Department of Primary Industries

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Mr John Pierce
Chairman
Australian Energy Market Commission
PO Box A2449
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Dear Mr Pierce,

RELIABILITY SETTINGS FROM 1 JULY 2012.

The Victorian Department of Primary Industries (DPI), as the portfolio agency responsible for energy policy in Victoria makes the following submission in relation to the Rule Change Proposal, Reliability Settings from 1 July 2012 submitted by the Australian Energy Market Commission (AEMC) Reliability Panel.

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.

The key features of the proposed Rule Change are:

- from 1 July 2012 indexation of the current values of the Market Price Cap (MPC) and the Cumulative Price Threshold (CPT) based on the Intermediate (Stage 2) Producer Price Index (PPI);
- an annual review to determine whether indexation of the MPC and CPT to the PPI is still appropriate having regard to how the indexed MPC and CPT have impacted on spot prices, investment in the NEM and the reliability of the power system;
- subject to the outcome of the annual review, the MPC and CPT would continue to be indexed in the proposed manner indefinitely;
- the requirement for biennial reviews of the Reliability Standard and Reliability Settings be removed;
- the AEMC would be able to request that the Reliability Panel conduct a more detailed analysis of some or all of the Reliability Standards and Settings at any time.

Whilst the annual indexation of the values of both the MPC and CPT is appropriate, DPI has concerns regarding the proposed removal of the requirement for biennial reviews of the Reliability Standard and Reliability Settings. For the reasons outlined below, DPI considers that the removal of this requirement is contrary to the National Electricity Objective as set out in section 7 of the National Electricity Law.

DPI notes that the fundamental assumption that underlies this proposed Rule Change and the removal of the requirement for biennial reviews is that the current values of both the MPC and CPT (indexed to the PPI) will support sufficient investment to achieve the Reliability Standard on an ongoing basis.

DPI is concerned that reasons advanced for maintaining the current values of the MPC and CPT advanced in the Reliability Panel's Final Report on the *Reliability Standard and Reliability Settings Review* published on 30 April 2010 and in the Panel's Rule Change proposal are not sufficiently robust to justify this conclusion.

The Review characterised the Reliability Standard as "the minimum acceptable level of bulk electricity supply delivered to consumers in a region..." but 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 rather than delivering the level of reliability of electricity supply expected by consumers.

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 a disruptions top 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 itself, it does argue for setting the MPC and CPT with a view to delivering more, rather than less capacity.

In addition, it provides a strong argument for not accepting the validity of the Reliability Panel's comparison of the current value of the MPC of $12,500 MWh with the estimated Value of Customer Reliability of $13,250 MWh for the residential sector in Victoria. Given the potential widespread impacts of bulk supply shortfalls, setting the MPC 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 significantly under values the impacts of these shortfalls on the community as a whole.

The decision of the Reliability Panel to index the current MPC 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 <u>minimum</u> acceptable level of bulk electricity supply reliability.

Moreover, the Reliability Panel's decisions in relation to the values of both the MPC and CPT are inconsistent with:

- the results of the modelling undertaken by ROAM Consulting which demonstrates a prima facie case for an increase in the MPC to at least $16,000 MWh from July 2012 and an increase in the CPT to $240,000; and
- an independent review of the modelling undertaken by Dr E.G Read which suggests that the truncation of potential MPC events by the CPT means that the theoretical MPC should be far higher than $16,000 MWH.

In rejecting the results of the modelling the Reliability Panel advances three arguments:

- That sufficient investment in new generation capacity is taking place in all regions of the National Electricity Market to meet the Reliability Standard. The 2010 AEMO Statement of Opportunities for the National Electricity Market (NEM) shows that Queensland is the only NEM region requiring new generation capacity within the next five years. On a prima facie basis this appears to support the Reliability Panel's contention that sufficient new capacity is becoming available to meet the Reliability Standard at the current levels of the MPC and CPT, but the current outlook for new investment is less supporting. Over the ten year period to 2019/20 AEMO could identify only a further 1,400 MW of firmly committed new generation projects or less than one years growth in peak demand across the NEM. While it is likely that additional investment in new generation will take place over this period, the current investment outlook gives no assurance that sufficient new generation will come forward on a sustained basis to ensure that the Reliability Standard will be consistently met in all regions of the NEM.

