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Dear Commissioners

ERC0115: Consultation Paper: National Electricity Amendment (Reliability Settings form 1 July 2012) Rule 2010

A: Introduction

The NGF welcomes the opportunity to make a submission to the AEMC's Consultation Paper: National Electricity Amendment (Reliability Settings from 1 July 2012) Rule 2010.

We support the Rule change on the basis it calls for the Reliability Panel to index the Market Price Cap (MPC) and the Cumulative Price Threshold (CPT) annually. Given the significance of these parameters in the energy only market, the improved price certainty will encourage more investment to help achieve the reliability standard.

We believe it is important to maintain the real value of the reliability settings regardless of what one believes the absolute value of these parameters should be. We note the Reliability Panel (in the RSSR) and the AEMC (for the EWE report) have different views on whether the MPC should reflect the capital costs associated with delivering the Reliability Standard or the value customers place on reliability. In addition, we note the considerable debate on whether the financial risks from increasing the reliability settings would be acceptable. Regardless of one's views on these issues, the real value of the reliability settings should be maintained annually.

We consider the changes to the regular review process are also appropriate. In short, these changes, coupled with indexation, provide greater regulatory certainty, transparency and predictability of the outcomes in terms of the changes in the MPC & CPT for market participants. As such, they are likely to promote a more efficient level of generation investment.

B: Expected costs and benefits of indexation

1 Would the maintenance of the MPC and the CPT in real terms be beneficial and effective in achieving the Reliability Standard in the long run?

The NGF considers the indexation of the MPC and the CPT will be beneficial in achieving the Reliability Standard in the long run.

Overall, we believe that investment in generation to deliver the reliability standard is driven by a number of factors, including but not limited to: forecast demand growth, forecast contract prices, cost and availability of project finance. In this regard, the MPC is not the prime driver for investment by either existing participants or new merchant investors.

Having argued this, given we operate in an energy only market, we believe that the indexation of the MPC and CPT will benefit the market to help ensure the reliability standard is met.

The key reasons for this are:

<u>Investor certainty increased</u>

The NGF believes the annual indexation of the MPC and CPT will add to investor certainty. In an energy only market, we consider this change will assist to deliver more investment and help achieve the reliability standard.

In contrast, under the current biennial review process, there is a possibility that the MPC, CPT and the Market Floor Price (MFP) could in theory be adjusted in a dramatic manner, including reducing these values. When regulatory decisions are subject to such dramatic change, investors perceive this as a risk. As a result, this could impact the overall level of investment.

<u>Time value of money sustained</u>

Currently, the MPC and CPT reflect a nominal value whose real value decreases over time. And, if these key reliability settings remain unchanged over time, there is a possibility that the reliability standard may be breached in the future. As a result, we support the indexation of key parameters like the MPC and the CPT on the basis they help support investment to achieve the reliability standard.

<u>Generation costs increases captured</u>

The NGF considers the indexation of key parameters like the MPC and the CPT will be beneficial in achieving the Reliability Standard following the significant increase in generation costs in the last two years.

The ROAM Report used by the Reliability Panel (Panel) in the recent Reliability and Standards Review suggested the capital costs of an open cycle gas turbine (OCGT) increased by around 22% in real terms over the past two years. The increase in entry costs for peaking generation implies new entrants require higher revenues to recover the required rate of return on their investment (WACC).

We note that the ROAM Report used a low WACC to discount revenue streams in modelling the market. This suggests that new OCGT investments will require even higher revenue streams to recover their costs. In this context, we suggest that the indexation of the MPC and CPT is even more important in achieving the reliability standard.

Peakier demand factored in

The NGF considers the indexation of key parameters like the MPC and CPT will help deliver the reliability standard in a “peakier “energy only market in the future.

