imo Independent Market Operator

Independent Market Operator

Final Market Rule Change Report

Title: Funding of Supplementary Reserve Capacity

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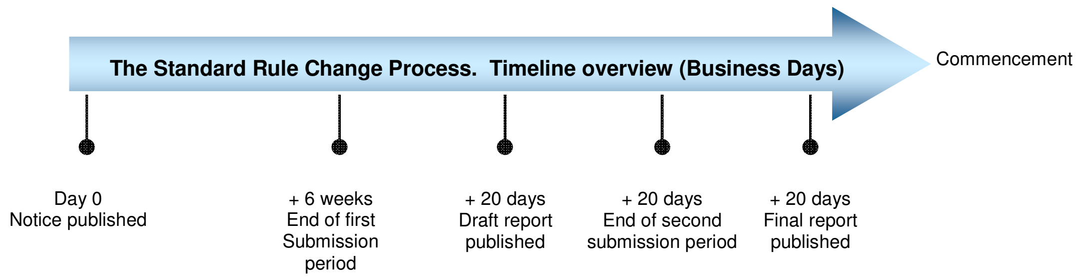
1. INTRODUCTION

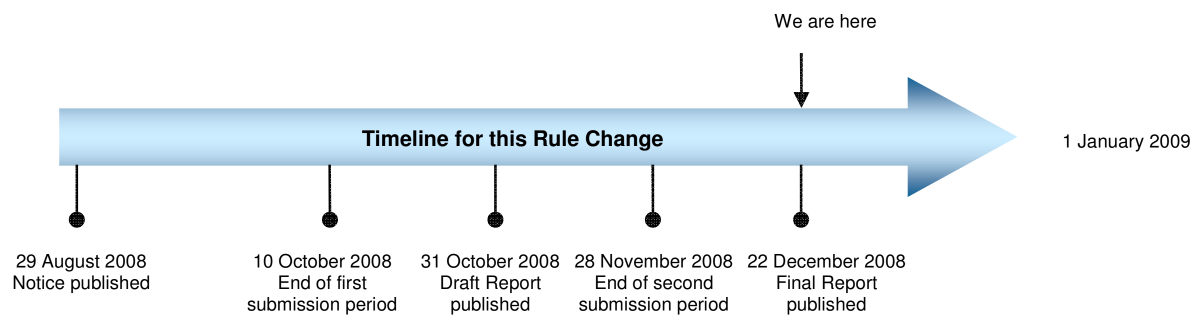
On 28 August 2008 the Independent Market Operator (IMO) submitted a Rule Change Proposal regarding changes to clauses 4.28.3 and 4.28.4 of the Wholesale Electricity Market Rules (Market Rules).

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 it's assessment of the submissions received, the IMO's final decision is to implement the Rule Change Proposal in the form outlined in section 7 of this Report.

This Final Rule Change Report on the Rule Change Proposal has been prepared by the IMO in accordance with clause 2.7.8 of the Market Rules.

The amendments to the Market Rules made as a result of this Rule Change Proposal will commence at 08.00am on 1 January 2009

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 was 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 concluded its discussions.

2.3 The Proposal and the 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 submitted that the proposal supports market objective (b) by encouraging competition among retailers in the SWIS. This would be achieved by correcting the apparent inequitable treatment of some retailers under the current Market Rules.

2.4 The Amending Rules Proposed by the IMO

The amendments to the Market Rules proposed by the IMO are outlined in section 7 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. FIRST SUBMISSION PERIOD

The first submission period for this Rule Change Proposal was between 29 August 2008 and 10 October 2008.

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 the 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 Submissions received

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.

3.2.1 Submission from LGP

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.

3.2.2 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 reviewed this rule change at some length, and 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 would 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.

3.2.3 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 term, 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 contended 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.

3.2.4 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.

3.3 Public Forums and Workshops

No public forums or workshops were held in relation to this Rule Change during the first submission period.

3.4 The IMO's Assessment of First Submission Period Responses

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 decided that it was beneficial to issue the Draft Rule Change Report, and then conduct a public workshop during the second submission period. The objective of this workshop was to review the issues raised from submissions and report on progress of the SRC working group. The IMO also commissioned an independent expert to review the rule change in light of the submissions received. In doing this, the IMO undertook to meet the timeframes outlined in section 1 of this report. However in accordance with Market Rule 2.5.10, the IMO noted it may extend the normal timeframe for processing Rule Change Proposals.

