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28 September 2007

Ian Woodward
Chair
AEMC Reliability Panel

By email (panel@aemc.gov.au)

Dear Ian

TRUenergy submission to Second Interim Report: Comprehensive Reliability Review

Thank you for this opportunity to comment upon the second interim report.

The panel is welcome to publish this submission on its website.

We note that several key market parameters, including the market price cap and CPT are to be determined by the panel in its final report. Given the fundamental importance of these parameters to the market, and the proposal not to review them for 3 years following a final decision, we believe it would be beneficial for the panel to issue a draft decision on these parameters to allow for stakeholder input prior to the final report. It is our view that this would result in a more robust final determination.

Other more detailed comments and suggestions are outlined the attached submission.

Yours sincerely,

Mark Frewin
Regulatory Manager

TRUenergy Submission on the Comprehensive Reliability Review Second Interim Report

Our response contains some brief comments on the decisions made by the Panel in its second interim report. However it primarily focuses on areas identified by the Panel as requiring feedback, and still subject to decision in the final report.

As an overarching comment, there are some significant decisions yet to be made in this review, including the level of the market price cap, and the value of the cumulative price threshold amongst others. Ideally it would be preferred if draft decisions on these matters could be issued prior to them being finalised. This would allow stakeholder comment on the proposed decisions and improve the robustness of the regulatory process.

Decisions in the Second Interim Report

In regard to decisions noted in the 2nd interim report, we note the following:

- o We are comfortable with the reliability standard definition, level and scope;
- o Support removal of external events (eg. Industrial action) from the reliability measure;
- o Support the proposal to review short term reserve levels and reporting of SOO demand accuracy; and,
- o Support an urgent review of the administered price cap.

Replacement of annual Voll Review with Reliability Parameter Review every 3 years

The panel has proposed that the annual Voll Review process should be replaced by a review of all reliability settings every 3 years.

From our point of view, provided that Voll is initially set at an appropriate level, less frequent reviews would provide market certainty benefits.

However if the Panel opts to maintain the price cap at current levels, which we view as insufficient to deliver the standard, annual reviews should be maintained. This would allow increases to be made should critical investment shortfalls emerge, to address impacts resulting from the imposition of carbon pricing, or other impact.

Regardless of when reviews occur, a key consideration is to give several years notice of any change in the price cap to allow financial markets time to adjust. We also note that should a decision be made to index the price cap, indexation changes should occur automatically every year (and therefore would fall outside the notice period for other changes).

Extreme outcomes should not be published

In section 4.2.5 (2) of the second interim report, the Panel suggests that detailed reporting of the frequency, duration and depth of shortfalls identified in the most extreme scenario's emerging from reliability modelling should be performed.

We do not support this recommendation.

By its very nature, the scenario modelling performed will contain a small number of very low probability high consequence events which are outside the design criteria of the power system and market. Identifying and drawing attention to these scenarios

would appear to offer no practical value, and runs the real risk of being taken out of context by stakeholders (potentially including the media). This could result in alarmist reporting that could bring the industry unnecessarily into disrepute.

A more conventional approach may be to develop some specific credible “stress test” scenarios if that is the objective intended by the Panel.

The design, operation and information dissemination process of the EAAP

Overview of the EAAP

TRUenergy does not perceive the EAAP to be a useful process for participants. In our view, it is the role of energy traders to assess the future supply demand balance and determine the risk of energy shortfalls. Perceptions of these risks can then be priced in the forward market and a broad consensus position reached. Our review of the recent NEMMCO drought report revealed little information that had not already been identified by traders in the market through careful research and examination of public data.

While market theory indicates that increased information disclosure should enhance market efficiency, we believe that this ideal should not be pursued at any cost. As we perceive minimal additional information is likely to be available from the EAAP, the transaction costs in developing it and the administration costs to participants in providing data to it should be kept to a minimum.

We are also concerned that aspects of the mandatory provision provided in the proposal stray into areas currently considered confidential by participants. The more confidential information that is collected by NEMMCO, the higher the risk to participants of it falling inadvertently into the wrong hands. Concerns on this front may create problems with the veracity of data collected.

