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Alinta

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Dear Allan

WEM Rule Change Proposal RC 2008 27 – Funding of Supplementary Reserve Capacity

Thank you for the opportunity to provide comments on Rule Change Proposal RC 2008 27 "Funding of Supplementary Reserve Capacity". Please accept my apologies for this late response. This letter sets out the view of Alinta Sales Pty Ltd (Alinta).

The proposed change

On the 28th of August 2008 the Independent Market Operator (IMO) submitted RC 2008 27, proposing to change the Market Rules relating to the funding arrangements for Supplementary Reserve Capacity (SRC).

Currently, the Market Rules stipulate that the costs of funding capacity be divided into a "Shared Capacity Cost" and a "Targeted Capacity Cost". All retailers are liable, in proportion to their Individual Reserve Capacity Requirements (IRCR) market share of the total costs allocated to the Shared Capacity Cost pool. Conversely, only retailers that do not have bilateral IRCR cover are required to fund the Targeted Capacity Costs.

The cost associated with funding SRC is currently classified as a Targeted Capacity Cost. The IMO has proposed to change the Market Rules so that SRC is funded from the Shared Capacity Cost pool.

Alinta's view

Whilst Alinta believes that the rules relating to the cost allocation of SRC require to be changed, it does not agree with the proposed rule change and believes that it would be detrimental to facilitating the achievement of the WEM objectives[1].

The Market Rules should incentivise participants to effectively manage risks associated with the timely delivery of reserve capacity in to the WEM. Alinta considers that the guiding principle for this issue should be to ensure that the participant that is best placed to manage a risk should be exposed to the financial consequences of failing to manage that risk appropriately. In the case of SRC, the Market Rules should provide that costs are borne by the party or parties who are most able to avoid the requirement for SRC. As there may be different drivers for SRC (for example a late commissioning generator vs load growth exceeding forecast values), Alinta considers that the Market Rules need to address each scenario specifically. Alinta therefore supports that further work is undertaken by the SRC working group to address these issues.

Alinta understands that one of the drivers for the rule change proposal was the possible requirement for SRC this summer that is due, at least in part, to a late commissioning generator. Furthermore, as the price paid for SRC is not capped, the total cost could be significant. Under the current Market Rules, that SRC cost would be spread across those retailers that do not have full bilateral contract cover to meet their IRCR requirements. Alinta has chosen to maintain a long position on capacity credits to, amongst other things, avoid the potential exposure to uncapped SRC costs. In doing so, Alinta has also underpinned stable, long term investment in generation in the WEM.

Other retailers can choose to adopt different risk management strategies in the market and may choose to maintain a short position on capacity credits and source them through the IMO at administered prices - believing this to be a potentially cheaper, but higher risk alternative. As these retailers are not making the same long-term commitment to generation projects they are also not to the same degree underpinning investment in capacity in the system. In effect, these retailers choose not to pay an insurance premium to ensure sufficient long term investment in capacity. However, in making the decision not to contract bilaterally for capacity credits, these same retailers would have been fully aware of their exposure to the cost of funding SRC. This is reflective of the fact that in paying the arguably lower cost of not committing to a long term agreement to underpin capacity investment these retailers choose to take on the risk of having to fund SRC should it be required.

As stated above, Alinta believes that the party that is best placed to manage the risk associated with the need for SRC should also be exposed to the financial cost associated with SRC. In the case of a late commissioning generator, Alinta believes that in principle the costs should be borne by the late commissioning generator. The late commissioning generator is the party that has the greatest ability to influence the outcome and minimise the risk of having to call for SRC in the first place.

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[1] The objectives of the Market Rules are contained in Market Rule 1.2.1 and are:
(a) "to promote the economically efficient, safe and reliable production and supply of electricity and electricity related services in the South West Interconnected System"
(b) "to encourage competition among generators and retailers in the South West Interconnected System, including by facilitating efficient entry of new competitors"
(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"
(d) "to minimise the long-term cost of electricity supplied to customers from the South West interconnected system"
(e) "to encourage the taking of measures to manage the amount of electricity used and when it is used"

Alinta believes that the current rule change proposal would be a step in the wrong direction. Rather than targeting costs to the party responsible, it would further socialise costs, having a detrimental impact on efficiency and competition in the market. The rule change would also severely diminish the incentives that currently exist for retailers to contract bilaterally for capacity, which currently underpin long term investment in generation. Currently, covering capacity requirements with bilateral contracts provides both price certainty and insurance against SRC cost exposure.

Alinta has made a conscious decision to have a long position on capacity. This decision was made with due consideration of the rules relating to the allocation of costs for SRC. The proposed change would completely change both the value and the risk profile of Alinta's portfolio. Alinta believes this represents unnecessary sovereign risk which will only serve to increase the long term cost of operating in the market. Alinta understands and accepts that in all markets there is an element of sovereign risk which must be considered when making an investment decision. This risk should be minimised by carefully assessing whether proposed changes to the market rules facilitate or impede achievement of the market objectives. Alinta considers the proposed rule change would impede achievement of the market objectives.

Alinta understands that some market participants have represented that they are unable to obtain a bilateral contract for capacity credits, and are thereby unable to hedge their exposure to the cost of SRC. As stated at the Market Advisory Committee, Alinta is currently and has for some time been long on reserve capacity. Furthermore, Alinta has been approached by some market participants seeking to purchase capacity credits. Alinta can only speculate on the reasons for the lack of interest from some retailers to cover their requirements bilaterally. However, Alinta cannot accept the argument that has been put forward that it is impossible to purchase a bilateral contract for capacity credits.

In summary, Alinta makes the following points:

- Alinta considers that the proposed market rule change would impede the achievement of market objectives (a) and (b) relating to efficiency and competition.

- Alinta considers that the current Market Rules provide a greater incentive for bilaterally contracting for reserve capacity and more effectively underpins long term investment in generation than those provided by the proposed market rule change.

- The current Market Rules provide a greater incentive for the efficient long term investment in generation compared to that which would exist under the proposed market rule change.

- Alinta also considers the change proposal would adversely impact retail competition as it effectively removes the ability of retailers to manage their exposure to SRC costs.

- The change proposal therefore removes some of the potential for product diversification and offerings to be made available to the market.

IT systems and cost implications

Alinta has not identified any significant cost impact for its own IT systems.

Time required for implementation

Alinta does not require any specific lead time to allow implementation of the proposal.

Please call me on 08 9486 3313 to discuss any of the issues raised in this letter in more detail.

Yours sincerely

Kristian Myhre
Manager Market Analytics