



Conference on Australian Energy Reform

Duxton Hotel, Melbourne, 29/6/04-1/7/04

Global trends in electricity markets

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Outline

- Basic principle of electricity market design
- Market design types - net or gross pool
- UK: experience with NETA
- USA: California & East Coast blackout
- Implications of gas-based electricity gen'n
- Future challenges for Australian electricity & gas markets

Features of the electricity industry

- Consists of a *supply side* & a *demand side*, both with characteristics of *infrastructure*:
 - Electricity supply industry (traditional monopoly)
 - Provides (imperfect) availability & quality of supply
 - End-use equipment & user premises (private)
 - Operates according to end-user requirements
- Provides continuous *energy conversion*:
 - From primary to end-use energy forms
 - To deliver *essential (end-use) energy services*
 - Valued more by their absence than their presence

Challenges of electricity industry operation & planning

- Continuous energy flow is infused with risk:
 - Can't cost-effectively store electrical energy
- Temporal risks to energy service delivery:
 - Very short term to very long term
- Location risks to energy service delivery:
 - Network constraints can restrict energy flow
- Techniques to manage risk:
 - Physical aggregation of uncertainties by network
 - Industry decision making
 - Collective & individual, supply industry & end-users

Objectives & challenges of electricity industry restructuring

- Desirable objectives - to enhance:
 - Economic efficiency, social accountability & environmental sustainability
 - By decentralised (competitive) decision making
- Accountability challenges:
 - Shared, essential nature of network services
 - Collective (supply & demand) responsibility for availability & quality of supply
 - *Expose decision maker to associated risk*

Five perspectives on accountability of an agency (Hodge et al, 2004, p 200)

Parliamentary control	Accountable to a Minister
Managerialism	External control strategic rather than detailed
Judicial & quasi-judicial review	Formal, reviewable decision-making
Constituency relationships	Public hearings; advisory bodies; ombudsmen
Market processes	Requires meaningful consumer choice

Decision-making & risk allocation in the electricity industry

- Some centralised decision-making inevitable:
 - Instantaneous & continuous energy flow
 - Network, generation & end-use services hard to separate
- Some decentralised decision-making inevitable:
 - Demand-side of the industry privately owned
- Centralised risk allocation to:
 - System & market operators, NSPs, regulators, politicians
- Decentralised risk allocation to:
 - Generators, retailers & **end-users**
- *Difficulties arise because decisions & risks interact:*
 - *Bilateral contracts cannot manage shared risks well*

The electricity industry restructuring process

Issue	Transition	Key challenges
Industry structure	<i>From</i> monopoly <i>To</i> competing firms	Cultural change; Adequate competition; <i>Accountability</i>
Commercial framework	<i>From</i> cost recovery <i>To</i> market prices	Market power; Market design fidelity; <i>Accountability</i>
Industry regulation	<i>From</i> rate of return <i>To</i> Incentive Reg'n	Multiple objectives; Measuring outcomes; <i>Accountability</i>
Sustainability	<i>From</i> direct cost <i>To</i> full costs	Variable RE energy flows End-user participation; <i>Accountability</i>

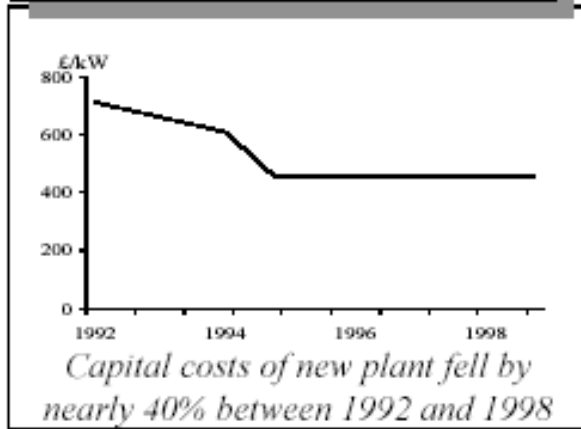
Electricity market models

- Gross pool (eg NEM):
 - Temporal & location risk managed collectively:
 - Ancillary services, spot market, PASA, SOO
- Net pool (eg UK NETA):
 - Long term & location risk managed bilaterally
 - Network not modelled in trading arrangements
 - Short-term operational risk managed collectively:
 - System operator given only one day's notice of bilateral trades

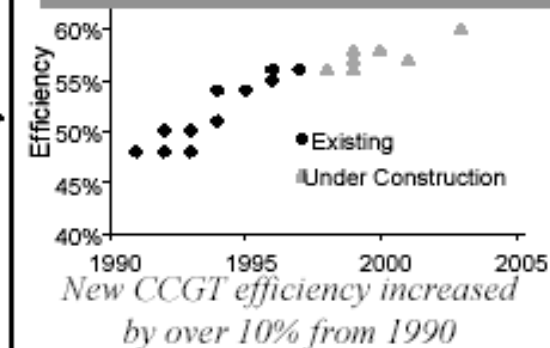
Perceived problems with the UK pool

(E Marshall, England & Wales wholesale market 2 years on, Ofgem, 2003)

