



10 April 2014

Mr Neville Henderson, Commissioner
Reliability Panel
Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

Dear Mr Chairman

Reliability Standard and Reliability Settings Review 2014 – draft report

Alinta Energy welcomes the opportunity to make a submission in response to the Reliability Panel's draft report of the *Reliability Standard and Reliability Settings Review 2014* (the Review).

Alinta Energy is an active investor in the energy retail, wholesale and generation markets across Australia. Alinta Energy has around 2500 megawatts of generation capacity in Australia (and New Zealand) and a growing retail customer base of over 750,000.

Alinta Energy appreciates the work of the Reliability Panel in advancing the draft report given the breadth and complexity of the issues at hand. Alinta Energy particularly welcomes the conclusive position the Reliability Panel has taken with regards to the reliability standard which continues to be satisfied in the form of an output-based measure expressed in terms of unserved energy.

Nevertheless, Alinta Energy is disappointed with the lack of progress around the analysis of fundamental questions and issues that go to the establishment of the reliability settings. This includes the detailed matters raised by Alinta Energy in its previous submission.

The draft report presents a series of inconclusive positions which lead to the status quo by default, while opening the door to a large number of further reviews to be undertaken at some stage between now and the commencement of next review in 2017. This is less than desirable and suggests the draft report has not fully met its objectives.

The current inertia around reliability settings, and their role in sustaining the market, forms a position of convenience as it satisfies some large participants' interests, avoids debates around potential rising wholesale market costs in the short term and is more marketable to some stakeholder groups. However, it has not been shown to satisfy the interests of the market more generally or the long-term interests of customers. Maybe the settings are right, maybe they are not.

The starting point for every review of market settings, and any discussion around price caps, should be: are they needed? The Market Price Cap (MPC), the Market Floor Price (MFP) and the Cumulative Price Threshold (CPT) are distortions that while introduced to meet specific objectives still interfere with the ability of market participants to reveal their actual preferences in a fully transparent manner. Thus determining their value in meeting clear objectives, their continuing relevance and the value at which they should be set are critical if the Review is to have appropriate value.

For this reason, a primary objective of the Review should be consider the merits of continuing to allow these distortions when they are deemed appropriate, but also ensuring that price caps are set at levels which interfere with the market as little as possible.

The draft report demonstrates this is not the case in the National Electricity Market (NEM) and can't be the case where the Reliability Panel acknowledges that a new entrant peaker would not be able to recover its revenue in the spot market and thus would be required to trade in the same manner as is assumed for existing participants in order to guarantee a return on investment.

In a market without significant distortions, like the MPC being below that required by a new entrant peaker, participants would have an unfettered range of commercial positions that they could pursue. This flexibility would allow each participant to pursue its competitive advantage thereby promoting dynamic efficiency in the long-term interests of customers. Market settings that contribute to a vertically integrated cap defender approach to investment being the only option cannot by definition do this.

Electricity is treated unlike any other product as the boundaries of prices are set by administrative dictate; in many cases for understandable and justifiable reasons. Nonetheless, the industry should be ever vigilant to ensure price controls are not in place for price controls sake. Interestingly, while it is widely agreed that price monitoring, not heavy-handed price control, is desirable in the retail space the Reliability Panel and Australian Energy Market Commission are yet to entertain the removal or significant relaxation of price controls in the spot market where they have direct responsibility. The starting point for the Review seems to be that that existing price controls should be tightly guarded. Understandable but not necessarily appropriate.

Reliability Standard

The trade-offs associated with a change to the reliability standard are well understood in part as a consequence of work undertaken during past reviews administered by the Reliability Panel. Hence, there is little surprise that the Reliability Panel has strong grounds on which to recommend no change to the current form of the reliability standard as measured each financial year.

It is also not surprising, given the detailed and fit-for-purpose analysis to date, that industry is broadly comfortable with the Reliability Panel's recommendation. Likewise, Alinta Energy supports the Reliability Panel's recommendation that there be no change to the reliability standard.

Value of Customer Reliability

Alinta Energy remains unconvinced by arguments that suggest the Value of Customer Reliability (VCR) and MPC do not greatly relate to each other. It is also difficult to build upon ROAM's conceptual relationship between total generation cost and cost of unserved energy given a proxy VCR of \$30,000 has been selected.

Nevertheless, the use of a proxy of \$30,000, which corresponds with a 0.002% level of reliability does suggest that the inconsistency between the level of the VCR and the MPC is worthy of further consideration.

The perspective that that the current MPC, set well below the proxy VCR, is likely to create a bias towards transmission build for the purpose of guaranteeing reliability against the standard over generation build and demand side alternatives was not resolved within the draft report.

It is understandable that the reliability panel has not made firm recommendations in this area given continuing developments and analysis, including ongoing work by the Australian Energy Market Operator. Nonetheless, the ongoing hesitation to consider the benefits of more closely aligning the MPC with the VCR is an impediment to potential reform.

