



Tel: 03 9201 7694
Fax: 03 9201 7771

AGL Hydro Partnership
ABN 86 076 691 481

Melbourne
Level 2, 333 Collins Street
Melbourne VIC 3000

Locked Bag 14120 MCMC
Melbourne VIC 8001
www.agl.com.au

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The Reliability Panel
Australian Energy Market Commission
PO Box H166
AUSTRALIA SQUARE NSW 1215

By email to panel@aemc.gov.au

Comprehensive Reliability Review Issues Paper May 2006

AGL welcomes the Reliability Panel Comprehensive Reliability Review ("the Review"). AGL supports market forces being allowed to work in a way that guarantees rising electricity demand is met by either increased generation capacity, interconnectors or demand-side management.

AGL's primary concern in relation to reliability, is the interference in the market by Governments and the requirement on NEMMCO to intervene for reliability purposes. Such intervention can distort market signals and, at the limit, lead to market failure. Examples of such intervention include:

- Retail price caps, which increase retailer risk;
- Reserve trading under the reliability safety net arrangements, which has increased costs and distorted the market;
- Government reliability and risk management arrangements that artificially distort pool and contract prices; and
- Inefficient price capping mechanisms that are unrelated to physical market issues.

AGL considers that it is imperative that the market is allowed to work as originally designed and that mechanisms for market intervention must be removed. If the Reliability Panel wants to retain any of these elements they must be applied so that:

- Market distortion is minimised, that is the mechanism must not impact normal operations of the market; and
- costs imposed on participants are hedgeable and reflected in prices charged to customers. Preferably the costs should be isolated from the energy market and recovered through market fees or network charges.

Reliability in the NEM

1. *Is there now, or is there likely to be in the future, a problem with supply reliability in the NEM?*

AGL believes that reliability in the National Electricity Market ("NEM") has not been, nor is likely to be in the future, at significant risk. The current reliability settings have ensured that growing demand has been met by increased supply, with capacity substantially increasing in all jurisdictions since the formation of the NEM, as well as interconnectors being built and demand-side management contracts pursued.

The only possible threats AGL sees to reliability is in relation to:

- Government interventions that supplant or distort wholesale market pricing signals to investors. The market must be left to work;
- NEMMCO intervention that distorts market mechanisms. NEMMCO must only intervene for security reasons; and
- network congestion. This issue is a matter for examination through the Congestion Review.

Reliability standard

10. *Is a measure based on unserved energy the most appropriate form of standard?*

AGL supports preserving the reliability standard in its current form and at its current level. It is a reasonable target that can be met without imposing significant costs on customers. Changing the standard or altering its level is unlikely to result in a better supply demand balance than what is achieved today.

13. *Should the standard be determined on a NEM-wide basis or separately for each region?*

AGL does not support different standards in each jurisdiction. Having a uniform standard ensures that all customers are treated equally and that suppliers have consistent incentives for investment across jurisdictions.

16. *Should the reliability standard be treated as a cap or as a target? If the latter, should the standard be expressed as a range for NEMMCO to target?*

The standard should be a target rather than a cap. A single number which can be used as a measure of whether the market is likely to meet the target is the most concise way of assessing future reliability.

22. *Should the scope of the standard be extended to encompass matters currently treated as system security issues such as multiple contingency events? Should near misses be reported?*

The Reliability Panel should focus solely on reliability, not system security. AGL believes that system security is a matter for NEMMCo, and should be achieved through the market design. NEMMCo should be governed by guidelines that limit the way that NEMMCO ensures system security so that there is minimal interference with the reliability settings.

24. Should specific 'exogenous' matters such as industrial action be included or excluded? If so, what factors and why?

AGL supports specific exogenous factors being excluded from the standard's scope. For example; industrial action, 'acts of god' and terrorism. Such factors are impossible to account for in long-term forecasts, and have little to do with the incentives for investment in the market.

Price Mechanism

25. Do the current price mechanisms encourage appropriate investment? Explain why or why not.

Except for the CPT, AGL supports the current price mechanisms and believe they should remain. The evidence to date indicates that sufficient investment has been made available to meet the demand.

