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Neville Henderson
Chairman
Reliability Panel
PO Box A2449
SYDNEY SOUTH NSW 1235

Dear Mr ~~Henderson~~ Neville

AER submission on Reliability Panel issues paper – Reliability Standard and Settings Review 2014 (REL0051)

The Australian Energy Regulator (**AER**) welcomes the opportunity to comment on the Reliability Panel's issues paper for the Reliability Standard and Settings Review.

As you would be aware, the AER has made a number of submissions when the NEM reliability settings have been considered previously.[1] In these submissions, we raised concerns with the current arrangements for the cumulative price threshold (**CPT**). We continue to hold these concerns and indeed believe that subsequent experience suggests even more strongly that the design of the CPT needs to be considered in this review.

While both the MPC and the CPT deal with extreme market events, it is important to note that they were intended to perform different roles. The MPC is set at a level that balances the financial risks faced by market participants through exposure to peak prices, with the need to promote investment through high price events. While a high MPC exposes market participants to significant risks, it promotes generator investment by providing high returns during peak periods, which can make it commercially viable to invest in generators that are only dispatched for a handful of periods throughout the year.

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[1] AER (2008), *NEM Reliability Settings: VoLL, CTP and Future Reliability Review, Response to Reliability Panel Exposure Draft*, October 2008; AER (2009) *National Electricity Amendment (NEM Reliability Settings: VoLL, CPT and Future Reliability Review) Rule 2009, Response to AEMC Draft Rule Determination*, April 2009; and AER (2010) *Proposed Rule Change: Reliability Settings from 1 July 2012, Response to AEMC Consultation Paper*, December 2010.

Further, by creating a high price risk for retailers which has to be managed, either through financial instruments or by purchasing additional physical cover, the MPC helps develop a market for risk management. In managing their risk, retailers sponsor greater long-term reliability, as their risk management financial arrangements can effectively underwrite new generation investment, particularly in peaking plant that are natural physical hedges for cap contracts.

The CPT, however, is an explicit risk management mechanism. It was designed to limit the exposure of market participants to high spot prices over a protracted period of time, rather than just the short-term peaks. The temporary administered pricing regime that is invoked after a breach of the CPT is intended to protect the market from extreme events which may threaten its stable operation.

The AER believes that there are number of factors which support the Reliability Panel reviewing the effectiveness of the CPT as a risk management mechanism.

First, it has been a decade since the design of the CPT was considered in detail. At this time the Reliability Panel considered a number of different aspects of the CPT including:

- the time period over which the cumulative price is determined
- whether all spot prices that occur during a period should count towards the cumulative price, or only those over a certain threshold, and
- the level of the administered price.

Given the period of time that has elapsed since the design of the CPT was last reviewed, it appears appropriate to undertake a 'sense check' of whether the current design of the CPT remains suitable.

Second, the CPT has been breached on a number of occasions since the design of the CPT was considered in detail. The CPT has been breached on five occasions - once in Victoria in January 2009, once in Tasmania in June 2009, and three times in South Australia in March 2008, January 2009 and November 2009. There have been a further nine incidents of near CPT incidents - one in Queensland, two in New South Wales, and six in South Australia. A number of the incidents in South Australia were in close time proximity. It would appear to be necessary to analyse these events to determine whether the CPT is effectively managing risk in the NEM.

Third, under the arrangements whereby the level of the CPT has been pegged to the level of the MPC and then indexed by CPI, the level of the CPT has increased by over 30 per cent on its initial level of $150 000. This has led to a situation whereby the second highest cumulative price in the history of the NEM, in New South Wales in February 2011, when the cumulative price reached almost $169 000, did not breach the threshold. It would be useful to analyse this event to determine whether the higher CPT creating unnecessary risk in the market or whether the CPT was set at an appropriate level.

As part of a review of the CPT mechanism, the Panel could consider arguments the AER has made previously that opportunities exist for generators to manipulate the price such that the cumulative weekly price comes very close to, but does not exceed, the CPT for a number of days and over a longer period than one week.

The AER considers that the Panel should consider possibilities, such as changing the CPT mechanism so that it operates on a longer time horizon (i.e. a limit based around a 90 day rolling cumulative price). This may ensure that it achieves its stated purpose of limiting participants' financial exposure to the wholesale spot market during significant periods of high prices, while preserving as far as possible the market's ability to use price signals to provide supply reliability.

The AER believes that the above factors warrant the Reliability Panel undertake a thorough review of the CPT mechanism to assess its ongoing effectiveness at managing risk in the NEM.

If you would like to discuss any aspect of this submission please contact Tom Leuner on (03) 9290 1890.

Yours sincerely

Michelle Groves
Chief Executive Officer