- That the ROAM modelling may not accurately estimate patterns of investment in new generation capacity because it assumes that the trigger for new investment is spot market prices in the NEM. The argument put forward by the Reliability Panel is that investment in the NEM is driven by a number of factors, including contract prices, forecast demand growth, and the cost and availability of project prices. While the forward contract price may be expected to correlate with the forward spot market price, uncertainty over forecasts and regulatory stability may mean that spot and contract prices are not well correlated. While there will be some divergence between spot and contract prices there is a strong case that over time there will be a strong and consistent correlation. If this were not the case there would be ongoing opportunities for market participants to exploit the divergence between spot and contract prices. As the report provides no analysis of how any divergence between spot and contract prices might allow the Reliability Standard to be consistently achieved with a lower MPC and CPT than the ROAM modelling suggests, it provides no support for the Panel's decision to maintain the MPC and CPT at current levels.
- That the increased market volatility associated with a higher MPC and CPT may lead to an increase in costs and risks for market participants which will of itself reduce the level of new investment and compromise the ability of NEM regions to consistently meet the Reliability Standard, rather than incentivise additional investment in new generation. While this is a theoretical outcome the Report provides no evidence or analysis to support its assertion that this is a material risk.

On this basis the Reliability Panel has not put forward a case that is sufficiently robust to support this Rule Change because it has failed to demonstrate that the current levels of the MPC and CPT will consistently deliver the Reliability Standard in all NEM regions.

In addition, the Report fails to convincingly demonstrate that the modelling undertaken by ROAM Consulting in relation to the levels of the MPC and CPT is incorrect.

DPI analysis against the National Electricity Objective

DPI notes the Panel's view that the removal of the requirement for a biennial review would create more regulatory certainty and is therefore likely to promote more efficient investment.

DPI considers that the removal of a requirement for a thorough and transparent biennial review will merely serve to embed the existing MPC and CPT. Given the significant impact of the Reliability Settings and Standards on security of supply it is critical that there remains a structured and consultative process for their regular review. Indeed, this is particularly important given the existing concerns around the adequacy of the current settings which have been set out above.

DPI would also note that the NEM is facing significant challenges at present, including those introduced by the global financial crisis, a tightening supply/demand balance and the need to respond to climate change. These challenges, including in particular the uncertainties associated with climate change policies, are already having a dampening impact on investment in the generation sector.

In view of this, DPI believes that it would be unwise to remove the requirement for a regular review of the Reliability Standards and Settings at this critical time. To do so, would not be prudent and would represent a departure from the aims of the National Electricity Objective. As such, whilst the removal of the biennial review requirement may provide some short term gains in terms of regulatory certainty, the long term risks to security of supply, in the current market environment significantly outweigh any such benefits.

DPI also notes the view of the Panel that the rule change will enhance transparency. DPI does not understand how the removal of a requirement for a consultative biennial review would enhance transparency. Indeed, it would reduce the amount of information available to the market surrounding the factors that are used to underpin the Reliability Standards and Settings. This can only be contrary to the interests of transparency.

It is therefore proposed that the AEMC reject the proposed Rule Change and direct the Reliability Panel report on:

- an appropriate transition mechanism through which the value of the MPC and CPT can be increased in real terms to levels consistent with those indicated by the ROAM Consulting modelling; and
- a future approach to reviewing the appropriateness of the real levels of both the MPC and CPT on a periodic basis. At the very least this should include retaining the requirement for a biennial review of the Reliability Standard and Reliability Settings.

Yours sincerely,

Peter Naughton

Peter Naughton
Executive Director
Energy Sector Development Division

8/12/2010