23 February 2010

Mr Neville Henderson
Chair, Reliability Panel
Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

Dear Mr Henderson,

Re: Draft Report - Reliability Standards and Settings Review

Loy Yang Marketing Management Company welcomes the opportunity to make a submission in response to the Reliability Panel's Reliability Standards and Settings Review, Draft Report released on 23 December 2009 and the associated ROAM Consulting report released on 15 January 2010.

The purpose of our submission is to outline our position on the ongoing role of the unserved energy form of the Reliability Standard, and discuss a number of issues relating to the Reliability Settings including the changes proposed in the ROAM Consulting report. We suggest a number of these matters require further analysis and consideration before it would be appropriate for the Panel to recommend changes.

Our positions on these matters are informed by our experience as National Electricity Market participants. As the largest privately owned generator in the National Electricity Market, Loy Yang Marketing Management Company trades in excess of 2,200 MW which represents around one third of Victoria's electricity needs and more than 8% of the total generation for the south-east of Australia. As a consequence, we have significant business exposure to any changes to Reliability Settings or the Standard.

While this submission raises a number of concerns; we continue to support the Panel's ongoing work in this area. In that regard, we note the difficulty and complexity surrounding these matters and commend the Panel on its transparent and engaging approach including the use of the recent forum.

If you have queries in relation to this submission please do not hesitate to contact me on (03) 9612 2236 or jamie_lowe@lymmco.com.au.

We seek your consideration of the attached submission.

Yours faithfully,

Jamie Lowe
Manager, Regulation and Market Development

Submission to Draft Report - Reliability Standards and Settings Review

23 February 2010

Introduction

Loy Yang Marketing Management Company (LYMMCO) trades the largest privately-owned generator in the National Electricity Market (NEM). In total, LYMMCO trades in excess of 2,200 MW which represents around one third of Victoria's electricity needs and more than 8% of the total generation for the south-east of Australia.

LYMMCo, in conjunction with International Power and TRUenergy, raised a broad series of issues concerning Reliability Standards and Settings Review at the recent Reliability Panel (the Panel) public forum of 12 February 2010. That presentation, served the purpose of generating discussion without prejudice within the context of the public forum.

The purpose of this submission is to formally respond to the issues raised by the Panel's Reliability Standards and Settings Review, Draft Report (the Review) released on 23 December 2009 and the associated ROAM Consulting report (the ROAM Report) released on 15 January 2010.

The submission primarily focuses on the ongoing role of the unserved energy (USE) form of the Reliability Standard, and issues relating to the Reliability Settings including the changes proposed in the ROAM Report. We suggest a number of these matters require further analysis and consideration before it would be appropriate to recommend changes.

Discussion

Reliability Standards

The Panel addressed a series of proposals to market participants and interested stakeholders. We address those proposals in turn.

Proposal to retain the unserved energy form of the Reliability Standard

LYMMCo maintains its support for the current USE form of the Reliability Standard. While a series of alternatives are available, and are likely to have their own advantages, there appears no convincing argument to suggest replacing the USE with an alternative measure will be relatively beneficial to reliability within the NEM.

We do however support the provision of additional information by AEMO or other relevant bodies which may have the effect of providing additional interpretations on reliability in the NEM. However, those alternative interpretations should not be binding measures as is the case with USE.

Proposal to leave the level of the Reliability Standard at 0.002% USE per annum for each region, and therefore the NEM as a whole

We appreciate the perspective that there is a tension between the political and economic consequences of the Reliability Standard and that the use of such a standard is an attempt to encourage outcomes in the interests of the community. However, any case to change the USE measure must be driven by clear economic drivers.

We continue to support the Panel as the appropriate body to undertake any economic analysis in favour of a change to the Reliability Standard. However, we do not believe the evidence to date supports a move from the current level of 0.002% USE and its application across the entirety of the NEM remains appropriate.

Retain the scope of the Reliability Standard in terms of system security events, industrial action and 'acts of God'

The MEU submission to the issues paper[1] does question the exclusion of certain sources of supply interruption from the USE, including industrial action and multiple contingencies.

