

17 September 2010

Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

Dear Mr Pierce,

AEMC RERT Review

The NGF and ERAA are pleased to provide comment on the Reliability Panel's *Review of the Reliability and Emergency Reserve Trader (RERT) Issues Paper*, as released on 3 August 2010.

This submission covers five key areas:

- the reasons why the NGF and ERAA oppose the retention of the RERT
- a response to the issues raised by the Reliability Panel
- a response to the specific questions posed in the Reliability Panel's issues paper
- a discussion of why the RERT is inconsistent with the achievement of the National Electricity Objective, and
- some suggestions for making marginal improvements to the RERT if the Reliability Panel decides to retain a reserve procurement mechanism.

This submission has the full support of the industry associations representing the generation and retail sectors. We would be disappointed if the Reserve Panel did not take account of the industry's unanimous opposition to the RERT mechanism when considering whether to terminate the current reserve arrangements.

1 NGF and ERAA position

The NGF and ERAA oppose the retention of the RERT for the following reasons:

1.1 It is not needed

The RERT (and previously the Reserve Trader) has not increased the actual supply reliability in 10 years, making a case that this change is required rather doubtful. Although AEMO have contracted load under the Reserve Trader provisions, it has never been dispatched. Despite the lack of use of the Reserve Trader, the market has consistently achieved the reliability target of 0.002% of unserved energy. Over the period 1999-2000 to 2008-09 the average USE was zero or near zero in all regions – Queensland (0%), NSW (0%), Victoria (0.00044%), South Australia (0.00051%) and Tasmania (0%). In Victoria and South Australia USE for 2008-09 was above 0.002%. AEMO estimated that the conditions that lead to the 2008-09 load shedding event as a 1 in 20 year event. As the NEM is planned to meet 1 in 10 year extreme demand events, some load shedding during 1 in 20 year extreme events is not unexpected.

The Reliability Panel observes that there is ongoing uncertainty regarding the external regulatory policies such as the Australian Government proposed introduction of a price on carbon. We note that in November 2009, the AEMC wrote to the Department of Climate Change¹ expressing limited concerns over possible reserve shortfalls as a result of the implementation of the RET and CPRS:

“... the AEMC strongly supports the principles of allowing energy markets to operate without distortion as the primary means of protecting the interests of customers in the long term in respect of reliability, security and price. ... The AEMC has recently completed an extensive review of energy market frameworks, and their ability to support efficient transition in the light of CPRS and expanded Renewable Energy Target. Importantly, while we identified a small number of incremental improvements, our broad finding was that current frameworks are capable of supporting an efficient transition.”

The Government’s CPRS Electricity Sector Adjustment Scheme was designed to support ongoing energy security, without impeding a transition to a lower carbon electricity generation sector.

ESAS assistance is conditional on the recipient complying with the ‘power system reliability test’. This test can be met in three ways:

- The generator maintains its capacity at the same level as at 3 June 2007. The capacity must remain available to generate in the event it is required to do so for system security reasons by the market operator. The test does not require the generator to produce any particular amount of electricity – for example, the provision of ESAS does not require a generator to maintain its pre-CPRS level of output.
- The generator withdraws some capacity, but receives certification from the relevant market operator that this will not be likely to cause a breach of power system reliability standards.
- The generator withdraws some capacity, but replaces it with less emissions-intensive capacity, under the Low Emissions Transition Incentive. New investment that is eligible for Low Emissions Transition Incentive will be required to have an emissions intensity less than current best practice coal-fired generating capacity in Australia.

If the Reliability Panel is concerned by the possible closure of large scale baseload plant in the near term, the size of this event will dwarf any capacity which AEMO will be able to procure under the long-, medium- and short-term RERT mechanisms.

The real test of the need to retain or remove the RERT mechanism is to look at the projections for the demand-supply balance over the short to medium term. In the ESOO released recently, the forecast level of unserved energy is less than 0.0001%² for the next two years. This is at a level some 20 times the Reliability target. What is even more remarkable is that even under a scenario with the removal of 995MW from the NEM, the level of USE forecast for the NEM is materially the same.

AEMO also have very extensive powers to direct participants when system security is at risk. These powers can be used to address shortfalls as a last resort and have the potential to have a much greater impact than a RERT at the time of the problem.

