31 March 2010

Dr John Tamblyn
Mr Neville Henderson
Mr Ian Woodward
Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

Dear Commissioners,

Review of Effectiveness of NEM Security and Reliability Arrangements in light of Extreme Weather Events

Loy Yang Marketing Management Company welcomes the opportunity to make a submission in response to the Australian Energy Market Commission's Review of Effectiveness of NEM Security and Reliability Arrangements in light of Extreme Weather Events.

We continue to support the Australian Energy Market Commission's ongoing work and note the difficulty, complexity and stakeholder interest in reliability and security in the National Electricity Market and commend the Australian Energy Market Commission on its continued engagement of market participants. An analysis of the implications of whole of power system security and reliability and the use of reliability forecasting and information appears timely.

While we appreciate the Australian Energy Market Commission's stakeholder engagement, we are concerned that the recommendations the Australian Energy Market Commission may be minded to make in its Final Report have not been fully justified. As it stands we have concerns in relation to: the abandonment of the 10-year rolling average measurement of unserved energy; the proposal for a 10-year Market Price Cap trajectory; a change to the process for establishing reliability parameters; removal of Reliability Settings from within the National Electricity Rules; and the establishment of different settings for each jurisdiction.

Our submission outlines our concerns in relation to these proposals and we look forward to your consideration of these matters in the Final Report.

We would also like to take this opportunity to suggest, given the late engagement of stakeholders and market participants, there may be value in the Australian Energy Market Commission considering the use of additional engagement processes prior to the conclusion of the Final Report.

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

Yours faithfully,

Jamie Lowe
Manager, Regulation and Market Development

Submission to Consultation Paper –

Review of Effectiveness of NEM Security and Reliability Arrangements in light of Extreme Weather Events

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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.

Discussion

The Australian Energy Market Commission (AEMC) Consultation Paper addressed the following key areas:

1. whole of power system security and reliability;
2. reliability standard and settings;
3. technical standards and issues;
4. governance arrangements for policy decision making on the reliability standard and settings; and
5. demand and capacity forecasting and information.

Each of these issues is addressed below.

1. Whole of power system security and reliability

The AEMC raised two general issues being:

- the inter-relationships between the investment regimes for each stage of the electricity supply chain, and mechanisms that may improve consistency or linkages to enable end user reliability to be supplied more efficiently; and
- the impact of modifying the reliability standard at one stage of the supply chain on investment at other stages of the supply chain.

Discussion

The interrelationship between the different parts of the supply chain is complex and there exists potential for decisions in one part of the power system to undermine outcomes in another. This is particularly the case with respect to the interaction of the regulated and unregulated sectors.

On this basis, we believe not enough attention has been given to the effect regulatory investment decisions in transmission have on the operational climate for generators. Generation, underpinned by retail competition, is at the forefront of efficiency gains in the NEM, with its substantial benefits for customers.

However, the impetus to produce efficient outcomes is hampered if regulated investment in transmission, and to some extent distribution, does not create the appropriate operational climate for generation. This raises two related issues:

- consistent management and application of the differing standards in transmission and distribution across the regions; and

- investment in assets and augmentations, especially transmission, as overseen by the regulator.

First, given our base load generator interests, LYMMCo operational decisions can be significantly impacted, and our financial position irrevocably damaged, if the level of reliability in distribution supply or transmission limited the plants ability to provide fuel or access the market.

While LYMMCo accepts the reasoning for different standards across the regions, we our particularly interested in ensuring the standards of distribution supply and transmission access are maintained to a level that ensures the reliable delivery of the product we trade to the market. If the documented standard at the time of connection is not, at least in the planning domain maintained, it provides us with no operational certainty and undermines our existing investment. This disincentive also undermines new investment generally.

This issue extends to the investment in network assets and augmentations. This means ensuring forward transmission investment supports new generation investment and meets the needs of existing generators who rely upon the transmission system being maintained in order to effectively compete for market share.

As it currently stands the incentives for distribution and transmission networks to meet clearly defined service standards and the capacity for regulatory investment to take account of the generation investment climate is mixed. Furthermore, the operation of the National Electricity Rules (NER) in this area remains unclear.