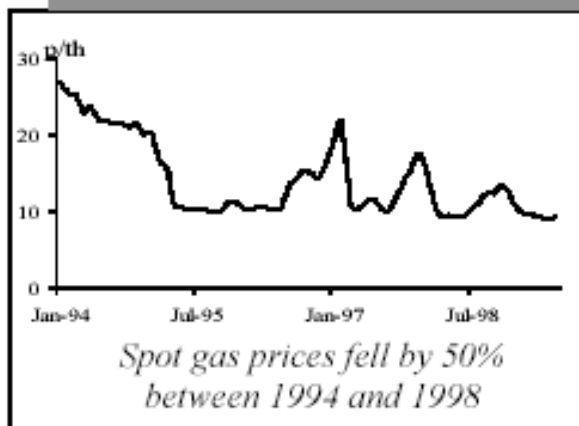
Capital costs fell



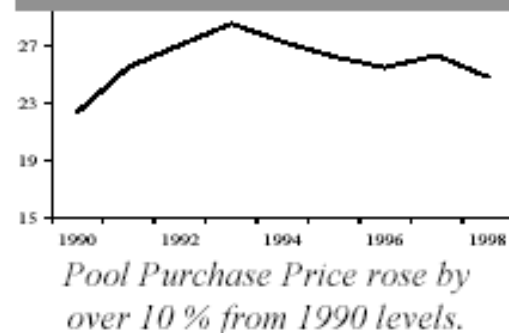
Efficiency Improved



Fuel costs fell

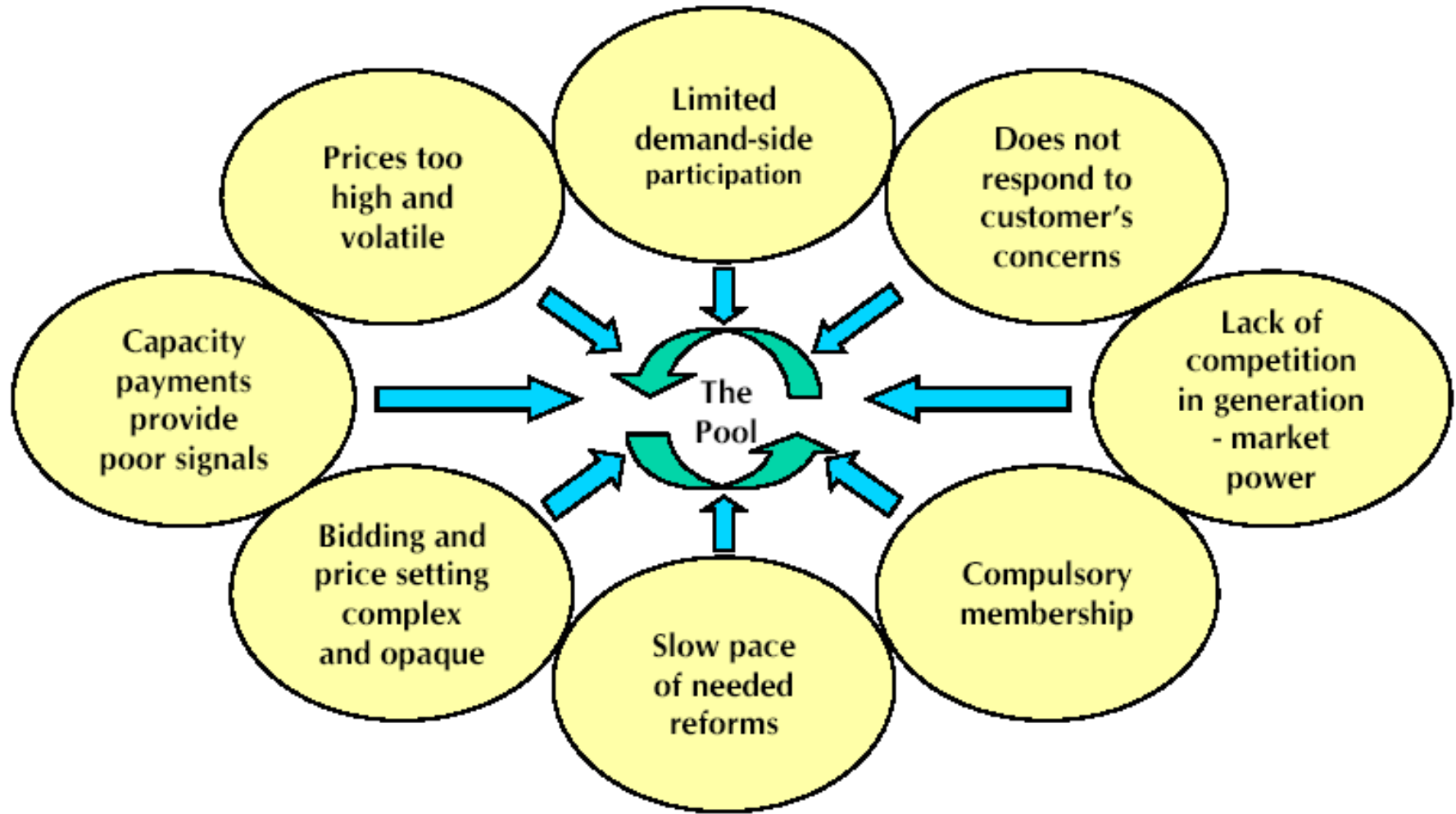


But Pool Prices didn't



Perceived problems with the UK Pool

(E Marshall, England & Wales wholesale market 2 years on, Ofgem, 2003)



Marshall regarded these problems as fixable but easier to introduce NETA instead.