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 (RC_2008_34), released for its first submission period on 10 November 2008, 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, 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 towards 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 requested 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.

3.5 The IMO's Assessment against the 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 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 submitted that the proposal supported market objective (b) by encouraging competition among retailers in the SWIS. This will be achieved by retailers competing for and retaining customers.

4. THE IMO'S DRAFT DECISION

Based on the submissions received and its assessment against the Wholesale Market Objectives, the IMO's draft decision was 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 decided that it would be beneficial to issue the Draft Rule Change Report, and then conduct a public workshop during the second submission period. The objectives of this workshop were to review the issues raised from submissions and report on progress of the SRC working group. The IMO also commissioned 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 7 of this Report.

5. SECOND SUBMISSION PERIOD

Following the Draft Rule Change Report publication on the IMO website, the second submission period was between 3 November 2008 and 28 November 2008.

Early in the submission period the IMO appointed McLennan Magasanik Associates (MMA) to undertake the independent review of the Rule Change Proposal. An input into this review was the public workshop, held on 14 November 2008, which was chaired by Dr Ross Gawler of MMA.

5.1. Public Workshop

The objectives of the public workshop were to allow for a forum to review the issues from the first round of submissions and to provide input into the MMA review.

The workshop was well attended by a range of Market Participants, attendees included:

- Alinta
- Energy Response
- ERA
- Griffin Energy
- IMO
- LGP
- Office of Energy
- Perth Energy
- Premier Power Sales
- Synergy
- System Management
- TransAlta
- Verve
- Western Power

The workshop demonstrated a high level of engagement from the industry, and in particular allowed the IMO and MMA access to feedback from a number of smaller participants. The workshop provided a forum which allowed all participants to hear the views of others and respond, if appropriate.

The discussion at the workshop supported the submissions previously made in the first round of consultation. Some additional perspectives offered were as follows:

- Synergy argued that there would always be a retailer which could not completely cover itself against supplementary capacity cost risk simply because the last MW to be purchased would be held by one party which would prefer to obtain the uncapped supplementary capacity revenue rather then sell the capacity to the IMO or to the remaining party. Thus there would always be a high risk of an unfair distribution of the SRC cost;

- Verve supported Synergy’s view recognising that it would bear the costs under the vesting contract of any supplementary capacity cost;

- Alinta argued that different scenarios should have different treatment and that causers should be exposed to costs. Alinta was adamant that retailers would be able to obtain bilateral coverage; and

- All presenters except Alinta supported the IMO's proposed Rule Change. Alinta considers that retailers should have the incentive to purchase bilateral contract cover to avoid exposure to SRC.

5.2. Independent Expert Review

As noted above, MMA was appointed to undertake an independent assessment of the Draft Rule Change Report. This was in response to the diverse submissions received in the first consultation round. The "Economic Assessment of Rule Change 27" (MMA Report) is available on the IMO's website.

In its final report MMA concluded that the Proposed Rule Change does support the Market Objectives, especially in relation to support for retail competition. MMA noted that RC_2008_34 (Funding of SRC in the event of capacity credit cancellation) will deal with the recovery of supplementary capacity costs from generators where appropriate.

MMA did note that the Proposed Rule Change could be made more efficient and equitable by means of further consideration to the distribution of supplementary capacity costs related to forecast error. For example, some portion of the costs should be distributed to those retailers which have not fully covered their increased demand by means of bilaterally contracted Capacity Credits. This direct distribution could be based on demand associated with new meters and be capped to protect less well established retailers.

MMA contend that if a cap is considered desirable, the industry could consider the development of a coinsurance reserve fund. Under such as scheme all customers could be levied a small fee to build a pool of funds that could be used to buy supplementary capacity when needed, or to cap excessive Supplementary Reserve Capacity Cost. Any deficits in that fund could be recovered from the Shared Reserve Capacity cost when needed. This would smooth the cash flow associated with SRC over time and reduce financial risk for less well established retailers.