VoLL

AGL believes that the level of VoLL, currently set at \$10,000/MWh, achieves a reasonable balance between creating an incentive for investment, while not adding an unreasonable risk and therefore cost to market participants. AGL does not believe that any further investment would be created by increasing VoLL. AGL considers that the only outcome of increasing VoLL at the moment would be increased costs to consumers.

Cumulative Price Threshold ("CPT")

AGL does not support interference in the market by NEMMCo, even in the case of extreme events, unless there is a defined physical *force majeure* event. The CPT in its current form should therefore be removed.

Any mechanism that seeks to cap participant exposure to pool prices creates a market disturbance by favouring less prudent participants and is likely to result in windfall gains and losses for participants. In the case of the CPT, prudent retailers who hedge for extreme events are effectively compensating those retailers that have chosen to remain unhedged.

This outcome occurs because the CPT imposes a price cap of \$100 (\$50 off-peak) when a 7-day accumulation of spot prices exceeds \$150,000. While the market is settled at the cap or below, generators are free to seek compensation if their costs exceed the cap. This means that prudent retailers not only pay for their hedge but also for an equal share of any compensation to generators. In the case of a CPT event, imprudent retailers are comparably better off than prudent retailers, which is a perverse outcome.

Ideally, instead of a CPT, the market should rely on the hedging mechanism. For this to work retail price caps need to be abolished to ensure the market is not faced with a 'Californian situation' where retailers are caught between potentially high wholesale costs and unreasonably constrained retail prices.

In addition, the market should establish *force majeure* rules that protect the market against sustained and extreme events such as acts of terrorism. AGL had proposed such a change to NECA, which was not implemented at the time but could now be modified to achieve this end.

If the Panel insists on maintaining the CPT, the threshold trigger level should be doubled to \$300,000 per accumulation period. This was the initial value determined to be equivalent to the prior regime and was proposed when the CPT was introduced. The trigger value was reduced to \$150,000 when VoLL was set lower than the proposed \$20,000, but without any rigorous analysis of the correct value. AGL considers that the initial value should have remained.

It is also not clear why the Panel did not increase the Administered Price Cap when the CPT was introduced. The Panel report at the time proposed increasing the cap value to \$300 (\$150 off-peak) from \$100 (\$50 off-peak) but it was not changed. AGL considers that the Panel should increase the cap to at least this value at the conclusion of this review.

31. *Would the introduction of improved forward market mechanism contribute to reliability outcomes?*

AGL would not like to see another forward trading market. There are enough trading mechanisms in place to ensure retailers and generators can access appropriate cover.

32. *Are there ways that NEMMCO could improve its forecasting accuracy that would enhance reliability outcomes?*

NEMMCo should strive for better forecasting. We understand that NEMMCo are already looking at how they can improve their forecasts. AGL looks forward to the outcome of this work.

NEMMCo should ensure that forecasts are not overly conservative. Evidence from reviews of summer demand outcomes indicates that in almost all cases demand forecasts are significantly overstated. AGL considers that it is important that they be as accurate as possible to prevent unnecessary intervention.

33. *Are consumers able to signal their reliability-related prices to the wholesale market effectively? If no, why not and how could that signalling be improved?*

34. *What do stakeholders see as the role of DSR in terms of supply reliability outcomes?*

Demand response is a useful tool for reliability. Retailers should be left to contract for demand response, except in the case of very large customers who could contract directly with NEMMCo, should they choose.

The market adequately creates incentives for participants to enter demand-side contracts but the signals to all but large customers are currently muted. The rollout of automated interval meters in Victoria, and other jurisdictions, will allow residential customers to receive price signals so that they can see the benefits of managing their demand.

AGL questions the extent that VoLL is an incentive for demand-side management. VoLL events are normally short-lived and due to network events. Where they are forecast in pre-dispatch due to a tight supply demand balance the price does not occur due to supply side responses. We therefore consider that the contracts between retailers and customers as part of retailer risk management are best placed to provide the incentive since they can take these type of events into account.