We are not suggesting these types of events should be included in Reliability Standard; however, we do believe that any changes to the Reliability Standard and Reliability Settings need to be cognisant of the implications of these events and the risks they pose to market participants and their effects on consumer's expectations. Moreover, the implications of possible multiple contingencies for new investments will have implications for the capacity of MPC and CPT to bring on new investment if those risks are not managed.

Therefore, we support the Panel's position that:

> . . . increasing the MPC and CPT is not the appropriate mechanism to manage the unserved energy caused by system security events such as multiple contingencies. The Panel considers that such incidents are better managed through operating procedures, technical compliance programs and the economic regulation of the networks.[2]

We appreciate that the Panel is not currently responsible for reliability standards for transmission and distribution networks or the implications of system security events and non-credible contingencies on market participants.

Retain the current operational approach of targeting to achieve an expectation of no greater than 0.002% USE each year and in each region, and in the NEM as a whole

LYMMCo supports the retention of USE of 0.002% within each region and across the NEM as a whole. However, we do note that there are potential issues that need to be considered and better understood if a single region is facing ongoing concerns in relation to breaches of USE that are not shared across the wider NEM. Additionally, whether under investment in capacity in a single region is a consequence of Reliability Standards and Reliability Settings or other factors need to be considered.

[1] MEU submission "Review of Operational Arrangements for the Reliability Standard (REL0035) and Review of the Reliability Standard and Settings (REL0034)", August 2009, p.37.
[2] AEMC, Reliability Panel, Reliability Standards and Settings Review, Draft Report, 23 December 2009, p.14.

Consider compliance with the Standard each year with the objective of providing continuous improvement to the processes that monitor and maintain reliability in the NEM, rather than the current process of measuring compliance with the Reliability Standard over a ten year moving average

We experienced some difficulty in reconciling the practice of aiming to achieve the Reliability Standard of no more than 0.002% in each year with the practice of measuring Reliability Standard performance over a ten-year period. However, we are concerned that the proposed changes, which form attachment C of the Review, may facilitate inappropriate consideration of USE.

A change from a ten-year moving average to an annual measure alone may give rise to increased emphasis on breaching the Reliability Standard as compared with over ten years, when in actual fact the overall performance of the NEM in terms of reliability may have been maintained. In this regard, it is not clear why an annual assessment (which in extreme circumstances may led to further analysis) in the context of a ten-year and/or five-year rolling average would not better inform the Panel, market participants, jurisdictions and consumers.

Reliability Settings

We note that the Panel's analysis concerns only the Reliability Settings themselves, being the MPC, Market Floor Price (MFP), and CPT and not the energy market frameworks. Therefore, while LYMMCo has some enduring concerns regarding the application of the existing frameworks we have contained our analysis to the Reliability Settings and the implications of altering those settings that we believe should be considered by the Panel.

Regular reviews by the Reliability Panel

We maintain our support for regular and transparent reviews of the Reliability Settings and Standards by the Panel. However, we are not certain whether every two years is the appropriate timeframe and have some concern these reviews may generate uncertainty and create an expectation of change in the absence of a compelling and holistic case for change.

This is not to suggest the Panel will recommend change for changes sake; rather, we make this comment in light of the Panel's reporting obligations, of April 2010, not allowing the Panel time to consider the implications and market experience of observing the 1 July 2010 changes in Reliability Settings. One could suggest this places undue weight on the reliability modelling exercise performed by ROAM and any additional economic analysis that may be provided that market participants may not have appropriate time to consider.

We suggest the implications of these outcomes be considered moving forward.

ROAM Report

The ROAM Report indicates that it is necessary to consider raising the:

- MPC from $12,500/MWh effective from 1 July 2010 to $16,000/MWh from 1 July 2012; and
- CPT from $187,500/MWh effective from 1 July 2010 to $240,000/MWh from 1 July 2012.

ROAM does not recommend the consideration of any change to the MFP or the APC.

At a general level LYMMCo considers the ROAM Report an appropriate reliability study; however, we have some general concerns that such a reliability study as opposed to a market study does not appropriately

reflect the dynamics of the market but does include assumptions that emphasise the need to increase the MPC.