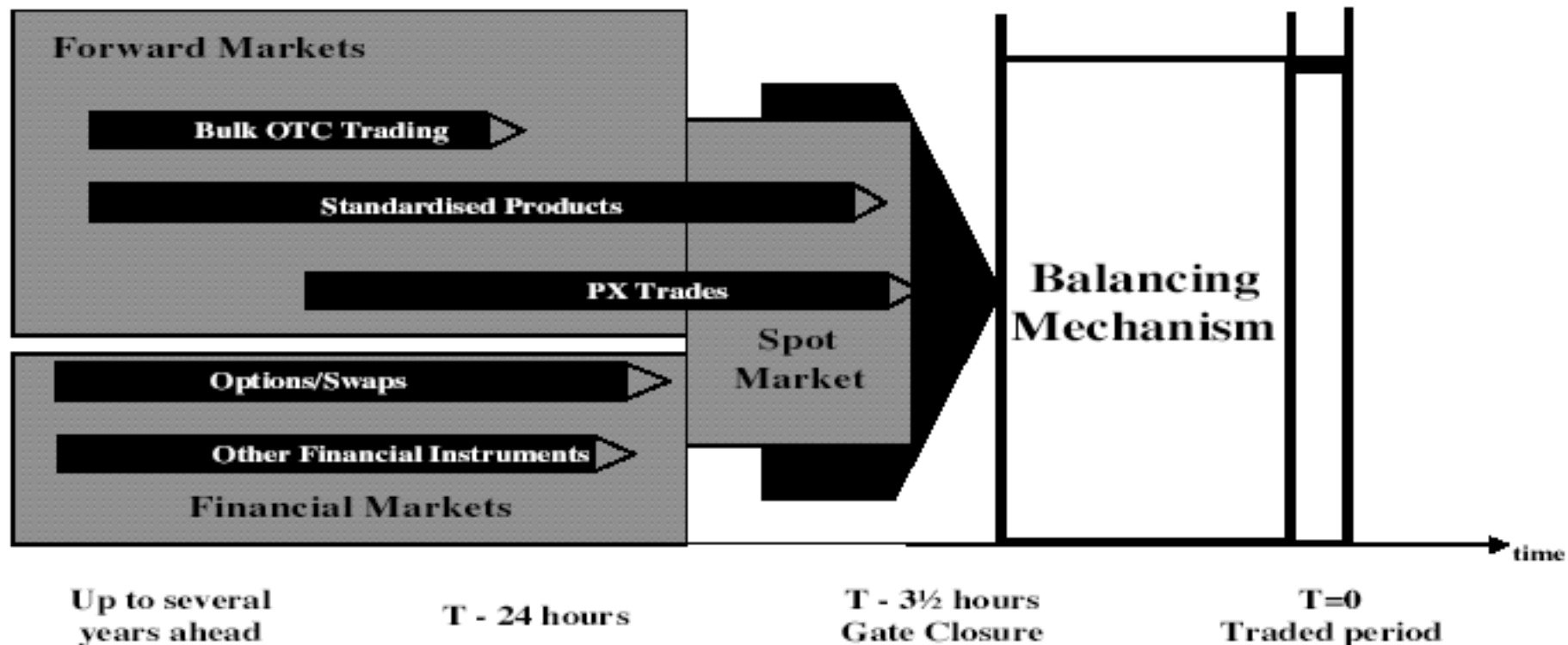
Key features of NETA

(www.ofgem.gov.uk)

- Bilateral forward trading:
 - Compulsory notification of contract position to System Operator (NGC) by “Gate Closure”:
 - Initially 3.5 hour then 1 hour ahead from 2/7/02
- Voluntary offers to provide balancing services
- Settlement process for mismatches:
 - Under contracted generators & over contracted retailers receive “system sell” price (SSP)
 - Over contracted generators & under contracted retailers pay “system buy” price (SBP)
 - Normally expect that $SBP > SSP$

Key features of NETA

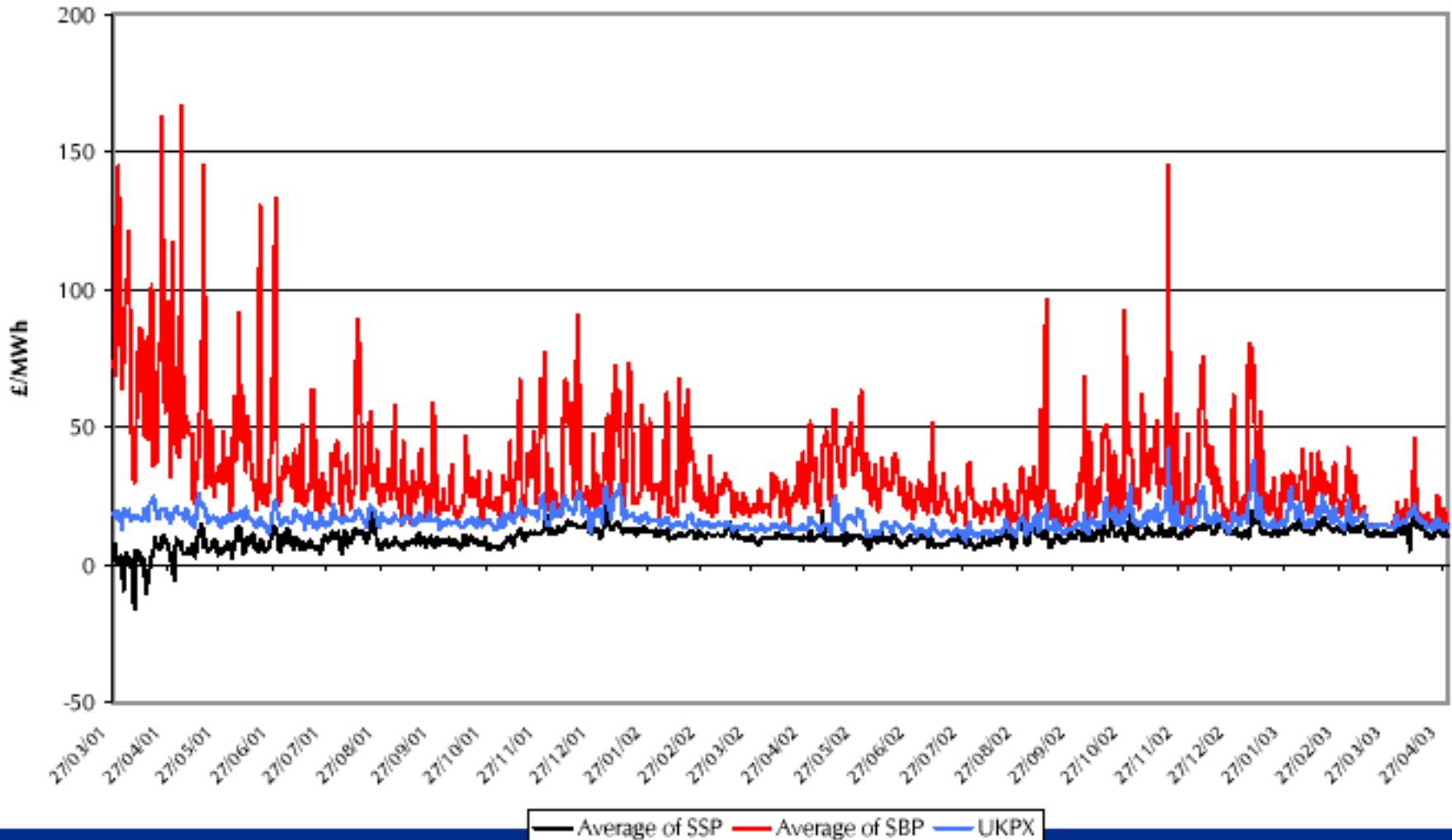
(Ofgem 1 year review of NETA, July 2002)



