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Mr Neville Henderson
Chairman, Reliability Panel
Australian Energy Market Commission
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Our Ref:

Dear Neville,

SUBMISSION TO THE AEMC RELIABILITY PANEL REVIEW OF THE RELIABILITY AND EMERGENCY RESERVE TRADER

The Victorian Department of Primary Industries (DPI), as the portfolio agency responsible for energy policy in Victoria makes the following submission to the AEMC Reliability Panel on the Review of the Reliability and Emergency Reserve Trader.

Any queries in relation to the submission should be directed to Mr Mark Feather, Director National Energy Development by email at mark.feather@dpi.vic.gov.au or on telephone (03) 9658 4793.

DPI submits that the Reliability and Emergency Reserve Trader (RERT) provisions of the National Electricity Rules (NER) should not be allowed to expire on 30 June 2012 and that they should be extended at least until 30 June 2013.

It is acknowledged that a case can be made for the removal of the RERT provisions:

- the predecessor provisions to the RERT were incorporated into the NER as a transitional safety net at market start due to concerns that in its early years of operation the market might not deliver sufficient capacity to consistently meet the reliability standard. Over the past 10 years annual unserved energy has remained within the Reliability Standard of no more than 0.002 per cent unserved energy in all regions of the NEM, but at least in part, this performance is a legacy of excess capacity available at market start;
- reserve capacity has only been contracted for twice under these provisions and in neither case was this capacity actually dispatched. However, in both cases the reserve capacity was contracted to cover a projected summer reserve shortfall and both summers were relatively mild;
- given the experience with reserve contracting only limited amounts of capacity are likely to be available and they would be insufficient to ameliorate any significant shortfall;



- the RERT is inconsistent with the design of the NEM as an energy only market. The RERT creates a submarket reserve that can be contracted for at a price in excess of the market cap and its costs are smeared across all market customers regardless of the extent to which they have contracted to cover their market exposure.

DPI's concerns with the removal of the RERT at this time arise primarily from our reservations about the Reliability Standard and its associated market settings, including in particular the current level at which the MPC is set. For the reasons outlined below, DPI considers that the effect of the existing MPC in the short term is to dull incentives on retailers and generators to engage in risk management during extreme demand days and/or where there are significant supply shortfalls. In the long term, its effect is to dull incentives to invest in generation capability. As such, DPI considers that the RERT should be retained as a safety net, at least whilst the MPC remains at current levels.

Reliability Standard and Reliability Settings Review

The Reliability Standard has recently been examined by the Australian Energy Market Commission Reliability Panel's *Reliability Standard and Reliability Settings Review*. While the Review characterises the Reliability Standard as "the minimum acceptable level of bulk electricity supply delivered to consumers in a region..." the approach taken by the Reliability Panel in setting the MPC and CPT appears to have been more strongly influenced by a concern to protect market participants from financial risk.

The Reliability Standard is in some sense a measure of consumers' preferences, but consumers do not distinguish between the sources of electricity supply disruption and therefore their preferences in relation to bulk supply need to be indirectly inferred. Based on Victoria's recent experience with major supply outages consumers have little tolerance for the widespread bulk supply incidents. There appear to be a number of reasons for this but the key issue is that bulk supply incidents can involve widespread disruption to the social and economic life of the community such as disruptions to public transport and traffic flows and the closure of shopping centres and schools. Even if this does not provide a convincing case for revising the Reliability Standard, it does argue for setting the MPC and CPT with a view to delivering more, rather than less capacity.

The decision of the Reliability Panel to index the current MPC of \$12,500 per Megawatt hour and the CPT to the Stage 2 (Intermediate) Producer Price Index from 1 July 2012 therefore appears to be inconsistent with the Reliability Standard being the minimum acceptable level of bulk electricity supply reliability for the following reasons:

- while the figure for the MPC is reasonably close to the estimated Value of Customer Reliability of \$13,250 for residential customers, given the potential widespread impacts of bulk supply outages it is not clear that the MPC should be set simply with reference to residential customers, even though they are the consumers most likely to experience load shedding as a result of a bulk supply shortfall; and
- the modelling undertaken by ROAM Consulting for the Review shows that the estimated value for the MPC to deliver the Reliability Standard for 2012-13 and 2013-14 is \$16,000 per Megawatt hour and this is an average figure across the NEM. For regions such as New South Wales and Victoria that have a combination

of high overall demand levels and more peaky demands the MPC should therefore be higher.

