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AEMC Reliability Panel Comprehensive Reliability Review – Interim Report March 2007

EnergyAustralia welcomes the opportunity to provide comments on the Australian Energy Market Commission (AEMC) Reliability Panel (the Panel) Interim Report on the Comprehensive Reliability Review (the Review).

EnergyAustralia is of the view that there is not sufficient evidence to support major reconstruction of the current market design, as proposed by the Panel in Group 3 of the possible options for amending the reliability mechanisms. EnergyAustralia recognises Group 2 options do have some merit, however at this time any adjustments or additions to the reliability settings and mechanisms, other than some incremental changes to the reserve trader, would not be supported by EnergyAustralia. The current market is still developing as new jurisdictions (for example Tasmania) join, and any issues should be considered in this context.

EnergyAustralia would not support increasing the Value of Lost Load (VoLL) from the current price cap level of $10,000/MWh unless there is conclusive evidence to support such a proposal. It is EnergyAustralia's opinion that the analysis to date on VoLL has been relatively narrow and incomplete. EnergyAustralia contends that the starting point of any analysis should be an assessment to determine what are the real drivers behind investment. If it can be established that the sole reason is the market cap, then the minimum or reasonable amount for a market cap that would deliver this new investment must be determined.

Partner

Since the price cap was increased from $5,000 to $10,000/MWh in April 2002 a myriad of new peaking plants have been announced, built and committed. This continues to be the case with the recent announcements by Origin Energy[1], Delta Electricity[2] and TruEnergy[3] for example. EnergyAustralia believes the current policy uncertainty of the Australian Government in respect of reducing greenhouse gas emissions is one of the main impediments to future investment in Australia's energy sector (especially base load generation). This could compromise timely generation investment required to meet the reliability standard in the future. This is of concern to EnergyAustralia.

Given that the current price cap level of $10,000/MWh seems to be sending sufficiently strong price signals to facilitate new generation, to increase this level higher (even to $12,500/MWh as modelled in the Interim Report) would only increase the risks faced by market participants and may translate into generally higher prices to end-use customers in order to manage this additional exposure. Also it is arguable whether regulators would permit retailers to factor this risk into future price determinations.

Further, increasing the level of VoLL would reduce a generator's ability and motivation to provide hedge cover as this would place the generator under heightened pressure to safeguard against unit outages. This poses a greater threat to retailers that these risks would be passed through in the form of force majeure or non-firm provisions in hedge contracts. Reducing the liquidity in the contract market will affect the ability of retailers to put hedge arrangements in place to manage their exposure to the spot market. The recent tightening of the supply and demand balance in the NEM and the need for medium to long term contract commitments for cessation of the NSW ETEF arrangements highlights the need and importance of a liquid contract market.

EnergyAustralia is of the view that the current level of VoLL is allowing generators to earn a fair return on investment, promoting liquid financial markets, and limiting exposure of market participants to high spot prices, while meeting the reliability standard.

EnergyAustralia supports the Panel's preliminary conclusion that the reliability settings have performed adequately to date, and that the current energy-only format of the NEM is largely delivering sufficient supply to cover demand. EnergyAustralia also supports the Panel's view that the current level and scope of the reliability standard, being unserved energy (USE) of no more than 0.002%, should be retained, and that the same standard should generally be applied to each NEM region.

EnergyAustralia believes a hybrid standard (such as loss of load probability – LOLP or loss of load expectation - LOLE in conjunction with USE) should be used to measure reliability in the NEM. Specifying the expectation in hours per year (over the long term, on average across the

[1] 120MW expansion in South Australia of Origin's Quarantine Power Station.
[2] Munmorah Power Station - 600MW of new capacity proposed for completion 2009-2010.
[3] Tallawarra – 400MW Combined Cycle Gas Turbine proposed for commissioning in 2008.

NEM) where there will be insufficient generation to meet all load in all parts of the NEM will, for example, increase transparency and provide valuable information about the likelihood of an interruption to customer supply. This information will also assist when planning to set margins for capacity required to off-set identified reserve deficiencies.

Given Sydney is a major financial centre for the Asia Pacific region there is scope for specifying a higher capacity reserve level in NSW to manage regional loss of load expectation than the rest of the NEM. This combined with the negative minimum reserve margin in NSW does put too much reliance on interconnecting transmission lines. EnergyAustralia however believes this is a jurisdictional issue and if there are additional costs to be borne they should be paid for by the consumers in the respective region.

The Panel's recommendation to make the current reliability standard more precise by quantifying it as 'over the long term' to mean ten years looking backwards, targeted to be achieved prospectively on an annual basis, NEM-wide and in each region is supported. EnergyAustralia believes this will make the reliability standard more transparent and precise.

The Panel's proposal to reflect regional differences in load profiles and plant mix by specifying the amount of demand (MW) or duration of interruption that is at risk at anytime in a particular region will be beneficial to market. Contracting any additional capacity required in a region to meet this standard as standby generation or demand side response that is bid into dispatch at VoLL with costs being recovered from consumers within that region is supported by EnergyAustralia.