While this may be appropriate at a general level it is of concern given it forms a significant input to the Panel's consideration of changes to the Reliability Settings. A few of the issues LYMMCo suggests may not reflect actual market outcomes are:

- ROAM has used historical generator bidding strategies for existing generators while new entrant generators adopt typical bidding strategies for their technology;
- ROAM has not considered strategic or Cournot bidding to determine the behaviour of existing plant (although we note the reasons for not doing so);
- MPC has only been considered on the basis of a 'market failure' case, where extreme peaking generators only generate at times of necessity, as price would otherwise not reach MPC; and
- the MPC has been determined in the absence of opportunistic bidding by extreme peaking plant as some generators may be unable or unwilling to operate in such a fashion.[3]

An additional, and general point, is that the determination of an appropriate price cap for the spot market is an inexact science. While quality reliability modelling can be used to guide the thinking of the Panel and market participants as it relates to generator profitability, it is by no means able to provide a series of exact measures that guarantee reliability.

Proposal to increase Market Price Cap to $16,000

The Panel indicates the main reasons that an increased MPC is required are due to:

- increased capital costs for new entrant open cycle gas turbines;
- peakier demand; and
- more detailed representation of interconnector assumptions resulting in reduced inter-regional capabilities at times of higher demand.[4]

The ROAM Report cites additional reasons for a possible increase in MPC, being:

- the time value of money;
- a preference for shoulder versus extreme peaking plant; and
- peaking generator availability.

LYMMCo does not dispute the analysis that indicates:

- generation costs, particularly in relation to purchasing open cycle gas turbine have increased in the past two years and notes the implications for peaking generation investors seeking to achieve their desired rates of return; and
- Reliability Settings need to consider the time value of money, given in particular the nominal value of the MPC decreases over time.

Both of these arguments are relatively straight-forward and are subject to ongoing variation in either direction depending upon circumstances.

[3] ROAM Consulting, Presentation to Reliability Panel Public Forum, 12 February 2010.
[4] AEMC, Reliability Panel, Reliability Standards and Settings Review, Draft Report, 23 December 2009, p.29.

LYMMCo also notes the Panel's point that a more detailed representation of interconnector assumptions resulting in reduced inter-regional capabilities at times of higher demand supports an increase in the MPC.[5] However, we are unable to identify the specific effect or the significance of that effect. We would be concerned if there were significant differences driven primarily by these factors; having not been previously considered by earlier reviews.

The ROAM Report suggests current open cycle gas turbine plant represents investments in shoulder plant rather than peaking plant.[6] ROAM goes on to state, in the context of the absence of super peaking plant which operates solely to avoid unserved energy, that

> Without such a class of generation, which has been previously filled by liquid fuelled, fast start generation, the market will progressively become less competitive and less likely to deliver the capacity to meet extreme events that the Reliability Standard is intended to insure against.[7]

We are not convinced the analysis which is based on an artificial construct of reliability and not market outcomes can be inferred to provide this conclusion. LYMMCo is not convinced the market will not continue to commit to new capacity in the absence of the proposed MPC increase and therefore does not support this conclusion in the absence of more detailed analysis.

Additionally, this conclusion highlights one of our earlier concerns with a reliance on reliability type modelling. It fails to consider the possibility peaking plant will engage in opportunistic bidding and creates a role for super peaking plant that will only operate to serve unserved energy whereas such plant may never eventuate. While again this may be an appropriate modelling assumption it may not reflect markets outcomes.

As it relates to peaking generator availability, if ROAM modelled availability of 97 per cent, i.e. best in class, it is would be unclear how this factor supports an increase in the MPC to $16,000 as it suggests that super peaking plant will nearly always be available to be dispatched in the periods of extreme demand. However, given such a rate was used for only one generator per region and a forced outage rate of 28 per cent was more generally applicable including for new open cycle gas turbines this provides a likely explanation for this point. Again, however, we are slightly uncomfortable with this factor, high forced outage rates, being cited as one of the reasons a required increase in MPC is considered necessary as it is unlikely to reflect the availability of new peaking or shoulder plant going forward.

In relation to demand, the ROAM Report suggests a peakier 'demand profile will result in the increased occurrence of large magnitude, short duration events'.[8] However, ROAM goes on to suggest these events, large and of a short duration, are not likely to be greatly beneficial to peaking plant. LYMMCo wishes to raise a few points in relation to this conclusion.

