

Our Ref: DMS #3178145 V1
Enquiries: Ms Jenni Conroy
Telephone: (08) 6212 1661



27 November 2008

Mr Allan Dawson
Chief Executive Office
Independent Market Operator
Level 3, Governor Stirling Tower
197 St Georges Terrace
PERTH WA 6000

Dear Allan

FUNDING OF SUPPLEMENTARY RESERVE CAPACITY

Synergy appreciates this opportunity to comment on the draft Rule Change Report - RC_2008_27 - Funding of Supplementary Reserve Capacity.

Synergy notes that currently under the Wholesale Electricity Market Rules (**the WEM Rules**), if the Independent Market Operator (**the IMO**) were to undertake a Supplementary Reserve Capacity Auction for the 2008/09 Summer period, the cost of this supplementary capacity would be passed onto those retailers not having their Individual Reserve Capacity Requirements (**IRCR**) bilaterally covered. The existing WEM Rules therefore create a plausible risk of passing on to small retailers a significant capacity cost, one greater than their energy portfolio and beyond their financial ability to sustain operation. At the extreme, this could result in a single small retailer bearing the complete cost of the Supplementary Reserve Capacity Auction, although the entire market would in effect benefit from extra capacity cover. Synergy therefore sees an urgent need to rectify this circumstance within the WEM Rules.

The Rule Change Proposal (RC_2008_27) proposes to allocate the cost of Supplementary Reserve Capacity onto all retailers, as a shared capacity cost. This would remove the exposure for small retailers who do not have their IRCR bilaterally covered and allow retailers to pass on a manageable cost to customers¹. Synergy supports this rule change proposal in its current form.

Synergy highlights the following paradigm in existence within the WEM. The WEM is a bilateral market, not a gross pool, and is subject to regulated

¹ The share cost approach also allows the supplementary auction cost to be explicitly described in a customer supply contract meaning the retailer can protect its margin by passing through to the end user the risk. A non-shared cost approach is extremely difficult to describe in a customer supply contract because no independent verification of how a retailer should charge its customers exists.

price caps. The capacity mechanism is in effect a regulated cap, established as a regulated mechanism to avoid the need for VOLL style pricing.

The WEM is a small, isolated, market with few players. There is limited flexibility of supply options. Due to the bilateral nature of the WEM (including for the supply of capacity credits) competition only occurs at the margins. Derivative products are not freely offered within this market. Within this paradigm, small retailers are critical to ensure a level of competition and choice to customers.

The Reserve Capacity Mechanism is a centralised regulated facility and therefore not created to insist each and every retailer perfectly bilaterally covers their IRCR. In fact, Synergy argues that it is impossible for a retailer to perfectly cover its capacity exposure as there exists uncertainty in every timeframe as to the quantum of that exposure. The retailer only receives confirmation of their IRCR just before the start of the applicable month. Developing a strategy for coverage is further constrained in that the risk of exposure is exponential with time - the further a retailer is away from the applicable month, the more uncertainty its IRCR is, due to factors beyond retailer control, such as: growth and churn; the medium of the 12 summer values resetting load IRCR; and the dynamic of hot or mild summers adjusting the allocation of IRCR between contract loads and Notional Wholesale Meter loads.

In the presence of this uncertainty of both IRCR and total capacity cost, retailers are exposed to both volume and price risk for capacity. Given these uncertainties retailers are likely to seek to unbundle capacity and pass these risks/costs directly onto customers. Currently, the targeted nature of Supplementary Reserve Capacity within the WEM Rules, is difficult to quantify within contracts or indeed to pass through. This creates a substantial risk for retailers, particularly smaller retailers, and at its extreme could act as a barrier to entry for new retailers to the WEM.

The likelihood of a Supplementary Reserve Capacity Auction occurring can only be ascertained a short time before the commencement of the Summer period. While retailers could bilaterally arrange for capacity cover before the start of each month, this coverage would be obtained at a cost premium above the cost of capacity available from the IMO, through the centralised and regulated Reserve Capacity Mechanism, effectively creating inefficient outcomes.

Given the limited suppliers of capacity credits within the WEM, spare capacity credits are highly likely to be vested with one or two participants, allowing these to extract scarcity pricing (there is evidence of this).

To conclude, Synergy views that the Reserve Capacity Mechanism, is a centralised, regulated instrument. We see no evidence of the existence of a market for capacity credits at this time, nor do we see the likelihood for such a market to evolve in the near term, given the bilateral nature of the WEM.

We note the significant concern that the current WEM Rules relating to the funding of Supplementary Reserve Capacity can lead to inefficient outcomes and has the potential to over-penalise certain retailers, making the WEM a risky market to operate within. This has the potential to severely constrain the development of future retail competition.

The proposed rule change (RC_2008_27) proposes to allocate the cost of Supplementary Reserve Capacity onto all retailers, as a shared capacity cost. This would remove the exposure for small retailers who do not have their IRCR bilaterally covered and allow retailers to pass a manageable cost on to end users. Synergy supports this rule change in its current form and sees an urgent need for it to be given effect within the WEM Rules.

Please do not hesitate to contact me directly if you would like to personally discuss any issues raised in this letter.

Yours sincerely



JENNI CONROY
MANAGER WHOLESALE REGULATORY AND COMPLIANCE