



Department of Primary Industries

Our Ref: SU507458

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Our Ref:

Dear Australian Energy Market Commission,

SUBMISSION OF THE AEMC'S REVIEW OF THE EFFECTIVENESS OF NEM SECURITY AND RELIABILITY ARRANGEMENTS IN LIGHT OF EXTREME WEATHER EVENTS

Re: Submission to the Australian Energy Market Commission's (AEMC) Review of the Effectiveness of the National Electricity Market (NEM) Security and Reliability Arrangements in light of Extreme Weather Events (Reference No. EMO 0010)

The Victorian Department of Primary Industries (DPI), as the portfolio agency responsible for energy policy in Victoria, welcomes the Australian Energy Market Commission's Review of the Effectiveness of National Electricity Market Security and Reliability Arrangements in light of Extreme Weather Events. The Review was initiated by the Ministerial Council on Energy following electricity interruptions that had a significant impact on Victorians on 29 and 30 January 2009.

DPI is pleased to be able to make this submission in response to the 2 March 2010 Consultation Paper.

Any queries in relation to this submission should be directed to Mr Peter Naughton, Acting Executive Director, Energy Sector Development by email at peter.naughton@dpi.vic.gov.au or on telephone (03) 9658 4924.

Yours sincerely,

Richard Bolt
Secretary

31 / 3 / 2010

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Victorian Department of Primary Industries

**Submission to the AEMC's Review of the Effectiveness of NEM Security and Reliability
Arrangements in light of Extreme Weather Events**

31 March 2010

The Victorian Department of Primary Industries (DPI), as the portfolio agency responsible for energy policy in Victoria, welcomes the Australian Energy Market Commission's (AEMC's) Review of the Effectiveness of NEM Security and Reliability Arrangements in light of Extreme Weather Events. The Review was initiated by the Ministerial Council on Energy (MCE) following electricity interruptions that had a significant impact on Victorians on 29 and 30 January 2009.

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Consumers' expectations

DPI is disappointed that the AEMC's Review currently appears to lack a consumer perspective.

The paper distinguishes between interruptions to the electricity supply from events at the bulk supply level (those caused by transmission or generation) and those at the distribution level. Bulk supply events are further distinguished between reliability or security events. Consumers do not make such distinctions. From a consumer perspective, they either have electricity or do not.

Where a distribution event occurs, the consumer will observe local impacts only, and there is unlikely to be any material impact on the economy or broader community.

However where there is a bulk supply event, the impacts are far more widespread and may have a more material impact on the economy and broader community. For example, the widespread interruptions on 16 January 2007 and 30 January 2009 occurred during the evening peak transit time, crippling public transport, the road network, hospitals, shopping centres, high rise buildings etc.

This results in a characterisation of the reliability standard (unserved energy (USE) of 0.002 per cent) in the Second Interim Report and Consultation that is misleading.

The report expresses the USE target as a loss of load for 10 minutes per customer per year on average. Whilst bulk supply interruptions are widespread, they do not impact the whole state. Of more interest to consumers is that a reasonable proportion of consumers (around 20 – 25 per cent of the state) can be without an essential service for up to several hours.

The events of 16 January 2007 and 30 January 2009 have demonstrated to the Victorian Government that the community does not appear to accept these types of widespread interruptions, and especially not every two years. It is not acceptable that the reliability standard potentially hides many significant impacts on consumers and allows for these types of widespread events to occur frequently.

Consumers also have expectations regarding the affordability of electricity as an essential service. An understanding of the impacts of any change in the MPC on electricity retail prices is therefore

critical in determining whether there should be a change in MPC. It is disappointing that the modelling of the price reliability trade offs will not be available until the Review Final Report is released.

With the completion of the AEMC's Review, the MCE will need to carefully consider whether the reliability standard of 0.002 per cent USE continues to reflect community expectations, noting the types of interruptions that are excluded from the measurement and reporting of the USE.

Distinction between reliability and security events

The regional USEs for the past 10 years, as set out in Table 2.1 of the Second Interim Report, indicate that the reliability standard for Victoria has been met.

However this table excludes, for example, the major interruption in Victoria on 16 January 2007 (due to bushfires) and the load shedding events that occurred after 5.30pm on 30 January 2009 as these were considered to be security events rather than reliability events. If these events were included, the average USE in Victoria over the last 10 years would increase from 0.00044 per cent, as set out in Table 2.1, to around 0.00253 per cent, which is higher than the reliability standard.

By differentiating between reliability and security events, the report also does not recognise the interrelationship between reliability and security events. For example, if the Market Price Cap (MPC) had been higher over the last few years, Origin Energy may have invested in the Mortlake gas fired generator earlier. This would have reduced the level of load shedding that was required in western Victoria on 30 January 2009.

The Market Price Cap

The Consultation Paper states that "the MPC is currently set at \$10,000, but will rise to \$12,500 on 1 July 2010 ... [and] has been set to achieve the reliability standard of 0.002%".

DPI eagerly awaits the completion of the modelling to verify whether the MPC is consistent with a USE of 0.002 per cent. This modelling is critical to understanding the impact of a change in MPC on USE. It is disappointing that it will not be available until the Review Final Report is released.

If the MPC is set too high, there is an increased risk of market power and thereby volatility in the spot prices in the wholesale electricity market, but consumers will continue to be supplied with electricity. If the risks associated with market power and thereby volatility in the spot prices do materialise, they will be temporary, providing a signal for additional investment.

Conversely, if the MPC is set too low, there will be insufficient investment in, for example, peak generation capacity. Under this scenario, customers will not be able to be supplied with electricity.

The value that customers place on reliability (around \$47,000 per MWh) is well in excess of the electricity retail price (around \$20 per MWh). The consequences for customers in setting the MPC too low are greater than the consequences for customers in setting the MPC too high.