¹ AEMC letter to Martin Parkinson, DCC 23 November December 2009

² AEMO 2010 Power System Adequacy Executive Brochure page 5

We also note that the Panel recently reviewed the Reliability Settings to Implement the Reliability Standard. The Panel recommended retaining the current market price cap from 1 July 2012. After considering various modelling and industry input, the Panel formed the view that the current settings would deliver reliability levels in each region that were within the USE target.

AEMO (NEMMCO) has only ever contracted dedicated reserves twice in the past 12 years. While this has imposed costs on retailers and end-use customers, it has not contributed a single MWh to the reliability of the NEM.

1.2 Poor policy to develop a sub-market for reserve

We recognise that there is scope for the more active involvement of small generators and some loads in the NEM. Possible barriers to entry for small generators and demand side participants include compliance and registration costs and high technical requirements. Non-registered participants, although small, may collectively make a reasonable impact at times of high demand and stress in the market.

The AEMC has a clear market design choice. By keeping the RERT, it is continuing to marginalise the activities of these non-active participants into a reserve market. We believe that efforts should be directed at encouraging these participants to take part in the main market, not a separate reserve market.

We note that the AEMC recently finalised its Review into Demand-side Participation in the NEM (December 2009). AEMO is also reviewing the Small Generator Framework Design looking at the technical requirements for registering and metering non-scheduled generators. We believe that efforts should be made to overcome any inefficient hurdles to market entry directly not indirectly through other regulatory measures. Sharper and more accurate supply and demand signals would encourage participants to enter into commercial contracts that have the secondary effect of improving NEM reliability.

The RERT Guidelines require AEMO to satisfy itself that any contracted participants would not otherwise be available to the market. This is a very difficult assessment for AEMO to make. It is possible that the participants who contracted for the RERT in the past would actually have been active in the market. Timing is an important issue here. Load aggregators and large loads may prefer to contract with AEMO under the RERT mechanisms because they perceive that they will achieve better terms and conditions than if they contracted at a later time with retailers. It is a difficult task for the market operator to second guess the incentives of retailers and customers to agree some form of load varying contracts. The RERT mechanism as currently designed is likely to encourage some crowding-out of private contracting activity.

We believe that the RERT long, medium and short term mechanisms represent a very administrative, limited and distortionary way to involve market participants in the NEM and are likely to block innovation in the contract market. The RERT is effectively mandating the negotiation of contracts between participants and blunting the market signals for generators, retailers and customers to enter into commercially negotiated contracts. Efficiency will be maximised by allowing these participants to make contracting decisions at their discretion in their own best interest.

1.3 Inconsistency in the implied value of achieving a secure operating state

The Reliability Panel should recommend terminating the RERT as it currently creates an inconsistency within the Rules. This inconsistency relates to the implied value of achieving a *secure operating state*.

Rule 3.8.1(c) requires AEMO to establish procedures to relax constraints to resolve infeasible dispatch solutions in order to determine prices. This implicitly accepts that dispatch at times will not comply with security constraints. In other words load shedding will not be used to avoid a risk of load shedding.

This Rule sets a value of achieving a *secure operating state* that is less than the value attributed to load shedding, namely the market price cap.

In contrast, the RERT allows contracted reserves under the RERT to be used to address a power system security event, in other words these reserves may be used to achieve a *secure operating state*.

The primary effect of the RERT is to provide a role for services that could be in the market, but choose not to deal with the difficulties and costs of market entry given revenue available as restricted by the *market price cap*. Thus the application of reserves acquired under the RERT implies a willingness to pay more than the *market price cap*.

The proposed Rule would thus introduce an inconsistency, with the achievement of a *secure operating state* valued in one context at up to the *market price cap*, but under the RERT, valued at above the *market price cap*. This is a symptom of the separate reserve market which is in danger of developing under the RERT provisions.

We note that the most common departures from a *secure operating state* involve a risk that some load shedding will become necessary in the unlikely event that a critical contingency event occurs. Thus from the perspective of the customers, who are faced with the cost of market intervention, the actual value of achieving a *secure operating state* is, in most cases, very much lower than the market price cap.

We submit that a consistent approach to the important issue of system security is required under the National Electricity Objective, and that the Reliability Panel should give consideration to this important issue in its assessment of the retention of the RERT.

2 Issues raised by the Reliability Panel

In the paper the Reliability Panel raised three issues. The NGF and ERAA response is outlined below.

