Independent Market Operator

Draft Rule Change Report
Title: Funding of Supplementary Reserve Capacity

Ref: RC_2008_27

Standard Rule Change Process

Date: 31 October 2008

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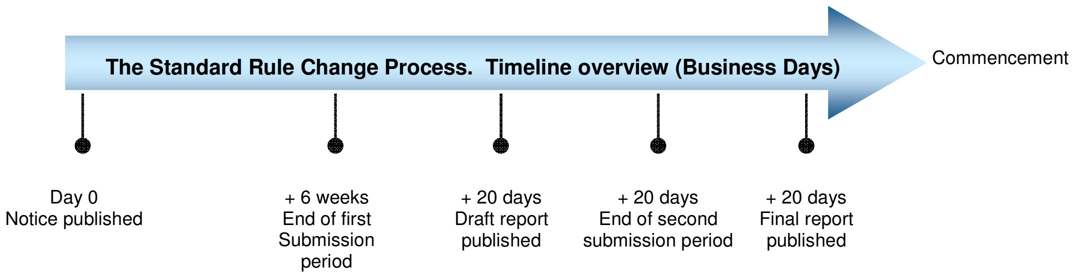
1. INTRODUCTION

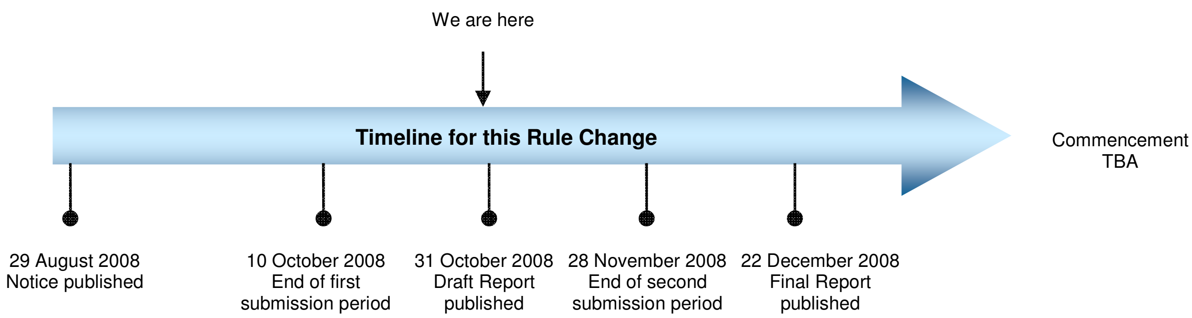
On 28 August 2008 the Independent Market Operator (IMO) submitted a Rule Change Proposal regarding changes to clauses 4.28.3 and 4.28.4 of the Wholesale Electricity Market Rules (Market Rules).

This Proposal is being processed using the Standard Rule Change Process, described in section 2.7 of the Market Rules.

The standard process adheres to the following timelines, outlined in section 2.7 of the Market Rules:



The key dates in processing this Rule Change Proposal are:



Based on the submissions received, the IMO's draft decision is to implement the Rule Change Proposal in the form outlined in section 6 of this Report.

This Draft Rule Change Report on the Rule Change Proposal has been prepared by the IMO in accordance with clause 2.7.6 of the Market Rules.

Interested parties are invited to provide further submissions in relation to this Draft Rule Change Report. In accordance with the Market Rules timelines, the deadline for submissions is 28 November 2008.

2. THE RULE CHANGE PROPOSAL

2.1. Submission Details

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Date submitted:	28/08/2008
Urgency:	3-high
Change Proposal title:	Funding of Supplementary Reserve Capacity

2.2. Details of the Proposal

The IMO submitted that under the current Market Rules, the IMO must separate the total costs of funding Capacity Credits into two separate sets – a Targeted Reserve Capacity Cost and a Shared Reserve Capacity Cost.

The IMO explained in its proposal that the Targeted Reserve Capacity Cost is the cost of Reserve Capacity that is shared amongst those Market Customers who have not been allocated enough Capacity Credits for the trading month to cover their Individual Reserve Capacity Requirements. Under the current Market Rules, the Targeted Reserve Capacity Cost includes the net payments to be made by the IMO under any Supplementary Capacity Contracts.