Firstly, and most simplistically, if demand is peakier, which implies peak demand is growing faster than average demand, it would logically result in more trading periods at prices where peaking plant can recover long run marginal costs not less. It is unclear the extent to which ROAM's conclusions arise from their escalation of a specific year to represent future market outcomes as opposed to multiple scenarios with varying weather outcomes and load growth.

[5] AEMC, Reliability Panel, Reliability Standards and Settings Review, Draft Report, 23 December 2009, p.29-31.
[6] ROAM Consulting, Report to Reliability Standards and Settings Review, 15 January 2010, p.17.
[7] ROAM Consulting, Report to Reliability Standards and Settings Review, 15 January 2010, p.18.
[8] ROAM Consulting, Report to Reliability Standards and Settings Review, 15 January 2010, p.18.

Secondly, there appears to be a degree of inconsistency when its comes to arguments about peakier generation. On one hand ROAM is suggesting peakier demand may mean less opportunities for super peaking plant to be dispatched, whilst on the other hand ROAM suggests:

- more peaking generators in the market may cause prices to remain at higher levels for longer periods of time than if base load plant had instead been built;
- renewable generation may result in higher periods of sustained high prices (for a series of reasons); and
- whilst maintaining the fifteen times ratio between MPC and CPT ROAM suggests 50 per cent of MPC incidence will occur under the APC. It is unclear if this suggests a greater occurrence of MPC events, a non-linear relationship between MPC and CPT multiples, or that ROAM's modelling does not reflect likely market outcomes.

Third, in the context of broader perspectives that consider extreme weather events, one of the noted drivers of high priced events, may become more frequent[9] it seems premature to suggest that revenue opportunities for peaking generators will diminish going forward.

Finally, alternative NEM data sources present an alternative perspective than that provided in the ROAM Report. For instance the Australian Energy Regulator notes that the incidence of trading intervals with prices above $5000 per MWh has increased since the NEM commenced and notes 21 events in 2004-05 rising to 76 events in 2007-08, with 68 events in 2008-09.[10] Again this suggests the ROAM conclusions are open to further scrutiny.

Is a change to MPC needed to incentivise investment?

While high priced events provide investment signals in their own right it is not necessarily appropriate to suggest that investors would act on high-priced events in isolation of other more important factors. 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 possibly downplays the significance of non-spot price signals and other determining factors within the NEM 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 sentiment was reflected in the highly informative presentation from Origin Energy, provided by Mr Denis Barnes, General Manager, Energy Risk Management at the recent Panel public forum[11]. In his presentation Mr Barnes indicated, among other things, that:

- in the context of the NEM being one of the most volatile commodity markets in the world higher MPC may lower the contract level generators wish to carry;
- it is contracts not spot price outcomes which underpin new investments;
- the price risks associated with higher customer demand and high prices means more than 90 per cent of retailer costs and generator revenues are derived from contract prices not spot prices; and
- the existing level of market risk has resulted in new build requirement being met predominantly by retailers with no new open cycle gas turbine build left to earn revenue from the pool.

[9] In April 2009 the Ministerial Council on Energy commissioned the AEMC to undertake a Review of the Effectiveness of NEM Security and Reliability Arrangements in light of Extreme Weather Events.
[10] AER, State of the Energy Market 2009, p.85.
[11] Origin Energy, Response to Review on Reliability Standard and Settings Draft Report, Presentation to AEMC Reliability Panel by Mr Dennis Barnes, General Manager, Energy Risk Management at Hilton Melbourne Airport, 12 February 2010.