Market Price Cap

The impact of the MPC on the market and whether the MPC is required going forward has not been conclusively dealt with. Further, entertaining a reduction of the MPC is astounding, especially on the back of issues with the ROAM modelling and is not welcomed by Alinta Energy or considered a constructive suggestion.

Multiple reviews have failed to conclude whether the market could proceed without a MPC, or with an MPC large enough as to be largely irrelevant and therefore not distortive. If the role of the MPC is to signal scarcity there is little value in capping the MPC unless there are other specific objectives being considered. The MPC's role in managing risk is usually cited in a broad fashion as this additional objective.

However, given the primary role of the CPT in managing extreme market risk, the use of over-the-counter and futures products to hedge positions, the availability of outage insurance and a portfolio approach to generation to manage risk of physical failures, the availability of weather products to hedge extreme weather events occurring or not occurring and other more exotic strategies and options, the role of the MPC in managing risk seems to be overstated.

If it could be concluded that the MPC does not play a role in managing risk, or a plays a marginal role, than the rational for using anything other than the extreme peaker approach would be weaker than it already is.

Instead the draft report fails to progress consideration of this issue and instead highlights the uncertainty around the appropriateness of the MPC as can be seen in the following passage (with emphasis added).

*. . . the Panel considers there is value in drawing on the results of ROAM's two modelling approaches (the extreme peaker and cap defender approaches) to help guide the discussion with respect to an appropriate vale of MPC. On this basis, the appropriate level of the MPC to apply from 1 July 2016 is unlikely to be as low as the outcome of the cap defender approach (that is, \$9,000/MWh), and not as high as the outcome of the extreme peaker approach (that is, \$23,000/MWh). **The Panel notes that the current value of the MPC (\$13,100/MWh) sits within this range.***

(Reliability Standard and Reliability Settings Review, draft, report, p.34)

While Alinta Energy acknowledges the difficulty of the issue the Reliability Panel is assessing, the analysis presented provides a particularly imprecise and unscientific manner in which to justify the status quo and is an argument that fails to convince under scrutiny.

The reliance on modelling based on assumed participant behaviour, which does not take into account the broader range of business models, risk appetites and required returns of all participants that form the market, creates additional uncertainty.

The arbitrariness of suggesting both of ROAMs models are valid and that a number landing somewhere in the middle is therefore suitable fails to suitably answer many of the outstanding questions that the Reliability Panel is tasked with considering.

What is definitive is that the MPC required under the extreme peaker model, being the price needed to signal scarcity, is greater than the existing MPC and much greater than ROAM's cap defender approach.

If the MPC is set lower than it otherwise should be the longer term impacts on customers will be negative as new investment is not signalled and price increases to inefficient levels. This suggests examining whether the distortive impact of the MPC is justified should be central to the Reliability Panel's thinking.

Regarding contract market premiums, a higher MPC and higher contract prices will increase contract liquidity and if that results in an increased purchase of contracts may translate to less spot price volatility not more as market participants may be more likely to be fully contracted.

Regarding prudential requirements, concerns around potential increase in prudentials should be managed through avenues that reduce total credit risk in the market. For instance the potential for a shorter settlement cycle is something that requires detailed consideration and should be addressed as it would dramatically reduce credit in the market. In that context, changes to the MPC have marginal impacts on prudential obligations.

The Reliability Panel correctly highlights that the level of MPC directly influences demand side participation and especially the willingness of market participants to engage demand side as an alternative to generation and contracting.

Cumulative Price Threshold

The original purpose of the CPT was to replicate a force majeure clause to limit the exposure of participants to major events¹ In fact, the Reliability Panel, in an earlier review envisaged that the CPT would operate as the primary risk management mechanism for extreme events² and has indicated the CPT is an 'explicit risk management mechanism'³.

The benefit of the CPT is management of extreme events over a protracted period of time without impeding voluntary market clearing within shorter peaks. If a CPT of \$197,100 has not provided significant time to allow the market to respond after successive periods of high volatility then it is appropriate to suggest the situation may not be remedied by the market without intervention and that such intervention is needed to maintain the viability of market participants.

The issue is what the appropriate threshold is for the CPT. On one hand, the CPT takes revenues away from generators who otherwise may not be able to recover capital costs within an acceptable period of time. Conversely, these same generators may be constrained off and exposed to prices to which they cannot respond and hence market intervention would be desirable.

In the submission to the issues paper Alinta Energy noted a number of key points.