Energy demand is likely to become “peakier” in the next 10 years as demonstrated by the Electricity Statement of Opportunities (ESOO) 2009, and without additional generation investment, could result in more large magnitude, short duration USE events. In addition, the increased penetration of wind generation, as a consequence of the expanded Renewable Energy Target (RET), is likely to require additional standby generation for when wind generation fails to generate. Given the large variation in wind generation output, the significant volume of standby generation that will be required and the uncertainty of revenue for this standby generation, this may reduce the number of hours a marginal OCGT can run to recover its capital costs for a given level of USE reliability standard. As a result, this will make it even more important for the MPC and CPT to retain their real value in order to achieve the reliability standard.

2 Do you agree that the process of indexation as proposed by the Panel would provide increased certainty of MPC & CPT movements to market participants?

The NGF agrees the indexation proposed by the Panel will provide increased certainty of MPC and CPT movements to market participants.

Currently, the Panel adjusts these parameters every two years in accordance with the biennial review. In these circumstances, market participants can not be certain on the outcomes of the biennial review. As such, this creates uncertainty for the market.

This Rule change aims to index the MPC and CPT values every year using 2010 as the base year. This process will continue indefinitely. Therefore, the rule change gives the market more certainty in the MPC and CPT price movements. This can only result in more certainty for market participants.

3 Do you think that the suggested benefits of indexation could otherwise be achieved in the long run under the status quo or with minor adjustments to the status quo?

The NGF considers the minor adjustments proposed in this Rule change are appropriate.

Under the current biennial review, the Panel reviews the key parameters of the MPC, CPT and the MFP to ensure the reliability standard is met.

The current Rule change proposes to index the MPC and CPT annually. As we understand it, the Panel maintains an annual review process to determine whether higher increases in the MPC or CPT are necessary, and whether there are significant changes that occurred to the economics and mechanism for delivering the reliability standard.

Regardless of whether the reliability standard is met through the indexation process, market participants will benefit from the increased certainty of indexing the nominal values of the MPC & CPT. This will go on indefinitely. As a result, we submit this will strengthen investor certainty even further.

4. Do you think that the administrative costs of the proposed annual review are sufficiently identified in light of the level of actual intervention that might be required? Are these costs likely to be significantly different from the costs associated with the Biennial Review process?

The NGF considers the administrative costs of the proposed annual review are not sufficiently identified in this Rule change. However, we suggest these costs will not be excessive, given this review will amount to a small automated process. For this reason, we don't regard this omission is of a serious consequence.

We suggest the annual review will not result in an overly cumbersome administrative process. It will determine whether increases in the MPC or CPT are necessary; and whether there are significant changes that occurred to the economics and mechanism for delivering the reliability standard. In this regard, we believe that the annual review take on the characteristics of a small review, compared to the current Reliability Standards and Settings biennial review which tends to be of long duration and administratively time consuming.

We predict a low level of intervention from the Panel in the annual review. As we see it, the annual review will not be as large as the current integrated biennial review. And, the annual indexation process applied to the MPC and CPT should lead to a lower level of intervention from the Reliability Panel's in the annual review.

Therefore, as previously mentioned, even though the administrative costs of the annual review are not sufficiently identified in this Rule change, we suggest they will be relatively small.

5 Does the effective ratcheting of the index of the index strike the right balance between certainty for investors and cost reflectivity?

The NGF considers the effective ratcheting of the index strikes the right balance between certainty for investors and cost reflectivity.

We regard the revised arrangements as appropriate for the following reasons:

- They adjust the nominal values of the MPC and CPT annually accounting for real prices increases under an appropriate index in the PPI.

- They allow the Reliability Panel to adjust the MPC and CPT where significant changes occurred to the economics for delivering the Reliability Standard

- The amended values of the MPC and CPT would never be lower than the previous year's values

Overall, the revised arrangements together send the appropriate investment signals to the market. However, our support for these comments is subject to the condition that the arrangements that restrict the value of the MPC and CPT from falling below the previous years values are sustained. Importantly, we would withdraw our support for the current revised arrangements if this feature was removed.

C: Criteria for selection of an index

1 Do you agree that the requirements identified by the Panel are the appropriate requirements for the purpose of selecting a suitable index?