MMA suggest that these arrangements would provide better incentives for retailers to manage the uncertainty of the demand of their customers and smooth the cash flows associated with purchase of supplementary capacity to cover forecast error. However, these other alternatives would be more complicated and more costly to manage and monitor. Therefore MMA supported the current proposal as a way forward initially.

5.3. IMO response to MMA Report

The IMO has reviewed the MMA Report and notes the suggestion for additional work. The IMO intends to fully assess the issue raised by MMA and may consider reconvening the SRC working group as the forum to discuss this in more detail.

Where appropriate, the remainder of this report takes into account the conclusions reached in the MMA report.

5.4. Submissions received

During the second consultation round the IMO received submissions from Alinta, LGP, Perth Energy, Synergy, and Verve Energy. The full text of each submission is available on the IMO website: (http://www.imowa.com.au/Attachments/RuleChange/RuleChange_2008_27.htm).

5.5. The IMO's Assessment of Second Submission Period Responses

A full matrix summarising the submissions received has been included with this paper in Appendix One. The submission summary has grouped issues from submissions into like categories:

- Overall support for the rule change;
- The proposal and its effect on the Market Objectives;
- Bilateral contracts:
    - Participants ability to secure bilateral contracts for Capacity Credits; and
    - Levels of bilateral contracting and associated timeframe uncertainty.
- Risk to Market Participants;
- Additional work needed;
- IT system and cost implications; and
- Time requirement for implementation.

The following section outlines a number of issues from the submission summary in more detail and where appropriate provides a summary from the MMA report and the IMO's response. Some of the information in the submission summary is not outlined in the following sections, this is because the submissions were not of a contentious nature and therefore do not require a separate response.

5.5.1 Overall support for the rule change

The response to the Draft Rule Change Report submitted by the IMO was mixed, as shown below.

	Alinta	LGP	Perth Energy	Synergy	Verve	MMA
Support	No	Yes	Yes	Yes	Yes	Yes

Four submitters (LGP, Perth Energy, Synergy and Verve Energy) all expressed support for the Rule Change Proposal. In particular LGP and Synergy noted an urgent need for this rule change to take effect. LGP also noted that the SRC Working Group met six times and part-way through determined that the implementation of this rule change be the basis for progressing several matters contingent upon it (RC_2008_28 and RC_2008_34). LGP also noted that if this rule change is not implemented, the latter work of the group may need to be reassessed.

LGP asserted that in principle it may be useful to reconvene the SRC Working Group to consider further changes, but there is insufficient time for it to effectively contribute anything prior to February 2009, when the likelihood of SRC being called is at its highest.

Alinta did not support the proposal, citing a number of reasons for this view. The following sections outline the IMO's response to each of the main issues raised by Alinta. Overall:

- Alinta agrees that the rules relating to the allocation and funding of SRC need to be changed. However, costs should be targeted as much as possible to those that cause the costs and are best able to manage the risk factors related to the cost. Alinta noted that the rule change proposal does not achieve this and instead socialises the cost over a larger retail base than is current the case.

  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"*.

  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 notes that it is unclear whether it is prudent or permissible under the Market Rules to assess the extent to which a proposed rule change better achieves market objectives based on a current Rule Change Proposal being supplemented at a later date by a further rule change proposal. The IMO has responded to this issue raised by Alinta in the following section of the paper.

5.5.2 The proposal and its effect on the Market Objectives

A number of submitters commented on the potential effects on the Market Objectives of both implementing and not implementing this rule change.

The following table summarises submitters comments on the effect that implementing this rule change will have on the Market Objectives.

Market Objective	Alinta	LGP	Perth Energy	Synergy	Verve	MMA
A	Negative	Positive		Positive	Positive	Positive
B	Negative[1]/positive[2]	Positive	Positive	Positive	Positive	
C					Consistent	
D		Positive			Consistent	
E					Positive	

The following outlines submitter's comments on the effects on the Market Objectives in greater detail:

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

LGP, Verve and Synergy all agreed that the Proposed Rule Change would better this Market Objective overall. In addition LGP also endorsed the contention by Griffin Energy in the first consultation round 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."