2.1 External and policy regulatory factors

The Panel notes that there may be some reluctance from investors to commit to agree commercial contracts as a result of regulatory uncertainty. The 2010 ESOO shows the market is working well with a significant volume of non-wind investment announced even after several years of carbon uncertainty.

In relation to the RERT, if this is a problem, the volume of capacity available that AEMO could reasonably recruit from the demand side at short notice may not be sufficient to address this issue.

2.2 Uptake of Demand Side Participation

The Reliability Panel note the relatively minor uptake of demand side management. The NGF believes that this fails to recognise the development of loads which are exposed to spot reducing their load at times of high prices. A customer can unilaterally reduce its load below its contracted volume to take advantage of high spot prices. This does not require it to be registered or provide any bids and is a very straightforward way for it to take part in the market.

The nature of this involvement is very hard to measure but, anecdotally, it appears to be a growing way for customers to be involved in the market.

2.3 Other factors – extreme weather

The Reliability Panel note the AEMC's recommendations in its report on extreme weather events. This report noted that only 10% of customer interruptions come from transmission or generation. Within the 10%, 12% are due to reliability (reserve capacity exhausted) and 88% from security related events (rapid disconnection of power system equipment)³.

We can see from this that the RERT is targeting 1.2% of the problem in extreme weather events. We do not believe that this warrants its retention.

The other comment to make is that the strong signals provided by an energy only market are exactly the signals which are required for an extreme weather event. The drivers on generators and loads to respond to the event are very strong.

3 Questions posed by the Reliability Panel

The Reliability Panel posed three questions which are answered in the section below.

Question:

1. *The Reliability Settings have been set at levels that are expected to encourage sufficient investment in new capacity. Do stakeholders consider that the residual risk of insufficient capacity being available in the future is high enough to retain a form of reliability safety net (of similar form to the reserve trader)?*

Answer: No

- If there is a reserve problem from major plant closure, using off market capacity will be ineffectual due to the small volumes available
- The AEMO Power System Adequacy⁴ report shows that, even with almost 1000MW removed the NEM will still operate with an Unserved Energy level at 5% of the target – some twenty times more reliably than the target

3 AEMC Final Report Review of the Effectiveness of NEM Security and Reliability Arrangements in light of extreme Weather Events page i

4 AEMO 2010 Power System Adequacy Report page xx

Question:

2. *If a form of reliability safety net is required, do stakeholders consider that the current short, medium and long-notice forms of the RERT are effective?*

Answer: If there must be one, current RERT is tolerable

Question:

3. *Do stakeholders consider that the current expiry date for the RERT is appropriate and, if not, what is the most appropriate date?*

Answer: 30 June 2011 or earlier

- *This inefficient and unnecessary regulatory intervention should be removed as soon as possible and by no later than 30 June 2012.*

4 Removal of the RERT will increase the achievement of the NEO

The NGF and ERAA submit that there are several factors which would contribute to the better achievement of the NEO by terminating the RERT.

More efficient market – having a single market is more efficient than separating out some load and generation into a separate market. It also allows this generation and load to take part in the market all the time and not only when the RERT is active.

Removes inefficient costs from customers – Removal of the RERT will remove the costs of the RERT which has been borne by customers. These costs amount to several million dollars for which customers have received no benefit.

Removes a Rules Inconsistency – The RERT has introduced an inconsistency in the valuation of achieving a secure operating state which would be removed if the RERT were removed (see section 1.3).

5 Some suggestions for marginally improving the RERT

Whilst NGF and ERAA oppose the retention of the RERT, we recognise that there is a possibility that the Reliability Panel may not share this view. We consequently note two possible marginal improvements which could be made.

Cap on RERT prices – to remove the rules inconsistency, the revenue which can be received by a RERT provider could be limited to the Market Price Cap. This is not a simple exercise but could be done in the event that a RERT participant was called on to generate.

Increased transparency – we recognise the need to protect commercially sensitive information, but believe that some additional information could be published to inform the market of the type of generation or loads which are being contracted. This would help inform the market participants of potential barriers which are causing these participants to contract for the RERT and not to take part in the primary market.

6 Summary

The NGF and ERAA submit that the RERT should not be retained for the reasons stated above and recommend that the RERT mechanism expire on or before 30 June 2011. We have set out the reasons why the National Electricity Objective would be served by its removal.

Please contact David Bowker on 03-62305775 or by email to david.bowker@hydro.com.au if you wish to discuss any aspect of this submission.

Yours faithfully,



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