If the panel is of the view that the report does have value – perhaps as a tool to manage government expectations – then we urge that a pragmatic approach be taken to its preparation, which weighs the benefits of the report (if any) against the costs to participants of providing information for it, and to NEMMCO in preparing it. In particular the objectives of the report should be clearly identified, and its scope limited to ensure that the objective is met.

Generator Energy Models

As currently proposed, the Generator Energy Models to be provided as part of the EAAP span water (storage &/or cooling), fuel (thermal / gas) and any other constraints that may limit generator energy production.

We do not believe it would be valuable to seek Energy Models from fossil fuelled stations. Fossil fuelled generators tend to either:

- Be fuelled by dedicated mines with energy availability in excess of the generation plants lifetime; or
- Source their fuels from markets, which over the timeframes proposed for the EAAP, are also essentially limited only by price.

Any shortfalls in either of these mechanisms will be event driven, and are best handled through the existing capacity based PASA process.

The only generator data that may have relevance to the EAAP over a two year timeframe is water information primarily for hydro plant. The difference between this source of information and fossil fuel information is that variations in rainfall are stochastic and can create significant variations in energy availability over the timeframe considered by the EAAP. Fossil fuel availability does not vary over this timeframe (apart from short term matters that are best dealt with through the capacity based PASA process).

In any event, we encourage the panel to take a pragmatic view of what is required from the proposed EAAP and limit the cost of its preparation accordingly.

EAAP should not be a trigger for RERM

We are concerned that the EAAP will not provide a clear and objective basis for triggering RERM events.

The Panel should be clear in its determination to confirm its statement made at the recent forum, that the EAAP will not play any role in triggering RERM events. RERM should only be triggered on the basis of the current PASA process without any adjustments based on the RERM outputs. It should also ensure that this matter is clear in any draft rules submitted to the AEMC as a result of this process.

The design of the RERM

TRUenergy has had a long term position of opposing the Reserve Trader mechanism (aka Reliability Safety Net, and now RERM). While our earlier submissions explored this in more detail, at a fundamental level, we hold the view that interventions reduce market efficiency and should be avoided.

In situations when implementation of interventions cannot be avoided, the mechanisms implemented should be designed to:

- Be predictable;
- Low cost; and
- To operate extremely rarely (if ever).

While we maintain our opposition to extending the Reserve Trader, we will focus our comments to the specific changes proposed in the Second Interim report. Our comments are in line with the principles outlined above.

If the Reserve Trader is to continue, we believe that several of the alterations proposed will be beneficial. In particular the following reforms are likely to result in an enhanced procurement arrangement with resulting cost reductions:

- Extension of procurement period to nine months; and,
- Specific authorisation of NEMMCO to use multiple tender rounds to minimise costs.

We appreciate the Panel's efforts to reduce double dipping, and in particular the requirement in section C.3.6 of the draft RERM guidelines that NEMMCO publish the name of contracted counterparties, the volume of reserve procured and the timing of the reserves procured. We suggest that in addition to this proposal, information on the site of the reserve procured also be published, as many counterparties will have multiple sites across the NEM.

We are also supportive of revised cost recovery arrangements, which aim to recover costs over multiple years. Improvements that smooth out recovery of these unbudgeted cost imposts will benefit both retailers and consumers.

While we support smoothing recovery over time, we do not support the proposal for NEMMCO to form a fund ex-ante from which reserve trading costs can be recovered. With improvements in demand forecasting and reserve level calculations it is hoped that the incidence of RERM will be significantly reduced in future. Forming a fund to exist "just in case" the RERM is triggered is likely to be costly given that it is proposed that relatively significant funds will be recovered and potentially never (or very infrequently used).

In our view the preferred approach would be to allow NEMMCO to arrange finance when a RERM event occurs, and recover these funds (along with finance costs) over several years following the event. This approach will avoid the definite costs of creating an infrequently used fund, provide a cost recovery regime for NEMMCO, and make recovery of the funds more manageable for price capped retailers and exposed customers.

The level of VoLL and whether or not it should be fixed or indexed

Our comments in this section relate to the value of the market price cap, referred to by the Panel and in this document interchangeably as Voll.

