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## **Agenda Item 6b (ii): Reserve Capacity Mechanism Working Group Update**

### **1. INTRODUCTION**

The Reserve Capacity Refund Mechanism Working Group (working group) was reconvened to discuss the merits of a Rule Change Proposal (proposal) submitted by Griffin Energy (RC\_2008\_35: Capacity Refund Mechanism – New Generators) against the Wholesale Market Objectives.

The proposal introduces changes to the capacity refund table in clause 4.26 of the Market Rules. In the proposal Griffin Energy contended that the change is necessary to remove discrimination in the Wholesale Electricity Market Rules (Market Rules) against new entrant plant.

The working group was requested to:

- Assess the merits of introducing a series of seasonal maximum caps on capacity credit refunds (as outlined in section 3 of Griffin's proposal) against the market objectives; and
- Provide an update to the MAC on its assessment.

In order to allow for the working group to complete its assessment of the proposal against the market objectives, the IMO extended the submission timelines for the proposal, as allowed under Market Rule 2.5.10. This extended the first submission period until 13 February 2009.

The working group met on two occasions, 17 December 2008 and 23 January 2009. During this time the working group developed a list of questions to aide in its assessment of the proposal against the market objectives. A summary of the questions and the working group's responses is contained in appendix one.

The IMO requests that the MAC express its views on the proposal, using this working group update as the initial basis for discussion. The IMO will, in accordance with Market Rule 2.4.3, have regard to the views of the MAC when producing the Draft Rule Change Report in order to decide whether to:

- Accept the rule change proposal in its current form;
- Accept the rule change proposal in a modified form; or
- Reject the rule change proposal

This report summarises the working group's conclusions with additional detail around the process and deliberations outlined in appendix one.

## 2. WORKING GROUP CONCLUSION

The working group did not reach unanimous agreement on the merits of the Rule Change Proposal vis-à-vis the market objectives.

The majority view of the working group was that:

- The proposal, of itself, does not appear to better the market objectives, as a whole.
- On balance, the working group concluded that there seems to be little net change, or no clear benefit for the market as a whole, if this rule change were to proceed. However, if implemented, the rule change may provide some positive effects on new entrant generators (the plant at the margins).
- There was some concern that the proposal, if implemented, may change the profile of the existing incentives of the Reserve Capacity Mechanism, which places high value on refunds around the summer period, when capacity is typically needed the most. The proposal appears to disincentivise availability when its value is highest – during February. There should be no reduction in incentive for December-March. This is against the general premise of encouraging availability for summer.
- There is no overriding evidence that this rule change is solving an issue with the current rules, and if this rule is amended to soon then the credibility of the market rules may be compromised.

The rule change proposer advocated the continuation of this Rule Change Proposal since there is some benefit to new entrants, with no substantial disbenefit to other participants. However, it was widely recognised that this needs to be balanced with both the regulatory risk that the Market is faced with if this area in the rules is amended again; and the potential additional complexity in the Market Rules.

Additionally the rule change proposer has noted that, notwithstanding this particular rule change, they would like to see a thorough review of the overall capacity refund mechanism at some stage. The IMO raised concerns that these provisions have recently undergone significant review and there are issues associated with revisiting components of the market design, particularly when there is no clear evidence of problems. In saying that, the IMO recommends that this be added to the participant issues log and prioritised appropriately by the MAC against all issues.

## 3. PROCESS FROM HERE

The rule change will continue through the process already underway, the next steps are:

- Submissions closing 13 February 2009; and
- Draft report to be prepared by 25 March 2009.

The MAC's views on this Rule Change Proposal will form part of the Draft Rule Change Report.

## 4. RECOMMENDATIONS

The IMO recommends that the MAC:

- **Discuss** the conclusions reached by the working group; and
- **Provide** the IMO with a view on the Rule Change Proposal to include in the Draft Rule Change Report.

## **APPENDIX ONE:**

### **1. MEETING NUMBER ONE**

#### **1.1. General discussion**

At the first meeting the working group had a general discussion around the rule change and the reason why Griffin had put forward the change. Griffin informed that its aim was for a minimal change to the current rules, keeping the current refund multipliers and only adding an additional seasonal component to the refund table in clause 4.26.1. Griffin argued that a new generator coming on is a one-off event in its lifetime and the current rules treat late entrants too harshly. In Griffin's opinion, the Rule Change Proposal sought to limit this adverse treatment of new entrants.

