
Wholesale Electricity Market Rule Change Proposal Submission Form

RC_2007_08 Calculation of Reserve Capacity Refund

Submitted by

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Submission

1. Please provide your views on the proposal, including any objections or suggested revisions.

The IMO advises in its rule change notice that the proposed rule change is to clarify the wording in the Market Rules that describes the Reserve Capacity Refund Mechanism so that it specifically reflects the intention of the refund mechanism. That expressed intention is to provide incentive for generators to meet their Reserve Capacity Obligations and encourage capacity to be fully available at peak times.

The rule change emanated from the report of a working group established to consider the matter. While Verve Energy was represented, it could be argued that such an arrangement was inappropriate for this matter as Verve Energy has most to lose from the proposed outcome and was outnumbered on the working group by other market participants who stand to benefit from the increased level of refunds proposed. With matters involving significant transfers of wealth, independent and rigorous analysis is required. The working group was not in a position to perform this function.

Verve Energy, in its support for the market principles, favours the application of market-based solutions. In this case, that would involve a refund mechanism that takes account of the relative security of the system. That is, refunds should be determined in real time and be dependent on the specific impact an unplanned plant outage has on system security. Accordingly, Verve Energy contends that of the options considered by the working group, the second option considered but dismissed on page 3 of the report (ie "adopt a different concept with refunds being made

proportional to the amount of demand on the system, or proportional to the amount of reserve generation capacity, at the time of the outage) is preferable. Verve Energy does not agree with the notion for dismissing that option, namely that "...a real time outage mechanism was not necessarily compatible with a day ahead market". It can be argued that the connection is tenuous at best.

It is evident that at no time over the last summer was system capacity jeopardised by unplanned outages. Verve Energy plant enjoyed excellent availability yet Verve Energy was required to make substantial refunds. Those refunds would have been approximately 50% higher if the proposed changes were in force. It is difficult to see the justification for continuing with the same refund philosophy with the added burden of increased refund level.

In addition, it is not evident that sufficient consideration has been given to the question of whether the proposed increase in refund level will prevent generators from earning economic profit and/or serve as a disincentive to the installation of new capacity. The working group canvassed this issue, and expressed a subjective view that it would not, but has an appropriate economic analysis on this aspect been conducted?

Verve Energy has previously, at Market Advisory Committee meetings, placed on record its opposition to this proposed rule change and reiterates it here.

2. Please provide an assessment whether the change will better facilitate the achievement of the Market Objectives.

The proposed (and current) methodology for calculating reserve capacity refund does not meet the prescribed Market Objectives:

- (a) "...promote the economically efficientsupply of electricity..." , nor
- (d) "...to minimise the long-term cost of electricity"

We note that the *"IMO must not make Amending Rules unless it is satisfied that the Market Rules, as proposed to be amended or replaced, are consistent with the Wholesale Market Objectives"* (clause 2.4.2). The IMO has not presented analysis quantifying the cost to the market of the proposed rule change, nor the other options considered.

Any prescribed outcome (in lieu of a true market-based arrangement) cannot possibly satisfy (a). The proposed rule change clearly undervalues the availability of capacity during times when the system is short of supply through the averaging of capacity refund penalties on a seasonal basis. Conversely, the value of maintaining available capacity when the system has a surplus of capacity will be overstated under the rule change proposal. Importantly, these price signals have a real impact on actual power station repair and maintenance expenditure. With a market price signal like that considered by the IMO as "option two", Verve Energy would be able to target its annual expenditure of between \$150M and \$200M to more accurately meet the system reliability and security requirements. The proposed rule change prevents such economic efficiencies, in direct contradiction of one of the market's main objectives.

Verve Energy strongly believes that the savings available through economically efficient price signals for capacity refunds, even if it results in just a 5% change in annual expenditure, are worth pursuing.

The muting of price signals distorts outcomes in the long-term as well. As proposed, the penalty for non-delivery of energy when the system is in stress has been reduced at the expense of imposing a penalty for the potential non-delivery of energy at times when it is not required. This may impact generation plant selection. Additionally, the proposed rule change dramatically increases the expected total cost of capacity refund penalties. Applied to the 2006/07 financial

year, the proposed rules would cost Verve Energy approximately \$20M versus \$14M under the current market rules. This increase in both risk and cost for electricity generators has yet to be justified as being consistent with the long-term objective of minimising electricity supply costs.

Clause 2.4.2 of the Market Rules clearly requires the IMO to consider only rule changes that work to improve the economic efficiency of the electricity supply industry and minimise overall costs. It has not been demonstrated that the proposed rule change will improve market efficiency, and in Verve Energy's assessment, it is more likely to result in further distortion and loss of efficiency.

To proceed with a rule change relating to the reserve capacity refunds the IMO must quantify the expected efficiency gain of the options considered. The rule change should then reflect the option that is demonstrated to be the most consistent with the Market Objectives .

3. Please indicate if the proposed change will have any implications for your organisation (for example changes to your IT or business systems) and any costs involved in implementing these changes.

N/A

4. Please indicate the time required for your organisation to implement the change, should it be accepted as proposed.

N/A
