Wholesale Electricity Market – Rule Change Proposal Submission Form

RC_2008_27
Funding of Supplementary Reserve Capacity

Submitted by

Name:	Graeme Alford
Phone:	9475 0144
Fax:	9475 0173
Email:	graeme.alford@landfillgas.com.au
Organisation:	Landfill Gas & Power Pty Ltd
Address:	PO Box 861 CLOVERDALE WA 6985
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Submission on the Draft Rule Change Report

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

LGP lodged a submission supporting the proposed Rule Change during the first round of the process and having now participated in the Public Forum and thoroughly reviewed the Draft Rule Change Report and submissions from other Market Participants, now reaffirms that support.

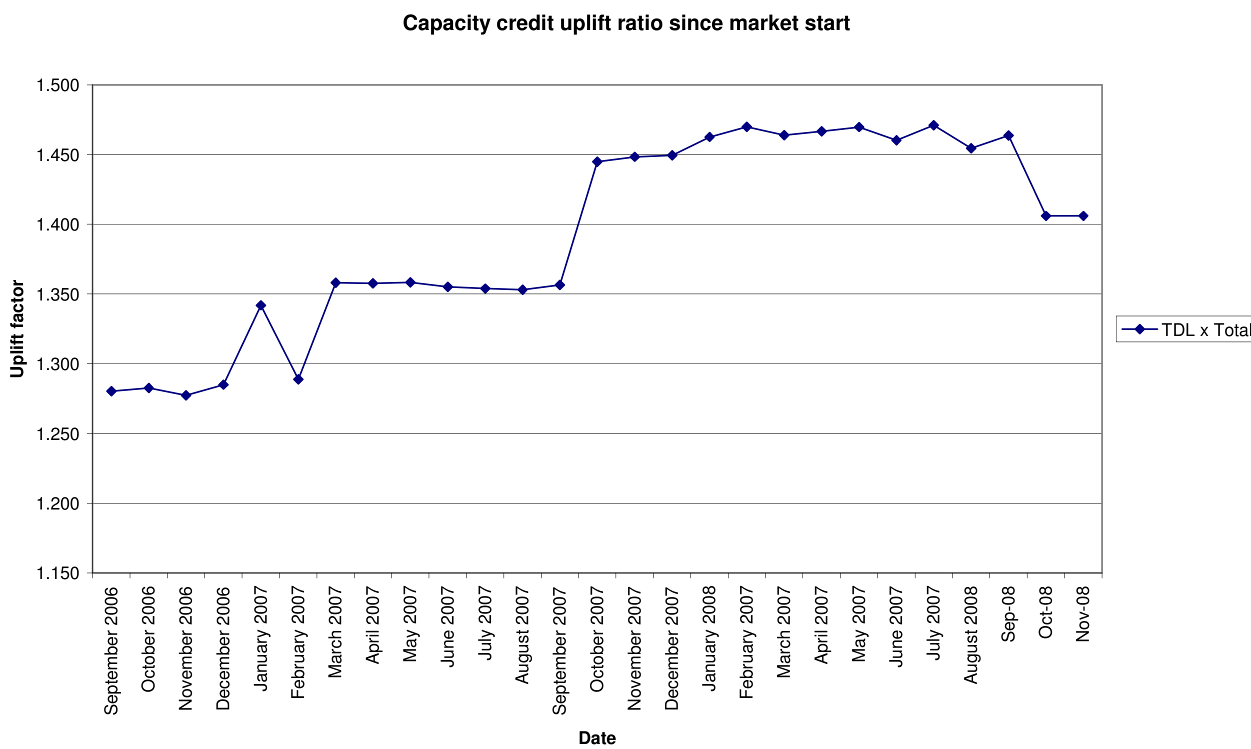
LGP considers the principal issues to be capacity credit liquidity and the avoidance of uncapped liabilities that are potentially massively out of proportion to participants' ability to bear them, and unrelated to the parties that caused them to eventuate.

Specifically, we refer to the prospect of a hypothetical 200MW generator that contracts to supply customers but whose commencement is delayed and which delay causes the IMO to seek Supplementary Reserve Capacity (SRC) in the amount of 200MW. That generator would be granted 200MW of capacity credits with which to discharge its capacity credit liability without further charge. However, as the generator is late in assuming its responsibilities, it would have to make capacity credit "refund" payments to the market until the value of the capacity credits over the entire capacity year (approximately $20 million) had been refunded. These refunds would be allocated to all market customers in proportion to their respective contributions to the system load. However, the cost of the SRC that results from the delayed generator is allocated only to participants that buy capacity credits from the Wholesale Electricity Market (WEM) in proportion to their share of the total number of capacity credits sold by the WEM to participants. Further, details of these purchases are not published, so that participants purchasing from the WEM have no basis to perceive that they will not be paying for the entire SRC cost – potentially $10,000 per MW per hour. Assuming that 200MW of SRC is called, this will cost $2 million per hour. While the number of hours for which SRC would be required is uncertain, the indicative figure considered by the SRCWG was 10 hours, being $20million in total (plus or minus a wide margin of accuracy). This means that if a single participant is short 0.1MW of capacity credits, it is potentially liable for $2million per hour even though it has nothing to do with the reason for the SRC being called and does not, except for an insignificant payment, participate in the refunds that arise from the party that did cause it, which refunds could be used to fund 10 hours of SRC but are otherwise distributed to the market as a whole.

