

30 October 2008

Mr Ian Woodward  
Chairman  
AEMC Reliability Panel  
PO Box A2449  
SYDNEY SOUTH NSW 1235

Dear Mr Woodward *Ian*

**RE: NEM Reliability Settings: VoLL, CPT and Future Reliability Review**

Please find attached the AER's submission on the Reliability Panel's Exposure Draft on NEM Reliability Settings.

Please contact me if you have any questions in relation to the matters raised in our submission.

Yours sincerely



Michelle Groves  
Chief Executive Officer



**AER Submission**

**NEM Reliability Settings: VoLL, CPT and Future Reliability  
Review**

**Response to Reliability Panel Exposure Draft**

**30 October 2008**

## **Introduction**

The Australian Energy Regulator (AER) welcomes the opportunity to respond to the Reliability Panel's exposure draft of a proposed Rule change relating to NEM Reliability Settings. The Rule change will seek to:

- increase the level of the price cap (VoLL) from the existing level of \$10 000/MWh to \$12 500/MWh, effective from 1 July 2010;
- define the cumulative price threshold (CPT) in the Rules as 15 times VoLL;
- replace the term "VoLL" with "Market Price Limit (MPL)"; and
- replace the current annual review of VoLL with a reliability standards and settings review (i.e. the reliability standard, MPL, CPT, and the market floor price) which is to take place every two years with two years' notice of any change.

The AER's submission firstly focuses on the threshold question of whether it is appropriate to progress the review in the current environment. The development of the Carbon Pollution Reduction Scheme (CPRS) has wide-ranging implications and it may be prudent for the Reliability Panel to suspend this review until the form of the CPRS has been determined.

The submission then focuses on the detail of the exposure draft. The comments are limited to the proposal to increase the MPL to \$12 500/MWh and the CPT to \$187 500; and the timing of these increases.

### **The review in the broader policy context**

The AER appreciates that the exposure draft of the Rule change reflects the recommendations in the Reliability Panel's Comprehensive Reliability Review (CRR) Final Report of December 2007 and that the recommendations in that report followed broad consultation. However, there have been subsequent policy developments which have important implications for this review.

There has been significant progress towards developing the CPRS. The Federal Government's CPRS Green Paper was released in July 2008. By the end of this year, the exposure draft of the CPRS legislative package and the medium-term trajectory for the scheme are due to be released.

There are important linkages between the CPRS review and this current Rule change exposure draft.

First, the CPRS Green Paper acknowledged that the electricity sector, in particular coal-fired generation, will face particular challenges as a result of the introduction of the CPRS. It therefore proposed setting up a new fund, the Electricity Sector Adjustment Scheme, to deliver support to the coal-fired generation sector. The Green Paper notes that in part this support is designed to ensure security of energy supply. Second, the CPRS Green Paper notes that there are barriers to investment emerging from

uncertainty about future greenhouse policies and the future cost of carbon emissions which may affect reliability. The proposals to increase the MPL and CPT contained similarly relate to generation investment decisions and the reliability of energy supply.

With the finalisation of the CPRS, the policy uncertainty leading to any investment deferral will have been dealt with and specific measures designed to promote reliability will, in all likelihood, have been introduced. Further, by September 2009 the AEMC will have completed its Review of Energy Market Frameworks in light of Climate Change Policies. The scoping paper canvasses generation capacity and reliability issues as key areas of focus for the review. The AER believes that the implications of any recommendations arising from the AEMC review should be considered before proceeding with the current Rule change proposal.

It is particularly important to consider the implications of measures resulting from the CPRS review because, as acknowledged in the exposure draft, the MPL – CPT proposals are likely to increase wholesale prices which will ultimately lead to higher prices for consumers. In these circumstances, it appears prudent to ensure that the proposals are necessary and will have their desired effect. If there are more significant issues influencing investment, such as the uncertainty around the CPRS, increasing MPL and the CPT may deliver higher prices for consumers but do very little to promote investment necessary to ensure reliability.

### **Increase in Market Price Limit**

The Reliability Panel states that there would be a very likely breach of the reliability standard after 2011 NEM-wide and therefore proposes an increase in the level of the MPL as a medium term signal for investment in new generation and demand side response.

As recognised by the Reliability Panel, uncertainty about the future cost of carbon emissions has been the primary cause of deferred generation investment. Accordingly, it is not entirely clear that the existing MPL is insufficient.

However, while the AER has not reviewed the Reliability Panel's modelling supporting an increase in the MPL, it appreciates that a significant period of time has elapsed since the last MPL increase. It also recognises the importance of allowing price signals to be revealed. Accordingly, the AER has no strong objection to an increase in the MPL.

### **Increase in Cumulative Price Threshold**

The CPT is the NEM's primary risk management mechanism against extreme prices. It has a key role in protecting market participants from financial stress associated with sustained price volatility brought about through market failure.

The types of events that can trigger the CPT are not restricted to "force majeure events", as was the case with the administered pricing mechanisms in place before the introduction of the CPT. Any event or behaviour that increases price significantly and for sufficient duration, such as supply shortages or abuse of market power, can trigger the CPT.

The CPT is primarily designed to manage the risk of market failure while. On the other hand, the level of MPL is primarily set having regard to the need to encourage generation investment. Changes to the CPT, therefore, should receive careful consideration in their own right rather than simply being treated as an adjunct to the MPL.

The exposure draft proposes to set the level of the CPT at 15 times the level of the market price limit. This would involve an increase in the CPT from \$150 000 to \$187 500.