Regulatory uncertainty is a major barrier to long term investment in the market (in particular investment in base load generation). To increase certainty for potential investors and consumers the current annual review of VoLL should be replaced by a comprehensive and holistic review of all the reliability settings (as proposed by the Panel). EnergyAustralia supports the Panel's proposed review period of three to five years, however a review outside the normal cycle (triggered by events such as a certain number of breaches, entrant of new regions, significant load shedding events etc) has merit and may help in making the reliability provisions more efficient and effective. Post review, any changes should have a minimal grace period for implementation of two to three years to allow participants the opportunity to adjust their positions, systems and processes. Ultimately however this should be determined by the nature of the change, its urgency, or the impact the change has on the market.

EnergyAustralia supports the Panel's preliminary conclusion not to raise the level of the Cumulative Price Threshold (CPT) based on the financial risk such a change would impose on market participants. Despite the existence of episodes of extreme market events, since its introduction, the CPT period average pool price has remained well below the threshold trigger (even given the recent extreme events in Victoria on 16 January 2007 which resulted in a rolling seven-day price of only ~$91k). EnergyAustralia is still of the opinion that the current level of CPT cuts in too late and therefore the threshold does not remain faithful to its principle of offering

protection in extreme system stress. Based on evidence and history[4] EnergyAustralia believes a reduction in the CPT from $150k to approximately $100k to $120k would also be justified.

EnergyAustralia is of the view that the reserve trader should be redesigned as an emergency reserve trader. The proposal to retain it for a five year sunset period, with a review of its operations after three years as part of the general review of the reliability settings, is supported. However, EnergyAustralia believes the review process in the Rules should permit an annual review of the emergency reserve trader in certain instances (for example if the reserve trader fails).

EnergyAustralia accepts that there are problems with the reserve trader in that the reserve trader is regularly invoked but not often required. The nature and extent of intervention through the reserve trader can affect participants' financial risks and stakeholder perceptions of market performance. The intervention by the National Electricity Market Management Company (NEMMCO) in the South Australian (SA) and Victorian (Vic) markets in 2004/05 and 2005/06 summers through its reserve trader activities should be investigated to understand why this occurred and whether or not there are sufficient forward signals to ensure that constraints are ameliorated in a timely manner and at minimal cost.

The other issue is that, given the short period for the reserve trader to put arrangements in place there is little capacity short of demand side response that can be signed up. This means that if the reserve trader really does need some additional capacity there will not be enough time to get it in place. Given our view is that it is greenhouse policy uncertainty that is holding generation investment back EnergyAustralia does not propose significant changes to reserve trader to address low reserve levels going forward. Given this policy uncertainty, this issue should be addressed in the next few years.

EnergyAustralia recognises that forecasting will be a continuing challenge for NEMMCO, especially as non-scheduled generation such as wind farms continue to increase in the NEM. EnergyAustralia believes having the Panel monitor the accuracy of NEMMCO's most recent Statement of Opportunities (SOO) demand forecast and any improvements in the forecasting process that will be used in the preparation of subsequent SOOs will increase stakeholder confidence in NEMMCO's processes. The Panel's request to have NEMMCO conduct a review of the level of short term reserve that should be used in the short term Projected Assessment of System Adequacy (PASA) is also appropriate.

EnergyAustralia's view is that contracting for standing reserve on a continual basis should not be required and would lead to excess overlapping reserve in the NEM. Currently, portfolio generators generally hold reserve to manage plant outages and retailers generally hold reserve

[4] As noted in the AEMC Annual Electricity Market Performance Review Reliability & Security 2005 Final Report the weekly cumulative price period in NSW late November, early December 2004 reached its highest ever level of $125,000, which in our opinion is still some way (17%) off administered pricing commencing.

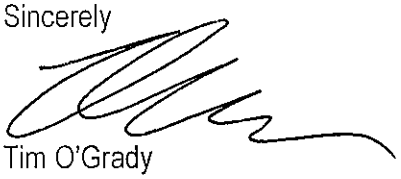
capacity in the form of option contracts to manage portfolio load variability from average customer demand. Given the market has been structured to provide market responses to capacity requirements we do not support this centralised generation planning initiative.

Any issues regarding insufficient capacity in the market are not necessarily due to deficiencies in the market itself but in the wider environment. For example the lack of certainty around the regulation and pricing of carbon must be addressed to enable investment in generation capacity.

The impact of the setting of the NEM spot price, in a region during times of network constraints when there is significant capacity not dispatched would be unnecessary financial risk for market participants. Such occurrences also result in inappropriate signalling for the need to invest in generation within a region which would benefit from additional network investment. Efficient investment in, and operation of, the transmission network would improve the reliability of the bulk system and would enhance competition in the NEM.

Should you have any questions in relation to this submission please contact me on (02) 9269 4911 or Philip Dixon-Flint, Regulatory Strategy Manager, on (02) 9269 2317.

Sincerely



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