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Mr Zaeen Khan
Executive Director, Public Utilities Office
Department of Treasury
David Malcolm Justice Centre
28 Barrack Street
Perth WA 6000

via email: puosubmissions@treasury.wa.gov.au

Dear Mr Khan

IMPROVING RESERVE CAPACITY PRICING SIGNALS

Thank you for the opportunity to provide feedback on the proposed reforms to improve reserve capacity pricing as outlined in the consultation paper, *Improving Reserve Capacity Pricing Signals – Alternative Capacity Pricing Options*.

Synergy considers potential reforms to reserve capacity pricing should be assessed against the following key principles:

- **Simplicity and administrative efficiency:** The mechanism should be simple for market participants to navigate and cost-effective to administer. The direct and indirect costs of the mechanism's reforms should not risk outweighing the benefits.
- **Efficient price signals and least cost outcomes:** The mechanism's price signals should be broadly reflective of the marginal value of new capacity.
- **Fit for purpose:** The mechanism should suit the Wholesale Electricity Market's (WEM) unique characteristics, such as its relatively small size and illiquidity. The reforms should also account for industry changes, including rapid developments in technology, decentralisation of generation sources, and concurrent market reforms.

Synergy has conducted a high level assessment of the two options (Option 1: Administered pricing and Option 2: Retailer led contracting with a bulletin board trading mechanism) proposed in the consultation paper, against each of the suggested key principles. While acknowledging that these principles can be contradictory, Synergy considers that the continuation of the current administered approach to pricing capacity, but with potential changes to its pricing response, best achieves them on aggregate.

A summary of Synergy's assessment is provided below.

Simplicity and administrative efficiency

Synergy considers Option 1 is preferable in terms of administrative efficiency, given that it is already largely understood by market participants and requires the least changes from the current model.

Synergy notes that industry opposition to the previously proposed capacity auction was primarily driven by concerns it would be too complex and costly to administer given the small size and illiquidity in the Wholesale Electricity Market (**WEM**).

Synergy considers that Option 2 may present similar risks to the auction while also providing significantly muted short-term economically efficient price signals due to the likelihood of extremely volatile prices.

Efficient price signals and least cost outcomes

It is not clear whether Option 2 would result in price signals that are more efficient or least cost than what would be achieved under Option 1. For example, in times of excess, Option 2 is likely to value all capacity beyond the Reserve Capacity Target at \$0/MW. This is significantly less than the marginal value of that capacity. Alternatively, in times of capacity shortfall, all capacity is likely to be valued at the penalty price. In effect, it appears Option 2 is simply an auction with no administered demand curve (i.e., it will contain all of the issues the Public Utilities Office has previously identified with such auctions, such as the zero-infinity pricing issue).

Synergy agrees that making the gradient of the administered demand curve steeper (i.e. increasing price volatility) is likely to better align its price responsiveness with the marginal value of capacity. A more responsive capacity price is necessary to ensure downward pressure on long term costs, despite the likelihood it will negatively affect incumbents in the short term.

However, Synergy perceives a risk in the proposal to significantly steepen the gradients of the curve for high and low amounts of excess capacity as proposed by the Public Utilities Office. Synergy notes that the Public Utilities Office has previously indicated the marginal price of capacity relative to the level of excess capacity is a concave curve. The current demand curves from the transitional reforms already contain this shape. Therefore, it appears that the inflection points the Public Utilities Office is proposing to add to the price curve would be less reflective of this shape and therefore less reflective of the marginal price for capacity.

Fit for purpose

Option 2, while theoretically appealing, is untested in the WEM, was only recently implemented in France, and represents a significant shift from the Reserve Capacity Mechanism's more mature administered pricing structure. Synergy perceives a risk in implementing this new, potentially inflexible model, given it is unclear how it will interact with the emerging market conditions in the WEM, including the growing, large scale and distributed renewable generation capacity, and concurrent market reforms such as the proposed implementation of competitive ancillary services markets.

In light of this, and the apparent issues with both a reserve capacity auction and Option 2, as detailed in the Public Utilities Office's consultation paper, Synergy considers the incremental, minimum change approach of continuing with the current administered pricing model and retaining its potential for pricing adjustments is the most suitable to the WEM's transforming conditions.

Other comments

Synergy would be pleased to continue providing feedback in the more detailed design phase of these reforms. As one of only two demand response providers operating since reforms were made to availability requirements and pricing in October 2017, Synergy is well placed to discuss potential improvements to the value and participation of demand response capacity during this phase.

Should you wish to discuss these matters further, please contact Mr Jason Froud, Manager, Policy, on 08 6282 7395 or jason.froud@synergy.net.au.

Yours sincerely



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