Other key points from the discussion were:

- Before commissioning, the main focus for new generators is project risk, not market risk. The main incentives, especially for a plant with contracted capacity, are to fulfil its obligations towards its project financiers and customers contracted for the new capacity. The refund mechanism is not a driver for completion for these plant types. In the view of some members, the refund mechanism is a financial project risk built into the project as a worst case scenario.
- Different types of plant have different incentives to be complete on time. Contracted base load and mid merit plant may have pure commercial drivers for completion, while a peaking plant may rely solely on reserve capacity payments. Also, the risk of being late in commissioning is much greater for a 3 year construction of a base load plant compared to a 2-3 month installation of a peaking plant.
- Some members viewed that if a plant is late in commissioning and incurring high refunds in November and December, the proposed seasonal cap means it has no incentive to come on in January.
- The system is always at risk but the RCM is targeted to cover the summer peaks, thus having steeper refunds for the hot season. Griffin's proposal spreads the refunds more evenly throughout the year, which changes the whole underlying incentives behind the design of the Reserve Capacity Mechanism.
- Should the refund mechanism treat different types of plants in different ways, given they have different incentives for coming on time? There must be incentives for peaking plant to be on time, but maybe these incentives are different than for baseload plant.
- The members agreed that a refund mechanism accounting for all different plant types would be too complex and a generic mechanism was the viable option, at least in the short to medium term. Therefore it was decided not to explore these issues any further.
- It was argued by some members that for many projects the refund mechanism did not have any effect on project performance. It only distributes the penalties differently.
- Since the WEM is a bilateral market, high credit worthy customers have power to set conditions on new projects, for example committing them to deadlines. These commercial deadlines are stronger drivers for the generator than any capacity refunds.
- Although the refund mechanism itself is a risk, the potential cost of this risk is known. The alternative of not having a refund mechanism designed to incentivise plant to come online for the hot season is having to call Supplementary Reserve Capacity (SRC). As the cost of SRC is uncapped, the risk to the market is unquantifiable. Also reducing any incentives by the refund mechanism might result in a higher chance of having to call SRC year on year. The SRC should only be needed infrequently as it is a last-resort tool.

## 1.2. Questions to assess the Rule Change Proposal

Members were requested to identify questions around the market objectives and assess these questions within their respective organisations before the next meeting. The questions put forward by the members, and subsequently distributed to them by the IMO in a questionnaire were grouped around each of the market objectives. These questions and a summary of the working group's responses are contained in section 2.1 of this appendix.

## 2. THE SECOND MEETING

Following the receipt of answers from working group members, the IMO summarized the answers and provided these to the working group before the second meeting on 23 January 2009. At this meeting the group assessed the answers and completed its assessment of the Rule Change Proposal against the market objectives.

### 2.1. Response to the questionnaire

Below are the conclusions made by the working group on the questions provided in the questionnaire.

<b><i>(a) to promote the economically efficient, safe and reliable production and supply of electricity and electricity related services in the South West interconnected system</i></b>	
How will this proposal mean an overall lower cost to the market?	<ul style="list-style-type: none"> <li>• It is unclear whether the Rule Change Proposal, if implemented, would increase or decrease costs for the market as a whole.</li> <li>• The increase or decrease in costs is likely to have more of a material impact on individuals (generators) but not on the market as a whole.</li> <li>• It is not clear that the Rule Change Proposal, by itself, is material enough to change participant behaviour.</li> <li>• There are different incentives for new versus existing generators.</li> </ul>
How will this proposal increase the likelihood of new plant coming on time?	<ul style="list-style-type: none"> <li>• The proposal is not likely to impact on the timings associated with new plant coming in on time.</li> <li>• Noting that at the margin peaking plant maybe more exposed/affected, but peaking plant may also be positively affected by this Rule Change Proposal.</li> </ul>
How will this proposal help to reduce the amount of outages for new plant?	<ul style="list-style-type: none"> <li>• The proposal will not materially reduce the amount of outages for new plant.</li> </ul>
Does new plant present a higher reliability risk on the system compared to old plant and will the proposal have any effect on this?	<ul style="list-style-type: none"> <li>• The proposal is not likely to have a substantive effect on the reliability of new plant.</li> </ul>
In what way will the proposal affect outage planning for existing plant and thus overall system reliability?	<ul style="list-style-type: none"> <li>• The proposal could increase the risk of outages extending longer, this may have a consequence on other plant.</li> <li>• The potential impacts (as with other effects) would generally be at the margins.</li> <li>• Potentially system reliability is increased during the</li> </ul>

