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Electricity Market Review

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Dear Mr Martin,

Reserve Capacity Mechanism, Position Paper

GDF SUEZ Australian Energy (GDFSAE) welcomes the opportunity to respond to the 'Reserve Capacity Mechanism Position Paper', (the position paper) and notes the extensive work undertaken to date as part of the Electricity Market Review.

GDFSAE owns, in partnership, and operates the Kwinana Cogeneration Plant (Kwinana) located 40 kilometres south of Perth. Kwinana supplies steam and electrical power directly to BP Australia Kwinana Oil Refinery and electricity to the State-owned utility, Verve Energy. Kwinana has an installed capacity of 122 megawatts and employs 20 people.

The Reserve Capacity Mechanism has successfully promoted investment in capacity and has driven investor behaviour in the manner intended. GDFSAE accepts that the Government has cause to revisit the Reserve Capacity Mechanism but notes that where actual capability is being delivered to market in accordance with the Reserve Capacity Mechanism's intent, it would be inappropriate to characterise this as a failing in the market. As such, the burden of change should not fall bluntly on market participants.

In this regard, Kwinana has developed and relies upon the Reserve Capacity Mechanism. A sudden change to this arrangement, which reflects a change in Government policy, now commonly referred to as sovereign risk, would not be well received by GDFSAE or the wider market. For these reasons, GDFSAE encourages cautious and conservative changes to the Reserve Capacity Mechanism.

This submission reflects the expectation that there is a broad commitment to change which the Government intends to act upon with GDFSAE focusing on the best way of managing the period of transition so as to maintain investor confidence and minimise sovereign risk concerns.

Objectives and principles

GDFSAE notes the objectives and principles adopted in the position paper. While these principles have merit they may concern investors in long lived assets.

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First, reliance on centrally determined forecasts and auctions may be considered opaque and not conducive to least cost delivered energy to consumers.

Second, GDFSAE is unconvinced by the position that changes to the market are needed to provide “signals for efficient retirement” and “strong incentives to remove capacity”. There appears a view that cycling through old assets quickly and developing new assets is somehow desirable as opposed to a misallocation of capital.

An alternative view is that the capacity price should enable investors to meet long run marginal costs and prolonging the life of existing capacity, and maintaining the required reserve, would be optimal to ensuring lowest delivered cost of energy to consumers. This view acknowledges that Western Australia already has the fleet that it has, these are sunk costs, and that the transition costs to an optimal fleet - assuming the current fleet is sub-optimal- is expensive and will ultimately be borne by the consumer.

Third, the achievement of consistent medium term price signals via auction is premised on a period of retirements and losses to incumbents. This is cause for concern for existing participants and may ultimately increase costs to consumers.

Transition to a capacity auction

GDFSAE agrees that the transition to a capacity auction would be ‘financially disruptive for participants’. It is important to acknowledge that existing market participants have invested in good faith, have responded to incentives created by the Government and have delivered capacity in accordance with the prevailing market settings.

The uncertainty, and the need to honour the investments that have been made, strongly support the view that any transition should be slow and considered. GDFSAE welcomes the position papers acknowledgement of these considerations. As an investor and asset owner, GDFSAE would prefer a less aggressive slope than minus five.

Sudden changes will undermine market sustainability and the potential success of alternative market settings as existing participants may be reluctant to support new investment for fear of further loss. As such, it should not be assumed capital will appear in response to investment opportunities that arise under a structured auction where investors are now experiencing a loss in asset value.

If the transition period results in financial challenges, future capital is likely to attach more stringent conditions and higher risk ratings to Western Australian investment where a new market has arisen from a period of loss due to policy change. This supports a gradual transition over the period of a decade rather than any rapid changes.

On this basis, GDFSAE encourages a transition period which does not undermine existing investors in generation assets. GDFSAE appreciates the Government is acutely aware of this issue and therefore encourages a conservative annual adjustment to the payment calculations for generation.

The auction arrangements

GDFSAE appreciates the preference for a capacity auction and notes the economic drivers and theory underpinning this preference.

Nonetheless, the position paper’s confidence in a future auction mechanism is not entirely shared by GDFSAE given it will at least in part rely on projections and forecasts not dissimilar to those used to develop the existing, now considered challenged, Reserve Capacity Mechanism. In other words, it may be the case that the auction mechanism requires further consideration that only becomes evident at a later date – whether in relation to the desired level of excess capacity or term of payments. Acknowledging this inherent uncertainty is important as given current experience investors will consider the likelihood of further change high.

GDFSAE notes that the position paper references new investment in the Texas market that has been provided without any long-term commitments. The Texas market has undergone a series of reforms to better value the availability of capacity. While those may not reflect long-term capacity contractual commitments, the arrangements ensure more consistent returns to generators separate to the energy price. GDF SUEZ North American business was instrumental in the development of these changes at a time where there were significant concerns regarding market capacity. As such the comparison with the proposals for Western Australia may not be apt.

While the position paper proposes that in principle the average auction price will equal the long run marginal cost, there are some doubts where there is an existing fleet and the demand curve is constructed. The expectations of under procurement and the need for a “modified supplementary reserve capacity procurement process” are notable here.

The position paper makes reference to market power; however, the greater concern may be the potential for ongoing low priced auction outcomes which undermine asset values and the ability to make a return on investment. Where an auction determines a large component of revenues for a fixed asset, units cannot exit the market easily, and the potential for loss or being captive to sunk investment is significant. On this basis, GDFSAE favours payments periods of greater than one year.

Finally, GDFSAE notes that the market in Western Australia already caps the value of energy and hence there is little scope to increase revenue from energy where capacity is not valued in the market. This may be problematic where capacity is available but does not run. While unlikely the existing reduction in the value of energy is artificial and potentially value decreasing.

Should you have any queries in relation to this submission please do not hesitate to contact me on, telephone, 03 9617 8415.

Regards,

Jamie Lowe
Head of Regulation