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9 December 2010

Tina Wong
Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

Dear Ms Wong,

Response to Consultation Paper on Proposed Rule Change: Reliability Settings from 1 July 2010 (Ref: ERC0115)

The Australian Energy Regulator (AER) welcomes the opportunity to respond to the Australian Energy Market Commission's (AEMC) Consultation Paper on the National Electricity Amendment (Reliability Settings from 1 July 2012) Rule 2010.

The AER understands the need to ensure that the market settings deliver sufficient incentives to encourage investment in the generation sector. Central to this submission, however, is the need to draw a distinction between the market settings that create incentives to invest in generation capacity, and those that are designed to cap market risk. While the two roles of the market settings are clearly related, failure to analyse them separately creates the possibility of unnecessarily exposing market participants to added risk, without significant reliability benefits for the NEM being realised.

This submission sets out the AER's views on:

- indexation of the cumulative price threshold (CPT)
- indexation of the market price cap (MPC) and
- regular reviews of the reliability standards and settings.

Indexation of the CPT

The Reliability Panel has proposed the indexation of both the MPC and CPT to address the issue of future NEM reliability. While both MPC and the CPT deal with extreme market events, it is important to note that they were intended to perform fundamentally different roles.

The MPC is set at a level that balances the financial risks faced by market participants through exposure to peak prices, with the need to promote investment through high price events. While a high MPC exposes market participants to significant risks, it promotes generator investment by:

- providing high returns during peak periods, which can make it commercially viable to invest in generators that are only dispatched for a handful of periods throughout the year; and

- perhaps more importantly, providing a high price risk for retailers, which requires them to manage that risk either through financial instruments, or by purchasing additional physical cover. By appropriately managing their risk, retailers sponsor greater long-term reliability, as their risk management financial arrangements can effectively underwrite new generation investment, particularly in peaking plant.

Determining the optimal design of the CPT, however, is a fundamentally different issue. The CPT is an explicit risk management mechanism.[1] It was designed to limit the exposure of market participants to high spot prices over a protracted period of time, rather than just the short-term peaks. The temporary administered pricing regime that is invoked after a breach of the CPT is intended to protect the market from extreme events which may threaten its stable operation.

Breaches of the CPT arise as a result of extreme events and should rarely occur. MPC, on the other hand, is reached on a relatively frequent basis. As such, the level of MPC will be much more relevant to market participants when making investment and risk management decisions.

The CPT should not be treated as an adjunct to the MPC. Accordingly, the Rule Proposal does not adequately justify the indexation of the CPT. So far as the AER is aware—and despite repeated requests for it to do so—the Reliability Panel is yet to consider the CPT in its own right. Since March 2007, the CPT has been breached on five occasions – once in Victoria in January 2009, once in Tasmania in June 2009, and three times in South Australia in March 2008, January 2009 and November 2009. There have been a further five incidents of near CPT incidents - once each in New South Wales and Queensland and three times in South Australia. These events provide a body of evidence for a review of the effectiveness of the CPT.

An increase in MPC should not automatically trigger a commensurate increase in the CPT. Rather, the AER supports a thorough review of the CPT mechanism which assesses its effectiveness at managing risk in the NEM.

The AER's views on the CPT are set out in more detail in our responses to two previous consultations on the NEM reliability settings.[2]

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1 AEMC Reliability Panel, *NEM Reliability Settings: MPC, CPT and Future Reliability Review Rule Change Proposal*, December 2008, p2.

2 AER Submission, *National Electricity Amendment (NEM Reliability Settings: VoLL, CPT and Future Reliability Review) Rule 2009, Response to AEMC Draft Rule Determination*, April 2009; and AER Submission, *NEM Reliability Settings: VoLL, CTP and Future Reliability Review, Response to Reliability Panel Exposure Draft*, 30 October 2008.

Indexation of the MPC

The AER agrees that as the MPC is intended to create incentives to invest in generation, it is appropriate for it to increase in line with producer costs.

However, we are less sanguine than the Reliability Panel about the effect that a higher MPC has on the ability of market participants to exercise market power. In its final report, the Reliability Panel suggests that the bidding and rebidding provisions of the National Electricity Rules, together with the Trade Practices Act, are sufficient to prevent the exercise of undue market power in the NEM.[3]

The exercise of market power cannot be addressed by the National Electricity Rules. Clause 3.8.22A of the National Electricity Rules requires that electricity offers and re-bids be made in good faith. Although this provision attempts to improve the timeliness of information and the accuracy of dispatch, it does not specifically address market power.

Clause 3.1.4(b) of the National Electricity Rules states that the market rules are not intended to regulate anti-competitive behaviour by market participants which, as in all other markets, is subject to relevant provisions of the Trade Practices Act.

The objective of the Trade Practices Act is to promote competition and fair trading, and protect consumers. Section 46 of the Trade Practices Act prohibits the misuse of market power for particular purposes.

Section 46 states that:

> "A corporation that has a substantial degree of power in a market shall not take advantage of that power in that or any other market for the purpose of:
>
> (a) eliminating or substantially damaging a competitor of the corporation …in that or any other market;
>
> (b) preventing the entry of a person into that or any other market; or
>
> (c) deterring or preventing a person from engaging in competitive conduct in that or any other market."

While section 46 of the Act addresses the use of substantial market power for an exclusionary purpose, i.e. to exclude or deter competitors or competitive conduct, it does not prohibit monopoly pricing, or more broadly, the exercise of market power to charge prices that are above competitive levels.

Therefore, while it is appropriate for the MPC to increase in line with producer costs, the decision should recognise that a higher MPC has the effect of increasing the potential impact of an exercise of market power.

Regular reviews of the reliability settings and standards

Under the Reliability Panel's proposal, the requirement for biennial reviews of the reliability settings and standards would be removed. The AER supports regular, thorough reviews of the reliability settings and standards. These reviews should encompass the effectiveness of the reliability framework as well as the levels of the various parameters.

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3 Reliability Panel, *Final Report Reliability Standard and Settings Review*, 30 April 2010.

The AER notes that, if regular reviews are overly frequent, they tend to become an administrative exercise rather than a careful consideration of the issues. Accordingly, we consider that five years is a suitable interval between reviews, but reiterate that we consider that the function of the CPT warrants a separate review.

With respect to the Reliability Panel's proposal to undertake an annual review of whether the indexation is still appropriate, we note that the proposed timetable would make it difficult to implement any conclusion that doesn't affirm the status quo.

Please don't hesitate to contact me, or alternatively Mark Wilson on (08) 8213 3419 or Tom Leuner on (03) 9290 1890 if you have any questions in relation to this submission.

Yours sincerely,

Andrew Reeves
Chairman