

Contents

Preface	xv
Nomenclature	xvii
PART I INTRODUCTION TO ECONOMIC CONCEPTS	1
1 Introduction to Micro-economics	3
1.1 Economic Objectives	3
1.2 Introduction to Constrained Optimisation	5
1.3 Demand and Consumers' Surplus	6
1.3.1 <i>The Short-Run Decision of the Customer</i>	7
1.3.2 <i>The Value or Utility Function</i>	7
1.3.3 <i>The Demand Curve for a Price-Taking Customer Facing a Simple Price</i>	7
1.4 Supply and Producers' Surplus	10
1.4.1 <i>The Cost Function</i>	11
1.4.2 <i>The Supply Curve for a Price-Taking Firm Facing a Simple Price</i>	11
1.5 Achieving Optimal Short-Run Outcomes Using Competitive Markets	14
1.5.1 <i>The Short-Run Welfare Maximum</i>	14
1.5.2 <i>An Autonomous Market Process</i>	15
1.6 Smart Markets	17
1.6.1 <i>Smart Markets and Generic Constraints</i>	17
1.6.2 <i>A Smart Market Process</i>	18
1.7 Longer-Run Decisions by Producers and Consumers	20
1.7.1 <i>Investment in Productive Capacity</i>	20
1.8 Monopoly	22
1.8.1 <i>The Dominant Firm – Competitive Fringe Structure</i>	24
1.8.2 <i>Monopoly and Price Regulation</i>	25
1.9 Oligopoly	26
1.9.1 <i>Cournot Oligopoly</i>	27
1.9.2 <i>Repeated Games</i>	27
1.10 Summary	28

Questions	29
Further Reading	30
PART II INTRODUCTION TO ELECTRICITY NETWORKS AND ELECTRICITY MARKETS	31
2 Introduction to Electric Power Systems	33
2.1 DC Circuit Concepts	33
2.1.1 <i>Energy, Watts and Power</i>	34
2.1.2 <i>Losses</i>	35
2.2 AC Circuit Concepts	36
2.3 Reactive Power	38
2.3.1 <i>Mathematics of Reactive Power</i>	40
2.3.2 <i>Control of Reactive Power</i>	42
2.3.3 <i>Ohm's Law on AC Circuits</i>	43
2.3.4 <i>Three-Phase Power</i>	44
2.4 The Elements of an Electric Power System	45
2.5 Electricity Generation	46
2.5.1 <i>The Key Characteristics of Electricity Generators</i>	49
2.6 Electricity Transmission and Distribution Networks	52
2.6.1 <i>Transmission Networks</i>	54
2.6.2 <i>Distribution Networks</i>	57
2.6.3 <i>Competition and Regulation</i>	59
2.7 Physical Limits on Networks	60
2.7.1 <i>Thermal Limits</i>	61
2.7.2 <i>Voltage Stability Limits</i>	64
2.7.3 <i>Dynamic and Transient Stability Limits</i>	64
2.8 Electricity Consumption	66
2.9 Does it Make Sense to Distinguish Electricity Producers and Consumers?	67
2.9.1 <i>The Service Provided by the Electric Power Industry</i>	69
2.10 Summary	70
Questions	71
Further Reading	72
3 Electricity Industry Market Structure and Competition	73
3.1 Tasks Performed in an Efficient Electricity Industry	73
3.1.1 <i>Short-Term Tasks</i>	73
3.1.2 <i>Risk-Management Tasks</i>	75
3.1.3 <i>Long-Term Tasks</i>	75
3.2 Electricity Industry Reforms	76
3.2.1 <i>Market-Orientated Reforms of the Late Twentieth Century</i>	77
3.3 Approaches to Reform of the Electricity Industry	79
3.4 Other Key Roles in a Market-Orientated Electric Power System	81
3.5 An Overview of Liberalised Electricity Markets	82