Notably, this view was reflected in earlier statements by Dr Tamblyn's, AEMC Commissioner, 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.[12]

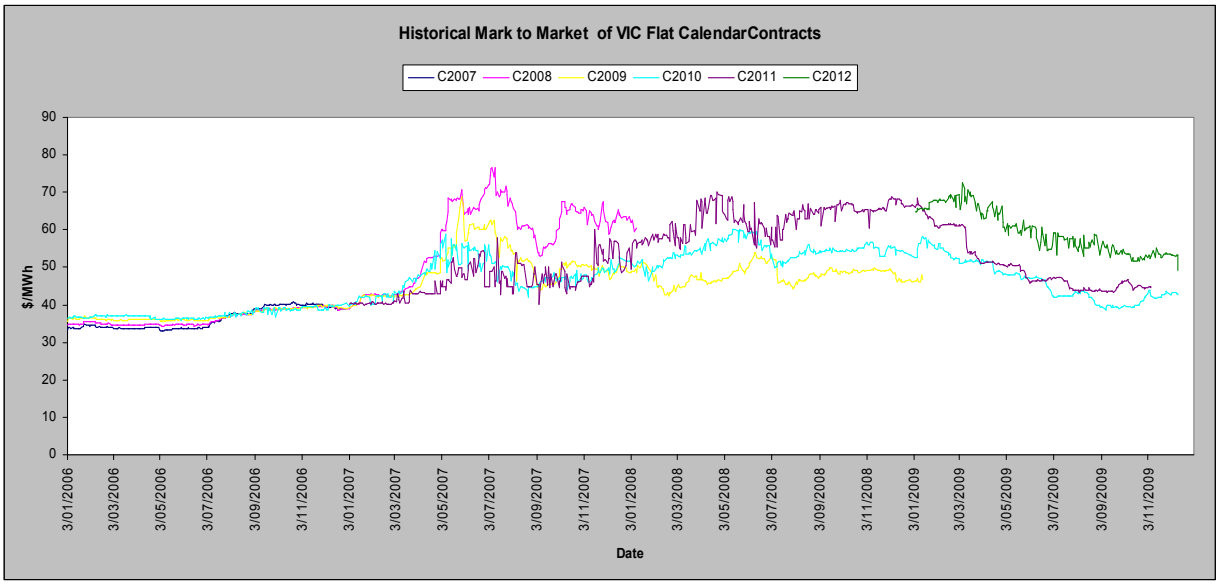
Therefore, it seems relatively certain that contract prices drive new investment not pool prices. Hence, any expected benefits of any increase in the MPC are reliant upon a consequent increase in contract prices. However, while one could expect higher spot prices to be reflected in the contract market forward curve; 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, demand growth 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. Conversely, and more notably, it is not given that an absence of higher pool price events will not lead to higher contract prices.

Therefore, the foundation argument that changes to MPC are needed to drive ongoing investment to satisfy the USE remains uncertain at this time.

Contract price movements and Reliability Settings

Interestingly, using Victorian prices as a proxy we can see that since 2006 there has been a step change in contract prices on the wholesale electricity market - as demonstrated in the graph below[13]. This increase could be considered a precursor to new investment under normal circumstances.



However, it has been suggested, and is implicit in the ROAM Report, that investment has not been forthcoming to the required standard.

[12] Dr Tamblyn, presentation to CEDA, 19 February 2009.

[13] The graph provides a historical mark to market of Victorian flat calendar contracts by year for C2007, C2008, C2009, C2010, C2011, C2012 by price in $/MWh.

Interestingly, in response to the Review of Energy Market Frameworks in light of Climate Change Policies a number of generators indicated 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 MPC did lead to higher contract prices there exists legitimate doubt that, in the absence of greater investor certainty in relation to the regulatory and investing environment, that new power plant projects will be commissioned at the desired rate.

Notably, these higher prices were in the absence of any changes to MPC thus indicating that the current levels of MPC and CPT are not inhibiting higher contract prices and that factors other than Reliability Settings are the primary determinants of contract prices in recent years.

Therefore, in our view there is no evidence that the current Reliability Settings have failed given the:

- range of existing and committed plant detailed in the Electricity Statement of Opportunities 2009[14] does not suggest any medium term supply shortfalls[15];
- prior to recent policy uncertainty there were ongoing commitments to new projects, both public and private, in New South Wales and Victoria; and
- contract prices, for example those during 2008 in New South Wales and Victoria, have been at levels which have supported new entry irrespective of MPC adjustments.

Hence, our concern that any change, if recommended and progressed, will not result in a noticeable increase in investment but will expose generators and retailers to a series of additional and excessive market risks and costs.

