Energy Retailers Association of Australia Incorporated

31 October 2008

The Chairman
Reliability Panel
Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

Dear Mr Woodward,

Re: Package Two - NEM Reliability Settings Exposure Draft

The Energy Retailers Association of Australia (ERAA) appreciates the opportunity to respond to the Reliability Panel's (Panel) Exposure Draft on the NEM Reliability Settings.

This submission presents the views of the ERAA on the four proposed Rule changes outlined in the Exposure Draft. In summary, while increasing the level of VoLL will increase the level of risk for retailers, on balance, we support a small incremental increase to ensure reliability standards will continue to be met in a carbon constrained world. The other Rule changes largely follow from this more substantive change to energy market settings and are therefore also supported.

In addition, the ERAA is unconcerned with the AEMC's proposal to implement the changes to reliability settings on the same day as the scheduled commencement of the Carbon Pollution Reduction Scheme (CPRS).

These issues are discussed in more detail below.

Increasing the level of VoLL

While the current increase in VoLL has been justified on an assessment of market reliability in the current policy environment (eg. no CPRS, and existing RET), we note that the likely future policy environment may well put further upward pressure on reliability settings. The 2 yearly review of reliability settings it therefore supported.

The introduction of the CPRS and the expanded Renewable Energy Target is likely to have a major impact on energy markets. It will lead to a significant increase in the volume of intermittent generation entering the NEM. As a consequence of wind generation being less reliable than other forms of generation it is likely that, to maintain reliability standards, this will need to be supported with 'back up' gas fired peaking capacity. However, due to its low marginal cost, increasing levels of wind generation competing in dispatch also weakens the ability of existing and new gas fired peaking capacity to recover their fixed costs. Consequently, a further future increase in the level of VoLL is likely to be required to sustain investment signals for this type of generation.

General market uncertainty surrounding the impacts of CPRS and RET, and how they might interact, is also likely to dampen investment incentives, particularly over the early operational phases of these policies. An increase in VoLL should help address this uncertainty by increasing potential revenues for generation while at the same time strengthening incentives for participants to enter into contracts. The latter should underpin future investment in generation capacity while at the same time alleviating the current lack of liquidity for contracts beyond 2010.

However, while the arguments in favour of increasing VoLL are acknowledged it is important to note that any increase in VoLL also increases the level of risk to which retailers and large customers are exposed. Such increased risk will be translated into more conservative trading limits and higher contract premiums. For this reason, the ERAA considers it imperative that any increase in VoLL is appropriately weighed against increased costs of contracting.

Nevertheless, on balance we consider that an incremental increase in VoLL, to $12,500 MWh, is acceptable from a risk perspective while at the same time providing some insurance against the potentially much more significant costs of increased intervention in the NEM by the market operator, and potentially governments themselves, to avoid breaches of reliability standards. The frequent activation of the Reserve Emergency Reliability Trader Mechanism, for example, is likely to distort market outcomes and could ultimately prove more burdensome to retailers than an incremental increase in the level of VoLL.

In light of the issues outlined above, ERAA supports a proactive approach in addressing them. The two-yearly review of the reliability settings, including VoLL, will provide the opportunity to monitor changes in the market and assess the appropriateness/effectiveness of the increase in VoLL.

The CPT be defined as 15 times VoLL

The ERAA considers it appropriate that the current level of the CPT relative to VOLL remain unchanged i.e. defined as 15 times VoLL. Increasing the level of VOLL while not increasing the CPT could lead to the CPT being triggered too frequently, and thus interfering with normal market clearing mechanisms.

The Term VOLL be changed to Market Price Limit (MPL)

The ERAA supports replacing the term VoLL with the MPL. As highlighted in the Exposure Draft, VoLL is in fact the upper price limit in the market. The MPL nomenclature therefore provides a more appropriate description of what VoLL actually is.

Two-yearly review of all the reliability settings

The ERAA considers that the Panels' proposal to review all the reliability settings in an integrated way every two years, and with a two year notice period, is reasonable. This means that there will effectively be four years before any changes to the reliability settings are made. This should provide investors with enough certainty and scope to modify their risk management arrangements in an orderly manner while providing the Panel with sufficient opportunity to make appropriate changes to the reliability settings in response to longer term directions in market fundamentals.

We note that this approach will not preclude alternate one off adjustments to the settings via a Rule change, should such adjustments prove necessary between scheduled adjustments periods.

Changing VOLL and CPT on the same day as the start of the CPRS

Given that this current increase in VOLL and the CPT is being implemented in order to support market sustainability, it appears sensible for the both the CPRS and increase in VoLL to occur concomitantly. Over time further review of VOLL may be required if investment in new generation stagnates, and therefore delaying the current increase because of CPRS implementation would appear counter-intuitive. The ERAA therefore supports a July 2010 introduction date.

If you require any further information in relation to this matter please feel free to contact me on (02) 9437 6180.

Yours sincerely

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