3.6	An Overview of the Australian National Electricity Market	85
	3.6.1 <i>Assessment of the NEM</i>	87
3.7	The Pros and Cons of Electricity Market Reform	88
3.8	Summary	89
	Questions	90
	Further Reading	90
 PART III OPTIMAL DISPATCH: THE EFFICIENT USE OF GENERATION, CONSUMPTION AND NETWORK RESOURCES		 91
4	Efficient Short-Term Operation of an Electricity Industry with no Network Constraints	93
4.1	The Cost of Generation	93
4.2	Simple Stylised Representation of a Generator	96
4.3	Optimal Dispatch of Generation with Inelastic Demand	97
	4.3.1 <i>Optimal Least Cost Dispatch of Generation Resources</i>	98
	4.3.2 <i>Least Cost Dispatch for Generators with Constant Variable Cost</i>	99
	4.3.3 <i>Example</i>	101
4.4	Optimal Dispatch of Both Generation and Load Assets	102
4.5	Symmetry in the Treatment of Generation and Load	104
	4.5.1 <i>Symmetry Between Buyer-Owned Generators and Stand-Alone Generators</i>	104
	4.5.2 <i>Symmetry Between Total Surplus Maximisation and Generation Cost Minimisation</i>	105
4.6	The Benefit Function	105
4.7	Nonconvexities in Production: Minimum Operating Levels	106
4.8	Efficient Dispatch of Energy-Limited Resources	108
	4.8.1 <i>Example</i>	109
4.9	Efficient Dispatch in the Presence of Ramp-Rate Constraints	110
	4.9.1 <i>Example</i>	111
4.10	Startup Costs and the Unit-Commitment Decision	113
4.11	Summary	115
	Questions	116
	Further Reading	117
5	Achieving Efficient Use of Generation and Load Resources using a Market Mechanism in an Industry with no Network Constraints	119
5.1	Decentralisation, Competition and Market Mechanisms	119
5.2	Achieving Optimal Dispatch Through Competitive Bidding	121
5.3	Variation in Wholesale Market Design	123
	5.3.1 <i>Compulsory Gross Pool or Net Pool?</i>	124
	5.3.2 <i>Single Price or Pay-as-Bid?</i>	125
5.4	Day-Ahead Versus Real-Time Markets	126

5.4.1	<i>Improving the Quality of Short-Term Price Forecasts</i>	127
5.4.2	<i>Reducing the Exercise of Market Power</i>	129
5.5	Price Controls and Rationing	129
5.5.1	<i>Inadequate Metering and Involuntary Load Shedding</i>	131
5.6	Time-Varying Demand, the Load-Duration Curve and the Price-Duration Curve	133
5.7	Summary	135
	Questions	137
	Further Reading	137
6	Representing Network Constraints	139
6.1	Representing Networks Mathematically	139
6.2	Net Injections, Power Flows and the DC Load Flow Model	141
6.2.1	<i>The DC Load Flow Model</i>	144
6.3	The Matrix of Power Transfer Distribution Factors	145
6.3.1	<i>Converting between Reference Nodes</i>	146
6.4	Distribution Factors for Radial Networks	146
6.5	Constraint Equations and the Set of Feasible Injections	147
6.6	Summary	151
	Questions	152
7	Efficient Dispatch of Generation and Consumption Resources in the Presence of Network Congestion	153
7.1	Optimal Dispatch with Network Constraints	153
7.1.1	<i>Achieving Optimal Dispatch Using a Smart Market</i>	155
7.2	Optimal Dispatch in a Radial Network	156
7.3	Optimal Dispatch in a Two-Node Network	157
7.4	Optimal Dispatch in a Three-Node Meshed Network	159
7.5	Optimal Dispatch in a Four-Node Network	161
7.6	Properties of Nodal Prices with a Single Binding Constraint	162
7.7	How Many Independent Nodal Prices Exist?	163
7.8	The Merchandising Surplus, Settlement Residues and the Congestion Rents	163
7.8.1	<i>Merchandising Surplus and Congestion Rents</i>	163
7.8.2	<i>Settlement Residues</i>	164
7.8.3	<i>Merchandising Surplus in a Three-Node Network</i>	165
7.9	Network Losses	166
7.9.1	<i>Losses, Settlement Residues and Merchandising Surplus</i>	167
7.9.2	<i>Losses and Optimal Dispatch</i>	168
7.10	Summary	169
	Questions	170
	Further Reading	170
8	Efficient Network Operation	171
8.1	Efficient Operation of DC Interconnectors	171
8.1.1	<i>Entrepreneurial DC Network Operation</i>	173