Consideration of the price cap in a financial framework

If Voll is considered from a financial perspective, it can be considered equivalent to a free option with a strike price equal to the price cap.

In theory if the market price cap is considered in this way, the level of impact it has on the market could be estimated by comparing the premium payable for an option with a strike price at Voll in an uncapped market, against zero – the premium payable for the free option inherent in a capped market.

Clearly the premium value of the option would be expected to reduce as the strike price increased. As such, the impact the price cap has on the market (relative to an ideal uncapped market) will reduce the higher it is set.

Moving from one very high strike price to another even higher one, would be expected to have negligible impact on the premium value inherent in the cap, and so should be of little concern to market participants. Our internal modelling, the work of ESIPC and CRA during this review, and the heated views of participants on the topic of adjusting the price cap convince us that the value of the option premium inherent in the price cap at \$10,000/MWh is significant. In other words the price cap at its current level is impacting on the operation and investment in the market.

In order to reduce the value of this free option to near zero, we continue to support a large increase in the market price cap. In our view, such an increase would remove the risk of the price cap impacting on reliability and investment, and impose incentives to ensure that risk tolerances and competition become the key determinants of investment.

Importance of Voll as an investment driver

At the recent forum, panel members sought views on how critical Voll is as a driver for new investment.

As an active investor in the generation sector (current owner of the Yallourn and Hallet Power stations, and developing Tallawarra) TRUenergy is well qualified to comment on this. We have also signed significant off-take agreements that have underwritten large power stations in the NEM, as well a number of renewable plants.

In all these investment decisions, as well as in our general wholesale contracting activities as a retailer and market trader, the current level of Voll (and the CPT) are critical.

Voll and CPT set the outer limit of what the market can be expected to deliver in terms of revenue to a generator, or cost to a retailer. In assessing the economics of any investment market participants perform detailed modelling, which assesses large numbers of market scenarios to determine a probabilistic view of revenues/costs available to the investment. The level of the price cap has a significant impact on the "tail" of the payoff expected from any particular investment. Mapping this back to the discussion on option values, in our evaluation of investments the price cap tends to truncate these lower probability tail outcomes – indicating that the option value inherent in the cap is significant.

In practical terms, with Voll at its current levels it is impacting on market and reliability outcomes. Varying the value of Voll around current levels can easily bring forward, or delay an investment case by years. This view is supported by:

- the ESIPC modelling results which indicated that with current settings returns from the market are likely to be truncated to levels that will tend to deliver investments later than required to meet the 0.002% standard; and
- by the CRA modelling which indicated a modest increase in Voll was required to ensure the price cap did not create a barrier to the achieving the standard.

To remove this impact, a large increase to Voll is required to ensure that the inherent premium value of the free option is negligible.

Level of Voll

As indicated in the preceding discussion, we continue to believe that a large increase in Voll is warranted to remove any influence of the price cap on market outcomes and reliability. An increase that brought the market price cap to levels in the range of the Value of Customer Reliability would open the way for increased demand side response, as well as aligning the generation investment regime with that of transmission investment (at least in Victoria).

While we believe there is a clear case for a large increase in Voll, this does not appear to be the direction foreshadowed by the Panel in its second interim report. If the Panel does not opt for a large increase, at an absolute minimum, it should increase the price cap to \$12,500/MWh.

This would recover the cap to a similar level (in real terms) to its original setting, and also address the apparent inability (or at best marginal ability) of the current price cap to deliver the 0.002% reliability standard indicated in the modelling by ESIPC and CRA. We note that the CRA modelling appears to indicate more consistent delivery of the standard at these levels.

In the event that the Panel adopts its proposal not to review the price cap for 3 years, and that a 3 year notice period is likely to be required for any change to the cap value, it would be even more critical that Voll is increased to more sustainable levels. Failure to do so runs the risk of locking in inadequate market settings for the medium term and creating reliability problems in future.

Indexation of Voll

As stated above, our core position is to raise the market price cap to levels at which the inherent premium value of the cap is negligible (ie. a very large increase). Should this occur, then indexation would be irrelevant – as the price cap would not be based on any particular cost estimate, and would be so high that indexation based changes in its value would be irrelevant.

