ETSA Power

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9 November 1999

Mr Michael Rawstron
General Manager
Regulatory Affairs - Electricity
Australian Competition and Consumer Commission
PO Box 1199
Dickson ACT 2602

Dear Mr Rawstron,

APPLICATION FOR AUTHORISATION OF AMENDMENTS TO THE NATIONAL ELECTRICITY CODE – RELIABILITY PANEL REVIEW OF THE VOLL.

ETSA Power wishes to add its strong support to the submission prepared by the Electricity Markets Research Institute (EMRI) on the draft changes to the National Electricity Code in relation to the review of the VoLL.

ETSA Power previously made a submission to NECA during the review conducted by the reliability panel (Attachment A). In this we stated that the NECA issues paper was predicated on the pretext that the current level of VoLL is set too low to allow voluntary clearing of the market, without any detailed analysis to support this assertion. Consequently the NECA review recommended an increase in the VoLL. The paper submitted by EMRI includes this detailed analysis and concludes that the VoLL should not increase.

The level of wholesale pool spot prices and contract hedge prices in the SA electricity market has a direct relationship with the level of VoLL. Since the start of the NEM the average pool price in South Australia has been significantly affected by price spikes in January, February and April where the half hourly price has been as high as $4400 MWh. Without these price spikes the average pool price would have been 20-30% lower (ie around $35 MWh instead of $50 MWh). An increase in the level of VoLL will increase the potential size of the price spikes, which will increase the average pool price. Since the hedge contract price is a function of the expected level and volatility of the pool price, it would also rise if the level of VoLL were increased.

We note that the ACCC considered that "the main rationale for the price cap is to ensure that the market is not subject to large price shocks, particularly in the transitional phase of the NEM". It also noted that "without a price cap customers in particular may be exposed to price shocks and potential bankruptcy".

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South Australia will be affected more by an increase in the level of VoLL than NSW or Victoria because it has less available capacity (currently) to meet peak demand than those states. Since South Australia entered the NEM it has experienced more frequent and more extreme price spikes than the other states. As a result an increase in the level of VoLL would be expected to have a bigger increase on South Australia's pool price and contract price than in the other states, with a consequent detriment to public benefits from the proposed change.

It is ETSA Power's position that no increase in the VoLL is warranted and the ACCC should not approve the proposed changes to the National Electricity Code.

Please note that the views within this submission are the independent assessment of ETSA Power Pty Ltd. As such they do not represent a policy decision of the South Australian Government and should not be judged or reported as such.

In some instances they may be at odds with the views of other electricity companies also under ownership of the SA Government. This reflects the complexities and competitive nature of the industry.

If you have any questions or concerns relating to this submission, please feel free to contact our Mr Tony Pfeiffer on 08 8404 5189.

Yours sincerely,

John Barton
Chief Executive Officer
ETSA Power Pty Ltd

ATTACHMENT A

ETSA Power

ACN 082 928 701

SUBMISSION ON THE VALUE OF LOST LOAD IN THE NATIONAL ELECTRICITY MARKET.

3 June, 1999

1 INTRODUCTION

This submission details ETSA Power's response to the "Issues Paper" on the "Review of VoLL in the national electricity market" prepared by the National Electricity Code Administrator. These comments broadly follow the sequence of the "issues paper'.

2 OVERVIEW

The level of wholesale pool spot prices and contract hedge prices in the SA electricity market has a direct relationship with the level of VoLL. Since the start of the NEM the average pool price in South Australia has been significantly affected by price spikes in January, February and April where the half hourly price has been as high as $4400 MWh. Without these price spikes the average pool price would have been 20-30% lower (ie around $35 MWh instead of $50 MWh). An increase in the level of VoLL will increase the potential size of the price spikes which will increase the average pool price. Since the hedge contract price is a function of the expected level and volatility of the pool price, it would also rise if the level of VoLL was increased.

We note that the ACCC considered that "the main rationale for the price cap is to ensure that the market is not subject to large price shocks, particularly in the transitional phase of the NEM". It also noted that "without a price cap customers in particular may be exposed to price shocks and potential bankruptcy".