The IMO posited that the Shared Reserve Capacity Cost, on the other hand, is the cost of Reserve Capacity to be shared amongst all Market Customers for the Trading Month. This cost, for example, will include the cost of any surplus of Capacity Credits relative to the Reserve Capacity Requirement.

According to the IMO, this current arrangement for funding the costs of the Supplementary Capacity Contracts does not appear to be equitable. At the extreme, if all but one Market Customer fully covered their Individual Reserve Capacity Requirements, the entire cost of any existing Supplementary Capacity Contracts would be covered by that one participant. This would be particularly inequitable if the need to acquire Supplementary Capacity was caused by the unavailability of a generator whose Capacity Credits were used to cover the Individual Reserve Capacity Requirements of a different Market Customer.

The IMO's rule change proposal aimed to correct this potential inequity in the Market Rules by removing the net payments made by the IMO under any Supplementary Capacity Contracts from the Targeted Reserve Capacity Cost and including these in the Shared Reserve Capacity Cost.

The Supplementary Reserve Capacity (SRC) Working Group formed by the Market Advisory Committee (MAC) agreed that this proposal should be progressed as soon as practicable. It noted, however, that the Working Group is yet to fully deliberate on the appropriate funding for the additional costs associated with the use of the Supplementary Reserve Capacity mechanism and the distribution of these costs amongst Market Participants. The Working Group noted, therefore, that there may be further proposed changes to the mechanism once it has concluded its discussions.

2.3. The Proposal and the Wholesale Market Objectives

The IMO submitted that the proposal supported market objectives (a) and (b) as follows:

(a) to promote the economically efficient, safe and reliable production and supply of electricity and electricity related services in the South West interconnected system;

The IMO submitted that the proposal supported market objective (a) by promoting the economically efficient supply of electricity in the South West Interconnected System (SWIS). This will be achieved by spreading the cost of SRC across all Market Customers rather than targeting individual Market Customers which may have little to do with triggering these costs.

(b) to encourage competition among generators and retailers in the South West interconnected system, including by facilitating efficient entry of new competitors;

The IMO also submits that the proposal supports market objective (b) by encouraging competition among retailers in the SWIS. This will be achieved by correcting the apparent inequitable treatment of some retailers under the current Market Rules.

2.4. Amending Rules proposed by the IMO

The amendments to the Market Rules proposed by the IMO are outlined in section 6 of this report.

2.5. The IMO's Initial Assessment of the Proposal

The IMO decided to proceed with the proposal on the basis of its preliminary assessment, which indicated that the proposal was consistent with the Wholesale Market Objectives. This preliminary assessment was published in a Rule Change Notice on 29 August 2008.

3. SUBMISSIONS

The IMO received four submissions on the Rule Change Proposal, from Alinta, Griffin Energy, Landfill Gas & Power Pty Ltd (LGP) and Synergy. The submissions are summarised below, and the full text is available on the IMO website.

3.1. Market Advisory Committee

MAC discussed the proposed rule change at two consecutive meetings, 20 August 2008 and 10 September 2008.

At the August meeting it was advised that this proposed rule change was an 'interim solution' while the SRC Working Group (Working Group) continued to debate the issue of funding SRC. In the meantime, the Working Group would devise a more permanent solution. It was noted that it is highly unlikely that SRC will be called before February 2009.

MAC agreed that proposed rule change be processed, however MAC did not support that it be processed via the fast-track mechanism. It was posited that although the proposal should not be 'fast-tracked', the IMO could shorten its timeframes for drafting rule change reports and publishing rule change material and thereby significantly reduce the time required for processing the rule change.

During the discussion at the September MAC meeting, one MAC member expressed concern with the rule change proposal, noting that:

- The rule change proposal does not improve the Market Rules nor does it promote any of the market objectives;
- The rule change proposal removes the incentive for retailers to trade bilaterally and hedge their risk because all market participants would be subject to an equal share of the SRC cost regardless; and
- It did not seem fair that retailers, which have tried to limit their exposure by taking on excess capacity, must face their share of the SRC cost despite having taken measures to negate the need for SRC.

The rest of MAC supported the change as proposed.

3.2. Submission from LPG

LGP supported the rule change proposal on the grounds that it removed a manifest error that stood to cause participants that purchase capacity credits, at the market price, to be liable for funding the entire cost of procuring any requirement for SRC for the market as a whole.