2. Reliability Standard and Settings

The AEMC raised the following issues:

- Market Price Cap (MPC) in the context of extreme weather;
- investment certainty from the MPC and the use of a 10-year trajectory;
- wider implications of raising the MPC; and
- differences in jurisdictional expectations and a proposal to have different reliability settings in each region.

<u>Reliability settings in the context of extreme weather and wider market risks</u>

Given the debate caused by modelling undertaken as part of the Reliability Panel's Reliability Standard and Settings Review, we are concerned how the ROAM Consulting modelling undertaken as part of the Review may be used by the AEMC or other parties to justify change that is not in the interests of market participants or consumers.

This is particularly relevant given the modelling may be heavily reliant on assumptions regarding increasing extreme weather events, which naturally will be less extreme by virtue of their increased prevalence and consumers expectations in such an environment; which is an environment which may never eventuate.

Additionally, raising MPC raises a number of wider market risks as outlined below.

- 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, severely impact NEM sustainability and deter investment, especially base load.

- 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, and to market stability.

- Prudential obligations may inhibit retail competition - Prudential requirements on market participants will increase as a consequence of an increase in reliability settings and 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. This will increase barriers to entry especially for small retailers who play an important role in 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 spectre of another series of setting changes outside of the normal accepted process can only add to growing market unease at regulatory developments. Both developments increase the complexity of hedging price risk.

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

Given the AEMC has not expressed a perspective on market risks in the context of the interaction of the MPC and extreme weather events, we are apprehensive about the Final Report advancing recommendations on the level of MPC required to meet reliability in the face of more frequent extreme weather events.

Investment certainty from the MPC

LYMMCo agrees that:

- the current process for establishing reliability parameters creates uncertainty;

- the current two-yearly reviews may not be the best way to proceed with future reliability parameter decisions; and

- there is an absence of information on likely reliability setting trajectories.

However, this does not necessarily lead us to conclude that alternatives arrangements would be more appropriate as opposed to creating uncertainties and inconsistencies of their own.

As it currently stands, assuming that reliability setting changes will be rare provides some certainty when undertaking market activities with the biggest singular risk being that when a change occurs it may be unexpected or beyond the expectations that have developed prior to and during any known review process. Therefore, it is in this context that a 10-year trajectory for the MPC must be considered.

We agree that such a proposal could be informative; however, we are particularly concerned that:

- a formal trajectory will be ultimately flawed leading to an over- or underestimation of the appropriate level of the MPC required in outgoing years (developing demand growth, fuel costs, and capital costs assumptions for the purpose of modelling will be very challenging);

- the need to continually revise a formal trajectory will ultimately add additional uncertainty and politicisation to the reliability parameter decision-making framework;

- a formal trajectory is likely to have implications for the contract market which may result in corrections when that trajectory is adjusted, which creates a new form of market risk (which would be difficult to price);

- this increased uncertainty may ultimately reduce willingness of some participants to enter into longer contracts; and

- it is highly likely, especially when considered in the context of previous modelling exercises concerning the NEM, that the results will be volatile over time which will further undermine the benefit of a 10-year MPC trajectory.

An alternative option is that a trajectory not be used as a formal tool to set price rises and not be used to identify single values.

We propose that a 10-year MPC trajectory be used to identify the possible range of reliability settings based on a range of scenarios and be developed by an independent modelling house. In that regard, the 10-year trajectory would have no formal status in the NER and not be endorsed by the AEMC, the MCE or the Reliability Panel and be removed from the formal reliability parameter settings process.

This may be a more pragmatic and useful exercise as it allows market participants and stakeholders to review the modelling in the context of their own forward expectations across a range of scenarios. It also recognises the fact that investors are not going to invest on the basis of a 10-year trajectory alone and therefore the perceived value of a formal 10-year trajectory may be overstated.

Differences in jurisdictional expectations

We note that within the Second Interim Report the AEMC identified the possibility of establishing separate reliability settings for each region and outlined a series of narrow economic efficiencies associated with this proposal.

Our initial reaction was significant concern, as the proposal undermines the viability of the NEM and politicises reliability settings in an unacceptable manner. Our concern was somewhat eased as the AEMC indicated that overall this outcome may be economically inefficient. However, we believe the AEMC needs to draw greater attention to the inappropriateness of these types of ideas and the degree to which they create significant concern amongst market participants.

