

29 May 2009

The Reliability Panel
Australian Energy Market Commission
PO Box A2449
Sydney NSW 1235

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Dear Sir,

**Reference Code REL0035
Submission by Energy Response Pty Ltd**

Thank you for the opportunity to make this submission. Energy Response strongly supports RERT and believes improving its flexibility and using it for system security will improve the efficient operation of the electricity market. However, we suggest changes to both the concept and mooted rules of RERT that would make it a much more effective program.

RERT is a scheme to provide extra capacity to insure against market failure

Page x of the executive summary of the draft report of the AEMC Demand-Side Participation in the National Electricity Market Review (28 April 2009) states:

"The final policy area considered in the Review relates to the short-term management of reliability by NEMMCO. In circumstances where the market does not deliver sufficient **capacity** to meet the desired reliability standard of 0.002 per cent average unserved energy, then NEMMCO can intervene to buy additional **capacity** or issue directions to existing market participants. These are additional potential markets for DSP".

Clearly the AEMC report sees the issue as one of capacity which logically should be addressed with a capacity product. But conceptually the RERT program is based on the premise that NEMMCO is buying energy only.

If the energy-only market worked perfectly, there would be no need for RERT. However, the possibility of the price reaching \$10,000/MWh has not and does not give sufficient incentive to build enough capacity to cope with extreme situations. It is this market failure that necessitates the RERT scheme. In effect, RERT provides insurance against market failure.

Rationale for short-term RERT

The purpose of the proposed short-term RERT panel is to allow NEMMCO to delay a decision about exercising RERT. Insurance is a useful analogy to understand this idea. Consider private health insurance.

Under the current RERT scheme, a person considers how healthy they are feeling each year. If they're feeling fit, they don't buy health insurance for that year. They gamble they won't need it.

Under the proposed short-term RERT scheme, they avoid this gamble by getting firm quotes from various insurers at the start of the year for a policy under which they don't pay any premium unless they start feeling ill.

No insurer would offer such a policy. They would have to build hospital capacity to treat the customer without any certainty that they will receive a premium payment. This would only be a sensible business decision if the premium was set as high as the treatment cost for an uninsured patient – i.e. if it was not insurance at all.

Market failure

When RERT is exercised, it is because the market has failed: more capacity is needed than the market has made available. It follows that the potential of earning \$10,000/MWh has not proved to be a sufficient incentive to provide the capacity needed. To elicit extra capacity, the RERT scheme must offer some further incentive:

Option 1: The "uninsured private patient" scenario. An uninsured patient can seek private treatment if they pay the full cost. The cost of this is set sufficiently high to recover the costs of having the hospital capacity available. For RERT, this could mean paying much more than \$10,000/MWh for the extra energy needed. From the point of view of consumers, however, this is still preferable to involuntary load shedding.

Option 2: The "proper health insurance" scenario. In reality, people are encouraged to have continuous cover. The regular premium income allows health providers to build hospital capacity to meet demand. In the context of RERT, this would mean assembling sufficient capacity in a RERT panel, and paying a relatively lower premium for it to be available.

Option 2 provides a framework which allows potential reserve providers to make the up-front investments necessary to ensure that the reserve they provide is reliable and fast-acting. Under Option 1, any such investment would be purely speculative, and difficult for a rational business to justify. As a result, Option 1 is unlikely to result in much reliable, fast-acting reserve.

If the desired outcome is for a certain level of reliable, fast-acting reserve capacity to be available, it will be necessary to pay for that capacity to be available.

The need for up-front investment

RERT seems designed to be the least attractive possible use for reserves, as the overriding priority is to minimise market distortion. If this works as intended, it will attract only the reserves that nobody else wanted: the slowest and least reliable. This doesn't seem the right approach for a program that exists to maintain reliability and security and avoids involuntary load shedding.

Energy Response believes that the priority should instead be to ensure that a sufficient quantity of reliable, fast-acting reserve capacity is procured.

Done properly, demand-side response can provide highly reliable reserve capacity. However, doing it properly requires both up-front investment of both time and money:

- Manpower to identify and contract DSR with the right characteristics
- Capital expenditure to install remote control and monitoring equipment – essential for speed and reliability
- Operational expenditure to test that sites perform as expected, before they are needed

Not all uses of DSR require such an approach. Where DSR is used purely for financial hedging purposes, e.g. by a retailer, much lower reliability can be tolerated. Where DSR is used to deal with local network peaks, long lead times are acceptable. For RERT to be effective, however, the provided capacity must be fast-acting and reliable.