This would indicate that customers' long term interests are best protected by erring on the side of the MPC being set too high rather than being set too low.

With the completion of the AEMC's Review, the MCE will need to carefully consider whether the MPC is consistent with the reliability standard that meets community expectations, noting that customers' interests are likely to be best protected by erring on the side of setting MPC too high rather than too low.

Value of customer reliability

The AEMC's Review is predicated on an assumption that the value that consumers place on reliability is the same across all regions. Furthermore, the Consultation Paper states that "the community's expectations of the value and cost of reliable electricity supplies should be a key element of the policy decision framework for the NEM's reliability standard and settings".

A study has been undertaken, most recently by VENCORP in 2007, to assess the value that Victorian consumers place on the reliability of electricity. However DPI is not aware of any similar analysis having been undertaken in other regions.

A similar study is required in the other regions to inform any decisions on the reliability standard and settings in those regions.

In the meantime, either the Victorian analysis would need to be relied on by the other regions, or the Victorian analysis should be relied upon in determining the reliability standards and settings for Victoria which potentially differ to those in the other regions.

Impact of regional MPCs on economic efficiency

The Second Interim Report recognises that adopting different MPCs in each region would result in economically efficient outcomes because supply continuity is provided in each region up to the level at which it is valued in that region. However it also raises a concern that the outcomes may not be economically efficient across the NEM because it may lead to distortions in investment and operational behaviour.

The report does not recognise that there are already distortions in investment and operational behaviour across the NEM due to fundamental differences between the regions. There are fundamentally different incentives for investment in those regions where the generation and transmission businesses are privately owned relative to those regions where the generation and transmission businesses are Government owned. Those regions with private ownership are totally reliant on the appropriate market signals to facilitate the level of investment to meet the community's expectations.

It is also noted that economic efficiency in the NEM is also limited by the physical constraints in the interconnectors linking the regions.

In arguing against setting reliability standards by region, the Second Interim Report refers to the regulatory complexity this would introduce and the increased prudential requirements for retailers in the region with the higher MPC.

In relation to regulatory complexity, the Review needs to be more specific regarding the materiality of this issue, noting the existing differences between the regions.

DPI notes that, regardless of the outcomes of this Review, prudential requirements may need to be addressed given the increase in the level and volatility of the wholesale electricity price that is expected with the possible introduction of the Carbon Pollution Reduction Scheme.

Distortions between transmission and generation investment

In considering whether the MPC should be set by region, the Review currently identifies that this may lead to distortions in generation investment between regions. The Review currently does not consider the existing distortions within regions between investments in transmission and generation, and whether it is more economically efficient to have distortions between regions or within regions.

Planning of the transmission system in Victoria is currently undertaken on an economic basis, based on a value of customer reliability of around \$47,000 per MWh (recently increased from around \$30,000 per MWh). This compares to an MPC of \$10,000 per MWh, which is increasing to \$12,500 per MWh by 1 July 2010. There is therefore a greater incentive to invest in transmission than in generation.

If the MPC was set at a level that is more consistent with the value of customer reliability, generators would have a greater incentive to invest in removing constraints in the transmission network that can constrain the level of generation. Such constraints increased the risks of interruptions to customers' electricity supply during the January 2009 heatwave.

DPI notes that the Second Interim Report incorrectly states that "the Transmission Network Service Providers (TNSPs) must invest so that their networks achieve transmission reliability standards that are currently set by jurisdictions". In Victoria, the transmission reliability standards are not set by the jurisdiction.

Distribution

Similarly, the Consultation Paper incorrectly states that "matters concerning the reliability and security performance of distribution networks in the NEM (including network planning standards) are determined and monitored by jurisdictional bodies". Whilst this may be the case for the other jurisdictions, these are functions of the appropriate national energy market body in the case of Victoria.

It should also be noted that, consistent with investment in the transmission network, investment in reliability improvements in the distribution network are funded through a service incentive scheme. The incentive rate provided through the service incentive scheme is based on the value of customer reliability. A value of approx \$30,000 per MWh has been used during the 2006-10 period regulatory period, however DPI expects this to increase to around \$47,000 per MWh for the next regulatory period.

Governance arrangements

DPI supports a change to the arrangements for governing decisions which relate to reliability standards. The existing arrangements, particularly the role of the Reliability Panel, are a legacy of the previous governance arrangements, established prior to the Australian Energy Market

Agreement (which established AEMC and the Australian Energy Regulator) and the formation of the Australian Energy Market Operator (AEMO).

The governance arrangements for reliability should be consistent with the current governance arrangements in the NEM – the MCE should be responsible for high level policy, the AEMC for rule making and AEMO for technical and operational matters.

In making any rules relating to reliability, AEMC needs to be guided by the high level policy from MCE and seek advice on technical and operational matters from AEMO.

Stakeholder consultation is an important part of the decision making process. AEMC and AEMO should use their standard consultation processes as required.

The Second Interim Report recommends that the Reliability Panel provide advice to the AEMC on technical, commercial and consumer impact issues. The members on the Reliability Panel represent a broad range of interests. There is the potential for differences in views between panel members on various issues.

To ensure that the AEMC is advised of the range of views, rather than a consensus or compromised view, it is recommended that AEMO be consulted on technical issues (and for it to consult with stakeholders as required); industry stakeholders be consulted on commercial issues and consumer stakeholders be consulted on consumer issues. AEMC is best placed to then resolve any conflicts between the views of different stakeholders.

Other reliability standard settings

As recognised on page vii and 50 of Second Interim Report, the MPC, cumulative price threshold (CPT), administered price cap (APC) and the market floor price are an integrated set of arrangements. If the MPC is varied as a result of this Review, consequential variations to the CPT, APC and market floor price would also need to be considered.