If this anomaly is not removed from the Market Rules per the proposed rule change, retailers have no choice but to carry more capacity credits than they actually need and thereby create an unnecessary capacity surplus and attendant cost increase. Further, they have to carry substantially more capacity credits than they otherwise would because it is not practicable to accurately forecast capacity credit requirements month by month due to uncertainty caused by:

i) the annual variation in customer IRCR (being the correlation with the system maxima as determined from historical 30-minute consumption data),

ii) the monthly variation in the capacity uplift factor (TDL ratio multiplied by the Total Ratio) published by the IMO, as shown in the figure below. For example, on 1 October 2007, this quantity increased by 6.6%.



iii) changes to the customer portfolio due to contracting new customers and losing existing ones

iv) the monthly variability of customers represented as New Meters and subject to the different rules for allocation of IRCR related to current-month 30 minute consumption data.

Not only would a retailer have no choice but to carry more capacity credits than it actually needs, it couldn't reliably onsell its surplus because a counterparty purchasing via the month-by-month WEM capacity trading mechanism would assume the risk of bearing the SRC costs attached to their purchase.

LGP supports the IMO's assertion that all retailers underpin long term investment via central planning and IRCRs and that bilateral contracting of capacity credits is of much lesser importance in underpinning long term investment in generation. With the exception of existing capacity, all new capacity has to be financially underwritten by offtakers of sufficient credit-worthiness to attract debt finance. In this sense, the WEM is the centralised underwriter-of-last-resort via the WEM capacity trading mechanism which is itself underwritten by the prudential requirements placed on all market participants, including those who purchase otherwise uncontracted capacity from the WEM month-by-month. Alternatively, new power station developments are financed only by entities that have suitable credit-worthy balance sheets, such as the state-owned entities Verve and Synergy and other major participants. However, in the final analysis, all financiers depend on the WEM capacity trading mechanism as a worst-case source of income in case of offtaker default. This situation is of course, further limited by the current global financial crisis impeding the raising of debt.

LGP has a track record of long term commitment to generation in the SWIS and considers the 2 year lead time for capacity certification to be the most significant impediment to its ambitions to build further generation.

The WEM energy market features the liquidity required by an efficient market. Variable and unspecified amounts of energy can be bought or sold on a 30-minute basis at a published price that has a reasonable relationship to its cost. However, the WEM capacity credit market differs from the energy market in that its pricing is set 2 years ahead for the whole capacity year and new generators are also certified in "chunks" of capacity 2 years ahead of commissioning. The current WEM capacity trading mechanism, once enhanced by the proposed rule change, will nonetheless facilitate the necessary capacity credit liquidity by centrally underwriting new capacity and allowing participants to purchase or sell the exact quantity of capacity credits required for the exact time required without the attachment of quantumly disproportionate risks to the buyer. The alternative is that retailers will be prevented from increasing their customer portfolio on a real-time basis in response to competitive opportunities, and growth in market share will have to be carefully planned and financed.

There will also remain an important anti-competitive dimension to the current rules unless the rule change is implemented. The WEM is a recently formed, small market dominated by a single state-owned generator and a single state-owned retailer bonded together via a vesting contract that allocates effectively all of the generator's capacity credits (some 66% of the total) to the retailer while still not fully covering the retailer's total liability. As the number of credits is only marginally above the required minimum level, this creates scope for abuse of market power by entities with a surplus, particularly where they are retailer-generators with which the purchaser would be competing. In that regard, we note that in addition to the 66% capacity credit share held by Verve, the next most significant participants hold respectively 14.5% (retailer-generator), 7.0% (generator) and 4.9% (retailer-generator). There are a further 12 participants with around 0 to 2% each. Even if the major players do not abuse their market power, the equality of capacity credits and liabilities furnish the many small participants with the opportunity to do so at no risk, as they would otherwise sell though the WEM trading mechanism.