South Australia will be affected more by an increase in the level of VoLL than NSW or Victoria because it has less available capacity (currently) to meet peak demand than those states. Since South Australia entered the NEM it has experienced more frequent and more extreme price spikes than the other states. As a result an increase in the level of VoLL would be expected to have a bigger increase on South Australia's pool price and contract price than in the other states.

3 THE ISSUES

3.1 THE ROLE OF VOLL

We agree with the conclusion reached in the paper that "The primary role of VoLL should be that of a price cap which strikes a balance between allowing the market to clear with minimal intervention and containing market risk to tolerable levels".

3.2 THE IMPACT OF VOLL ON PARTICIPANT RISK

We note that the issues paper states that risk management becomes a central issue if the value of VoLL causes participants to be deterred from entering the market because of risk perceptions or the cost of prudentials. We believe that a higher level of VoLL will discourage new participants from entering the market and hence create a barrier to entry.

We further contend that any increase in VoLL will potentially reduce the amount of liquidity in the contract market, as there will be an increase in risk for both the retailer and the generator. If either party finds themselves in an over contracted position and a higher VoLL pool price occurs, there will be a significant increase in financial risk compared to the current scenario. There will be an increase in counterparty credit risk that once again will affect market liquidity.

3.3 MANAGING TRADING RISK IN THE NEM

Due to the tight demand/supply balance in South Australia there is insufficient hedge cover available from the generators in South Australia to cover all contestable and franchise exposures. As such market participants are already exposed to excessive price risk at a $5000/MWh VoLL, let alone any price increase which may occur.

The issues paper, on page 15, refers to limitations in the NEM preventing participants from varying their supply and consumption in response to price. The reasons given for retailers not being able to influence their customers consumption on a half hourly basis are all valid but an important one appears to have been overlooked. Customers, in general, are looking for retailers to protect them from exposure to pool price variations which is reflected in their preference for fixed price contracts. Strong retail competition ensures that the customers are able to achieve these fixed pricing arrangements. This means that demand side adjustments by customers will be limited until the market develops further. An increase in the level of VoLL would increase customer's preference for no pool exposure.

In addition the paper refers to the post hoc price changes that "sometimes" occur. These events are a regular occurrence in the South Australian market.

Also ETSA Power has been a victim of Network service providers scheduling outages at a time of high market impact. The particular event had a significant financial impact on ETSA Power which would have been exacerbated if the value of VoLL was higher. As inferred in the issues paper, these limitations inhibit participants from managing their trading risk as effectively as they would wish and would have even significantly greater impact if the value of VoLL was increased.

3.4 COLLECTION RISKS AND RETAILER OF LAST RESORT (ROLR)

Even at the current level of VoLL the financial risk exposure for the ROLR could cause systemic failure, as customers will not be able to bear the pass through of high pool prices and would potentially default on the payments leaving the ROLR exposed. Increasing the level of VoLL will only magnify the risk of failure under this scenario, along with the increased prudential requirements required by the ROLR affecting their ability to comply with the market requirements and leading to potential suspension of the ROLR by NEMMCO.

3.5 CLEARING THE MARKET

The issues paper appears predicated on the pretext that the current level of VoLL is set too low to allow voluntary clearing of the market.

"Setting too low a price cap would impair the ability of the spot market to clear voluntarily."

"The ability of the market to clear without intervention will be improved with a higher price cap".

ETSA Power contends that this causes the issues paper to be biased towards advocating an increase in the value of VoLL and consequently assists in the formation of the conclusions reached in the paper towards this end. We believe that before these assertions can be made it must be first proven beyond reasonable doubt that the current market is failing to clear voluntarily.

We have already indicated that the tight supply/demand balance in South Australia has caused frequent and more extreme price spikes than in the other states. The operation of the market under these circumstances has contributed to the announcement of significant investment in new and refurbished generation for South Australia as well as two "competing" proposals for interconnection with NSW. ETSA Power has also continued and expanded previous demand side response initiatives to assist in the management of the pool exposure.