8.2	Optimal Network Switching	173
	8.2.1 <i>Network Switching and Network Contingencies</i>	174
	8.2.2 <i>A Worked Example</i>	174
	8.2.3 <i>Entrepreneurial Network Switching?</i>	176
8.3	Summary	177
	Questions	178
	Further Reading	178
 PART IV EFFICIENT INVESTMENT IN GENERATION AND CONSUMPTION ASSETS		 179
9	Efficient Investment in Generation and Consumption Assets	181
9.1	The Optimal Generation Investment Problem	181
9.2	The Optimal Level of Generation Capacity with Downward Sloping Demand	183
	9.2.1 <i>The Case of Inelastic Demand</i>	185
9.3	The Optimal Mix of Generation Capacity with Downward Sloping Demand	186
9.4	The Optimal Mix of Generation with Inelastic Demand	189
9.5	Screening Curve Analysis	191
	9.5.1 <i>Using Screening Curves to Assess the Impact of Increased Renewable Penetration</i>	192
	9.5.2 <i>Generation Investment in the Presence of Network Constraints</i>	193
9.6	Buyer-Side Investment	193
9.7	Summary	195
	Questions	196
	Further Reading	197
10	Market-Based Investment in Electricity Generation	199
10.1	Decentralised Generation Investment Decisions	199
10.2	Can We Trust Competitive Markets to Deliver an Efficient Level of Investment in Generation?	201
	10.2.1 <i>Episodes of High Prices as an Essential Part of an Energy-Only Market</i>	201
	10.2.2 <i>The 'Missing Money' Problem</i>	202
	10.2.3 <i>Energy-Only Markets and the Investment Boom–Bust Cycle</i>	203
10.3	Price Caps, Reserve Margins and Capacity Payments	203
	10.3.1 <i>Reserve Requirements</i>	204
	10.3.2 <i>Capacity Markets</i>	205
10.4	Time-Averaging of Network Charges and Generation Investment	206
10.5	Summary	207
	Questions	207
 PART V HANDLING CONTINGENCIES: EFFICIENT DISPATCH IN THE VERY SHORT RUN		 209

11	Efficient Operation of the Power System in the Very Short-Run	211
11.1	Introduction to Contingencies	211
11.2	Efficient Handling of Contingencies	212
11.3	Preventive and Corrective Actions	213
11.4	Satisfactory and Secure Operating States	215
11.5	Optimal Dispatch in the Very Short Run	216
11.6	Operating the Power System Ex Ante as though Certain Contingencies have Already Happened	218
11.7	Examples of Optimal Short-Run Dispatch	219
	<i>11.7.1 A Second Example, Ignoring Network Constraints</i>	221
	<i>11.7.2 A Further Example with Network Constraints</i>	222
11.8	Optimal Short-Run Dispatch Using a Competitive Market	223
	<i>11.8.1 A Simple Example</i>	224
	<i>11.8.2 Optimal Short-Run Dispatch through Prices</i>	227
	<i>11.8.3 Investment Incentives</i>	228
11.9	Summary	229
	Questions	230
	Further Reading	230
12	Frequency-Based Dispatch of Balancing Services	231
12.1	The Intradispatch Interval Dispatch Mechanism	231
12.2	Frequency-Based Dispatch of Balancing Services	232
12.3	Implications of Ignoring Network Constraints when Handling Contingencies	233
	<i>12.3.1 The Feasible Set of Injections with a Frequency-Based IDIDM</i>	235
12.4	Procurement of Frequency-Based Balancing Services	238
	<i>12.4.1 The Volume of Frequency Control Balancing Services Required</i>	238
	<i>12.4.2 Procurement of Balancing Services</i>	239
	<i>12.4.3 Allocating the Costs of Balancing Services</i>	240
12.5	Summary	241
	Questions	242
	Further Reading	242
PART VI	MANAGING RISK	243
13	Managing Intertemporal Price Risks	245
13.1	Introduction to Forward Markets and Standard Hedge Contracts	245
	<i>13.1.1 Instruments for Managing Risk: Swaps, Caps, Collars and Floors</i>	246
	<i>13.1.2 Swaps</i>	246
	<i>13.1.3 Caps</i>	247
	<i>13.1.4 Floors</i>	248
	<i>13.1.5 Collars (and Related Instruments)</i>	249
13.2	The Construction of a Perfect Hedge: The Theory	249
	<i>13.2.1 The Design of a Perfect Hedge</i>	250

