CME

29 January 2015

Mr Simon Middleton
Project Director, Electricity Market Review
Department of Finance
1st Floor, Albert Facey House
469 Wellington Street
PERTH WA 6000

via email: electricitymarketreview@finance.wa.gov.au

Dear Mr Middleton

Feedback on the proposed reforms to the Reserve Capacity Mechanism

The Chamber of Minerals and Energy of Western Australia (CME) is the peak resources sector representative body in Western Australia. CME is funded by its member companies, which generate 95 per cent of the value of all mineral and energy production and employ 80 per cent of the resources sector workforce in the state.

The state's resources sector is diverse and complex, covering exploration, processing, downstream value adding and refining of over 50 different types of mineral and petroleum resources. In 2014/15, the value of the sector's production was $99.5 billion, or almost 90 per cent of state merchandise exports.[1]

Energy is a critical input to, and export from, Western Australia's resources sector operations and energy security is important for ensuring the sector can continue to deliver economic benefits to the state and national economies.

Reforms to the Reserve Capacity Mechanism are particularly relevant to CME's members that provide capacity, including generation and demand response capacity, and industrial scale energy consumers, many of which are demand response customers. CME is therefore pleased to again have the opportunity to provide input to the Electricity Market Review.

As outlined in CME's response to the initial Electricity Market Review discussion paper, moving to a transparent auction to procure capacity is a potential reform that would more closely align with allowing the market to determine the lowest cost supply of capacity, and would therefore be consistent with the reform objectives and principles outlined in the position paper.

A transparent auction would be a substantial change from the existing administrative mechanism for capacity procurement, under which market participants have made significant investments. The proposed inclusion of transitional arrangements to the mechanism is therefore an appropriate means of mitigating some risk for private sector investors in changing to an auction. Changing the mechanism to more rapidly diminish capacity payments, and thus the incentive to invest in capacity beyond the reserve requirement, is an appropriate transitional arrangement.

However, several aspects of the proposed transitional arrangements appear to be inconsistent with the Reserve Capacity Mechanism reform objectives and principles of adopting market

[1] Department of Mines and Petroleum, *Western Australian Mineral and Petroleum Production Statistics Digest 2014-15*, 2015, p. 11.

driven price signals, as well as the overarching reform objectives of the Electricity Market Review to foster greater private sector participation in the state's electricity sector.

The transitional arrangements do not appear to take a technology agnostic approach to capacity procurement, with the position paper instead proposing substantially differentiated treatment for demand response capacity payments and supporting this proposal by noting demand and supply capacity have different cost drivers that should be reflected.

Individual capacity providers within both the demand and supply sides also have a range of cost drivers, which differentiate between baseload, mid-merit and peaking capacity. This range of technologies and cost drivers, coupled with a market based process for procuring various capacity providers, would be expected to result in the most efficient outcome to meet the capacity requirement. Transitional arrangements that prevent certain technologies and/or providers from competing are at odds with the reform objectives and principles.

The position paper identifies the proposal to move from the transitional arrangements to the auction only after such time as the excess capacity has been reduced to five or six per cent of total capacity to avoid volatility in capacity price when moving. While this reform proposal is consistent with the objectives and principles, the method to reduce capacity to this level does not appear to be.

According to the position paper, approximately 220 MW of demand response capacity is expected to exit the market under the transitional arrangements. Yet this will not bring excess capacity to within five to six per cent within the next decade. Even if all demand response capacity (currently around 550 MW) exited during the transitional arrangements as a result of the differential treatment, additional capacity would also be required to exit, as the position paper notes, to reach the 595 MW reduction needed to bring excess capacity to around six per cent in 2020-21.

The oldest and most inefficient generation capacity still in the market, which would be expected to have been decommissioned were it operated by the private sector, is provided by the government owned utility, Synergy. In the absence of any changes to the government's current position to retain this capacity, the additional capacity needed to exit the market to reach five to six per cent would have to come from the private sector, which has a generally newer and more efficient generation profile overall.

If private sector capacity, offered by both demand response and generation providers, does exit the market, Synergy's resultant increase in capacity share could allow it to exercise sustained market power when moving to the auction. Further, under the proposed negative five coefficient curve for the transitional capacity pricing mechanism, all other things held constant, capacity remaining in the market would be expected to receive more per megawatt as other capacity exits.

The negative five coefficient in the transitional pricing mechanism also exceeds that which was previously developed and proposed by the Independent Market Operator's Reserve Capacity Mechanism Working Group, following over a year stakeholder consultation. The position paper does not appear to provide any evidence in support of the greater coefficient other than the expectation it would expedite the reduction in capacity.

If Synergy retains its current capacity, these transitional arrangements would have the perverse effect of redistributing capacity payments from exiting private sector capacity providers to the remaining capacity providers, predominantly Synergy, given its market share.

These outcomes are clearly inconsistent with the reform objectives and principles, especially given the level of excess capacity can partly be attributed to previous government policy decisions, such as the refurbishment of Synergy's Muja AB Power Station.

As a result, while beyond the options considered in the position paper and beyond the scope of the Electricity Market Review, a government commitment to retire Synergy's most inefficient generation capacity during the transition period should be a necessary precondition of moving to the auction.

Retiring Synergy's inefficient capacity would be consistent with the Electricity Market Review objective of facilitating private participation in the electricity sector without government investment, underwriting or financial support. It would also retain the more efficient private sector capacity, which has been commissioned over approximately the last decade.

After the commitment to retire Synergy's inefficient capacity, a staged increase in the negative coefficient of the transitional pricing mechanism could further assist in smoothing the move to the auction.

As with other work streams for the Electricity Market Review, the specific details of the proposed auction should be developed further through a dedicated working group of market participants to resolve outstanding queries, such as whether the current market structure can sustain an effective auction prior to the separation of Synergy to reduce its market share.

CME thanks the department for its consultative approach to the Electricity Market Review and looks forward to continued involvement in the process.

Should you wish to discuss this matter further, please contact Benjamin Hammer, Manager – Infrastructure, on 08 9220 8527 or b.hammer@cmewa.com.

Yours sincerely

Reg Howard-Smith
Chief Executive