Feedback from AGL's customers shows that the biggest obstacle is the administrative burden of customers managing the contracts. This is particularly the case given that high priced events cannot be predicted with certainty and

most businesses can not be economically shut down with a moment's notice. Because VoLL events occur so infrequently, some customers believe they are not compensated adequately for the inconvenience of being on stand-by.

Increasing VoLL will not resolve either of these issues.

Reliability Safety-net

38. *Does NEMMCO intervene in the market too often? Should intervention be seen as part of the 'normal' workings of the market, or should there be continued effort to treat intervention as exceptional and to expect the market to deliver investment sufficient to maintain reliability to the level of the reliability standard?*

AGL considers that NEMMCO has intervened in the market too often. NEMMCO has directly intervened on two occasions and only stopped its intervention at the last moment on a third.

The direct cost of these actions has been \$5 million in levies on retailers (of which only a portion could be recovered from customers) and the unknown costs that surround the Reliability Safety Net process. In addition, NEMMCO removed existing demand side response from the market, increasing participant costs.

Customers received no benefit from NEMMCO's actions. AGL therefore believes that the Reliability Safety net should be removed.

39. *Does the reliability safety net remain an appropriate mechanism for managing against the risk of market failure? If yes, should NEMMCO's intervention powers be extended indefinitely or for a specific period of time and why? If no, what constitute appropriate alternative measures?*

AGL would like to see the removal of any intervention by NEMMCO in the market. The market design should ensure that appropriate incentives for investment are created. Accordingly, we believe the reliability safety net should be abolished since it has:

- provided no benefit to the market or customers;
- distorted the market for demand side response; and
- imposed an unpredictable cost on retailers that in many cases cannot be recovered from customers.

If the market believes that another mechanism is needed to guarantee that forecast demand will be met, AGL supports examination of scenario 6 in Appendix 2 to the issues paper. We believe a mechanism where:

- NEMMCO would periodically identify any forecast shortfall in capacity;
- NEMMCO would tender for supply to meet the reserve shortfall. The supply would be contracted long term (exclusively to NEMMCO) and be unavailable to the market;
- The plant would be retained by NEMMCO during periods when no shortfall exists and NEMMCO would only "top it up" when an additional shortfall is expected;
- The plant should only be dispatched as an alternative to involuntary load shedding and not be bid into the market;
- The spot price would be at VoLL before the plant is dispatched and remain at VoLL while the plant is being dispatched, to ensure it does not become the price setter;

- NEMMCO would recover all income for use of the plant to offset its costs; and
- The nett cost of the reserves would be levied as an explicit cost to the network or as a market charge so that it can be transparently passed through to the beneficiaries, the customers.

The benefits of a capacity mechanism of this form is that:

- the cost of the reliability is transparent to the market and predictable;
- it would allow jurisdictions the comfort of maintaining supply while not distorting the NEM; and
- it would allow NEMMCO to remove conservative data used during the development of the Statement of Opportunities and in publishing the Medium Term Projected Assessment of System Adequacy.

Review of the settings

The review of any or all of the reliability settings should not be routine. The market should be provided with the certainty that the settings will be maintained for a significant period, such that commercial decisions can be made.

A review should be triggered, however, when reliability has been placed at risk in consecutive years. For example, where either the reliability standard has not been achieved or there has been load shedding (or use of the capacity mechanism above) for two consecutive years.

The AEMC should consult on the timing of any changes to the settings, and any transitional arrangements that may be needed, once the changes have been determined.

Conclusion

AGL's primary concerns in relation to supply reliability in the NEM are mechanisms that require intervention by NEMMCO and interference by Governments. Both of these distort market signals leading to an inefficient outcome. AGL would therefore like to see the removal of all mechanisms for intervention in the market.

AGL believes that reliability has and will continue to be maintained with the current market design if it is allowed to freely operate.

If you have queries in relation to this submission, please contact Michelle Shepherd, Manager Electricity Market Development, on ph: (03) 9201 7232.

Yours sincerely



Michael Fraser
Group General Manager
Merchant Energy