13.3	The Construction of a Perfect Hedge: Specific Cases	252
	13.3.1 <i>Hedging by a Generator with no Cost Uncertainty</i>	252
	13.3.2 <i>Hedging Cost-Shifting Risks</i>	254
13.4	Hedging by Customers	256
	13.4.1 <i>Hedging by a Customer with a Constant Utility Function</i>	257
	13.4.2 <i>Hedging Utility-Shifting Risks</i>	258
13.5	The Role of the Trader	259
	13.5.1 <i>Risks Facing Individual Traders</i>	261
13.6	Intertemporal Hedging and Generation Investment	263
13.7	Summary	264
	Questions	265
14	Managing Interlocational Price Risk	267
14.1	The Role of the Merchandising Surplus in Facilitating Interlocational Hedging	267
	14.1.1 <i>Packaging the Merchandising Surplus in a Way that Facilitates Hedging</i>	269
14.2	Interlocational Transmission Rights: CapFTRs	269
14.3	Interlocational Transmission Rights: Fixed-Volume FTRs	271
	14.3.1 <i>Revenue Adequacy</i>	271
	14.3.2 <i>Are Fixed-Volume FTRs a Useful Hedging Instrument?</i>	273
14.4	Interlocational Hedging and Transmission Investment	273
	14.4.1 <i>Infinitesimal Investment in Network Capacity</i>	274
	14.4.2 <i>Lumpy Investment in Network Capacity</i>	274
14.5	Summary	276
	Questions	277
	Further Reading	277
PART VII	MARKET POWER	279
15	Market Power in Electricity Markets	281
15.1	An Introduction to Market Power in Electricity Markets	281
	15.1.1 <i>Definition of Market Power</i>	281
	15.1.2 <i>Market Power in Electricity Markets</i>	282
15.2	How Do Generators Exercise Market Power? Theory	284
	15.2.1 <i>The Price–Volume Trade-Off</i>	284
	15.2.2 <i>The Profit-Maximising Choice of Rate of Production for a Generator with Market Power</i>	286
	15.2.3 <i>The Profit-Maximising Offer Curve</i>	287
15.3	How do Generators Exercise Market Power? Practice	289
	15.3.1 <i>Economic and Physical Withholding</i>	289
	15.3.2 <i>Pricing Up and the Marginal Generator</i>	291
15.4	The Incentive to Exercise Market Power: The Importance of the Residual Demand Curve	292
	15.4.1 <i>The Shape of the Residual Demand Curve</i>	293