Daily average system buy & sell balancing prices and current day forward price (UKPX)

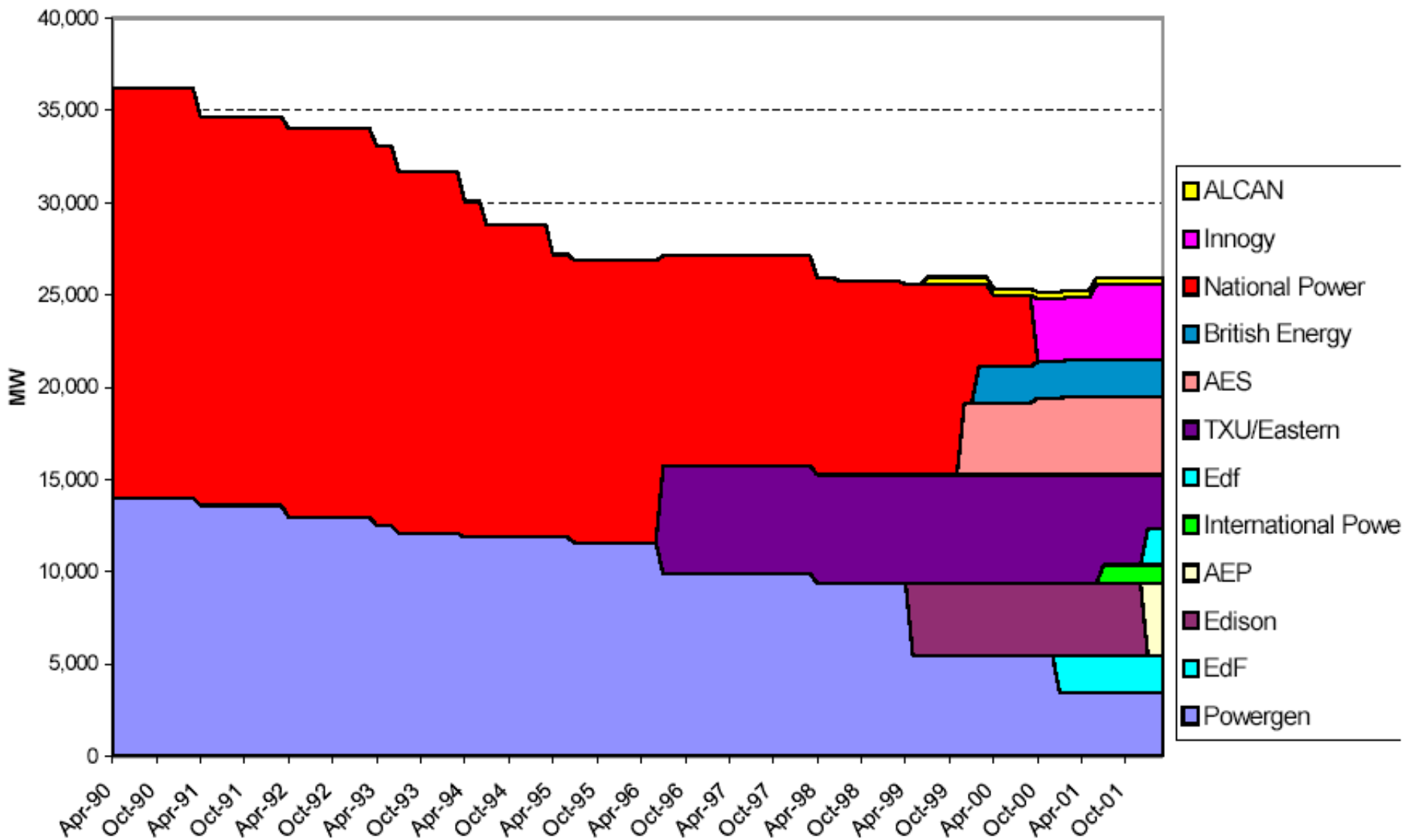
(S Brown, England & Wales wholesale market 2 years on, Ofgem, 2003)

