

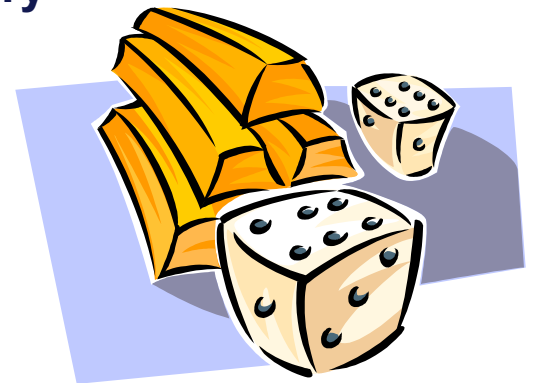


Reserve Generation Proposals: Issues and Options

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M^{co} Overview

- **Government parameters**
- **Challenges with reserve generation (RG) proposal:**
 - **Minimise risk of RG displacing ordinary generation (OG)**
 - **Minimise risk that wrong RG options will be chosen**
 - **Ring-fencing RG is not efficient and not necessary**
- **Concluding thoughts**





Government Perspectives

▶ **The Governments view appears to be:**

- Markets under-provide security of supply
- Financial interventions are inadequate to assure security of supply
- A 'bricks and mortar' approach provides the best assurance of security of supply

▶ **My comments work within these parameters**

- Suggest areas for refinement of policy
- Certainly RG preferred to Leyland approach





Issue #1: Risk of Displacing OG

- ▶ **High risk that reserve generation (RG) will increasingly displace ordinary generation (OG)**
 - **Demand-side:** pressure on Commission to reduce prices at which energy is offered the dispatcher (“strike price”)
 - **Supply-side:** more attractive for generators to secure low-risk, long-term contracts for RG rather than pursue contracts for OG with consumers or supply the spot market



Solutions to Displacement Risk

- ▶ **RG proposal seeks to address two problems: insurance and gaming**
- ▶ **Don't use one instrument to hit two targets**
 - Perhaps consider market power mitigation measures to address gaming risks
 - Use RG to provide insurance
- ▶ **Possible options to 'firm up' strike prices:**
 - Obtain forecasts from multiple sources
 - Involve consumers in setting RG quantities
 - Activate regulations requiring consumers to be hedged
 - Perhaps consider NETA type arrangements, where parties are penalised for deviating from contract positions





Issue #2: Risk of Selecting High Cost RG Options

- ▶ RG contracts intended to pay separate prices for capital costs, O&M costs, and fuel costs
- ▶ Hence, selecting RG suppliers requires trading-off capital costs against variable costs
 - May not always be obvious who should win the contract
 - May give rise to high administration costs
 - May impose high compliance costs on generators
 - Real risk that selections may artificially favour some proposals over others
- ▶ Alternative: just pay an annual fixed fee (\$/MW)





Issue #3: Ring Fencing RG

▶ Intention is to withhold RG from the market

- This doesn't do anything for security of supply, which depends on **total** energy supply and demand
- Provided RG fuel stocks are replenished as used, then using RG does not compromise security of supply
- Motorbike analogy



Issue #3: Ring Fencing RG

▶ **But withholding RG increases dispatch costs**

- Efficiency requires RG to operate whenever the spot price (P) exceeds the opportunity costs (OC) of generation – that is, whenever $P > OC$
- But Proposal is for RG to operate when $P >$ strike price.
Okay if strike price = OC
- But OC changes over time, so RG plant:
 - Doesn't supply energy when it should ($P > OC$)
 - And supplies energy when it shouldn't ($P < OC$)

▶ **Alternative: adopt 'price cap' type arrangement**

M^{co} Concluding Thoughts

- ▶ **Exposing investment decisions to market disciplines is critical for long-term economic growth**
- ▶ **But regulation is also required to promote growth**
... markets need rules to operate to their full potential
- ▶ **Getting the balance right between markets and regulation is critical to sustained growth**
 - Critical for long-term sustainability of the wholesale market that everything possible is done to minimise displacement risk
 - Very important to make RG contracting process transparent and for RG suppliers to bear risk

