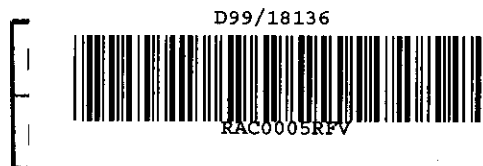


6 December 1999

Mr Michael Rawstron
Senior Assistant Commissioner
Electricity Group
Australian Competition And Consumer Commission
PO Box 1199
DICKSON ACT 2602



Dear Mr Rawstron,

**Submission On National Electricity Code Changes: Capacity Mechanisms
And Value of Lost Load**

The Business Council of Australia (BCA) Energy Reform Task Force (ERTF) welcomes the opportunity to comment on the proposed National Electricity Code Changes: Capacity Mechanisms and Value of Lost Load. The BCA submission is attached.



The BCA submission makes the following recommendation on Capacity Mechanisms:-

- rejects the NECA proposal for an energy-only market
- recommends the provision of capacity payments to augment the conditions for a competitive market
- attaches a condition requiring the establishment of an independent market monitoring process
- attaches a condition requiring implementation of market power mitigation measures drawn from best practice in comparable overseas countries
- recommends to NECA to submit Code Changes deemed necessary to prevent market power
- sets out its expectation/guidelines for the behaviour of properly functioning and efficient electricity markets.

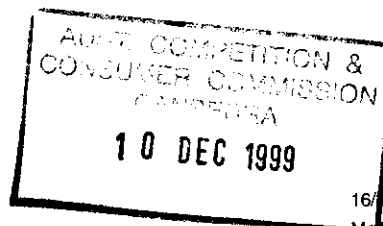
Recommendations with regard to the Value of Lost Load are:-

- rejects the NECA proposal to increase VOLL to \$20,000/MWh (in two steps)
- recommends that a comprehensive review of the VOLL concept, its implication (including especially for customers) and its appropriate, future level be undertaken by an independent body, including a review of the appropriate trading systems for Australia.

Please direct inquiries regarding this submission to Karen Grady at the BCA on (03) 9610 4222.

Yours sincerely

P L WEICKHARDT
Chairman
Business Council of Australia Energy Reform Task Force



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BCA Internet Home Page:
www.bca.com.au

Business Council Of Australia Energy Reform Task Force

Submission On NECA Code Change Proposals Relating To Capacity Mechanisms And Value Of Lost Load

1. Introduction

The Business Council Of Australia Energy Reform Task Force (BCA ERTF) has reviewed the NECA Code Change Proposals relating to capacity mechanisms and the value of lost load (VOLL) and welcomes the opportunity to provide its comments to the ACCC.

The BCA ERTF is opposed to the proposed code changes relating to capacity mechanisms and VOLL. The BCA ERTF is concerned with the potential adverse effects on electricity end users arising from the NECA proposals. In particular, as long as Australia continues to have a mandatory, single priced, energy – only pool system and substantial market power problems persist in some States, increasing the value of VOLL (whilst providing the signals for encouraging the appropriate investment in peaking plant or demand side options) may lead to inappropriate exercising of market power (and therefore prevent an efficient national electricity market from developing), and also adversely affect down-stream industry competitiveness and consumer welfare.

2. Mandatory Pool And Market Power

The BCA ERTF remains concerned about the fundamental deficiencies of the mandatory, single-price pool, which not only involves limited demand side participation, but is also inherently (price) volatile, potentially subject to misuse of market power and is not an efficient competitive market. Continued involvement of governments in the national electricity market through ownership of generator assets (thereby limiting competition through, for example, portfolio bidding and limited structural disaggregation of generators), the small number of large generators, and the regional nature of the Australian power systems, suggests that the mandatory, single-price pool system is inappropriate.

More recently, it has been expressed that the single pool price itself contains a multitude of hidden cross-subsidies and does not provide a true (competitive) market price for electricity. The NSW Treasury recently stated:

“Significantly the design of the electricity market which is based on all plants receiving a single system marginal price in each 30 minute period and which allows these prices to vary between zero and \$5,000/MWh explicitly creates both inter-temporal and inter-plant (for a single generator) cross subsidies.”

