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Mr Ian Woodward
Chairman
AEMC Reliability Panel
PO Box H166
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Dear Mr Woodward

AEMC Reliability Panel: Comprehensive Reliability Review Interim Report, March 2007

The Australian Energy Regulator (AER) welcomes the opportunity to comment on the Reliability Panel's Comprehensive Reliability Review Interim Report. The AER offers the following comments from the perspective of its role in monitoring compliance with the National Electricity Law and Rules, and in investigating and prosecuting breaches.

The AER supports some aspects of the interim report, including the observation that the NEM has performed well against the existing reliability standard, as well as a number of the specific proposals. First, there is value in reviewing the practice of using medium term minimum reserve levels to assess the adequacy of forecast short term reserves. As proposed in the interim report, it would be appropriate to request NEMMCO to calculate short term minimum reserve levels to better reflect the conditions that prevail in the short term.

Second, the AER notes the concern expressed by many stakeholders that NEMMCO's demand forecasts have been systematically too conservative, and that this can affect the extent of reserve trader intervention. It would be worthwhile requiring NEMMCO to periodically report on the accuracy of its most recent Statement of Opportunities (SOO) demand forecasts and on any improvements that have been incorporated into the forecasting process.

The interim report also raises stakeholder concerns that there are risks on the horizon that may affect the timing of generation investment to meet the reliability standard in the future, particularly from 2011 onwards. In particular, it refers to concerns that the effectiveness of the current market arrangements may be distorted by external factors such as uncertainty over greenhouse measures, perceptions of policy intervention in government investment and regulation, the continued use of retail price caps, a lack of price information and metering arrangements to facilitate demand-side management, and the operation of the contract market over the longer term.

The report sets out a range of possible responses to these concerns, including an increase in the level of VoLL and a shift towards more interventionist models with greater central control. The options include the introduction of capacity payment mechanisms that would require formal Rule changes, and possibly, a major reconstruction of the current market design.

The interim review included modelling by CRA on the effects of adjusting the level of VoLL to \$7,500 per MWh and \$12,500 per MWh. The analysis found that an increase in VoLL to \$12,500 would likely attract new capacity and improve reliability to some degree. Prior to considering more radical changes to market design, there would be value in undertaking a more detailed analysis of VoLL. This might include a first principles review of best practice for setting VoLL, taking account of current international approaches. It would also be appropriate to consider the projected impacts on reliability of changes to the level of VoLL over a wider range — for example, at levels of \$20,000 and \$30,000.

The AER considers that significant market alterations beyond adjustments to the current reliability settings would only be warranted if there is evidence that the risks are sufficiently material, and that the response is efficient. As a starting point, it may be useful to undertake a thorough analysis of the risks set out in the interim report, their possible impacts on the market, and — where action is justified — possible solutions that target the underlying problem. While many of the risks set out in the report raise significant challenges, a number appear to be of a relatively short-term nature or have policy responses in train. Others might warrant further analysis and targeted policy responses.

The recent report of the Energy Reform Implementation Group (ERIG) identifies similar risks to those set out in the Reliability Panel's interim report. But rather than proposing a change in market design, ERIG favoured more targeted solutions. For example, market distortions caused by retail price caps may be better addressed by reviewing the use of price caps, rather than changing the reliability framework. Similarly, the International Energy Agency has recommended market based solutions — such as specific measures to encourage demand-side participation — to address reliability concerns in the Australian context.¹

The options canvassed in the interim report focus on introducing new generation capacity mechanisms and represent a significant shift from the energy only market design currently in place. To date the energy only market has worked well in delivering timely investment outcomes and system reliability and is generally well regarded here and overseas. By contrast the experience with capacity markets in the US is not encouraging. They are inevitably complex and can be prone to market power issues. In the New England market, efforts to implement a suitable administered capacity mechanism have taken more than six years. The New York ISO and PJM capacity mechanisms are complex and include significant central control, with capacity market obligations both monitored and mitigated by the market operator. In each case, the additional layers of central control create new issues that require further intervention. The additional costs imposed by the capacity market are rarely articulated. In Australia a move towards capacity markets would likely impose significant costs, instability and introduce new risk factors.

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


¹ International Energy Agency, *Energy Policies of IEA Countries: Australia, 2005 Review*.

the US, the Midwest has recently adopted an energy-only design with no capacity market, while Texas has reaffirmed that approach with the introduction of a higher price cap in its energy-only market. Texas has also introduced a cumulative price threshold, similar to that which applies in the NEM.

In summary, the AER does not consider that some of the options canvassed in the report are appropriate for dealing with the risk issues raised. Further, there are potentially serious costs in applying a radical market restructure. These costs should be carefully considered before abandoning a market design that appears to have generally worked well.

Thank you once again for the opportunity to comment on these matters.

Yours sincerely



Steve Edwell
Chairman