LGP supports the IMO's contention that to not proceed with the rule change would potentially cause retailers to reduce their customer base prior to the hot season. This consideration must also be further developed: retailers with a capacity credit shortfall will effectively transfer their 'surplus' customers to the Retailer of Last Resort, whatever legal form it takes. From a risk management perspective, as capacity credit positions are not published, any entity with a shortfall must assume that it is the only entity with a shortfall and that it therefore stands to bear the entire cost of SRC, in the hypothetical case previously alluded to being $20million plus or minus a wide margin of accuracy. Further, due to the long lead times of the capacity certification process a retailer-generator with a capability to install capacity at short notice so as to alleviate its position is not permitted to do so. LGP cannot even procure its parent company to utilise its 300kW generators to alleviate the situation, either via a DSM capacity credit or participant in the delivery of SRC.

There is a further issue about a retailer's ability to pass through to its customers the costs of SRC. Assuming that it has so contracted, an SRC-event could reasonably be expected to bankrupt a number of small to medium enterprises. Insofar as the retailer has not been able to pass through the costs, then the retailer could itself be at risk of business failure. Indeed, even if the retailer has contracted the pass-through of the SRC costs to customers, it won't be able to collect the money from a bankrupted customer. Moreover, if customers and or retailers defaulted, the market still wouldn't get its money and the Market Rules default provisions would be invoked – thereby defaulting to the socialisation of SRC costs that the rule change seeks to introduce.

In response to the IMO's call for comment on the assertion that some market participants are "unable" to secure bilateral contracts for capacity credits, LGP advises that its experience is that bilateral contracts are available but were priced so as to render uncompetitive the retail offerings of which they were to become a part. In particular, LGP has formed the view that the retail cost structure does not accommodate the "insurance premium" that parties with surplus capacity credits perceive is payable in order to facilitate avoidance of the SRC cost obligation. We note that the Office of Energy nominated a suitable retail margin inclusive of competitive headroom to be 5% of the total. From LGP's experience, the capacity charge is around 25% of the total cost. Consequently, the entire retail margin equates to an "insurance premium" of only 20% on the capacity price. Further, the Office of Energy has acknowledged that gazetted retail tariffs are some 30 to 40% below cost-reflectivity. LGP submits that there ought not to be a capacity credit premium for the avoidance of an SRC liability.

The Market Objectives have as their core, safety, security, reliability, least-cost through competition, demand management and technology and fuel –neutrality. While abstract economic efficiency arguments have an important role in the market evolution, they should not be permitted to drive it, lest the old medical cliché apply: 'the operation was a success, but the patient died'. LGP endorses the contention by Griffin Energy that, "….regulation to prevent market failure and improve the long term function of the market is more beneficial than applying strict efficiency principles in this case." Further, we support Synergy's contention that the capacity 'market' is more accurately a regulatory mechanism and that mechanism needs to be adjusted to avoid perverse outcomes.

In terms of process and procedure, it is important to "start from where we are with what we have" and make incremental improvements from there. From this perspective, LGP notes that the Supplementary Reserve Capacity Working Group met 6 times in recent months and part-way through its deliberations determined that the implementation of the proposed rule change should be assumed as a basis for progressing the several matters contingent upon it. In particular, LGP was otherwise of the position that there was considerable merit in the IMO retaining Capacity Credit Refunds (from non-performing capacity credit suppliers) to create a fund from which SRC costs could be paid. However, this concept was not pursued on the ground that SRC was to be made a

Shared Cost. If the proposed rule change is not implemented, all the later work of the SRCWG is subject to review with the potential consequences of undermining the other outstanding Rule Change proposals. Further, there is an important process consideration; the SRCWG was widely representative of market participants and was proceeding on an urgent basis with many organisations committing significant resources to it. While it is to be expected that rule changes will adversely affect some market participants, LGP proposes that there is a very strong case for the IMO to proceed with the majority view of the SRCWG, from which the rule change was developed. Further, the regular attendees of the group were not aware that material objections to the proposal were to be pursued and had they been so notified, the group would no doubt have sought to remedy them. Time is now of the essence and while the SRCWG could in principle be usefully reconvened to consider further changes, there is insufficient time for it to effectively contribute anything prior to the expected SRC crunch time of February 2009.

In summary, LGP strongly supports the proposed rule change and perceives there could be dire market consequences if it is not implemented urgently. LGP supports the IMO's contention that to not proceed with the rule change would potentially cause retailers to carry more capacity credits than they actually need and thereby create an unnecessary capacity surplus and to reduce their customer base prior to the hot season. The latter would result in an unreasonable impost on the Retailer of Last Resort, expose customers to distressed-pricing and undermine confidence in the market. This would increase prices and seriously restrict competition and customer choice.

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

LGP supports the IMO's contention that the proposal supports the market objectives by spreading the cost of Supplementary Reserve Capacity across all Market Customers rather than targeting individual Market Customers which may have little to do with triggering these costs, or benefit disproportionately from them. It will also encourage competition among retailers by removing their exposure to uncontrollable and uncapped liabilities and exposure to excessive capacity credit prices.

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

LGP would incur no organisational costs as a consequence of adopting the change.

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

LGP would be able to implement this Rule Change immediately.