What this means is that there is an inherent cross-subsidy from industrial loads to domestic loads (since it costs the electricity supply industry much less to supply industrial customers, especially large, high load factor loads taken at high voltage, compared to domestic/commercial loads), and is

further confirmation that the trading system in use in Australia is not producing efficient and competitive outcomes.

It is therefore surprising that the NECA Review on Capacity Mechanisms did not analyse the full range of problems inherent in the Australian trading system. Moreover, the Review also failed to adequately assess the problems of the England/Wales trading system, on which there is considerable literature which does not appear to have been given adequate consideration. It is noteworthy that the UK OFFER review (July 1998) (after seven years of operation of the world's only mandatory, single-price pool) pointed to the ease at which market power had been exercised, and which resulted in pool prices remaining "stubbornly high" at some 25% above new entrant prices even though input prices had been falling. In effect, consumers and industry end-users in the UK did not gain the benefits of the reduced cost of production (of electricity) due to the ability to manipulate the pool price to levels well above what might be competitive market outcomes.

Accordingly, the BCA finds it surprising that NECA is pursuing an energy-only market proposal in the light of the reasons behind the England/Wales abolition of the single priced pool and the implementation of new trading systems consistent with normal competitive commodity markets. In this regard, a mandatory single priced pool should have provisions for capacity payments to enhance the chance of replicating the outcomes of a competitive market. Other countries use capacity payments to provide correct economic signals to generators to present themselves for loading.

The BCA ERTF supports the ACCC's recent statement that:

"...the underlying design of the NEM may need to be revisited at some time in the future, depending on both further international developments and the experience of participants and new entrants to the NEM, as well as end-users in the participating jurisdiction."

However, we consider that there should be a stronger sense of urgency in progressing the issue. Our interest behind this stems from continued concerns about the lack of competition (and hence the exercise of market power) in some States. We would therefore, strongly support a recommendation for more independent market monitoring measures similar to those used in overseas markets such as in California, Pennsylvania, New York and Maryland and in the UK.

The BCA ERTF recommends that the ACCC:-

- rejects the NECA proposal for an energy-only market
- recommends the provision of capacity payments to augment the conditions for a competitive market
- attaches a condition requiring the establishment of an independent market monitoring process
- attaches a condition requiring implementation of market power mitigation measures drawn from best practice in comparable overseas countries
- recommends to NECA to submit Code Changes deemed necessary to prevent market power
- sets out its expectation/guidelines for the behaviour of properly functioning and efficient electricity markets.

3. VOLL

The VOLL concept and the level of VOLL appears to have been heavily influenced by the England/Wales market, which contains a type of VOLL (Probability of Lost Load). VOLL is an important issue for electricity customers, as they are exposed to the risks of VOLL either being too high (high pool prices) or too low (potential for capacity problems). In terms of VOLL as a price ceiling, it can have the consequence of 'ratcheting-up' spot prices to an artificial level when supply is restricted, regardless of whether this is the real economic value of the next unit of supply. This encourages generators with market power to push up pool prices and there is concern this may be occurring in the national electricity market.

We recognise that financial hedging would mitigate the price impact to customers of the occasional times when the spot price goes to VOLL. But there is an increased cost to customers in the short term, as they would have to pay a premium to generators to cover coincident failure at these times. In the longer term assuming market power is not excessive, true price signals should lead to optimum generation/demand management investments, which result in lower average cost to customers.

Nevertheless, we would like to point to the fact that small periods of time at prices at the level of VOLL of \$5,000/MWh can have a very large effect on the average pool price in a given period. Thus, each hour at a price of \$5,000/MWh adds \$0.6/MWh to the annual average pool price. At \$20,000/MWh (as presently proposed by NECA) each hour would add \$2.30/MWh to the annual average price. Against this possibility, it is understandable why electricity consumers are opposed to raising VOLL. By raising VOLL to \$20,000/MWh under the current situation of frequent prices spikes, would seriously expose end customers to higher pool prices. Moreover, we believe that NECA should provide justification for the VOLL ceiling, as there is no clear statement on the matter in the NECA report.