Reliability Standard

In regards to the reliability standard, we remain comfortable with the 0.002% measure of unserved energy as appropriate for a future with or without additional extreme weather events, noting that this measure has worked well during past extreme weather events.

As noted in our submission to the Reliability Panel's Reliability Standard and Settings Review we agree that there is 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 do not support a move to an annual measure and remain concerned that the abandonment of the existing measure may be counter-productive by giving increased emphasis to breaches of the reliability standard.

We recommend the AEMC consider:

- maintaining the existing 10-year rolling average and annual measures;
- supplementing existing measures with an additional 5-year rolling average;
- introducing measures which translate outages into expected frequency and duration of events;
- implementing additional statistical measures to assess whether annual unserved energy outcomes are within an acceptable statistical range; and
- in extreme circumstances undertaking further dedicated analysis.

We believe these additional tools would provide a more appropriate and informed measure than abandonment of the 10-year average in favour of an annual measure of unserved energy alone.

We would also like to respond to the unsettling comment regarding increasing the MPC to represent the value customers place on reliability; which we suggest implies the value previously developed by VENCorp in Victoria.

Some stakeholders continue to assume that a large increase in MPC will drive significant generation investment and increase reliability. This narrow view provides an ongoing distraction which bypasses experience showing that the bulk of reliability failures occur within the distribution system, and therefore

improving distribution and transmission performance, and not increasing the MPC or the Reliability Standard, would be of greatest value to customer reliability. That narrow view also fails to consider the risk implications of changes to MPC or the Reliability Standard which have been dealt with elsewhere in this submission.

3. Technical standards and issues

The AEMC raised the issue of technical standards in the context of extreme weather events.

LYMMCo does not consider technical standards to be a significant driver of reliability and therefore it is not immediately apparent how technical standards and extreme weather events interact. We suggest technical standards are more concerned with issues of security of supply and quality of supply.

Nevertheless, we support the AEMC proposal that the interaction of technical standards and extreme weather should be addressed as part of technical standards review.

4. **Governance arrangements**

The AEMC provides three options for change. One of those options is not a defence of the status quo. We assume this to be an oversight given the absence of a demonstrated case for change.

<u>MCE Policy input</u>

LYMMCo has not been advised of any specific desire for the MCE to have a greater degree of policy input in relation to reliability parameter decisions. We understand how this may be the case and agree that a high-level MCE Statement of Policy Principle is one possible avenue for the MCE to provide policy input. However, we note that the MCE already has the capacity to submit a rule change directly or make a submission to the Reliability Panel as part of the Reliability Standard and Settings Review. The MCE's reluctance to do so should not necessarily be conceived as a failing in the current process.

Nevertheless, if it considered desirable to formalise MCE policy input through a MCE Statement of Policy Principles, which has legal obligations under the NEL, our support for use of such an instrument is contingent on it not including actual proposed Reliability Settings, but general high-level guidance on community expectations.

We are comfortable with the use of such an instrument in the context of the status quo or option 1.

We are not comfortable with the use of such an instrument within option 2.

<u>Location of reliability policy parameters</u>

The rationale for placing the Reliability Standard and Settings outside the NER appears to be based on a number of flawed assumptions. These are discussed below.

The first flawed assumption appears to be that market participants are likely to continually lodge reliability parameter rule changes, thereby heightening uncertainty. We do not believe that frequent requests for change have been a feature of the current process to date. In reality, and as seen during the recent Reliability Panel Reliability Standard and Settings Review, market participants and customers are, on balance, particularly conservative about reliability parameter changes. This is the case for generators whom an outside observer may generally expect would intuitively desire higher prices, when in actual fact many generators vigorously oppose higher prices.

Second, that the AEMC will be powerless to knock back a lodged reliability parameter rule change even if it is not in the markets interest. The AEMC has the power to knock back a rule change proposal that it considers is misconceived. Hence, the AEMC rationale for change appears misguided and fails to highlight the strength of the AEMC's current rule-making powers.

Therefore, while it is true to suggest that locating reliability parameters in the NER means they could be subject to more frequent requests for change (which we believe is unlikely in any case), it does not mean they will be subject to more changes.

A benefit of the current system is that if the Reliability Settings at a level which created significant dissatisfaction amongst a wide group of market participants and stakeholders one could expect a rule change request from industry. If such a request received widespread support backed by robust arguments consistent with the NEO it would need to be considered by the AEMC. We do not consider elimination of

such an outcome as beneficial to industry and suggest in its current form it promotes accountability and transparency.