On the national scene, Queensland also has a tight supply/demand balance which has caused similar volatility in the pool price in that state. It is well documented that significant investment in new generation is also occurring in Queensland.

Victoria, apart for its summer peak period, has a surplus of capacity. This has resulted in low average pool prices. Despite this the current market arrangements have spawned a proposal for new peaking plant generation.

NSW also has surplus supply capacity, which has presumably resulted in low average pool prices. We contend that as the supply/demand ratio converges in this state then the pool volatility will increase under the current market arrangements. Extrapolating the results from the other jurisdictions, it appears reasonable to assume that proposals for additional supply capacity or demand initiatives would eventuate.

It is therefore our conclusion that the current market arrangements facilitate voluntary clearing of the market and indeed have attracted sufficient new investment to ensure that the market continues to clear voluntarily into the future. We find no basis for the statement that the ability of the market to clear would be enhanced by increasing the value of VoLL.

3.6 REGULATORY RISK

We agree with the issues paper on relation to regulatory certainty. The current uncertainty surrounding a potential increase in the value of VoLL has a significant affect on the liquidity of the contract and derivative market, that if allowed to continue will further inhibit the ability of participants to manage their risk.

The issues paper advocates a balance between certainty and retaining flexibility. We cannot agree with this approach and believe that the three year price path for VoLL should be firm. This issue needs to be resolved and a fixed path forward into the future established to ameliorate the regulatory uncertainty.

4 ANALYSIS FRAMEWORK

4.1 CRITERION

The issues paper continues to assert that an increase in VoLL is required to develop an appropriate demand side response, yet on page 33 of the paper it states:

At the present value of VoLL there are indications that the amount of price responsive demand is increasing and in parts of the market is reasonably well established already.

The paper further concludes that:

...as long as values of VoLL in excess of $20,000/MWh are not involved, the basic criterion for setting VoLL should be to select a value that maximises the ability of the market to clear voluntarily, without creating an intolerable risk management problem.

We again wish to register our concern in regard to the apparent premise in the issues paper that the value of VoLL is required to increase to achieve an appropriate demand side response and to facilitate voluntary clearing of the market. We state again for the record our belief that the current level of VoLL is achieving the required market outcomes, in both demand side response (supported by the issues paper as per above) and voluntary clearing of the market (as detailed earlier).

4.2 TIME HORIZON

As indicated earlier ETSA Power supports the view provided in section 5.3.2 of the issues paper, diamond point one, that a schedule of VoLL for a number of years into the future needs to be established which is completely firm and unalterable. Any flexibility in the process for setting of VoLL would have an adverse effect on the liquidity of the contract and derivative market meaning that the ability of participants to hedge their risks is reduced.

4.3 CODE CHANGE PROPOSAL TO REMOVE VOLL

We support the conclusion reached in the issues paper that the complete removal of VoLL is not recommended.

4.4 IS THE MARKET CLEARING NOW

An alternative view that the panel has decided to present for comment is that regardless of the conclusions drawn from the preceding data it could be concluded that market clearing is in fact occurring with VoLL at the current level of $5000/MWh.

Again we wish to express our concern that the issues paper has worked on the basis that an increase is warranted, and the debate is around the recommended value. This view is supported by the above extract from the paper which sees the current situation as an "*alternative view*". ETSA Power believes that the current market is clearing voluntarily, as detailed earlier in this response, and we contend that the issues paper should be based on this premise with discussions around proving this assertion incorrect before any debate on increasing the value of VoLL is undertaken.

5 CONCLUSION

ETSA Power supports Option One, that is that no increase in the level of VoLL is warranted to facilitate voluntary clearing of the National Electricity market. Further we are concerned that any increase would not be able to be adequately covered by the contract and derivative markets particularly as there is currently insufficient hedge cover available in South Australia to cover all contestable and franchise exposures now. Market participants are already exposed to excessive price risk at $5000/MWh, let alone any price increase which may occur.

We have provided evidence that the market is currently clearing voluntarily under the current value of VoLL, and expressed our concern that the issues paper was based on a premise that the value needed to increase to allow the market to clear voluntarily.

6 DISCLAIMER

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