15.4.2	<i>The Importance of Peak Versus Off-Peak for the Exercise of Market Power</i>	293
15.4.3	<i>Other Influences on the Shape of the Residual Demand Curve</i>	295
15.5	The Incentive to Exercise Market Power: The Impact of the Hedge Position of a Generator	295
15.5.1	<i>Short-Term Versus Long-Term Hedge Products and the Exercise of Market Power</i>	297
15.5.2	<i>Hedge Contracts and Market Power</i>	297
15.6	The Exercise of Market Power by Loads and Vertical Integration	298
15.6.1	<i>Vertical Integration</i>	299
15.7	Is the Exercise of Market Power Necessary to Stimulate Generation Investment?	300
15.8	The Consequences of the Exercise of Market Power	301
15.8.1	<i>Short-Run Efficiency Impacts of Market Power</i>	301
15.8.2	<i>Longer-Run Efficiency Impacts of Market Power</i>	302
15.8.3	<i>A Worked Example</i>	302
15.9	Summary	304
	Questions	306
	Further Reading	306
16	Market Power and Network Congestion	307
16.1	The Exercise of Market Power by a Single Generator in a Radial Network	307
16.1.1	<i>The Exercise of Market Power by a Single Generator in a Radial Network: The Theory</i>	308
16.2	The Exercise of Market Power by a Single Generator in a Meshed Network	311
16.3	The Exercise of Market Power by a Portfolio of Generators	313
16.4	The Effect of Transmission Rights on Market Power	314
16.5	Summary	315
	Questions	315
	Further Reading	315
17	Detecting, Modelling and Mitigating Market Power	317
17.1	Approaches to Assessing Market Power	317
17.2	Detecting the Exercise of Market Power Through the Examination of Market Outcomes in the Past	318
17.2.1	<i>Quantity-Withdrawal Studies</i>	319
17.2.2	<i>Price–Cost Margin Studies</i>	321
17.3	Simple Indicators of Market Power	322
17.3.1	<i>Market-Share-Based Measures and the HHI</i>	322
17.3.2	<i>The PSI and RSI Indicators</i>	324
17.3.3	<i>Variants of the PSI and RSI Indicators</i>	326
17.3.4	<i>Measuring the Elasticity of Residual Demand</i>	328
17.4	Modelling of Market Power	330
17.4.1	<i>Modelling of Market Power in Practice</i>	331

17.4.2	<i>Linearisation</i>	332
17.5	Policies to Reduce Market Power	332
17.6	Summary	333
	Questions	334
	Further Reading	334
PART VIII NETWORK REGULATION AND INVESTMENT		335
18	Efficient Investment in Network Assets	337
18.1	Efficient AC Network Investment	337
18.2	Financial Implications of Network Investment	338
	18.2.1 <i>The Two-Node Graphical Representation</i>	339
	18.2.2 <i>Financial Indicators of the Benefit of Network Expansion</i>	341
18.3	Efficient Investment in a Radial Network	342
18.4	Efficient Investment in a Two-Node Network	344
	18.4.1 <i>Example</i>	345
18.5	Coordination of Generation and Network Investment in Practice	348
18.6	Summary	350
	Questions	351
	Further Reading	351
PART IX CONTEMPORARY ISSUES		353
19	Regional Pricing and Its Problems	355
19.1	An Introduction to Regional Pricing	355
19.2	Regional Pricing Without Constrained-on and Constrained-off Payments	357
	19.2.1 <i>Short-Run Effects of Regional Pricing in a Simple Network</i>	360
	19.2.2 <i>Effects of Regional Pricing on the Balance Sheet of the System Operator</i>	361
	19.2.3 <i>Long-Run Effects of Regional Pricing on Investment</i>	363
19.3	Regional Pricing with Constrained-on and Constrained-off Payments	364
19.4	Nodal Pricing for Generators/Regional Pricing for Consumers	367
	19.4.1 <i>Side Deals and Net Metering</i>	367
19.5	Summary	369
	Questions	370
	Further Reading	370
20	The Smart Grid and Efficient Pricing of Distribution Networks	371
20.1	Efficient Pricing of Distribution Networks	371
	20.1.1 <i>The Smart Grid and Distribution Pricing</i>	373
20.2	Decentralisation of the Dispatch Task	374
	20.2.1 <i>Decentralisation in Theory</i>	374

20.3	Retail Tariff Structures and the Incentive to Misrepresent Local Production and Consumption	377
	20.3.1 <i>Incentives for Net Metering and the Effective Price</i>	378
20.4	Incentives for Investment in Controllable Embedded Generation	380
	20.4.1 <i>Incentives for Investment in Intermittent Solar PV Embedded Generation</i>	384
	20.4.2 <i>Retail Tariff Structures and the Death Spiral</i>	385
	20.4.3 <i>An Illustration of the Death Spiral</i>	386
20.5	Retail Tariff Structures	388
	20.5.1 <i>Retail Tariff Debates</i>	389
20.6	Declining Demand for Network Services and Increasing Returns to Scale	390
20.7	Summary	393
	Questions	395
	References	397
	Index	399