The ACCC's attention is drawn to the Reliability Panel's qualification of its recommendation regarding the level of VOLL in view of its concerns with market power issues:-

"Although the matter of market gaming is not within the ambit of the Panel's role, the Panel notes that a further source of risk is the potential gaming of market price, It has earlier been noted that efficient market prices can be volatile particularly over the short term. Provisions of the code which allow market participants to efficiently respond to that volatility also allow the possibility of abuse if there is insufficient competition to counteract its effect. An increase in the level of the market price cap recommended in this report will have the effect of increasing the alternatives for balancing supply and demand under extreme conditions when abuse is potentially attractive. It will also reduce any perceived need or justification to act in a non-competitive manner. However it will also increase the potential return from it." (emphasis added).

Surprisingly, the NECA proposal to increase VOLL is not accompanied by suitable proposals to mitigate gaming, which we believe increases significantly with VOLL at \$20,000/MWh. In fact, a deficiency of the NECA proposal is that it does not recognise the influence of market power, nor does it give recognition to the impact and consequences of VOLL (and alternative options), especially from a customer perspective.

It is noted that several overseas markets have set price caps at considerably less than \$5,000/MWh let alone \$20,000/MWh. In California, the pool operates at a current price cap of \$US 250/MWh (but we understand it is moving to a price cap of US\$750/MWh). Full investigations of pool price above \$US 150/MWh are also common. In the England/Wales market, the UK OFFER has investigated any bids

higher than £60/MWh and has been concerned about the frequency of such bids. Notwithstanding such vigilance, in February 1999, OFFER stated:-

“There is strong evidence that manipulation of Pool prices has in fact been occurring; that participants in the Pool have been operating within the existing Pool rules to take advantage of those rules for their commercial interest – the “gaming” of complex rules; that prices have been manipulated; and that higher wholesale prices have been established which will result in higher prices to customers. The occurrence of this manipulation has been accelerating.

The challenge presented by these problems is both important and urgent. It is important because it affects industrial competitiveness and consumer welfare - that is jobs and living standards. It is urgent because Pool prices are an important reference point for negotiations between generators and their customers, now in train, on long term contracts. It is central to the duties of OFFER, of protecting customers and promoting competition in the electricity industry.”

(see Pool Price – A consultation by OFFER, February 1999. Available on the OFFER web site).

Proponents of a higher VOLL or price cap often claim that a peaking generator operating for just a few hours of the year has to bid very high prices in order to recover sufficient revenue to cover fixed costs and a reasonable return on investments. We understand that this justification suffers from several basic flaws:-

- peaking generators are the most likely to be recipients of ancillary service contracts (for spinning reserve, black start, voltage control and frequency control) and revenue available from these sources must be taken into account. This can be significant, averaging over \$3.5 million per week for the first nine months of 1999 for the combined VIC/NSW/SA and Queensland regions;
- the amounts of money involved in covering fixed costs of peaking plants are very small in relation to the overall payments for energy in the NEM, and to allow increased opportunities for all other generators to lift pool prices (where market power exists) is not sensible practice. It is much better to deal with the problem directly via capacity payments;
- even if there is a case for these peaking generators to be able to bid up to the prevailing price cap, there is no justification or logic in allowing all generators this degree of freedom.

Proponents of a higher VOLL (i.e. the generators) see the proposal as a ‘default demand side bid.’ We consider that it is arguably a poor surrogate, particularly when the level of VOLL is recognised as simply an arbitrary figure and not scientifically-based. It is a poor substitute for the lack of effective demand side participation in the ‘market’. We note of course, that NECA has made frequent statements to the need to encourage more demand side participation in the NEM and much publicity has been given to the (proposed) establishment of a Demand Side Working Group. There is, however, an absence of detail regarding such proposals and the ACCC should not give authorisation for an increase in VOLL until firm and effective proposals for Demand Side Participation and market power mitigation measures are implemented.

The BCA ERTF recommends that the ACCC:-

- rejects the NECA proposal to increase VOLL to \$20,000/MWh (in two steps)
- recommends that a comprehensive review of the VOLL concept, its implications (especially for customers) and its appropriate, future level be undertaken by an independent body, with the review to include the appropriate trading systems for Australia, the problems of market power, and the inclusion of effective market power mitigation provisions in the National Electricity Code.

November 1999