Average Daily Energy Imbalance Prices in comparison to Average Daily UKPX Prices



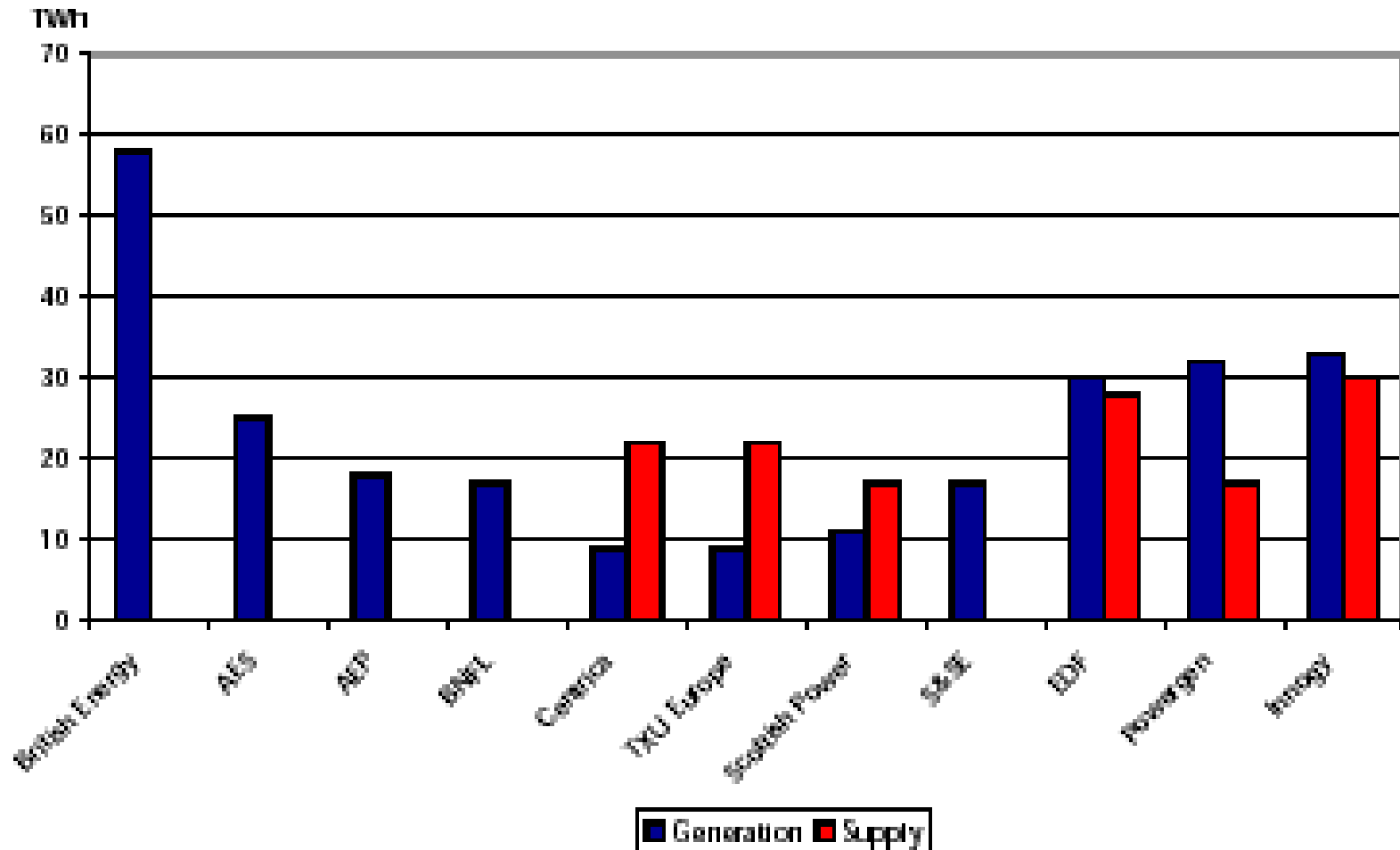
Ownership of UK coal-fired generation 1990-2001

(D Newbery, England & Wales wholesale market 2 years on, Ofgem, 2003)



Trend towards vertical integration reduces reliance on balancing mechanism

(Ofgem 1 year review of NETA, July 2002)