Role of the Cumulative Price Threshold

The original purpose the CPT was to replicate a force majeure clause to limit the exposure of participants to major events[16]. In fact, the Panel, in an earlier review envisaged that the CPT would operate as the primary risk management mechanism for extreme events[17] and has more recently indicated the CPT is an 'explicit risk management mechanism'[18]. In that regard, MPC (or VoLL at that time) was established as a market clearing mechanism whilst the CPT was established for risk management purposes.

Is a change to Cumulative Price Threshold warranted?

Given the scope of the terms of ROAM's engagement it is evident that the case for raising the CPT, as presented in the ROAM Report, is not conclusive. ROAM supported this view in their presentation to the Panel public forum wherein they stated:

> Further assessment would be needed to provide a more refined estimate of the CPT to fairly incentivised generators whilst mitigating risk to market participants.[19]

[14] AEMO, Electricity Statement of Opportunities for the National Electricity Market, 27 August 2009
[15] See AEMO, Electricity Statement of Opportunities for the National Electricity Market, 27 August 2009, table 3, p.5 executive briefing.
[16] Reliability Panel, VoLL and the cumulative price threshold, Issues paper, December 2003, p.40, indicates that the original FM threshold was $2100/MWh average price over 72 hours.
[17] Reliability Panel, Review of VoLL in the National Electricity Market, Report and Recommendation, July 1999, p.3.
[18] Reliability Panel, National Electricity Market Reliability Settings: VoLL, CPT and the Future Reliability Review Rule Change Proposal, December 2008, p.2
[19] ROAM Consulting, Reliability Standard and Setting Review, Public Forum Presentation, 12 February 2010.

As the NEM has been slow to respond to participants concerns over non-credible risks and congestion the CPT remains the primary mechanism for dealing with low probability, high impact events that jeopardise a participant's cash flow. This is not to suggest the cash flow risks to participants of events below the current CPT are insignificant. Clearly, one event at $150,000/MWh can have the same cash flow effect as ten events at $15,000/MWh.

However, the benefit of the CPT is management of extreme events over a protracted period of time without impeding voluntary market clearing within shorter peaks. If a CPT of $150,000 has not provided significant time to allow the market to respond after successive periods at or near the MPC, than it is appropriate to suggest the situation may not be remedied by the market without intervention and that such intervention is needed to maintain the viability of market participants.

Although ROAM notes these issues it predominantly evaluated a change in CPT from the perspective of available revenues for open cycle gas turbines (who were not contracted, not undertaking strategic bidding and only being utilised to meet unserved energy). We agree that a higher CPT may increase returns for some generators; however, we support the position of the Australian Energy Regulator in this regard that it is 'unlikely generators will have significant regard to this factor when making investment decisions'[20].

There are numerous factors for why this is the case, including the reliance on contracts not spot price outcomes for revenue and the irregular and the unpredictable nature of extreme events. MPC events occur more readily than CPT events and are thereby more relevant to open cycle gas turbine investment decisions (were an investor to invest primarily on the basis of spot price outcomes). Hence, it is difficult to see how financiers would support a business case that sought to recover capital costs through CPT events that could not be reasonably anticipated.

A higher CPT has definite risk implication for generators, retailers and potential investors. However, we are not convinced that a higher CPT will lead to the offer by generators or the purchase by retailers of additional contracts. Even if an alternative case could be made we are not convinced that a change in CPT would specifically encourage increased investment in new super peaking generation. This position is again shared by a range of market participants and was used by the Australian Energy Regulator to argue against the increase in CPT from $150,000 to $187,500 where they suggested that it is inappropriate to consider MPC and CPT increases in tandem.[21] We share these concerns and suggest it would be premature to recommend any change to CPT at this stage.

Interaction of Cumulative Price Threshold and Market Price Cap

In its analysis ROAM considers the CPT from the perspective of revenue opportunities for super peaking generators and implies that a failure to increase the CPT at the same time as the MPC will mute the effect of the MPC increase. We are not convinced by this suggestion.

