Department of Primary Industries

1 Spring Street
GPO Box 4440 Melbourne
Victoria 3001 Australia
Telephone:(03) 9658 4000
Facsimile: (03) 9658 4400
ABN 42 579 412 233
DX 210404

Mr Neville Henderson
Chairman, Reliability Panel
Australian Energy Market Commission
PO Box A2499
Sydney South NSW 1235

Dear Neville

REVIEW OF THE RELIABILITY AND EMERGENCY RESERVE TRADER - DRAFT REPORT

The Victorian Department of Primary Industries (DPI) as the portfolio agency responsible for energy policy in Victoria makes the following submission to the AEMC Reliability Panel on the Review of the Reliability Reserve Trader (RERT) Draft Report

Any queries in relation to this 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 Terms of Reference for this Review require the Reliability Panel to consider two questions within the context of the National Electricity Objective:

- whether the RERT is the required to ensure the reliability of supply to a region or regions of the National Electricity Market (NEM); and
- the potential and/or actual effectiveness of the RERT arrangements.

In answering the first of these questions, the Panel concludes that the RERT is unlikely to be required given the historically strong performance of the NEM in delivering sufficient capacity to maintain reliability at or above the NEM Reliability Standard. On the second question, the Panel notes that while the current form of the RERT may be effective in addressing relatively small, location based supply shortfalls it is not an appropriate mechanism to address major power system events, such as the short notice closure of a major baseload plant.

On this basis the Panel proposes to recommend that the RERT terminate on 30 June 2013.

How the historical and likely future reliability performance of the NEM is evaluated fundamentally depends on a judgement about the preferences of electricity consumers for supply reliability. As noted in DPI's submission on the Issues Paper for this Review, Victoria's experience with recent major supply disruptions is that consumers have little tolerance of supply outages.

While 100 percent supply reliability is, of course neither feasible nor cost effective, we believe that the Reliability Panel appears not to have given appropriate weight to the importance that consumers give to reliability of supply in this Review and in previous reviews of the reliability standard and settings. This is a matter of concern as the National Electricity Objective clearly requires that the interests of consumers be given primacy in relation to considering the regulatory framework in which the NEM operates.

The retention of the RERT and the National Electricity Objective

In our submission to the Issues Paper for this Review, DPI argued for the retention of the RERT due to the distortions introduced by the current Market Price Cap (MPC) and Cumulative Price Threshold (CPT). The effect of these distortions is that the market may not deliver sufficient capacity to meet consumers' preferences for reliability of supply.

By enabling AEMO to contract for additional capacity to meet demand at a price that is higher than the MPC, the RERT should help to promote the efficient use of electricity services for the long term interests of consumers with respect to reliability and security of supply. The RERT can therefore act as an important safety net for consumers given the distortions that have been introduced through the MPC arrangements.

Whilst DPI accepts that the RERT is a distortion, it represents a secondary distortion that is necessary given the existence of the MPC arrangements which serve to dull market incentives and which transfer risk away from generators and retailers and onto consumers, thereby increasing the potential for emergencies.

In this context it instructive to note the conclusion of an assessment of distortions arising from the RERT arrangement prepared by ACIL Tasman for the National Generators Forum:

> *"Finally, it is noted that it is anomalous that the RERT scheme has been subjected to considerable criticism, but the price cap has not. This may be because the RERT scheme is under review whereas the price cap has become an accepted limitation on the market with the level subject to regular review. However, it has been shown above that this asymmetric scrutiny of the two schemes is inappropriate. The deadweight losses associated with the RERT scheme arise not only because of the design of that scheme, but also more fundamentally, because of the existence of the price capping arrangements which have been put in place to meet a variety of competing objectives. It is ACIL Tasman's assessment that in the absence of the current price cap regime, the RERT scheme would be redundant."*
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> (ACIL Tasman November 2010: NEM Reliability and Emergency Reserve Trader Assessment of Distortions Arising from RERT Arrangement page 16)

DPI is still strongly of the view that the MPC is too low and as a result, acts as a barrier to timely new investment. As was noted in our response to the Issues Paper, DPI considers that without the safety net of the RERT there remains a risk that, with the existing MPC arrangements in place, there will be insufficient incentives on market participants to manage the risks associated with supply shortfalls or demand peaks,

particularly during extreme weather, In particular, retailers will have reduced incentives to contract innovatively for demand side response and generators will have reduced incentives to make available additional generation capacity. In the absence of these incentives there is an increased risk of emergencies occurring.