Under the proposed short-term RERT, there is no business case to carry out these activities, as no payment is proposed. These steps only make sense if there is a commitment to buy the

capacity. Since most of the costs are up-front, the longer the term for which the capacity is contracted, the more cheaply it can be made available.

Detailed comments

Notwithstanding these issues we would also like to make the following observations on the draft rule change proposal:

2.1.2 Dispatching contracted reserves using existing RERT

There is a danger that the existence of a short-term RERT panel will make NEMMCO less likely to choose to exercise normal RERT. Since the short-term RERT seems likely to provide less capacity, less reliably, at much greater cost than normal RERT, this temptation must be avoided. What processes or triggers would be in place to ensure that the existence of short-term RERT does not bias NEMMCO's decision on normal RERT? This is a question of transparency.

2.1.3 Potential amendments to the existing RERT arrangements

Reducing the negotiating time may work for the few large industrial sites who would be able to participate directly. These account, however, for only a small proportion of the potential reserves. Much more is available from aggregating the response of the many providers who are too small to deal with NEMMCO directly. To do this, however, requires contracts in place with a large pool of providers. The details of these contracts depend on the details of the contract between the aggregator and NEMMCO. It is unrealistic to expect all these contracts to be negotiated, or even amended, in four weeks.

2.2.1 increasing the flexibility of RERT

This clause talks of pre-qualifying by resolving with NEMMCO some of the legal and technical issues. We would argue they should all be resolved. Our preference is that a full contract is in place.

2.2.3 No payments for RERT panel participation

In paragraph 1 the panel suggests to reimburse "one-off auditable out of pocket expenses associated with resolving any associated technical and legal issues with NEMMCO". In paragraph 2 it advises against allowing even that because it might be seen as a form of capacity payment: "Such a payment would be a form of capacity payment, and in the absence of a demonstrated market failure, would be a significant change to the arrangements for the NEM's energy-only market." (top of p.9). As we have argued, the need for RERT demonstrates market failure and that is why capacity payments are appropriate.

Given that the Panel wants to exclude DSR used for any other purpose (see 2.3.5), it follows that DSR is held in reserve exclusively for RERT, for use with as little as 24 hours notice, in return for no payment. While this may seem attractive to the buyer of reserve capacity, it's not a sensible proposition for anyone providing the DSR.

Payment of auditable expenses associated with RERT panel participation

At the very least we would like to see sourcing costs recovered. There are costs to sourcing and holding ready MW to be available for RERT.

Advising NEMMCO of availability on an ongoing basis

"Entities to advise when their capacity is unavailable". This wording implies that the DSR from a RERT panellist is derived from a single source. This paragraph should be reworded to "advise of any changes in the capacity they have available".

2.2.4 NEMMCO can negotiate reserve contracts at any time (but not necessarily enter into)

We agree that NEMMCO should be able to negotiate reserve contracts at any time but the negotiations should be made in good faith and if successful be entered into.

2.3.5 “Double dipping”

We understand that the Reliability Panel wishes to ensure that DSR is not double counted. We agree that DSR must not be in a retail pricing arrangement. However, we would caution that it is dangerous to assume that all other DSR, which has been procured by other parties for other purposes, will be activated or dispatched during a RERT event.

DSR used to address local network constraints will only be dispatched if the local network peak coincides with the RERT event. Since many of these programmes have long notice periods, such facilities may well not be used if a RERT event occurs on a day when extreme demand had not been forecast on the relevant part of the network.

DSR used as an energy product for financial purposes is fast acting, but the decision to dispatch depends on details of the hedge position of the buyer. Also, if a \$300 administered price cap is in place, no market-based DSR would be dispatched, as there is no price signal to encourage it.

If we want to ensure that all possible reserve capacity is activated when needed, some provision must be made to allow DSR which is contracted for other purposes to participate in RERT. Otherwise, we risk seeing a repeat of the ridiculous situation which occurred in South Australia in January 2009, where there was involuntary load shedding, inconveniencing thousands of end users, at the same time as reserve capacity from volunteer DSR providers went unused.

2.4 Using the RERT for system security events

Energy Response believes it is a positive change to use reserves contracted under RERT to manage system security events subject to our other comments.

2.8 Market distortion caused by RERT

It needs to be recognised that the distortion is necessary because of market failure. It follows that RERT is a program to provide capacity to restore the supply/demand balance. Therefore, contrary to clause 2.2.3, for RERT to be truly effective it needs to be treated as a capacity product and contracted with terms and conditions and cost recoveries that reflect this fact.

We trust these comments are useful in the design of the RERT and we would be very happy to discuss any of these matters further.

Yours faithfully



Ross S. Fraser
Executive Chairman