In particular, LGP submitted that such an impost would likely bankrupt a small retailer through no fault of its own and take no account of the causer or beneficiaries of the requirement for SRC. Moreover, with such a retailer having been bankrupted, the market still wouldn't get its money and the Market Rules default provisions would be invoked. Further, given that the number of capacity credits available equals the demand for them, the present rule facilitates an abuse of market power whereby a supplier with a surplus can demand an excessive premium for them under the threat of withholding them from the market. Indeed, such a possibility is facilitated by the fact that virtually all the capacity credits allocated to the dominant generator are allocated to the dominant retailer.

LGP supported 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.

3.3. Submission from Synergy

In its submission, Synergy supported the IMO's view that the current arrangements for funding the costs of the Supplementary Capacity Contracts does not appear to be equitable.

Whereas all Market Customers derive a benefit from SRC, the current method of allocating the cost can impose an unequal burden by allocating the cost to only those Market Customers that have failed to purchase sufficient Capacity Credits. The inequity of this burden is compounded where the need for SRC is created by either:

- The failure of a Market Generator whose Capacity Credits have been purchased to satisfy the Individual Reserve Capacity Requirements of a different Market Customer; or

- An overall increase in the load forecasts of the IMO establishing the need for the IMO to procure more capacity.

Synergy was the Chair of the Working Group, formed by MAC. The Working Group has reviewed this rule change at some length, and has agreed to support this rule change through the formal process. Synergy noted that the Working Group had some concerns in that the appropriate funding for the additional costs associated with the use of the SRC mechanism and the distribution of these costs amongst Market Participants has not yet been advanced, but that these arrangements are now in hand.

Synergy accepted the IMO's view that the proposed rule change supports the operation of the Market Objectives.

Specifically, Synergy's view was that the proposal supported market objective (a) by promoting the economically efficient supply of electricity in the SWIS. This will be achieved by spreading the cost of SRC across all Market Customers rather than targeting individual Market Customers which may have little to do with triggering these costs.

Further Synergy agreed that the rule change supported market objective (b) by encouraging competition among retailers in the SWIS. This will be achieved by correcting the apparent inequitable treatment of some retailers under the current Market Rules.

3.4. Submission from Griffin Energy

In its submission, Griffin energy contended that the costs associated with the SRC mechanism are difficult to apportion. The capacity market and its associated capacity refund and SRC mechanism are poor levers for managing reliability in and efficient manner. Griffin Energy noted that while reform of the overall system will take time and considerable effort, they supported this rule change proposal.

Griffin Energy noted that while all market customers can manage their exposure to potential SRC costs, large incumbent retailers are much better placed to do so. This creates a considerable barrier to entry, as the potential impact of related costs from a severe SRC event could bankrupt a smaller or less established retailer. Griffin Energy contended that markets should support competition over incumbent monopolies through sensible regulation.

In its submission, Griffin Energy suggested that, in the longer terms, costs of SRC events could be met through the allocation of a proportion of capacity refunds to a pool of reserves managed by the IMO. This pool of funds could be used to pay for SRC services or to improve reliability, such as investing in (or subcontracting) the construction of peaking generation facilities. Griffin Energy stated that this should be investigated as part of a long term review of the capacity mechanism.

Although Griffin Energy supported the rule change proposal, it did not agree with the IMO's assessment against the Market Objectives. In particular, Griffin Energy disagreed that objective (a) is supported, in that efficient markets often lead to participant failure. Griffin energy contends that this rule change proposal is, in fact, applying regulations to discourage efficient market behaviour.

In saying that, Griffin Energy noted that the long term effective operation of the market is aided by competition among retailers (objective (b)) and that this in turn leads to the reduction of the long term cost of electricity supplied to consumers (objective (d)). On balance, Griffin Energy contended that regulation to prevent market failure and improve the long term function of the market is more beneficial that applying strict efficiency principles in this case.

3.5. Submission from Alinta

In its submission, Alinta agreed that the rules relating to the cost allocation of SRC do need to be changed, but did not agree with the proposed rule change. Alinta contended that the rule change proposal would be detrimental to facilitating the achievement of the Market Objectives, in particular objectives (a) and (b) relating to efficiency and competition.

Alinta submitted 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, therefore in the case of SRC the market rules should provide that costs are borne by parties who are most able to avoid the requirement for SRC.