<b><i>(a) to promote the economically efficient, safe and reliable production and supply of electricity and electricity related services in the South West interconnected system</i></b>	
	<p>winter months and slightly reduced during the summer months. This is against the general premise of encouraging availability for summer.</p> <ul style="list-style-type: none"> <li>There are different effects for different types of plant.</li> </ul>
<b><i>(b) to encourage competition among generators and retailers in the South West interconnected system, including by facilitating efficient entry of new competitors</i></b>	
Will the proposal reduce barriers to entry and if so, how?	<ul style="list-style-type: none"> <li>The proposal is unlikely to have a significant effect on reducing barriers to entry.</li> </ul>
Are smaller competitors better off with the proposed amendments, and if so why?	<ul style="list-style-type: none"> <li>Smaller competitors are no better off with the proposed amendments.</li> </ul>
Are the effects of the change different for different capacity sizes? If so, in which way?	<ul style="list-style-type: none"> <li>The effects of the proposal are no different for different capacity sizes.</li> </ul>
How is the refund risk handled in projects? Through extra funding or as a cost on the bottom line if the risk occurs?	<ul style="list-style-type: none"> <li>Members were not entirely certain how financiers account for risk, however, there is evidence that financiers and banking institutions do keep an eye on the market in order to assess the potential risk factors.</li> <li>Some experience indicates that access to working capital needs to assume maximum refunds in the first year of operation.</li> </ul>
<b><i>(c) to avoid discrimination in that market against particular energy options and technologies, including sustainable energy options and technologies such as those that make use of renewable resources or that reduce overall greenhouse gas emissions</i></b>	
In what way will the proposal allow for the market rules to better address this objective?	<ul style="list-style-type: none"> <li>There was general agreement that the current proposal would not better address this objective</li> </ul>
<b><i>(d) to minimise the long-term cost of electricity supplied to customers from the South West interconnected system</i></b>	
In what way will the proposal allow for the market rules to better address this objective?	<ul style="list-style-type: none"> <li>The impact is different for the overall market versus impact on new generators (in first year of operation). It was agreed that these impacts are generally not seen as material for the market as a whole.</li> </ul>
<b><i>(e) to encourage the taking of measures to manage the amount of electricity used and when it is used.</i></b>	
In what way will the proposal allow for the market rules to better address this objective?	<ul style="list-style-type: none"> <li>While this Rule Change Proposal is not inconsistent with this objective the rule change does not better address it.</li> </ul>

***A summary of the additional comments provided by members***

- Accepting this rule change proposal shortly after completing an extensive consultation process on the refund allocation, which gained broad market participant approval, potentially reduces confidence market participants have in the WEM rules change process.
- The impact of the change may go further than reducing Market Participant confidence, and the impacts may be more significant on external parties (consultants and/or financiers) who may not have the visibility around the process.
- There is no overriding evidence that this rule change is solving an issue with the current rules, and if this rule is amended to soon then the credibility of the market rules is in danger of being compromised.
- The Chair noted that the IMO wants to reduce the potential of regulatory risk as much as possible.
- The proposal seems to disincentivise availability when its value is highest – during February. There should be no reduction in incentive for December-March.
- The WG reiterated a previous request for the IMO to target bankers/financiers (and their associated credit committees), in order to gain a better understanding of what things they take into account. A member noted that the IMO needs to know what credit committees think and how they interpret the information that the IMO and Market Participants tell them. The IMO has a strategy underway for targeting investors.