In the context of the fully privatised electricity market in Victoria the risk associated with an MPC below the level required to deliver the Reliability Standard is that the market will fail to deliver sufficient capacity to meet periods of high demand during the summer.

While the Australian Energy Market Operator's forecasts of supply demand balance show that Victoria has sufficient capacity for the 2010/11 and 2011/12 summers, the recent pattern has been for Victoria to have either just above or just below the required capacity for summer. In these circumstances if a single major generating unit fails, or there are delays in the commissioning of new capacity, as was the case with the commissioning of the Laverton North power station or Basslink, the State faces the prospect of entering a summer without sufficient capacity. The shortfalls that are likely to be experienced in these circumstances are likely to be small enough to be effectively resolved through the RERT.

It is possible that the ongoing development of the NEM might substantially reduce these risks. In particular, a greater demand side response would provide more flexibility for the market to deal with periods of temporary supply tightness. Mechanisms such as deregulation of retail prices and the introduction of smart meters and time of use tariffs will facilitate a greater demand side response, *but they need to be supported by an MPC that will consistently deliver sufficient capacity to achieve the Reliability Standard.*

For the present, any additional capacity to resolve a projected supply shortfall is likely to be available only from industrial and commercial customers who have the technical ability to make additional capacity available. However, these customers have a significantly higher Value of Customer Reliability than residential customers¹ and are only likely to make their contracted electricity available at a price well in excess of the present MPC.

The retention of the RERT

In the light of the arguments outlined above, whilst the MPC remains at its current levels, DPI believes that there is a strong case for the retention of the RERT as a safety net.

Without this safety net, DPI considers that there remains a risk that, with the existing MPC arrangements in place, there will be insufficient incentives on market participants to manage the risks associated with supply shortfalls or demand peaks particularly during extreme weather. In particular, retailers will have reduced incentives to contract innovatively for demand side response and generators will have reduced incentives to make available additional generation capacity. In the absence of these incentives there is an increased risk of emergencies occurring.

By contrast, in the short term an increase in the MPC should boost incentives on retailers and generators to engage in dynamic and innovative risk management arrangements, thereby promoting competition and the efficient use of electricity services in line with the

¹ A study to determine the Value of Customer Reliability was undertaken for VENCORP in 2008 by CRA International (*VENCORP, 2008, Assessment of the Value of Customer Reliability*). The study estimated unweighted sector level of the value of customer reliability of \$13,250MWh for the residential sector, \$111,060MWh for the agricultural sector, \$90,760MWh for the commercial sector and \$36,070MWh for the industrial sector. The weighted value of customer reliability for all sectors was \$47,850.

National Electricity Objective. Such an increase would ameliorate the distortions to the market associated with the current MPC and would also have the benefit of reducing the need for a safety net such as the RERT.

In addition, in the longer term, an increase in the MPC would help to facilitate investment in peaking generation, bringing on additional capacity to serve demand and promoting the long term interests of consumers with respect to reliability and security of supply. Additional investment would also reduce the future need for the RERT.

Ultimately, DPI believes that risk management within the market is best undertaken by those parties best able to manage it, namely generators and retailers. However, whilst the incentives to undertake risk management activities through a competitive process are dulled by the existing MPC arrangements, there remains a need for the RERT.

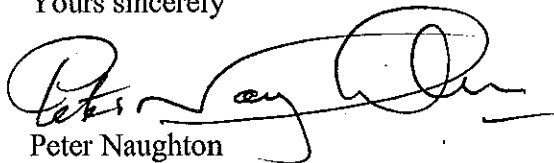
DPI notes that the use of the RERT mechanism in the past has been infrequent. However, going forward this does not mean that the mechanism will not be needed in the future as an insurance policy to address days of extreme demand combined with supply shortfalls.

In the absence of the RERT consumers would need to be willing to prospectively accept the higher risk of load shedding associated with periods of identified supply shortfall and be comfortable with no action being taken to try and resolve the problem. Our experience with the community response to recent major supply interruptions suggests that this is not the case.

In addition, DPI notes the view expressed by the Reliability Panel that under the current reliability framework the increasing financial risks associated with a higher MPC and CPT may mean that the market approaches a "tipping point" beyond which the reliability value of increases in the MPC and CPT are offset by the changed behaviour of participants in response to increased financial risk. While DPI does not accept this position, if the Reliability Panel adheres to this view, it would have a compelling reason to retain the RERT.

Officers of DPI would be pleased to discuss this submission with the Reliability Panel.

Yours sincerely



Peter Naughton
Executive Director
Energy Sector Development Division

17/9/10