Alinta noted that there are a number of different drivers for SRC and as such they considered that the Market Rules need to address each scenario specifically. Alinta supported further work to be undertaken by the SRC working group to address these issues.

Alinta submitted that the current rule change proposal would be a step in the wrong direction, rather than targeting costs to the party responsible, these costs would be socialised. Alinta contended that this would have a detrimental impact of efficiency and competition in the market. Additionally, Alinta noted that the rule change would diminish the incentives that currently exist for retailers to bilaterally contract for capacity, which

Alinta asserted to provide retailers with both price certainty and insurance against SRC cost exposure.

Alinta submitted that they have chosen to maintain a long position on capacity credits, to avoid potential exposure to uncapped capacity credits. In doing so, Alinta stated that they believed this to underpin stable, long term investment in generation in the WEM. Alinta asserted that other retailers choosing to maintain a short position on capacity credits are not making the same long-term commitment to generation capacity, and in effect would be fully aware of their exposure to SRC costs.

Alinta submitted that they do not support the argument from some market participants stating that they are unable to secure bilateral contracts for capacity credits (and are therefore unable to hedge their exposure to the cost of SRC).

In summarising their submission, Alinta highlighted the following points:

- The proposed rule change would impede the achievements of market objective (a) and (b) relating to efficiency and competition;
- 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 for by the proposed market rule change;
- The proposed rule change would adversely impact retail competition as it effectively removes the ability of retailers to manage their exposure to SRC costs; and
- The proposed rule change therefore removes some of the potential for product diversification and offerings to be made available to the market.

3.6. Public Forums and Workshops

No public forums or workshops were held in relation to this Rule Change.

4. THE IMO'S ASSESSMENT AND DECISION

4.1. Assessment

4.1.1. Submissions

The response to the Rule Change Proposal submitted by the IMO was mixed. Two submitters supported the proposal in its entirety, one submitter (Griffin Energy) supported the proposal but interpreted the impact on the market objectives differently to that proposed by the IMO. One submitter (Alinta) did not support the proposal, citing a number of reasons for this.

Given the range of views from the first submission period, the IMO has decided that it will be beneficial to issue this draft rule change report, and then conduct a public workshop during the second submission period. The objective of this workshop would be to review the issues raised from submissions and report on progress of the SRC working group. The IMO is also intending to commission an independent expert to review the rule change in light of the submissions received. In doing this, the IMO will endeavour to meet the timeframes outlined in section 1 of this report. However in accordance with Market Rule 2.5.10, the IMO may extend the normal timeframe for processing Rule Change Proposals.

Section 4.1.2 of this report addresses Griffin Energy's comments about the impact on the market objectives.

Below is the IMO's response to each of the main issues raised by Alinta:

- Alinta submitted 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. Alinta noted that the socialisation of costs would have a detrimental impact of efficiency and competition in the market.

  The IMO and the SRC Working Group agreed, in principle, that the financial risks of SRC be targeted at the party that is best able to control the risk wherever practicable. At the 4 June 2008 meeting of the working group it was generally agreed that "unless it was found reasonable that SRC costs can be attributed directly to specific market participants that caused the need for it, the mechanism should spread the costs across all Market Participants".

  To that end there is a second rule change proposal (proposal 34), due to be released for its first submission period shortly, that supplements this rule change proposal. Rule change proposal 34 proposes to target costs to a market participant if its capacity credits are reduced and that reduction results in a shortfall and SRC is called. It also proposes to target costs at generators that are late in commissioning, or otherwise experience an extended forced outage that causes the need for SRC.

- Alinta noted that there are a number of different drivers for SRC and as such they considered that the Market Rules need to address each scenario specifically.

The SRC Working Group has considered five scenarios that could lead to a shortfall in reserve capacity, thereby necessitating a need for a SRC auction. These were:

1. Simple shortfall;
2. Late commissioning;
3. Existing plant unavailable;
4. Forecasts revised upwards; and
5. Generators choosing to reduce capacity credits voluntarily.

The SRC Working Group Funding, which held its final meeting on 22 September 2008, agreed that scenarios 1 and 4 are to entail shared costs. Additionally it was resolved that additional changes would have to be implemented to the funding of Supplementary Capacity Contracts for scenarios 2, 3 and 5, to address the objectives of the market rules (this is covered in rule change proposal 34 and outlined below).