An increase in the MPC would have the effect of boosting incentives on retailers and generators to engage in efficient, dynamic and innovative risk management arrangements thereby promoting competition and the efficient use of electricity services in line with the National Electricity Objective. Such an increase would ameliorate the distortions to the market associated with the current MPC and would also have the benefit of reducing the need for a safety net such as the RERT.

In addition, in the longer term an increase in the MPC would help to facilitate investment in peaking generation, bringing on additional generation capacity to serve demand and promoting the long term interests of customers with respect to reliability and security of supply. Additional investment would also reduce the future need for the RERT. In this context we commend the assessment of distortions arising from the RERT arrangements prepared by ACIL Tasman for the National Generators Forum which clearly sets out the importance of price spikes to the efficient operation of the NEM as an energy only market and its discussion of the merits of market intervention through the MPC and CPT.

DPI notes that the Reliability Panel's Draft Report does not contain a direct or explicit assessment of the RERT against the National Electricity Objective. In particular, there is no detailed explanation as to whether the RERT would contribute to the National Electricity Objective. This is in contrast to the AEMC's own assessments of rule change proposals under the National Electricity Law. Indeed, there are limited references to the National Electricity Objective in the document, which DPI does not believe is consistent with the Terms of Reference for the review (as commissioned by the AEMC). DPI suggests that the Panel's Final Report include an assessment against the National Electricity Objective as set out in Section 7 of the National Electricity Law.

Ongoing investment uncertainty

As a result of ongoing debate about future Commonwealth Government policy in relation to the pricing of greenhouse gas emissions, the climate for investment in new generation is significantly more uncertain now than was the case in 2004-2006 and in 2007 when the Reliability Panel recommended that the Reserve Trader be retained due to tighter supply-demand conditions. While the 2010 Electricity Statement of Opportunities for the NEM found that only Queensland would require additional new generation capacity in the next five years the Report also shows that projects are not moving from the proposed to the committed stage. For example, in May 2010 Santos announced an indefinite delay in the construction of its Shaw River combined cycle gas turbine power station. In addition, Origin's Mortlake power station was originally intended to be built in two stages both being combined cycle gas turbines. While Stage 1 has been constructed as an open cycle gas turbine there is no firm commitment about when Stage 2 will be constructed.

Given the lead times associated with bringing on new capacity, including the risk that new generation projects will experience construction and commissioning delays, there is

a risk that NEM regions will begin to experience supply shortfalls in the second half of the decade.

The relevant risk in these circumstances is not that a major baseload power station will close suddenly, but that new capacity does not come on stream quickly enough to maintain supply reliability. In these circumstances the RERT can play an important role in the short-term in securing supply reliability while policy changes, such as a higher MPC and CPT are implemented to accelerate investment in additional capacity.

The demand side

The Panel's decision to recommend that the RERT be extended for a further year until 30 June 2013 and then be allowed to expire is based on a view that the RERT provides an additional opportunity for demand side participation in the NEM.

There is an assumption that the Ministerial Council on Energy's work program on Demand Side Participation will have adequately addressed any reasonable constraints on efficient demand side participation by the time that the RERT is proposed to expire.

Whilst this might be the case, the AEMC's Stage 3 Demand Side Participation Review is yet to commence and it is difficult at this stage to forecast the outcomes of the review. Further, to the extent that the review recommends rule changes, then these will need to be developed and then subsequently assessed by the AEMC.

As such, DPI considers that the Reliability Panel is placing undue weight on the potential conclusions of this work program in informing its proposals with respect to the RERT, particularly when the outcomes of the DSP 3 review and any consequential rule changes are unlikely to be known until well into 2013.

It should also be noted that the Draft Report infers that a function of the RERT is to provide "an additional opportunity for demand side participation". The primary purpose of the RERT relates to ensuring a reliable supply of electricity, and in this sense it provides a mechanism for both generator and demand side participants to provide additional capacity to the market.

Conclusion

In conclusion DPI continues to believe that the RERT should be retained both as an important mechanism to assist in maintaining supply reliability during an significant period of transition in the NEM and as a necessary response to the market distortions associated with an MPC and CPT that are set too low .

Yours sincerely

Peter Naughton
Executive Director
Energy Sector Development Division

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