators alike as a cap on financial exposure. This is the significant benefit of VoLL for generators that appears to have been overly discounted in the analysis which led to the recommendation to increase VoLL and CPT.

Failure to manage the implications of congestion and non-credible contingency events

In recent months, the National Generators Forum pursued a rules change that would have the effect of better managing the risk of non-credible contingency events. This includes the revenue or cash flow risks associated with increased congestion and transmission risk. To our disappointment the AEMC did not support the practical measures embodied in the physical market trigger CAPP proposal to manage the risk that is currently misallocated to generators.

This means a decision to increase VoLL and CPT without addressing the possible impacts of congestion and transmission constraints will increase the risk profile for existing and new generation projects. This exacerbates the chance of financial failure in circumstances where the market reaches VoLL and a generator or generators that are contracted are unable to be dispatched.

Carbon Pollution Reduction Scheme

The uncertainty associated with the introduction of the proposed Carbon Pollution Reduction Scheme (CPRS) has severely reduced liquidity in the contracts market and has reduced the ability of participants to hedge price risk in the short term. The long-term effects of CPRS strengthen arguments against increasing VoLL as it increases the complexity of hedging price risk and exacerbates cash flow risks for many participants (both generators and retailers). The significance of cash flow implications related to both CPRS and VoLL, coupled with the global financial crisis and the timing of debt re-financing for much of the industry suggests that “tinkering with too many levers” at this point in time may be counter-productive to achieving the objectives of the current rule proposal.

Additionally, the transmission congestion risk cited above is expected to increase with the introduction of more intermittent generation to meet the Government’s Renewable Energy Target and as a result of changed dispatch patterns and new generation under the CPRS. A decision to increase VoLL and CPT without addressing possible downside risks will further increase the risk profile of existing and new power plants.

Assumption that increasing VoLL and CPT will stimulate investment

The sentiment that high priced events provide investment signals in their own right is misguided when taken in isolation. While in a theoretical sense it is relatively straight-forward to expect that the greater the amount of possible revenue one can source from high-priced events the more likely those events will lead to investment decisions that take advantage of such events, this sentiment ignores the actuality of the National Electricity Market investment climate.

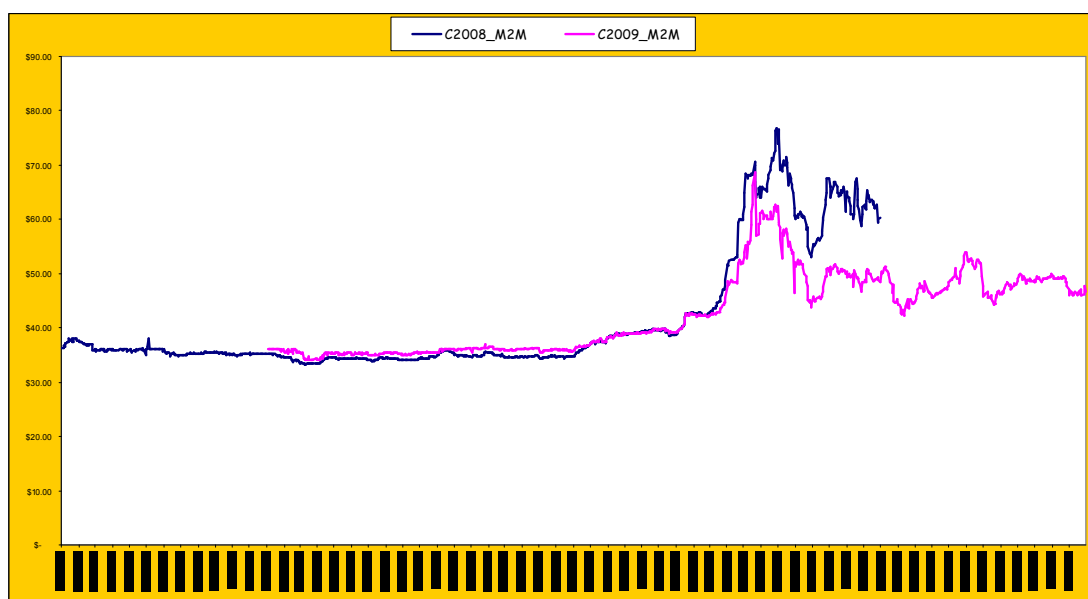
With the possible exception of some pre-existing peaking plants purchased at low cost that are able to take largely uncontracted positions, contracts and not pool price is the primary determinant of investment in new or upgraded generation. This is evidence by Dr Tamblyn’s recent statement recognising that:

Price uncertainty and volatility creates significant risk for generators and retailers. The contract market provides tools for both parties to manage these risks and also underpins most generation investments.