The majority view of the Working Group was that if a market participant has its capacity credits reduced, which results in a shortfall and SRC is called, the cost of SRC should be targeted at the market participant. That is, the market participant should pay to the IMO compensation due to capacity credits not being available to the market

In addition, the Working Group resolved that a market participant holding capacity credits for a facility undergoing an extended forced outage should also recompense the market by an amount equal to the cost of funding Supplementary Capacity Contracts associated with a capacity shortfall brought on by the extended forced outage.

This would also include new facilities which are not fully commissioned by 30 November of the Relevant Capacity year and thus experience an extended forced outage until properly commissioned.

In the case where a number of factors have contributed to a capacity shortfall, the proposed rule change 34 would require the IMO to proportion the total cost of funding the Supplementary Capacity Contracts in such a way that each relevant Market Participant only pays the portion which is attributable to its capacity being unavailable to the market.

- Alinta noted that the current market rules provide a greater incentive for bilaterally contracting for reserve capacity. This more effectively underpins long term investment in generation, than those provided for by the proposed market rule change. Alinta has adopted a long position on capacity credits to avoid potential exposure to uncapped SRC costs and sees this as underpinning long term investment. Alinta asserted that other retailers choosing to maintain a short position on capacity credits are not making the same long-term commitment to generation capacity, and in effect would be fully aware of their exposure to SRC costs.

Firstly, the IMO contends that all retailers are underpinning long term investment under the current design of the market in the SWIS. The SWIS wholesale market premise is for a central body to provide a mechanism for capacity via central planning, funded through IRCRs.

If, as Alinta asserted, the current rule provides strong incentives for bilateral contracts, then there is no reason all retailers would not be fully contracted under the current market rules which does not currently appear to be the case. The IMO is concerned however that most participants have not been fully aware of the current out-workings of the rules and that if the current rules are retained retailers would tend to either over-contract which would reduce the efficiency of the market as it would potentially lead to an over supply of capacity, or be conservative in their contracting strategies with customers which would reduce customer churn and competition in the market. The status quo is overly punitive and the IMO asserts that no participant could be perfectly matched, even if there were strong incentives to do so.

- Alinta submitted that they do not support the argument from some market participants stating that they are unable to secure bilateral contracts for capacity credits (and are therefore unable to hedge their exposure to the cost of SRC).

  The IMO would like to hear the views from other market participants on Alinta's assertion that they do not agree that some market participants are unable to secure bilateral contracts for capacity credits.

- Alinta submitted that the proposed rule change would impede the achievements of market objective (a) and (b) relating to efficiency and competition. The proposed rule change would adversely impact retail competition as it effectively removes the ability of retailers to manage their exposure to SRC costs. Alinta submitted that the proposed rule change therefore removes some of the potential for product diversification and offerings to be made available to the market.

  The IMO does not agree with Alinta's assessment of this issue. The overly punitive nature of the status quo could result in disproportionate acts by market participants. For example, if the rule change is not made, then the current rules may lead to retailers reducing their customer base prior to the hot season, in order to reduce their potential share of SRC costs. This is detrimental to both competition and the long term interests of the end user.

  Additionally, if the rule change proposal were not progressed, there is a likelihood that all retailers may choose to maintain long positions on capacity credits. This reduces the efficiency of the market as it has the potential to lead to an oversupply of capacity. Systemic oversupply of capacity has the potential to reduce the efficiency of the market and ultimately increase the costs to customers.

4.1.2. The IMO's Assessment

According to clause 2.4.2 of the Market Rules *"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".*

The IMO considers that the proposed Amending Rules will have the following impact on how the Market Rules address the Wholesale Market Objectives:

Impact	Wholesale Market Objectives
Allow the Market Rules to better address objective	a and b
Consistent with objective	c, d and e
Inconsistent with objective	-

The IMO's assessment against market objective (a) is as follows:

(a) *to promote the economically efficient, safe and reliable production and supply of electricity and electricity related services in the South West interconnected system;*

The IMO submits that the proposal supports market objective (a) by promoting the economically efficient supply of electricity in the SWIS. This will be achieved by:

- In appropriate instances spreading the cost of SRC across all Market Customers rather than targeting individual Market Customers which may have little to do with causing these costs (costs will still be targeted where applicable, as per rule change proposal 34); and
- Ensuring that an oversupply of capacity credits does not systemically eventuate with all retailers contracting a long position.