Alinta submits that the proposed rule change would impede the achievements of market objective (a) and (b) relating to efficiency and competition. In particular Alinta asserts that the rule change proposal (of itself) is not likely to promote the efficient supply of electricity as it removes incentives from new entrant retailers to effectively manage their contractual relationships with capacity providers (however, they did note that the rule change may support retail market entry (objective (b)).

The MMA Report notes that current arrangements potentially encourage inefficient contracting by forcing buyers into the bilateral market when the least cost solution may be to rely on the balancing qualities of the Reserve Capacity mechanism and that unnecessary insolvency risks introduce other barriers to efficient transactions in all related markets (finance, energy, ancillary services).

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

Perth Energy, LGP and Synergy all note that if this rule change does not go ahead this objective would be negatively affected due to the reduction in competition.

LGP note that the rule change will encourage competition among retailers by removing their exposure to uncontrollable and uncapped liabilities and exposure to excessive capacity credit prices.

[1] Negative: Alinta note that the rule change may reduce incentives for managing the facilitation of efficient entry and exit of generation.
[2] Positive: Alinta note that the rule change proposal may support retail market entry.

Alinta submits that the proposed rule change would impede the achievements of market objective (a) and (b) relating to efficiency and competition overall. However Alinta notes that the rule change proposal may support retail market entry (whereby the rule change would only expose retailers to SRC costs in proportion to their IRCR, which may significantly reduce their financial exposure if they do not hold sufficient Capacity Credits).

Alinta contends that the effect of the rule change may reduce incentives for managing the facilitation and efficient entry and exit of generation and load into the WEM. Alinta asserts that the proposed rule change removes incentives for all retailers to efficiently contract with new entrant generators and underpin long term investment in generation.

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, as has been indicated by some Market Participants, 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.

(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*

Verve agrees with the IMO's assessment that the rule change will better address this market objective.

(d) *to minimise the long-term cost of electricity supplied to customers from the South West interconnected system*

Verve agrees with the IMO's assessment that the rule change will better address this market objective.

(e) *to encourage the taking of measures to manage the amount of electricity used and when it is used*

Verve believes that the rule change will better address objective (e) as it will encourage all Market Customers to manage energy consumption when the use of SRC is likely, not just the small subset of customers currently exposed to SRC costs at present.

Additionally Alinta asserts that it is unclear whether it is prudent or permissible under the Market Rules to assess the extent to which a proposed rule change better achieves market objectives based on a current rule change proposal being supplemented at a later date by a further rule change proposal.

According to clauses 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 believes that on its own, Rule Change 27 is consistent with the Wholesale Market Objectives. Section 6.1.2 of this report outlines the IMO's final assessment of this rule change and its impact on the market objectives.

The MMA report also concluded that the proposed Rule Change supports the Market Objectives, especially in relation to support for retail competition.

5.5.3 Bilateral Contracting

5.3.3.1 Participants ability to secure bilateral contracts for Capacity Credits

In its submission Alinta notes that small retailers have expressed concerns about their potential uncapped exposure to SRC, but considers that this risk could be easily managed at minimal cost by contacting bilaterally[3]. As such Alinta does not consider that a change in Market Rules is necessary to protect small retailers. Alinta's has asserted that they do not agree that some market participants are unable to secure bilateral contracts for Capacity Credits.

Alinta notes that they maintain a long position on Capacity Credits and that a number of retailers have approached Alinta to discuss purchasing to cover their shortfalls in IRCR. Alinta states that they have offered to contract with these retailers at competitive prices based on the administered Reserve Capacity Price and anticipated movements in that price over the contract term requested by the retailer but to date, retailers have opted not to contract with Alinta.

In the Draft Rule Change Report the IMO specifically requested views from other market participants on Alinta's assertion.

Synergy notes that given the limited suppliers of Capacity Credits in the WEM, spare Capacity Credits are highly likely to be vested with one or two participants, allowing these to extract scarcity pricing. Synergy asserts that there is evidence of this.

In response to the IMO request for additional information 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.