The NGF agrees that the requirements identified by the Panel are suitable for the purpose of selecting an index.

The Reliability Panel considered that the selection of an index:

- be based on supply side costs of meeting the Reliability Standard
- follow similar economic trends to those parameters used in setting the MPC and CPT, particularly the capital costs of new OCGTs
- be independently verifiable
- be amendable to forecasting

After carefully considering these criteria, we submit the requirements identified by the Reliability Panel to select an appropriate index are appropriate.

2 Is the PPI the most appropriate index to use? Is there a more suitable index to use?

The NGF considers the PPI is the most appropriate index to use.

We agree with the Reliability Panel that the PPI provides a sensible reflection of the costs associated with meeting reliability and avoids being too general like the CPI, or too specific , as with a commodity specific index. As such, we support the use of the PPI.

In addition, the MPC reflects the value of lost load to customers. Thus, we believe it makes sense to adjust these reliability settings based on an index that best reflects the costs of the industry. This way, when load is lost during a high price event, the MPC should reflect the actual cost to the industry more closely.

Having argued this, we consider it would be appropriate for the AEMC to consult with the Australian Bureau of Statistics (ABS) and seek their view on the appropriateness of the PPI as an index to be used in the energy industry. We would support this move before a draft determination was issued on this Rule change.

D: Removal of Biennial Review Process

1 Do you agree that the removal of the requirement to remove the review of the Reliability Standard and the MFP would support greater regulatory certainty, transparency and predictability of outcomes for market participants?

The NGF agrees the removal of the obligation to review the Reliability standard every two years will benefit the market by providing greater regulatory certainty. But, we regard the decision to avoid any review of the MFP as a flaw in the revised arrangements.

We believe this part of the revised arrangements is sub optimal because:

- Given the MPC and CPT are adjusted annually to determine whether the revised MPC and CPT are appropriate and the index is no longer valid, we believe that the MFP could also be reviewed with a minimal of effort

- With wind becoming a more influential factor in the NEM, we believe that there will be an increase in the frequency of more negative pricing events in the future. Therefore, we believe it makes sense to also review the MFP on an annual basis.

- We previously argued the Reliability Panel's decision to make no adjustments to the MFP in the Reliability Standard and Settings Review was unjustified. In that review, ROAM consulting recommended the MFP should remain unchanged. ROAM argued the introduction of the Carbon Pollution Reduction Scheme (CPRS) would reduce the frequency at which the MFP is set at the floor price, as generators add additional costs of carbon emissions into their bidding strategies. As the CPRS failed to be passed by parliament, we are not sure that this conclusion is accurate. In addition, the Panel failed to provide any analysis and reasoning to support this decision in its Final Report

2 Is the limited opportunity for consultation during the annual review process of material concern, or does the proposed process provide sufficient certainty and transparency?

The NGF considers the proposed timetable during the annual review process is not of material concern. However, after carefully considering the timetable, we believe that the proposed process can be improved by some minor adjustments.

We remain concerned that the time frame for the indexation, annual review and reporting processes to be completed on annual basis may not leave much time for consultation. In particular, the publication of the indexed MPC and CPT values by the Panel – 10 business days after 30 March and the annual report - 30 April – only leaves the market with a short time frame to consult on the annual report. As such, we submit that the time frame for the publication of the annual report could be extended to 15 May. This would give market participants some more time to consult with the AEMC whilst still providing a sufficient period of notice for the adjustment of the MPC and CPT.

3 Should the Reliability Standard & Settings continue to be subject to a regular process of review which allows for the consideration of other factors, such as forecasts or use of the VCR, rather than a review initiated at the discretion of the AEMC?

The NGF does not support the Reliability Settings and Standards being subject to a regular process of review which allows the consideration of other factors such as forecasts or use of the VCR.

In short, we prefer this form of review was initiated by the AEMC or a market participant on an ad hoc basis.