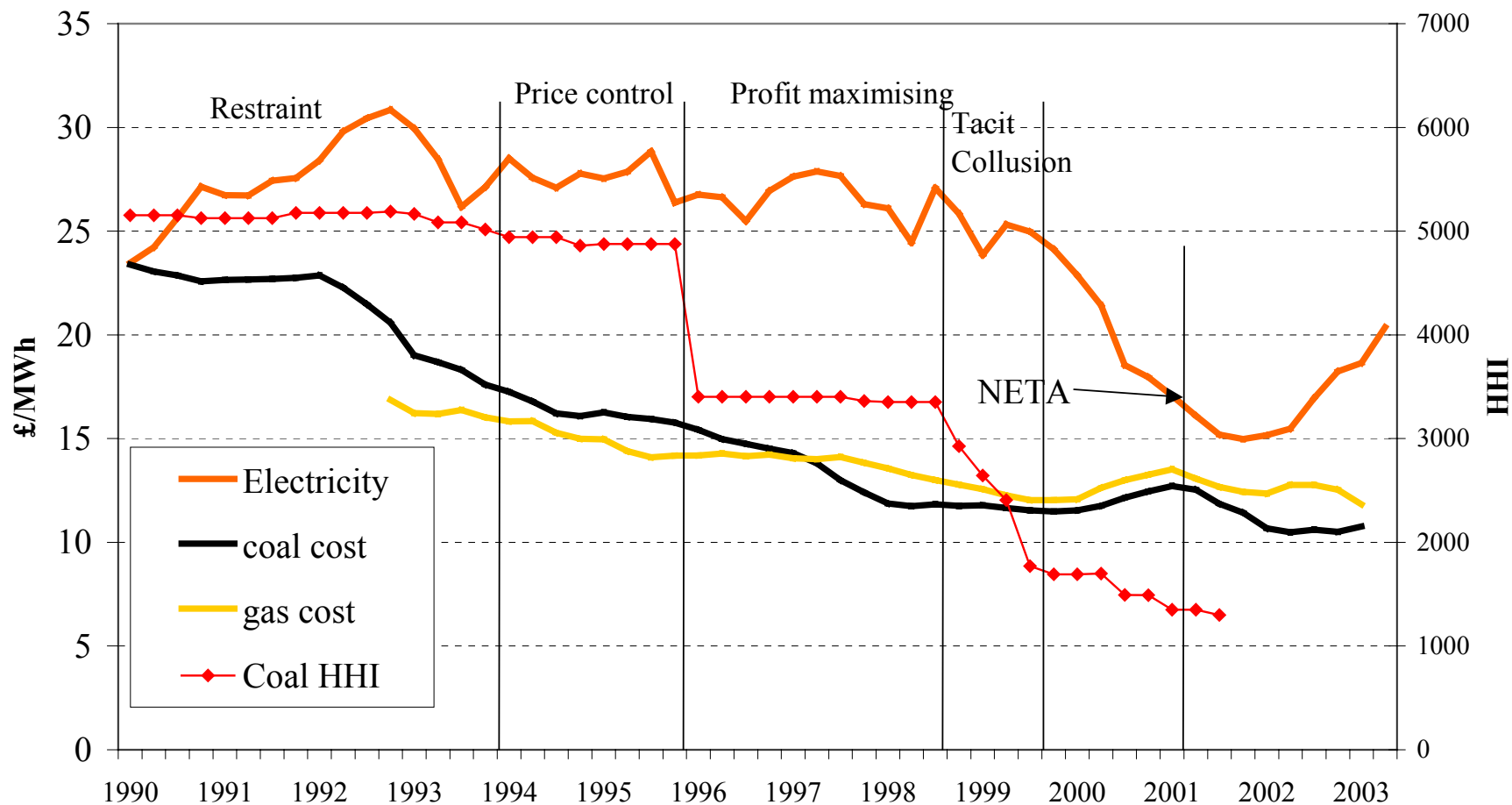
Some UK perspectives on NETA

(D Newbery, England & Wales wholesale market 2 years on, Ofgem, 2003)

- Newbery (Cambridge University):
 - Increased competition in fuel & generation may be the key driver on wholesale price reductions
 - NETA very expensive to implement
- Yarrow (Oxford University):
 - How will security of supply be maintained?
 - Demand side more clearly involved
 - Transmission losses & constraints difficult under NETA

Reduction in electricity prices “not due to NETA” (Mirrless-Black, IEE Ireland colloquium, 2004)

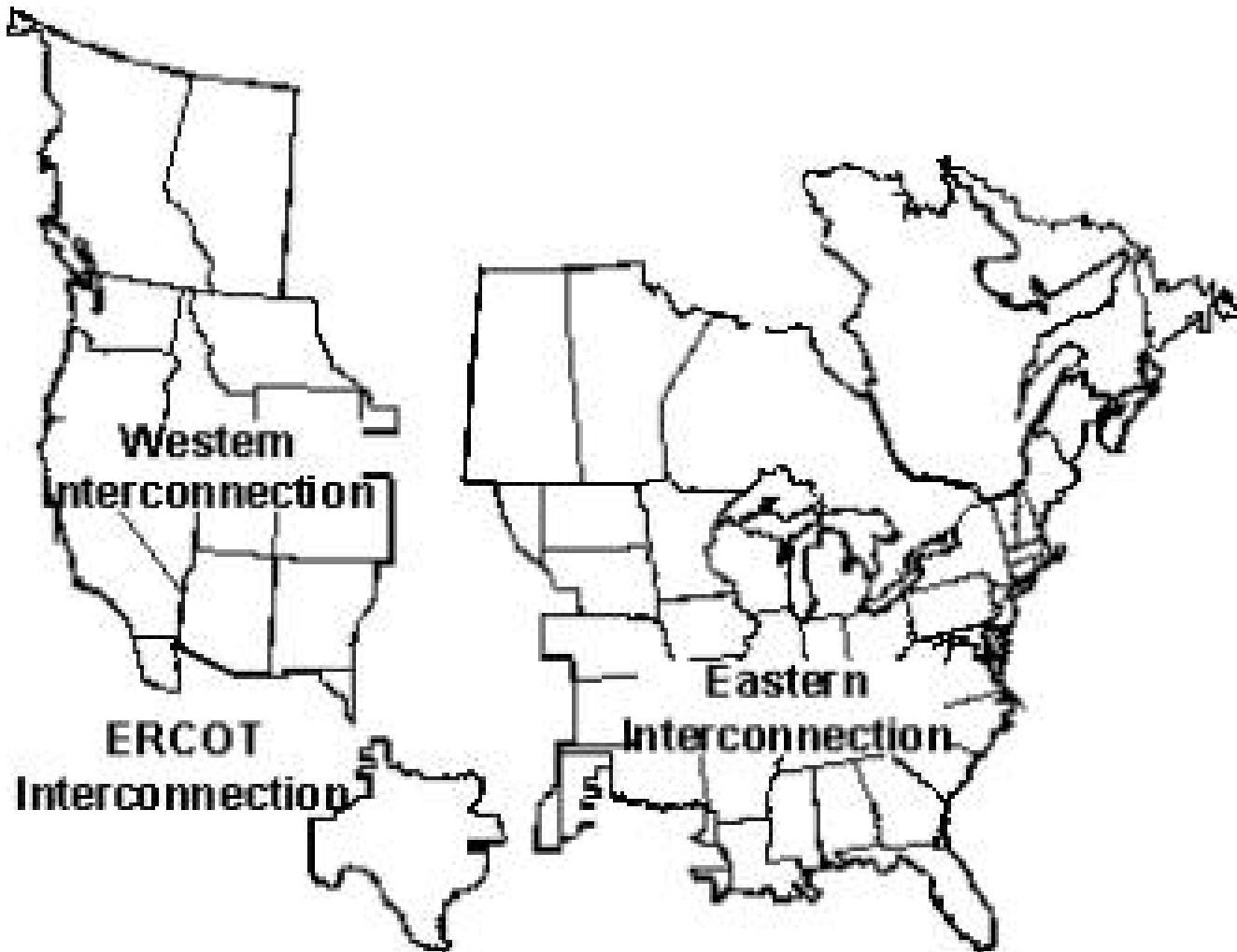
Real electricity and fuel costs 1990-2003



