International Power Australia and Loy Yang Marketing

Submission to the AEMC Comprehensive Reliability Review

Second Interim Report dated August 2007

September 2007

Summary

International Power Australia (IPRA) and Loy Yang Marketing Management Company Limited (LYMMCo) make this third joint submission reflecting their common views regarding the risks to market sustainability and long-term provision of reliability under the current NEM arrangements.

This submission reviews the key elements of the Comprehensive Reliability Review (CRR) Second Interim Report (CRR-IR2). Our primary interest remains the ongoing efficient operation and sustainability of a competitive electricity market, which is potentially jeopardised by a range of policy and regulatory initiatives.

We make the following key points in our submission:

- We strongly support the holistic approach the CRR has adopted in relation to market sustainability in the earlier reports (sustainable markets will lead to reliable supply to consumers)
- We reiterate that a much sharper focus on market robustness and sustainability is warranted in the face of government policies and initiatives (current deluge of greenhouse gas reduction

policies and measures, state development agendas, technology development subsidies etc.). It is urged that the AEMC facilitates a holistic market design review in the face of such impediments taking into consideration past and current Rule changes and reviews.

- We support the principles behind the EAAP but suggest a pragmatic and practical approach.
- We suggest that there is a need to achieve contract symmetry between supply and demand side settlements
- We don't support the resetting of VoLL and the CPT without first addressing the market sustainability issues and without resolving the market event distortions and financial risk.

In our view further work is required to demonstrate that the fundamentals of the market are robust and to analyse in detail the impact of the "other policy settings" on the market and investor confidence.

Introduction

International Power Australia (IPRA) is the largest private investor in electricity generation in Australia. Loy Yang Marketing Management Company (LYMMCo) trades the largest privately-owned generator in the NEM.

The partial owner of Loy Yang Power (AGL), and the owner of International Power Australia (International Power plc), one Australian, and one international, are two of the private investors that have persisted in investing in the Australian NEM while others have exited.

The outcomes of the CRR-IR2 are directly relevant to sustainability of ongoing investments in this market, and the regulatory and sovereign risks that face investors.

These two businesses have prepared this third joint submission to the Comprehensive Reliability Review (CRR) as they share a common interest in the sustainability of the NEM market, and a common concern that it may not be achieved under current arrangements.

These specific issues relating to the broader questions of market sustainability have been opened for discussion in the CRR-IR. These are critical to the on-going development of the NEM energy only market (EOM) and are to be commended.

Detailed response

We address the key issues raised in the interim report, as follows:

1 Implementation of Reliability Standard and its Interpretation – Statistical approach

NEM Implementation

In our view the earlier (First Interim report – CRR-IR1) analysis of the market fundamentals is incomplete and should be expanded to consider (in the absence of external policy intervention) whether the EOM implementation is robust or could be improved.

Most modelling of the NEM including that carried out by CRA for the CRR includes a number of assumptions that simplify the modelling such as steadily increasing demand profile, average long run new entrant costs, and static load shapes. After carrying out modelling on that basis the RP notes (on page 8 of CRR-IR1) that;

"Quantitative modelling indicates that spot prices would be just sufficient to signal the need for new investment in the absence of distortions due to the influence of external policy mechanisms such as greenhouse measures or retail price caps."

In reality there is not necessarily a clear link between an increased VoLL and increased investment / reliability as the simplified inputs identified above are dynamic and driven by externalities such as weather and climate change and national and international economic supply and demand all of which will increase the volatility and uncertainty of MEM outcomes. In our view if NEM investment signals are "marginal" under the circumstances modelled, before assessing the sustainability of the NEM design to the "*the influence of external policy mechanisms* ". The modelling of the NEM viability should be expanded to consider at least the following;

- Weather or climate driven demand volatility,
- The impact of the potential for mismatch between supply and demand curves, and a
- A range of new entrant costs.
- Range of discount rates (government owned and private)

2 Investor Confidence - External risks

The CRR-IR has identified a number of external risks these risks include;

Public policy issues, such as retail price caps and greenhouse measures such as:

- MRET, VRET, NGAC, Queensland gas – GAC, and soon to be introduced NRET and VEET
- Since our second submission, two additional and substantial schemes were announced.
    - NSW initiated NRET scheme poised to deliver 7,250GWh.
    - Federal governments Clean Energy Target (CET) of 30,000GWh announced in September 2007.