We support the revised arrangements that:

- abolish the biennial review of the Reliability Standard & Settings

- assume the newly indexed values of the MPC and CPT are appropriate, with the subsequent review to test whether the indexation is not appropriate

- allow the Panel to determine whether the PPI is on track , or whether it is diverging from the real costs of new entrant OCGT’s , even though this has not been made explicit

Whilst the annual review contained in this Rule change may not be as broad as the biennial review, we consider it is adequately flexible to deal with the critical issues it needs to. At the same time, it is sufficiently narrow, that together with indexation, it provides greater regulatory certainty, transparency and predictability of the outcomes of the changes to the MPC & CPT.

E: Focus and clarity on the proposed annual review process

1 Is there a need to review the appropriateness or otherwise of the indexation of the MPC and CPT on an annual basis?

The NGF considers that it is necessary to review the appropriateness of the indexed MPC and CPT values on an annual basis.

We submit this is a vital part of the revised arrangements. The annual review ensures that the PPI is on track and is not diverging significantly from the real capital costs of a new entrant OCGT. In addition, it determines whether the MPC and CPT can deliver the required investment in the NEM and the reliability of the power system.

The failure to review the suitability of the indexation process implies that the indexed MPC and CPT values will automatically achieve the reliability standard. We do not agree that this is a reasonable assertion.

2 Is the proposed timeframe, scope and process of the annual review satisfactorily defined, and if not, what other matters should be considered or included?

The NGF agrees that an annual review is sufficient but considers that the review scope and process are not well defined. The Rule proposal includes little detail about what the review process would involve or what the Reliability Panel may consider.

The NGF would like to see greater clarity around the proposed annual review process. It is important that specific details and definitions be developed and a more detailed procedure be established. As part of this, it is important that the AEMC consider what details are appropriate for inclusion in the Rules and whether an additional procedure document detailing the broader process needs to be developed to sit alongside the Rules. For example, we consider there needs to be a clear threshold definition for 'no longer appropriate'. This is particularly important given the move to a more limited consultation process, as identified by the AEMC, compared to the comprehensive consultation process associated with the current biennial review. The NGF considers that the limited opportunity for consultation may be more amenable if the scope and process of the annual review are better defined.

3 Do you think the parameters around the process should be more explicit? For example, do you think that the process to be followed in the event that the Panel concluded that the indexation is no longer appropriate is sufficiently clear?

The NGF considers that a significant systematic change in the NEM would need to occur in order for the Reliability Panel to conclude that indexation is no longer appropriate. While this may be unlikely, the proposed timing of the annual review represents a practical challenge should this occur. The short timeframe between when the revised MPC and CPT values are published (within 10 working days of 30 March), when the review is to be completed (30 April) and when the revised values are to come into effect (1 July) provides little time for the Reliability Panel to establish alternative MPC and CPT values. This would result in undue uncertainty for the market, which is counter to the intention of this Rule change proposal.

Given this, the NGF would like to see a prescribed process developed on how the MPC and CPT will be altered should indexation be considered no longer appropriate.

4 Do you agree that the proposal to obligate the Panel to determine and publish the indexed MPC and CPT values in the proposed manner is an efficient method of implementing this process? Is there a more efficient way of implementation?

The NGF agrees that the proposal to obligate the Panel to determine and publish the indexed MPC and CPT values in the proposed manner is efficient.

We do not have any suggestions which would be more efficient.

F: Conclusion

The NGF appreciates the opportunity to provide a submission to this Rule change.

We continue to support all the key components of the Panel's Rule change request subject to some minor qualifications.

In short, we support:

- the changes proposed that seek to firstly, fix the MPC and CPT at the 1 July 2010 levels and maintain the real values over time through indexation

- the implementation of the changes to the regular review process

We believe these revised arrangements will add regulatory certainty and predictability to these key reliability settings facilitating stronger investment to ensure the reliability settings are met.

If you have any enquiries regarding this submission, please feel free to contact Mr Con Noutso - Regulatory Manager at TRUenergy on Tel: 03 8628 1240

Yours sincerely

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