Therefore, if the process for establishing the Reliability Standard and Settings is robust, not subject to external political interference, is conducted in accordance with the NEO, appropriately weights stakeholder submissions and customer needs, and provides justifiable evidence based outcomes, then it should ultimately be of little consequence whether both instruments are located in the NER. On that basis, we support the retention of the reliability parameters in their current form.

Decision maker

LYMMCo remains comfortable with the Reliability Panel establishing the Reliability Standard. The most notable benefit of option 1 is the limited appeal of administrative consistency. While we can see the bureaucratic attraction, we do not necessarily see any practical value in supporting this change. We suggest the AEMC needs to make a stronger case for change from the status quo to option 1.

As for option 2 and option 3, we do not support the AEMC conducting the Reliability Standard and Settings Review in place of the Reliability Panel. The Reliability Panel contains significant industry expertise and contains representatives from across the industry and stakeholder groups. Through this model LYMMCo feels more confident that our highly technical and commercial concerns will be understood in the development of reliability parameter recommendations. We do not consider this a conflict of interest given the wide range of perspectives on the Reliability Panel and we are confident that any process can only benefit from the expertise and consistency of the Reliability Panel.

Decision mechanism

We remain comfortable with the status quo or option 1 should case for change be established. We do not support moving to any model which requires, as standard procedure, any body other than the Reliability Panel lodging reliability parameter rule changes.

Furthermore, if the Reliability Panel does not play a fundamental role in developing reliability parameter recommendations we believe the role of the MCE should remain as is. The potential interplay between an MCE Statement of Policy Principles, an MCE directed AEMC review, and an MCE-initiated rule change would be problematic and undermine the independence and integrity of the process.

Should the MCE wish to initiate specific rule changes it is able to do so in the context of the existing process and we believe this unlikely step would be more transparent that reducing overall accountability so as to enable the MCE to exert greater influence over reliability parameter decisions.

The politicisation of the process for establishing the reliability parameters is an ongoing concern. We are not convinced that option 2 and 3 do not move us towards a position where political pressure or untested ideas generated within government departments could override economic efficiency and the NEO.

Other input

We do not accept any proposition that the review process will be as robust if the role of the Reliability Panel is relegated to only providing submissions to the AEMC.

The current arrangements, whereby the AEMC sets the terms of reference for the Reliability Panel, and the MCE can make a submission should it wish is adequate.

LYMMCo preferred model

These proposals cause us concern and we do not believe the AEMC has made an adequate case for change. Additionally, we do not believe that the options proposed by the AEMC, especially option 2 and 3, provide any additional benefit to market participants or end use customers.

Nevertheless, this does not mean the status quo cannot be improved. We see two broad areas of interest: (1) MCE policy input; and (2) timing of reviews.

We consider that a MCE Statement of Policy Principles, delivered in high-level terms may provide a useful outline of customer expectations. We see this as a pragmatic method of establishing a formal mechanism for MCE policy input and could support its use to enhance the current process for reliability parameter decisions.

As it concerns timing of reviews, we are concerned the current two-yearly schedule is not necessarily appropriate. We suggest this timeframe does not allow for the impacts of previous changes to be evaluated. And we suggest change of such regularity creates uncertainty amongst market participants, especially amongst those businesses who face not only potential benefits but greater risk exposure from changes in reliability settings (i.e. base load generators, integrated businesses and large customers) as opposed to those who will only be exposed to upside from increases in the MPC. As such a longer timeframe, for instance four years, may be more appropriate; however, further analysis is required.

5. Reliability Forecasting and Information

We support further work to produce consistent and accurate reliability forecasting and information. However, we remain concerned at the overly conservative history of forecasts prepared by AEMO and the information obligations placed upon market participants.

We also suggest that the accuracy issues associated with these forecasts mean that they provide useful indicators but are not robust enough to justify market intervention and do not provide market participants with an authoritative signal for new investment.

Conclusions

On balance, we believe the consultation paper has failed to justify the proposed changes and raises a number of concerns that require further consideration by the AEMC.

Given these concerns we encourage the AEMC to consider further engagement with market participants prior to the development of its Final Report.

Contact Details

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