In earlier work commissioned by the Panel, Concept Economics[22] (Concept) examined the relationship between CPT and MPC as it pertains to generator profitability and generator bidding. Concept indicated that changes to CPT are likely to change generator behaviour and drew on relevant market events to reach these conclusions. Additionally, it was determined that higher MPC and CPT in tandem would result in a notable increase in price outcomes but overall increasing MPC without changing CPT has a minimal

[20] Australian Energy Regulator, Submission to AEMC Draft Rule Determination, National Electricity Amendment (NEM Reliability Settings: VoLL, CPT and Future Reliability Review) Rule 2009, p.3.
[21] Australian Energy Regulator, Submission to AEMC Draft Rule Determination, National Electricity Amendment (NEM Reliability Settings: VoLL, CPT and Future Reliability Review) Rule 2009, p.4.
[22] Concept Economics, Risk Assessment of Raising VoLL and the CPT, 13 October 2008, p.7-18.

impact on generator earnings while reducing price impacts.[23] For LYMMCo this suggests the weighting given to increasing CPT to stimulate new investment is unjustified.

We appreciate the Concept report is dated late 2008, however, we consider the timing of the report still makes it relevant given its analysis suggested that when reviewing the proposed increase in CPT to $187,500 it found that maintaining the CPT at $150,000 still allowed sufficient annual returns for peaking generators to recover costs to sustain their investment[24] if the MPC rose to $12,500. Concept also noted that if prices rises under a lower CPT were not sufficient to sustain peaking investment this is likely to be symptomatic of excess capacity rather that a problem with the level of CPT. [25]

Therefore, with the exception of the pure reliability modelling performed in the ROAM Report it is yet to be demonstrated that failing to move CPT will mute investment signals, or that changing the MPC for the purposes of providing an investment signal requires a change in the CPT.

As an aside, we suggest the ROAM Report's expectation that 50 percent of MPC events could occur under an APC seems overstated and requires further analysis as a justification to change the CPT. This is notwithstanding the point that APC events of themselves could be considered a valid investment signal of potential profitable spot market strategies for new super peaking generation. This point is reinforced given Concept's analysis suggest market outcomes are likely to work to minimise CPT breaches while maximising revenue.

Compensation arrangements and the role of the Administered Price Cap

In their earlier report Concept indicated CPT has an interrelationship with compensation mechanisms and the APC[26]. Concept went on to indicate that for numerous reasons generators would prefer not to breach the CPT and instigate an Administered Price Period (APP) which results in price outcomes at or under the APC and any uncertain compensation payments.[27]

To date, as part of this Review, it does not appear the Panel has given significant attention to the use of APP and application of the APC. However, Rule 3.14.1 permits the Panel to make recommendations in relation to the APC. We consider there may be more conservative measures available, which may possibly involve more sophisticated use of the APC, that could ease concerns regarding capital recovery for super peaking plant that do not require an across the board increase in risk as would occur if MPC and CPT were increased in tandem (this assumes an alternative application of an APP would not lead to perverse outcomes).

In that regard, it may be appropriate to consider a more fundamental analysis of the role of the CPT, APP and APC, and compensation payments through a separate review; notwithstanding our desire for the Panel to provide additional commentary and insight on these matters.

Market ancillary services and reliability settings

The NER establish that any increase in reliability settings for spot prices flows into the ancillary services markets. We are not aware of any detailed analysis which considers the implication of increased reliability settings for ancillary service markets and whether this flow-on effect is more than an artefact of the construction of the NER themselves.

[23] Concept Economics, Risk Assessment of Raising VoLL and the CPT, 13 October 2008, p.15-18.
[24] However, this is independent of any specified capital requirement criteria i.e. 150% or 300%.
[25] Concept Economics, Risk Assessment of Raising VoLL and the CPT, 13 October 2008, p.50-53.
[26] Concept Economics, Risk Assessment of Raising VoLL and the CPT, 13 October 2008.
[27] Concept Economics, Risk Assessment of Raising VoLL and the CPT, 13 October 2008, p.15-18.

This is of particular interest given the risk of high impact events on ancillary service prices which generators can not prepare for, and more recently the events of April 2009, where in Tasmania there was a breach of the CPT in which ancillary services charges in one market were exceeding energy revenue for the affected generator. We understand, at the time in that market an APP was declared while the remaining markets had low prices (i.e. below $10).

Notwithstanding these risks, and that form of event, overall, we suspect ancillary service markets have operated effectively and have resulted in efficient prices. However, we are uncertain in the absence of further analysis if increased Reliability Settings will continue to produce the required outcomes.