Since the CRR Final Report was released, the CPT was breached for the first time in South Australia in March 2008. The AER's analysis of the events in South Australia, outlined in two \$5000/MWh reports,<sup>1</sup> provide some salient lessons on the role and operation of the CPT.

South Australia experienced 51 spot prices above \$5000/MWh in the first quarter of this year. The cumulative weekly price approached the CPT on four occasions during this period before exceeding the CPT on 17 March. The cumulative price exceeded \$120 000 from 7 March, before the CPT of \$150 000 was exceeded on 17 March. Spot prices in South Australia averaged \$325/MWh for the month, the highest since the NEM commenced operation.

These market outcomes created significant stress for some participants in South Australia. A number of retailers have either decided to stop marketing to customers in South Australia or have wound back their retail operations. Indeed a survey conducted on behalf of the AEMC in June 2008 indicated that nine of South Australia's fourteen licensed electricity retailers had ceased active marketing, primarily because of high wholesale prices.<sup>2</sup>

The effectiveness of the CPT as a safety net during this period, the only time where it has been invoked, has not been assessed in the Rule change proposal. The Reliability Panel should consider the implications of raising the CPT and its effectiveness as a financial risk safety net. At present, prices could average \$446/MWh over a sustained period without breaching the CPT. The Reliability Panel's proposal means that prices could average \$558/MWh without breaching the CPT. Such prices would have significant potential to exacerbate financial stress to some market participants.

It is also not clear that the current level of the CPT needs to be increased to ensure that it does not hinder investment. Indeed, the exposure draft indicates that the Panel's modelling suggests that an increase in the CPT will not result in any reduction in unserved energy.<sup>3</sup> In South Australia, the existing CPT was able to accommodate 18 separate spot prices in excess of \$9950/MWh in a two week period before it was breached. Further the price was close to the price cap on 41 occasions over a 73 day

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<sup>1</sup> AER, *Spot prices greater than \$5,000/MWh – South Australia: 4 & 10 January, 18 & 19 February 2008*; AER, *Spot prices greater than \$5,000/MWh – South Australia: 5 – 17 March 2008*.

<sup>2</sup> LECG, *Survey and interviews with South Australian electricity and gas retailers*, Prepared for the AEMC, 18 June 2008.

<sup>3</sup> Reliability Panel, *NEM Reliability Settings: VoLL, CPT and Future Reliability Review*, Exposure Draft for Consultation, September 2008, pg 13.

period, which saw an average price for the March quarter of \$243/MWh. As noted above, prices could average \$446/MWh over a sustained period without breaching the CPT. These prices are well above new entrant prices, so therefore it is not clear that an increase in the CPT is required to stimulate generation investment.

Given the financial stress experienced by market participants in South Australia under the existing threshold, and the uncertainty over whether an increase in the CPT will be effective in promoting investment, the AER questions whether it would be beneficial to increase the CPT at this time.

While the AER appreciates the intuitive appeal in retaining the current relative level of the CPT, it is not clear in practice why the CPT should be set at 15 times the level of the MPL into the future. Even if the MPL was to be increased to \$12 500/MWh and the CPT was retained at \$150 000, the CPT would still only be breached in extreme conditions. Prices would still need to average \$446/MWh over a rolling seven day period for the CPT to be invoked.

Some respondents to the CRR expressed concern about the practical operation of the CPT and, in particular, its effectiveness as a risk management tool.<sup>4</sup> These concerns were expressed before the extreme pricing events of March 2008. The last time that the design of the CPT was considered in any detail was in December 2003.<sup>5</sup> The Panel at that time considered a number of different aspects of the CPT, including:

- the time period over which the Cumulative Price is accumulated;
- whether all spot prices that occur during a period should count towards the Cumulative Price, or only those above a certain strike price;
- the level of the administered price amount.

While the Panel decided against any changes to the design of the CPT during the 2003-04 review, it considered that it was appropriate to regularly review the CPT. Given that recent market events have provided an insight into the operation of the CPT in practice, it may be an appropriate time to reconsider the structure of the CPT as well as its level.

Rather than simply increase the CPT to reflect changes to the MPL, the AER considers the Panel should delay its decision whether to increase the CPT until a separate review that considers the appropriate design and level of the CPT in light of recent market experience has been completed.

### **Timing of the increases**

The exposure draft proposes increasing the level of the MPL and CPT on 1 July 2010, the same date that is currently proposed for the introduction of the CPRS.

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<sup>4</sup> Reliability Panel, *Comprehensive Reliability Review Final Report*, December 2007, page 11.

<sup>5</sup> Reliability Panel, *VOLL and the Cumulative Price Threshold, Issues Paper*, December 2003.

The introduction of the CPRS is a major change for the market to accommodate. Arguably it is the most significant change to the market since the NEM commenced in 1998. The immediate impacts on the market of the introduction of the CPRS cannot be predicted with certainty. It may create some shocks that the market will need to adjust to. Introducing an increased MPL and CPT on the same day may amplify the impact of any market shocks created by the introduction of the CPRS.

Further, the uncertainty about the future carbon price has led to very little forward contracting in the market. Therefore, at least initially, market participants may be restricted in their ability to adequately manage spot market risk in the market. A simultaneous increase in the MPL and CPT could exacerbate this problem.

To ensure continued confidence in the operation of the market in the initial stages after the introduction of the CPRS, it may be prudent to delay the increase in the MPL and the CPT until the market is more comfortable with the CPRS.