Additionally, a straw poll taken at the public workshop indicated that two participants had sought capacity that was available, but that it had a cost that did not make their business viable and so they had declined to accept it on the terms offered. This suggests that the issue concerning the availability of bilaterally contracted capacity it is not so much about the availability of capacity but that less well established retailers may not be able to access this remaining capacity at a competitive price or on reasonable terms. They may not be able to negotiate a capacity price that is favourable relative to the value of the wholesale electricity supply for their existing or prospective retail customers.

The IMO agrees with the MMA report that *"the argument by Alinta that capacity is available is not a sufficient justification for continuing with the current rule about SRC cost distribution. The*

[3] This then has the flow on effect of providing long term certainty on cash flow for new generators. Which underpins the long term investment in generation.

fact is that it is likely that there is market power in the market for remaining capacity, having the outcome that the distribution of SRC costs may be inequitable, above an efficient level, and therefore also detrimental to competition general. In this case capacity costs, although efficient when assessed within the definition of the existing Market Rules, may be higher than what they would be the case under the proposed rules, given that they are inflated by cost artefacts that are a feature of the market design, and that are not related to the structural costs of managing physical plant or infrastructure. In this case inefficient Market Rules may be inflating costs in the contract market".

5.3.3.2 Levels of bilateral contracting and associated timeframe uncertainty

Synergy asserts that the Reserve Capacity Mechanism is a centralised regulated facility and therefore not created to ensure each and every retailer is perfectly bilaterally contracted. Synergy argues that it is impossible for a retailer to perfectly cover its capacity exposure as uncertainty exists in every timeframe as to the quantum of that exposure. The further a retailer is away from an applicable month, the more uncertain its IRCR is, due to many factors outside its control.

LGP notes that if the proposed rule change does not go ahead, 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 a number of factors (outlined in greater detail in LGP's submission).

As in the Draft Rule Change Report, 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.

The IMO is concerned that if the current rules are retained retailers may be incentivised to either over-contract which would reduce the efficiency of the market as it may result in 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 agrees with Synergy and LGP's submissions that no participant could be perfectly matched, even if there were strong incentives to do so.

5.5.4 Risk to Market Participants

LGP, Perth Energy, Synergy and Verve all highlighted the insolvency risk to market participants, particularly small retailers, if the Proposed Rule Change was not implemented.

Perth Energy notes that the current advantage with the status quo is that it encourages Market participants to trade bilaterally in order to insure against the costs of SRC. However, this benefit is outweighed by several major disadvantages. In particular, Market Customers may not be able to secure Capacity Credits bilaterally or may temporarily be uncontracted. Therefore they could be faced with a significantly higher proportion of SRC cost than their capacity credit obligation.

Perth Energy notes that smaller participants could face severe financial stress if required to carry a substantial share of SRC costs and could lead to them being forced out of the market. This reduces competition and it is also likely that the exiting participant would have uncovered trading losses that would then have to be assigned to the remaining participants.

In its submission Alinta notes that they do not consider that a change in Market Rules is necessary to protect small retailers. However, Synergy notes that the WEM is a bilateral market, not a gross pool, and is subject to regulated price caps (i.e. the capacity mechanism). The characteristics of the WEM mean that there is limited flexibility of supply options. Due to the bilateral nature of the WEM competition only occurs at the margins with derivative products not being freely offered. Within this, small retailers are critical to ensure a level of competition and choice.

In addition to the insolvency risk on smaller participants LGP supports the IMO's contention (stated in the Draft Rule Change Report) 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, which could also potentially force someone into deficit. 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 is likely to increase prices and seriously restrict competition and customer choice.

The MMA Report states that "*facilitating new entry of small retailers while they are establishing their bilateral support will increase competition, reduce trading risk and thereby lower the cost of energy to retail customers…Unnecessary insolvency risks introduce other barriers to efficient transactions in all related markets (finance, energy, ancillary services) and therefore undermine competition in a broader sense.*"

The IMO agrees that the status quo provides unnecessary risk to less well established retailers.

5.5.5 Additional work needed

In addition to the extra work suggested by MMA (noted in sections 5.2 and 5.3) Verve suggest an area of further consideration.