In order to move the price cap to these desirable levels, a path of change might be considered desirable, with perhaps an increase of \$5000/MWh being scheduled at regular intervals over a decade to reach the ultimate desirable level (ie. perhaps every year, or every 2 years).

However, with the current settings, and even an increase to \$12,500/MWh, we are far below levels that cease to impact on investment. In fact as demonstrated by the CRA modelling, the price cap is currently set at such a marginal level, that the market's ability to deliver the targeted reliability standard is sensitive to input cost inflation.

On this basis, if the Panel opts to adopt the high risk approach of continuing to operate with the price cap set at marginal levels, a degree of indexation of Voll would be logical. This would guard against real reductions in the price cap, which could translate into a decaying ability of the market to deliver on the reliability standard.

The level of the CPT (noting that the CPT was nearly exceeded in June 2007)

As outlined in our previous submission, TRUenergy supports a significant increase in the CPT, at least to the levels originally intended (eg. \$300,000).

We also support the introduction of a physical trigger. This mechanism would remove a number of the historic high price spikes caused typically by unmanageable transmission related events – which are outside the bounds of what the market is designed to deliver.

Administered Price Cap (APC) Review

TRUenergy also supports the Panel's initiative to recommend the review of the APC.

In our view the APC should be set at levels that will cover the variable costs of the most expensive plant in the NEM (presumably low efficiency diesel fired gas turbines). In conjunction with this, the compensation provisions in the Rules that apply under APC conditions should be revised to remove any opportunity for cost recovery in excess of the actual variable costs incurred by compensated plant. In particular, any opportunity for pay as bid compensation should be eliminated.

These variations would significantly improve the prospects of the market maintaining its financial integrity in the event of prolonged administered price capping. This would occur because prudently hedged retailers would remain viable, as unhedgeable compensation costs would be kept to a minimum.

The consideration of additional or alternative reliability measures (such as a Reliability Ancillary Service or Reliability Options etc) to ensure reliability in the NEM

In our view the panel has yet to make the case that the energy only market design cannot deliver reliable outcomes (with appropriate price cap settings).

A strong case would need to be made to support the costly introduction of any new market design features such as reliability options or ancillary services.

Given the advanced stage of the review, we would have expected such a case to have been well articulated by now. However in our view, nothing has emerged that would not be dealt with by merely increasing Voll to a sustainable level.

As noted in our presentation to the panels form, we are also unclear on why an extension to the Reserve Trader (aka RERM) would be required if additional reliability mechanisms were to be implemented. In our view, the RERM could only be justified in an energy only market context. Should the panel decide to adopt an alternative market design, the RERM should be deleted from the Rules.

Other matters that arise through the upcoming stakeholder consultation process

Share the pain guidelines

As discussed in section 7.2.3 of the Panel's first interim report, the current approach to "sharing the pain" results in a suboptimal allocation of reserves between regions.

In response to these concerns, the panel has stated that it is NEMMCO's responsibility to determine load shedding during a given system incident, and that it is the role of Jurisdictions to determine which loads should be disconnected when a shortfall occurs.

Unfortunately this response does not address the concern, and suggests that the Panel may have failed to consider the impact of its own guidelines.

As pointed out in our presentation at the recent forum (and in our previous submission), the current conservative reserve allocations are due to limitations imposed by the "Guidelines for management of electricity supply shortfall events" issued by the Reliability Panel in September 1998.

In our presentation we proposed a simple amendment to these guidelines that would allow optimisation of reserve levels over time (rather than instantaneously as per the current guideline).

The outcome of this would be to deliver lower reserve requirements for South Australia, by allowing modelled load shedding to be spread over time in the calculation of reserve requirements (rather than requiring load shedding to be instantaneously shared). Importantly implementing this change would not reduce the ability of Victoria or South Australia to achieve the reliability standard.

In practical terms, the resulting reductions in reserve levels would lower the probability of Reserve Trader events being triggered in South Australia. Or put another way, it would remove the risk of Reserve Trader being triggered on the basis of calculations rather than on the basis of real reserve shortfalls. This would enhance

the market objective by reducing unnecessary costs to consumers resulting from over-conservative reserve levels, and unnecessary RERM events.