(Dr Tamblyn, presentation to CEDA, 19 February 2009)

Therefore, the expected benefits of this rules change are reliant upon an increase in contract prices. However, the correlation between contract prices and pool prices is no simple dynamic. The impacts of vertical integration, the effects of drought, uncertainty of future gas supply and price, and climate change policies all serve to weaken the correlation between these markets and it may not be accurate to assume the possibility of higher pool prices and higher priced events will be borne out in higher contract prices. Therefore, the belief that changes to VoLL and CPT will drive ongoing investment remains untested and questionable particularly at this time.

Interestingly, since 2007 there has been a step change in contract prices on the wholesale electricity market as demonstrated in the graph below. This increase could be considered a precursor to new investment under normal circumstances. However, it has been argued that such investment has not been forthcoming.



Note: The graph above presents the daily mark to market values for C2008 and C2009 over time.

The case has been strongly made by generators in response to the 1st Interim Report of the Market Frameworks Review that climate change policy uncertainty and lack of access to finance and refinance have been the primary determinants of decisions not to commit to new power plants despite higher contract prices in the past couple of years.

Hence, even if higher VoLL and CPT increases led to higher contract prices, as one would theoretically expect and may occur, there exists legitimate doubt that in the absence of greater investor certainty new power plant projects will be commissioned at the desired rate.

Interestingly, we note that the increase in contract prices indicated above has occurred in the absence of a change in VoLL or CPT thus indicating that the current VoLL and CPT levels are not inhibiting higher contract prices.

Therefore, in our view there is no evidence that the current regime has failed given:

- historically long run average unserved energy is close to zero, despite recent but not unexpected load shedding at times of extreme peak demand;
- prior to recent policy uncertainty there were ongoing commitments to new projects, both public and private, in NSW and Victoria; and
- average spot prices, for example those during 2008 in NSW and Victoria at \$39.14/MWh and \$40.23/MWh respectively, are below new entrant costs.

Hence, our concerns that the rules determination, if progressed, will not result in a noticeable increase in investment as:

- increasing VoLL does not improve revenue certainty for new generation investment;
- an increase in VoLL will lead to increased risks for both sides of the market;
- the only retailers likely to build new entrant generation are the major privatised entities, namely AGL, Origin Energy and TRUenergy each of which have and are still making investments in peaking, intermediate generation and renewable new entry in the absence of an increase in VoLL;
- smaller retailers and financially constrained generators simply face greater risks as a consequence of this proposal;
- an increased VoLL will most likely reduce entry of new start retailers as barriers to entry will increase;
- in response to the increased risk it may be necessary for base-load and intermediate generators to leave a larger portion of their portfolio's unhedged thereby reducing hedging instruments available to retailers;
- an increase in VoLL will increase prudential requirements for retailers – which would similarly increase barriers to entry and increase costs passed through to end-use consumers; and
- an increase in VoLL may also discourage renewable energy projects as the risks of selling firm contracts backed by non-firm energy increases.

Increased VoLL does not address the concerns of merchant investment

It should be acknowledged that merchant finance is concerned with a number of fundamental considerations in determining whether to proceed with a power plant project including:

- management of costs by ensuring access to necessary inputs and an acceptably priced fuel source for the life of the power project;
- access to a liquid contracts market to hedge price risk; and
- access to a market that ensures an investment can compete for dispatch of its full capacity with a high degree of certainty over the life of the investment:

not high-priced events and the level of VoLL and CPT per se.

In this regard, the primary beneficiaries of an increase in VoLL and CPT will be uncontracted peaking plant operators. We do not oppose policies that reduce interventions and improve revenue outcomes for market participants *ceteris paribus*; however, in this instance the reduced risk associated with VoLL and CPT at current levels has not been appropriately valued by the AEMC and does not deal with the fundamental investment drivers of importance to merchant investment.

This suggests the AEMC has taken the view that increased revenue for peaking plants should be viewed as of greater benefit to the market than reduced risk to generators overall and this proposal should be progressed in isolation of the wider question of what drives investment in the National Electricity Market. There are legitimate concerns with this approach and suggestions it demonstrates a failure to

holistically consider what does and will drive a more successful National Electricity Market from the perspective of customers, generators and investors.

Stability and reliability should be appropriately valued

Stability in the market and reliable supply of energy to consumers should be central considerations in the AEMC's analysis. In that regard it should not be assumed a determination which increases risk to generators overall will provide stable and reliable outcomes for the National Electricity Market nor encourage investment.

To this end we reiterate the view that the AEMC continue to employ a cautious approach to revising reliability settings and delay a determination to increase VoLL and CPT until at least the conclusion of the AEMC's Market Frameworks Review.

Please direct your response or any questions regarding this submission to the undersigned.

Yours faithfully,



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On behalf of:

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