Some Australian perspectives on NETA

- COAG energy market review final report:
 - NETA's requirement for individual balancing:
 - “a significant inefficiency that adds cost to the system”
 - Gross pools have advantages over net pools:
 - Encourage generators to supply at marginal cost
 - Reduce barriers to entry
 - Transparent data supports informed decisions
- ACCC:
 - Market power not reduced by moving to net pool
- Outhred:
 - NETA biased against intermittent generation & distributed resources

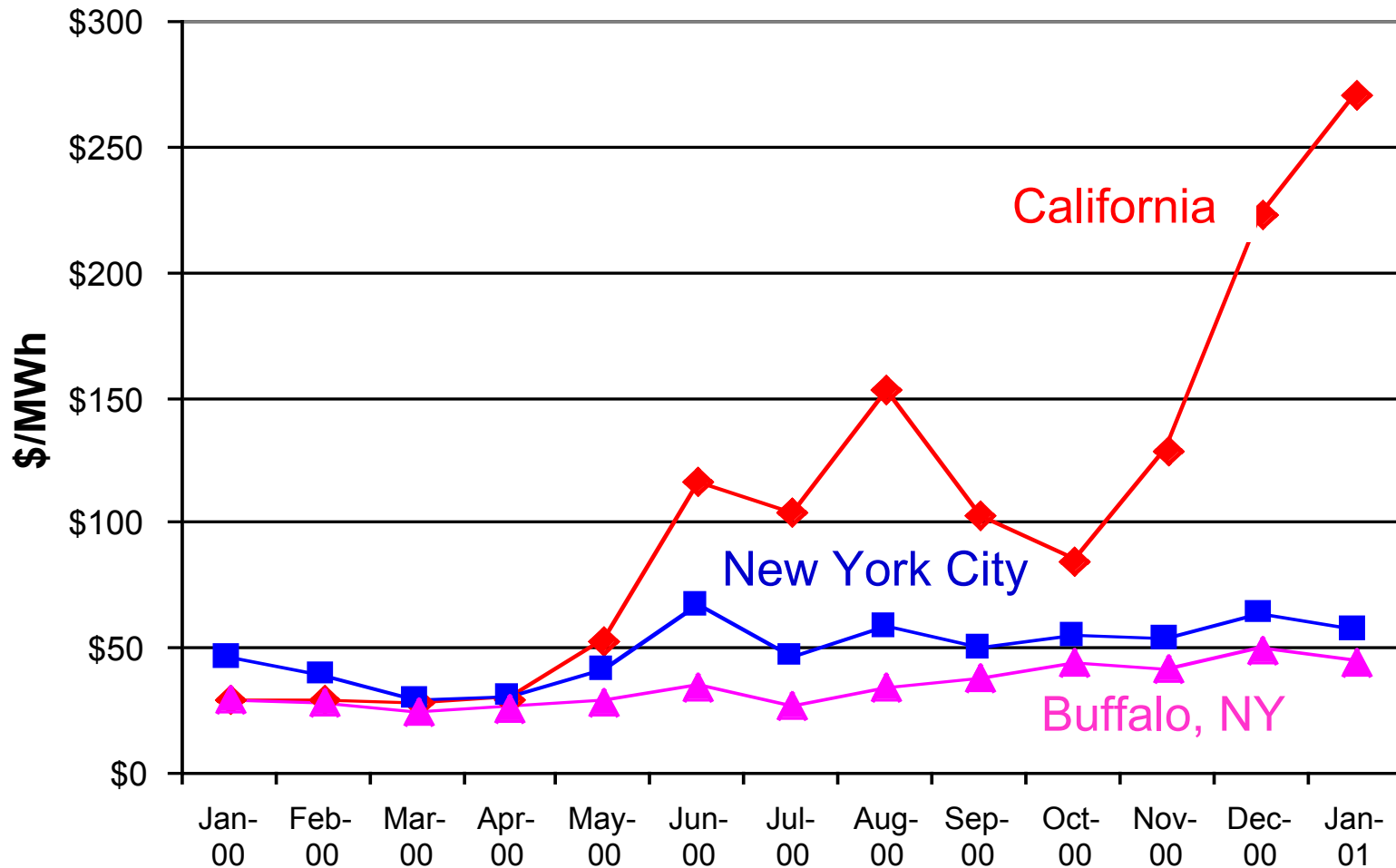
North America (USA, Canada, Mexico): Three interconnected power systems



Electricity industry restructuring in USA

- Federal level (inter-state trade):
 - PURPA (1978) required utilities to buy from “qualifying facilities” within their service territories
 - EPA (1992) mandated transmission access for wholesale transactions (buyers must be utilities):
 - Access & “wheeling” charges (a bilateral trade model) regulated by Federal Energy Regulatory Commission
- State level (intra-state trade):
 - Some states began EI restructuring:
 - Bilateral trade (eg California) or pool (eg PJM)
 - Single state (California) or groups of states (PJM)

Comparison of day-ahead average electricity prices in California & New York for 2000 (Flaim, 2003)



Source: NYISO MIS 3/1/01; UCEI Berkeley web site

SP15 DA (PX) NVC DA WEST DA

Comments on California restructuring

- A politically influenced bilateral trading model:
 - Compromises, inconsistencies & complexity
- Many non-ideal features:
 - Not consistent across Western System:
 - Or even within California
 - Economic & technical regulation separated
 - No coordinated support for investment decisions:
 - eg IOUs were forbidden to forward contract
 - Poor spot market design (CalISO default market)
 - Short horizon for managing system operation
 - Large residual task for ancillary services

Other contributing factors

- Hydro reserves had been run down:
 - California still ~25% hydro energy
- Gas & NOx permit prices were rising:
 - Allegations of market power in gas market
- Approval difficult for new generation & network
- Continuing growth in demand, including:
 - Temperature sensitive residential air-conditioning
 - High-value commercial & high-tech industrial
- High wholesale prices & regulated retail tariffs:
 - PG&E and SCE eventually went bankrupt