¹ Reliability Panel, VoLL and the cumulative price threshold, Issues paper, December 2003, p.40, indicates that the original FM threshold was \$2100/MWh average price over 72 hours

² Reliability Panel, Review of VoLL in the National Electricity Market, Report and Recommendation, July 1999, p.3

³ Reliability Panel, National Electricity Market Reliability Settings: VoLL, CPT and the Future Reliability Review Rule Change Proposal, December 2008, p.2

- It was determined that a higher MPC and CPT in tandem would result in a notable increase in price outcomes but overall increasing MPC without changing the CPT has a minimal impact on generator earnings while reducing price impacts⁴. This implies the link between CPT and MPC is not symmetrical. In other words, an increase in MPC is more relevant to incentivising merchant investment than an increase in the CPT.
- The Reliability Panel's preference of linking the CPT and the MPC, by making the CPT a factor of the MPC, should not necessarily continue and that the CPT's primary purpose is to ensure risk is appropriately managed not cost recovery. Therefore, an increase in the MPC does not necessarily require significant changes to the CPT.
- It is probable that the current CPT level is not set with reference to the level of risk it is trying to manage; however, it is not clear that a more appropriate threshold has been identified.
- The CPT should be analysed like other tools within a risk management framework. This is to identify the role it plays in ensuring no systemic failure would arise if participants were exposed to price risks they were unable to manage beyond a certain point. In this way the purpose of the CPT is to ensure participants, who are prudently hedged and managed, can absorb the effects of extreme prices using available products, like hedges and insurance, to a point where market efficiency is not undermined. This is unlikely to be perfectly correlated with the MPC.

Alinta Energy notes some support from the Reliability Panel for a further review in relation to the CPT. The unbundling of the CPT and the MPC so as to set a CPT based on broader risk considerations is one area that deviates away from the core work of the Reliability Panel as part of its role in reviewing the reliability standard and reliability settings. This is the area of the Review where further work separate to the Review's conclusions is welcomed by Alinta Energy if it is not to be undertaken by the Reliability Panel at this time.

Market Floor Price

The MFP was discussed in detail in Alinta Energy's earlier submission to the issues paper. The issues raised in that submission were not dependent on outcomes of external policy settings like the Renewable Energy Target or progress or otherwise of the Optional Firm Access review. Reliance on these two factors to not give detailed consideration to potential changes to the MFP is at best unfortunate as it fails to address the points highlighted.

- The -\$1000/MWh has effects other than providing a turn-off signal. This includes strategic bidding in the face of constraints, engaged in by all generators, and ensuring subsidised "zero" fuel cost generation can be dispatched by bidding negatively in the expectation that thermal generators with a higher short-run marginal cost must continue to generate. The effects of strategic bidding would likely be muted if the floor price was raised, for instance to -\$100.
- Wind generators, through the Renewable Energy Target, are generating pool revenue and are given preference in the pool as their short-run costs are effectively zero. This, in addition to being provided with Renewable Energy Certificates and power purchase agreements with retailers who need to meet renewable obligations, is the reason wind farms often bid negatively in the pool. This issue was not anticipated at the time the -\$1000 was established.

⁴ Concept Economics, Risk Assessment of Raising VoLL and the CPT, 13 October 2008, p.15-18.

(A more extensive commentary on the MFP can be found in Alinta Energy's earlier submission.)

Alinta Energy calls upon the Reliability Panel to give detailed consideration to the issues that have been raised and the strong indications that existing settings lead to inefficient outcomes in the spot market. The Reliability Panel's analysis should give further consideration to the range of alternatives that have been raised by stakeholders as part of the Review and in recent years and whether these alternatives would minimise or eliminate any identified inefficiencies.

Indexation of Reliability Settings

Alinta Energy agrees that indexation of reliability settings is an appropriate yearly exercise. However, the indexation process is a proxy for yearly capital cost increases for new peaking plant. As it is a proxy only, using the Consumer Price Index is sufficient when a more significant and detailed analysis occurs pursuant to regular settings and standard review. In this regard, investing further time in detailed consideration of a preferable index will provide false comfort to industry and the Reliability Panel.

Further, given the Reliability Panel has elected to not raise the MPC to match existing capital cost recovery for peaking generation, as demonstrated under the extreme peaker model, it would seem a conflict to recommend significant time and energy be invested in developing an index which tracks those same costs.

A MPC which broadly reflects existing capital cost recovery requirements for peaking investment partnered with yearly Consumer Price Index rises would seem appropriate and preferable to an index which tracks peaker capital costs for the purposes of adjusting an MPC which does not provide for capital cost recovery in any case.

Conclusion

Alinta Energy appreciates the role of the Reliability Panel and the work associated with the draft report. Nevertheless, the draft report fails to capture or progress many of the issues identified by participants and instead has elected to recommend a large body of additional work.

Alinta Energy suggests it is the role of the Reliability Panel under the auspices of this Review to resolve many of the questions that have been deferred in favour of supporting the status quo.

Alinta Energy calls upon the Reliability Panel to give further consideration to its recommendations around the reliability settings, and if not, at least give more detailed guidance and timing on the further work to resolve the issues that have been raised.

Should you have any queries in relation to this submission please do not hesitate to contact me on, telephone, 02 9372 2633.

Yours sincerely,



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