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Mr. Ian Woodward  
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Dear Ian,

David Headberry sent me Steve Edwell's letter of 14 May to you "AEMC Reliability Panel: Comprehensive Reliability Review Interim Report, March 2007". I write to disagree with the paragraph on page 2 that starts "The options canvassed...". I do not think it is correct to state that "the experience with capacity markets in the US is not encouraging". The first generation capacity market, the PJM which was a simple carry-over of the traditional obligations from the old PJM, was flawed in several respects including volatility of the day ahead market; the second generation New York capacity market attempted to fix the volatility flaw but left other flaws; the third generation capacity market at ISO-New England fixes all the flaws. While I accept that the PJM replacement market is complex, this is in part because it is trying to offset shortcomings in the energy market, I do not think that either the New York or the new ISO-New England markets are complex (which is not to say they are simple).

The letter refers to the markets being prone to market power issues. While this is undoubtedly the case in New York City because of limited sites, it is not the case in New England where potential electricity producers have filed expressions of interest to build over 14,700MWs of new generation plants, and demand-related projects have offered over 2,200MWs of new potential projects for a total of over 17,200MWs of new resources in next year's capacity auction. Furthermore, because the product sold in New England is a Reliability Option *it mitigates the exercise of market power in the energy market*, and so avoids the concern that some customers have in Australia about the ability of some generators to create price spikes.

The comment that it took six years to implement a suitable mechanism in New England puzzles me. The original capacity market introduced with the Standard Market Design market on 1 March 2003 (four years ago) was a copy of ISO-New York's market because ISO-NE did not also have the resources to develop a market to suit its own requirements. The market was recognised as a

temporary measure. Work on what has become the Forward Capacity Market (FCM) essentially began in April 2003 when FERC ordered ISO-New England to file a "...mechanism that implements location or deliverability requirements in the installed capacity (ICAP) or resource adequacy market...so that capacity can be appropriately compensated for reliability." In response, on 1 March 2004, ISO-NE submitted a filing which described a locational installed capacity market (LICAP). The presiding Administrative Law Judge concluded that the LICAP proposal was "just and reasonable" and should be accepted by the Commission, but to many of the participants in the hearings, LICAP promised very high rates, and a proliferation of potential market power concerns. Following protests, which included all of the governors and the Congressional delegation from the New England states threatening legislative action, FERC agreed to delay the implementation of LICAP, and to allow the parties to continue working on possible modifications.

On 13 September 2005, the Public Utility Regulatory Commissions from all six New England States and other parties representing load filed an alternative model broadly based on the National Economic Research Associates, Inc. report on "Centralized Resource Adequacy Markets", but the parties could not agree. FERC then appointed Judge Lawrence Brenner on 21 October 2005 as a Settlement Judge, and the participating parties were given until the end of February 2006 to design an electricity market for New England and to reach a consensus supporting it. My colleague Miles Bidwell introduced the concept of Reliability Options and what emerged was the FCM, which was approved in principle by FERC in June 2006; detailed rules were approved in April this year; the first auction is in February 2008. Although the process has been lengthy, that is in part due to the procedural nature of change in the US by due process, which routinely involves everyone having their say and lawyers making work to generate fees plus in this case politicians forcing FERC to rethink. The process compares favourably with the length of time in Australia debating the unresolved issue of boundary changes!

I also disagree with the statement that "Internationally, there appears to be a trend away from centrally managed capacity markets towards greater use of price signals to encourage investment and demand side response". In my study "An international assessment of competitive power markets" I studied 16 markets<sup>1</sup>, and subsequently I have looked at Texas and the Midwest Market. California is implementing a capacity market; Singapore (which has an enormous surplus of capacity because of the distortion in the market) was introducing a mechanism; the Netherlands has introduced a back-stop mechanism; and MISO will be introducing a reserve margin requirement that will de facto be a capacity mechanism. No markets have stripped back to energy-only; several that were energy-only have introduced centralised capacity markets or back-stop mechanisms.

Yours sincerely,

ALEX HENNEY

c.c. David Headberry

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<sup>1</sup> Austria, England & Wales, Germany, Netherlands, Nordic market, Spain, Alberta, Ontario, California, the markets of the PJM/New York/New England, Argentina, Australia, New Zealand and Singapore.