The North America Blackout of 14/8/03

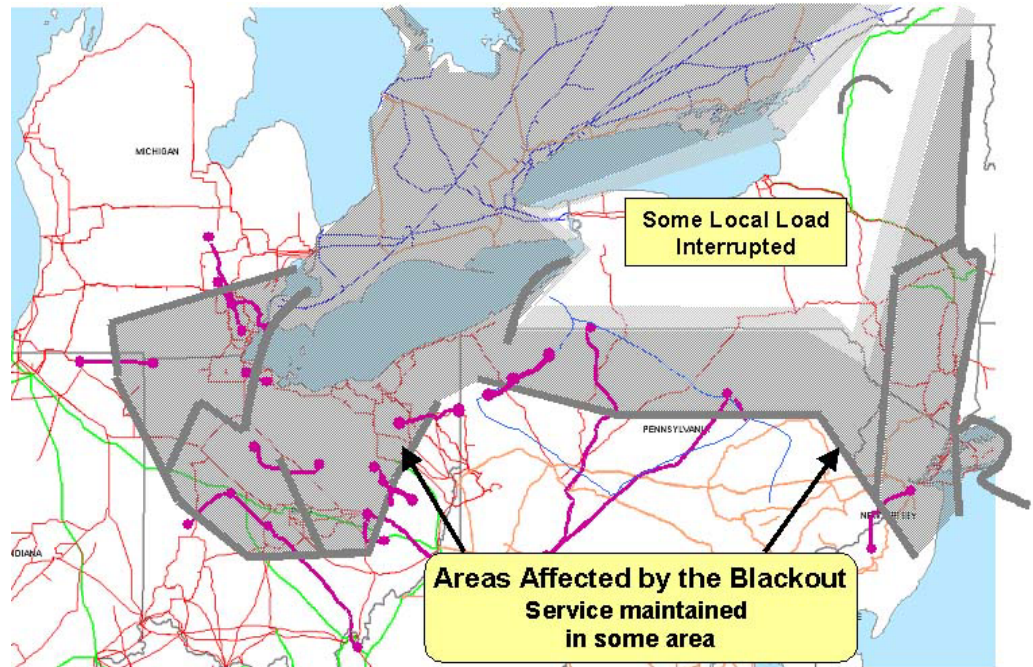
(www.spectrum.ieee.org/webonly/special/aug03/black.html)

- DOE studies had predicted trouble since '98:
 - Inadequate regional oversight & control
- Operators unable to stop problem escalating :
 - Midwest ISO had less authority than PJM & New England counterparts
 - Human errors & loss of institutional capacity
- Remedies:
 - Create regional ISOs
 - Build network capacity & institutional skills

Affected areas

(T Mount, Cornell University, 2004)

When the cascade was over at 4:13pm, over 50 million people in the northeastern USA and the province of Ontario had no power.



Conclusions on blackout 1

(T Mount, Cornell University, 2004)

The blackout was NOT caused by:

- **1) An Act of God (extreme weather)**
- **2) Maliciousness (sabotage or a computer virus)**
- **3) Insubordination (supply of reactive power)**
- **4) System conditions (wheeling power)**

BUT the limited control of system operators in some regions (#3) and the long distance transfer of power (#4) increase the complexity of operating a reliable grid compared to a fully regulated system.

Conclusions on blackout 2

(T Mount, Cornell University, 2004)

The blackout was caused by:

- 1) A series of **typical contingencies** occurred that were not recognized or contained by First Energy (FE):
 - Initial tree strikes → **POOR MAINTENANCE**
 - Many lines trip → **POOR MONITORING**
- 2) The problem was not contained locally by FE and other system operators in the Midwest → **POOR COORDINATION**
- 3) Unexpected power surges caused relays to trip correctly in a cascading system collapse
- 4) Damage to transmission and generating equipment was minimal, and the system was restored effectively
- 5) The costs incurred by many customers were substantial

A hypothesis: If the industry and regulators had followed the recommendations made after the 1965 New York blackout, the latest blackout would not have happened.

Conclusions from North American experience (Massey, 2003)

- Electricity doesn't respect political boundaries
- Fundamental design principles:
 - Spot market with locational pricing signals
 - Independent grid and market operation
 - Consistent rules over entire market region
 - Firm transmission rights
 - Market monitoring and mitigation of market power
- Enlarging market scope by interconnection:
 - Reduces supply-side market power
 - Requires consistent rules & regulation

General implications for Australia

- Industry structure & market design both matter:
 - Electricity & gas consistency, barriers to entry, market power, pressure to reveal preferences
- Consistent wholesale & retail market design:
 - For ancillary service, spot & forward trading
 - Across the full scope of a transmission network
- Governance independent from participants
- Regulation essential but implement carefully:
 - Market intervention can exacerbate dysfunction & increase uncertainty

Implications of natural gas for electricity generation

- Electricity gen'n has variable demand for gas:
 - Gas pipeline network has limited storage
 - Traditional gas market model not good at rationing scarce pipeline capacity
- New gas trading arrangements will be needed:
 - The NEM provides an appropriate model for existing gas networks
 - Special arrangements may be needed to support green-fields gas infrastructure investment

Conclusions - future challenges

- Electricity:
 - Enhanced demand side participation
 - Uniform governance & regulation
 - Efficient network investment that gives equal consideration to distributed resource options
- Gas:
 - Efficient market design for existing gas network
 - Efficient investment in gas infrastructure
- Sustainability of the stationary energy sector:
 - Dramatic reduction in climate change emissions

A key challenge: investment in new generating capacity:

Forecast surplus reserves for NEM Jurisdictions

(Medium growth + extreme (10% POE) weather, NEMMCO SOO, July 03)