(b) *to encourage competition among generators and retailers in the South West interconnected system, including by facilitating efficient entry of new competitors;*

The IMO also submits that the proposal supports market objective (b) by encouraging competition among retailers in the SWIS. This will be achieved by retailers competing for and retaining customers.

It will be necessary to make some changes to the Wholesale Electricity Market Systems operated by the IMO. The IMO has obtained a quote from its systems support vendor for AUD $4200 to carry out the system changes.

4.2. IMO's Draft Decision

The IMO's draft decision is to implement the proposed amendments to clauses 4.28.3 and 4.28.4 to protect a retailer that has not fully covered its IRCR from bearing the entire cost of SRC. However, given the range of views from the first submission period, the IMO has decided that it will be beneficial to issue the draft rule change report, and then conduct a public workshop during the second submission period. The objective of this workshop would be to review the issues raised from submissions and report on progress of the SRC working group. The IMO is also intending to commission an independent expert to review the rule change in light of the submissions received.

The IMO has made its draft decision on the basis that the resulting Amending Rules will allow the Market Rules to better address the Wholesale Market Objectives.

The wording of the relevant Amending Rules is presented in section 6 of this Report.

5. CALL FOR SUBMISSIONS

The IMO invites Market Participants to make submissions on this Draft Rule Change Report and proposed Rule Change. The submission period is 20 Business Days from the publication date of this Report.

Submissions must be delivered to the IMO by close of business on Friday 28 November 2008.

The IMO prefers to receive submissions by email to marketadmin@imowa.com.au using the submission form available on the IMO website:
http://www.imowa.com.au/10_5_1_b_rule change proposal.htm

Submissions may also be sent to the IMO by fax or post, addressed to:

Independent Market Operator
Attn: Manager Market Administration
PO Box 7096
Cloisters Square, Perth, WA 6850
Fax: (08) 9254 4399

6. PROPOSED AMENDING RULES

The IMO proposes to implement the following new clauses to the Market Rules (~~deleted words~~, <u>added words</u>):

4.28.3. For each Trading Month, the IMO must calculate the Targeted Reserve Capacity Cost being ~~the sum of:~~

~~(a)~~ the cost defined under clause 4.28.1(a)~~; and~~

~~(b) the net payments to be made by the IMO under Supplementary Capacity Contracts less any amount drawn under a Reserve Capacity Security by the IMO and distributed in accordance with clause 4.13.11(a)~~,

and the IMO must allocate this total cost to Market Customers in proportion to each Market Customer's Individual Reserve Capacity Requirement less the quantity of Capacity Credits allocated to that Market Customer in accordance with clauses 9.4 and 9.5.

4.28.4. For each Trading Month, the IMO must calculate a Shared Reserve Capacity Cost being the sum of:

(a) the cost defined under clause 4.28.1(b); <u>and</u>

<u>(aA) the net payments to be made by the IMO under Supplementary Capacity Contracts less any amount drawn under a Reserve Capacity Security by the IMO and distributed in accordance with clause 4.13.11(a); less</u>

(b) the Capacity Cost Refunds for that Trading Month; less

(bA) the Intermittent Load Refunds for that Trading Month; less

(c) any amount drawn under a Reserve Capacity Security by the IMO and distributed in accordance with clause 4.13.11(b)

and the IMO must allocate this total cost to Market Customers in proportion to each Market Customer's Individual Reserve Capacity Requirement.

7. GENERAL INFORMATION ABOUT RULE CHANGE PROPOSALS

Clause 2.5.1 of the Wholesale Electricity Market Rules (Market Rules) provides that any person (including the Independent Market Operator) may make a Rule Change Proposal by completing a Rule Change Proposal Form and submitting this to the Independent Market Operator (IMO).

In order for the proposal to be progressed, the change proposal must explain how it will enable the Market Rules to better contribute to the achievement of the Wholesale Market Objectives. The market objectives 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

A Rule Change Proposal can be processed using a Standard Rule Change Process or a Fast Track Rule Change Process. The standard process involves a combined 10 weeks public submission period. Under the shorter fast track process the IMO consults with Rule Participants who either advise the IMO that they wish to be consulted or the IMO considers have an interest in the change.