In our view the earlier (CRR-IR1) analysis (market modelling) undertaken by the CRR should be expanded to quantify the impact of these external risks on the EOM. In addition the relationship between these risks and

the solutions proposed should be identified to ensure that potential changes considered are effective in meeting the design objectives.

For example, modelling the penetration of wind into the market may identify the depressive effect wind has on regional prices, contract market dynamics and generation sustainability, despite wind offering a poor contribution to reliability due to its intermittent nature.

It should also be noted, that in the short term, wind is the primary candidate for meeting the bulk of the renewable energy targets.

The market is expected to come under increasing pressure from a range of externalities and these impacts on the market need to be considered in a holistic context along with the wide ranging Rule changes made and currently under consideration, by the AEMC. It is appreciated that for practical reasons Rule changes and market reviews are assessed within a constrained scope, however it is not clear that these changes are being considered within a framework as a whole, together with the external impacts. Consequently sub optimal or inconsistent decisions may result.

There is a pressing need for the AEMC to develop and implement a process to address the impacts of all these changes, particularly The MCE also needs to be exposed to these issues and their support for a holistic process secured.

3 Level of VoLL and the CPT

In an EOM and in the absence of intervention/externalities, and with the level of VoLL and CTP set to limit participant risk but not to constrain market clearing, the market should operate to provide sustainable outcome for participants and a meet the reliability target. However, as presented in our earlier submissions and as discussed the preceding section, NEM is far from being intervention free.

Greenhouse non-market related policies continue to mushroom at an accelerating pace and government facilitated investments remain problematic. In this context, the VoLL and CPT play a secondary role in determining reliability outcomes and should not be changed at this stage until the dominant market intervention impacts are remedied.

Secondly, during market events such as the one occurring on the 16th of January, the current level of VoLL creates a significant market risk. This event created market distortions, where dispatch was at times inconsistent with pricing, and presented large and unmanageable financial risks to participants. These risks would increase with any increase in either VoLL or the CPT.

Thirdly, high level of VoLL is also likely to attract greater regulatory and political scrutiny of high price outcomes with intervention more likely as the consequence. The impact of intervention on the market would be greater with higher levels of VoLL.

Currently the generators are working on possible remedies to the risks of mismatched dispatch and pricing, as is the AER. Some of the potential solutions may require rule changes to occur and the implementation timeframes are likely to be long.

The AEMC is urged to adopt a holistic approach when reviewing the level of VoLL, and should not contemplate increasing the level of VoLL until such time as the underlying problems impacting the market are satisfactorily resolved.

4 Reserve contract offers symmetry between supply and demand

We are concerned by an inconsistency in the settlement arrangements for reserve contracts. This inconsistency would make it difficult for NEMMCO to make a rational choice between alternative reserve contracts from supply-side and demand-side participants.

- For a supply-side participant with a reserve contract which is exercised, the effect of clause 3.15.6 (b) is that the participant receives the payment specified in the reserve contract, but no benefit in the energy market.
- For a demand-side participant with a reserve contract which is exercised, there is no dispatch of plant involved and hence clause 3.15.6(b) has no effect. The participant therefore receives both the benefit of payment under the reserve contract, and relief from payment obligations in market settlement as a consequence of the exercise.

Given the very different settlement outcomes in these two alternatives, NEMMCO has no basis for a rational choice if both alternatives were offered.

The RP is urged to address this issue in their review and to introduce Rule changes where necessary.

5 The design of the EAAP (Energy Adequacy Assessment Projection)

We support the principle to deliver useful information regarding energy constraints to participants and interested parties. However this principle needs to be delivered in a manner where individual businesses can best use their business expertise and knowledge.

The provision of energy models to NEMMCO is not considered practical and as such is not supported. It would be intrusive and subject to NEMMCOs interpretation and assumptions of future behaviours and price projections. It would most likely to result inconsistencies between individual participants assumptions and NEMMCOs application in modelling outcomes.

The EAAP scheme should be kept as simple as possible and leverage knowledge and skills from both participants and NEMMCO.

NEMMCO should be tasked with the development of internally consistent scenarios and for participants to supply high level data for each of the scenarios.

This is likely to be a resource demanding task and therefore the scenarios should be small in number and participant input should be should not be required more frequently then quarterly.