

A few
words.



23 February 2010

Australian Energy Market Commission
PO Box A2449
SYDNEY SOUTH NSW 1235

Dear Dr. Tamblyn,

RELIABILITY STANDARDS AND SETTINGS REVIEW (RELO034)

AGL Energy (AGL) welcomes the opportunity to comment on the Reliability Panel's (*Panel*) Review of the Reliability Standard and Settings (*the Review*).

This submission expresses our views on the form and level, and measurement of the reliability standard. As part of this the following key settings are considered:

- Market Price Cap (MPC);
- Cumulative Price Threshold (CPT);
- Market Price Floor (MPF); and
- Administered Price Cap (APC)

AGL believes the Review needs to establish optimal reliability settings that will provide adequate incentives for investment and minimise the risk of increased financial exposure to market participants. In our view, the process should be robust enough to consider direct and indirect impact of revising the settings. In this context, the ROAM Consulting modelling on MPC provides a necessary assessment on the potential scenarios on supply side response. However, the proposed changes in MPC and CPT need to be tested for potential impact on market cost and risk and other alternative market responses including demand side participation or network investment that directly influence reliability standard. AGL supports an increase in MPC and CPT, but contends that it should not be any higher than it is necessary to achieve an efficient market outcome.

Form and Level of the Reliability Standard

AGL supports the existing form of the reliability standard and the output-based approach of a targeted permissible level of unserved energy (USE) in each region at 0.002%.

Reliability Settings

There are some key issues for determining the levels for the reliability settings.



1. \$20,000/MWh - Long Term Intent of MPC

Ideally the MPC should be set at the Value of Customer Reliability (VCR). VCR has been assessed to be in excess of \$20,000/MWh for certain market segments. We recognise however that there needs to be a balance between the risks faced in the market by participants (also limited via the CPT and APC) and the interests of supplying customer load in the long term in a reliable and efficient manner.

The setting of MPC has been considered for a long time and in great detail. In 1999 the National Electricity Code Administrator (NECA) recommended that MPC (then named VoLL) rise to be \$20,000/MWh in 2002 for the NEM to ensure a reliable and efficient electricity supply.

2. Investor requirements

The cost of capital for suppliers of peaking generation is well understood in the market to be significantly in excess of what was assumed in the modelling work undertaken by Roam Consulting. Given the recent Credit Crunch, brought on by the Global Financial Crisis (GFC), there is a scarcity of capital and an international competition for it. This needs to be reflected in the price set for MPC.

There has been a large investment prior to the NEM operating by various state governments. This has caused the plant mix in the NEM to be long in base load and oversupplied¹. Whilst this inefficiency is working itself out as the load increases, there is still a requirement to attract more peaking plant into the NEM. One should also note that there has been some retirement of generation in the NEM and there will continue to be plant closing over time. This emphasises that an adequate price signal is required for generation investment.

AGL is a large investor of peaking plant in the NEM, having overseen the acquisition and construction of in excess of 2,650 MW. Contrary to other views put at the forum, we do not observe a relevant forward contracting price beyond about 4 years. When considering business cases, for the bulk of the projection period we must substitute our own view of future market prices, which are highly sensitive to the MPC.

3. Demand Side Participation (DSP)

In principle, the incentives for demand side participation would increase as MPC is increased. There is however little evidence in the past years to indicate any material increase in DSP. In AGL's view, price signals for DSP is blunted by the commercial practicality of load curtailment and the technological hurdles in operating in aggregate of 5 minute market. AGL expects DSP will remain muted in the next few years. This may however change as smart meter solutions and embedded generation become ubiquitous and as CPRS imposes higher cost on supply response. It seems to AGL that these changes are unlikely to occur within the horizon of the current review of reliability settings.

4. Indexation

The current MPC set in the NEM is not CPI adjusted. Yet all costs incurred in the NEM inflate over time. Clearly this anomaly cannot continue without having an adverse impact on the USE target determined for the NEM. If the current level of MPC were to be indexed annually the level considered previously would be reached in the course of the next few years.

¹ Capital adequacy, ETS and investment uncertainty in the Australian power market – July 2009 by Paul Simshauser

5. Operational losses

Settlement reductions due to the 5/30 market design and delayed starts caused by prices appearing without warning causes peaking plant to not earn the full income from high price events. AGL typically assumes a small portion of the theoretical revenue is forgone due to the inability to capture all high prices. As a result the estimate provided by Roam Consulting is a lower estimate of what would be required from the MPC as Roam Consulting don't allow for this dispatch in efficiency.



6. Network Congestion and the Impact of Transmission Network Service Providers (TNSPs)

There is an expectation that the Carbon Pollution Reduction Scheme (CPRS) is expected to increase both the level and volatility of wholesale energy costs. Additionally, a significant increase in renewable generation as a result of the expanded renewable energy target is expected to increase the incidence and materiality of network congestion due to the intermittent nature of a large portion of the renewable energy supply. This could contribute to volume constraints and higher risks to investors that must be rewarded by higher market returns.

The increase in intra regional congestion caused higher pool price volatility needs to be considered but is outside the scope of this review. The solution needs to consider how best signal to generators behind constraints their marginal cost to generate.

AGL notes that the CPT instrument does not protect participants from extreme transmission events that are outside the market design envelope, and continue to present a major risk to the sustainability of impacted generation businesses. AGL continues to support development of a mechanism to limit the impacts of risks of this kind.

Whilst acknowledging it to be outside the scope of this review, AGL strongly feels the need for more market reform to facilitate greater transmission access during times of high market value. The impact and efficiency of TNSP incentive schemes should be considered as part of this activity.

7. MPC recommendation

We support the proposed settings for the MPC increasing as proposed. This support is, however, subject to a crucial caveat – that there is a need for flexibility to adjust the MPC to an appropriate level if climate change policies mean that unserved energy limit of 0.002% would be breached. Although the rules oblige that the next review must be carried out by April 2012, they do not prohibit the Reliability Panel from undertaking a review earlier.

8. Role of CPT

The primary role of the CPT is to act as a risk management tool for the market. It also had the intent to allow the marginal generator recover a reasonable portion of its return on investment when it operated in the market (infrequently and at extreme demand times).

The opportunity exists for the Panel to take into consideration the learnings from recent events when considering any changes to the CPT as part of this review. The CPT is intended to ensure that an appropriate balance is struck between the risk management function and that of a facilitator of future investment. Consideration needs to be given whether there were sustained abnormal profits on generation investments made on an annualised basis during times when the regional pool price exceeded the CPT.

There has been no demonstrable case been made to date to change the existing format for determining what the level of CPT should be set at. AGL therefore supports the current level being maintained at least fifteen times MPC.

9. Link to APC

Whilst out side the scope of this review, there is a close nexus between the CPT and the APC. When the APC is exceeded, there is market uplift in costs incurred by customers. Whilst this cost can be passed through to contestable market segments, this is not possible for market segments that have regulated price caps in place. Hence there is a requirement to maintain the current relativity between the CPT and the APC.



10. Market floor price

AGL is comfortable with the current level of the market floor price and we don't see any compelling reason for having the price revised to a smaller negative value. In fact one would anticipate that with the increase in level of semi scheduled intermittent generation the likelihood of the current market floor price being triggered could rise. The need to signal generation off loading will increase in the future.

We thank you for your consideration of these issues. Please contact Mr. Chrys Chandraraj – Senior Commercial Manager, Power Development at AGL Energy on Tel: (03) 8633-6138 for any queries regarding this submission.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'AC', is positioned above the printed name of the signatory.

Alex Cruickshank
Head of Energy Regulation