The primary argument for tying the various markets to the same Reliability Settings would appear to be co-optimisation. In essence, the concern may be that less energy would be offered in the form of ancillary services if spot price outcomes where greater than ancillary service outcomes. This appears correct. However, it presumes that trading strategies already do not consider the current differences between prices in the spot market versus ancillary services market and that those generators do not opt out of energy in favour of ancillary services and vice versa based on price expectations already.

Therefore, if this occurs at levels below the MPC, which reflects the majority of the time the market is in operation, it is unclear if additional incentives would be created if the Reliability Settings did not match or the impact on participant behaviour.

Risks

Given the significance of the proposed changes there are a range of specific risks that need to be considered in making recommendations to change the Reliability Settings. Some of these risks have been detailed below for your consideration.

Transmission risk

Generators face an increase in market risk due to transmission congestion if the MPC is increased. As a result, they may be less willing to contract their capacity. Currently, generators are not able to mitigate against the risk of transmission failure due to unplanned outages, congestion and lack of ongoing access. The financial consequences of a transmission event when spot prices are high, while low in probability, would be high in impact, and have the potential to cause financial failure for multiple parties and severely impact NEM sustainability.

In this regard, we suggest generators exposed to increased market risk under a higher MPC will be less likely to invest in new capacity due to the increased risk of transmission events and less likely to contract existing capacity as the risks would become unacceptable.

Physical generation failures

Generators are likely to be less willing to contract their capacity under a higher MPC because they may be concerned about exposure to increased financial risk should their physical generation not be available at times of high prices. This is particularly concerning for older plant and may have the perverse effect of ensuring contracts are not offered to retailers in periods where retailers are most likely to desire contractual cover due to high prices.

Increased spot market volatility

Generators, who are less hedged because of the increase in the MPC than would otherwise be prudent, could change their bidding behaviour. In this scenario, one possibility is that they choose to bid more strategically which may be detrimental to some market participants, including smaller retailers.

Prudential obligations may inhibit retail competition

Prudential requirements on market participants will increase as a consequence of an increase in reliability settings. We support the perspective put forward by Origin Energy that: 'effective retail competition is likely to suffer as a consequence of the financial stresses from greater risk capital, working capital and prudential requirements – combined with an already constrained supply of bank guarantees'.[28]

Increased prudential requirements will increase barriers to entry especially for small retailers whom we consider an important driver of retail competition and downstream contract liquidity. At the same time, and while not seeking to increase barriers to entry for retailers, as a generation market participant we hold reservations about any steps taken to reduce the financial obligations placed upon retailers within the NEM.

Carbon Pollution Reduction Scheme

The uncertainty associated with the introduction of the proposed Carbon Pollution Reduction Scheme has severely reduced liquidity in the contracts market and has reduced the ability of participants to hedge price risk in the short term.

The possible long-term effects of CPRS strengthen arguments against changing Reliability Settings as it increases the complexity of hedging price risk and exacerbates cash flow risks for many participants (both generators and retailers).

Stability and reliability should be appropriately valued

Stability in the market and reliable supply of energy to consumers are important considerations in the Panel's analysis. In that regard, it should not be assumed a recommendation, if progressed, which increases risk to generators and retailers overall will provide stable and reliable outcomes for the NEM nor encourage investment.

To this end, we reiterate the view that the Panel should continue to employ a cautious approach to revising Reliability Settings and delay a recommendation to increase MPC and CPT until at least the impact of the impending 1 July 2010 changes can be appreciated.

The significance of cash flow implications related to both CPRS and MPC, coupled with the after effects of 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 Panel's objectives.

[28] Origin Energy, Response to Review on Reliability Standard and Settings Draft Report, Presentation to AEMC Reliability Panel by Mr Dennis Barnes, General Manager, Energy Risk Management at Hilton Melbourne Airport, 12 February 2010, p.2.

Conclusions

On balance, given the prevailing risks to market participants, the unsubstantiated impacts on investment incentives, the timing concerns, and the unmeasured impact of the impending 1 July 2010 changes, we believe the case for change at this point in time is not conclusive.

Contact Details

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