Verve note that the current Market Rules and proposed amendment recover SRC costs through the reserve capacity market based on IRCR's and/or net capacity positions. This solution ignores the fact that activation of SRC is largely determined by energy demand on the day and measures taken by participants to manage their demand at that time. Verve believes that consideration should be given to further rule amendments that facilitate recovery of some or all of the SRC activation costs via the market, possibly on deviations from net contract position.

The IMO intends to fully assess the issues raised by both Verve and MMA and will consider reconvening the SRC working group as the forum to discuss further issues. The timing for this will be subject to workload and prioritisation of issues currently under development or in the pipeline.

LGP asserts that the 2 year lead time for capacity certification to be one of the most significant impediments to its ambitions to build further generation. The IMO is aware that there are issues for Market Participants with the current timeframes for capacity certification, with requests for the IMO to consider both reducing and extending the timeframes associated with building projects. The IMO notes that a concept paper ("Reserve Capacity Timeframes Concept Paper") was discussed at the 10 December 2008 MAC meeting addressing the suggestion of extending the timeframe associated the building projects. The IMO is still to address the issue of shortening the timeframe for capacity certification and intends to do so in the future.

5.5.6 IT system and cost implications

As noted in the draft report, it will be necessary to make some changes to the WEM 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.

In addition to this Verve notes that minor system changes will be required to their systems, however there are unlikely to be any significant costs associated with this. There have been no other IT system or cost implications identified with this Rule Change Proposal.

5.5.7 Time requirement for implementation

All submitters responding to this question noted that they have do not require any specific lead time to allow implementation of the proposal. However, Alinta requested that, should the IMO conclude differently to their submission, the implementation timetable for RC_2008_27 be set so that it coincides with the likely implementation timetable for RC_2008_34. This recognises the linkages that the IMO has already drawn between the two rule change proposals.

Having considered the likely impacts of this rule change not being implemented the IMO does not approve Alinta's request for the delay in setting the implementation date.

6. THE IMO'S FINAL ASSESSMENT AND DECISION

6.2 Final assessment against the Market Objectives

According to clauses 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 has assessed all submissions and the MMA Report. While there are dissenting views contained in the submissions, the IMO (supported by the MMA report) considers that the proposed Amending Rules, on the whole, better address the Market Objectives.

The IMO's 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; 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 submits that retaining the status quo provides unnecessary risk to less well established retailers, which in turn can negatively affect competition. The IMO therefore submits that the proposal supports and allows the Market Rules to better address market objective (b) by encouraging and facilitating competition among retailers in the SWIS.

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.

6.2 The IMO's Final Decision

The IMO's final decision, therefore, is to implement the proposed amendments to clauses 4.28.3 and 4.28.4 to the Wholesale Electricity Market Rules to protect a retailer that has not fully covered its IRCR from bearing the entire cost of SRC.

The wording of the relevant amendments is provided in section 7 of this report.

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

6.3 Amending Rules Commencement

The amendments resulting to the Market Rules resulting from this Rule Change Proposal will commence at 8:00am on 1 January 2009.

7. 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.

8. 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:

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

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

(h) 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

(i) to minimise the long-term cost of electricity supplied to customers from the South West interconnected system

(j) 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.

9. APPENDIX ONE: SUMMARY OF SUBMISSIONS

Issue	Submitter	Submission
Support for RC_2008_27	Alinta	• Agrees that the rules relating to the allocation and funding of SRC need to be changed. However, costs should be targeted as much as possible to those that cause the costs and are best able to manage the risk factors related to the cost. Alinta notes that the rule change proposal does not achieve this and instead socialises the cost over a larger retail base than is current the case. • Alinta does not consider that a change in market rules is necessary to protect small retailers.
	LGP	• Supports the proposed rule change in its first consultation round, and having now participated in the public forum- and thoroughly reviewing the proposal in the second round, reaffirms this support. • Asserts that there could be dire market consequences if this is not implemented urgently. • Notes that the SRCWG, which was widely represented by market participants, met six times and part-way determined that the implementation of the Rule Change 27 should be assumed as a basis for progressing several matters contingent upon it. Therefore if this rule change is not implemented, the latter work of the group may need to be reassessed. • Asserts that sometimes 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. 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. • Asserts that in principle it may be useful to reconvene the group to consider further changes, but there is insufficient time for it to effectively contribute anything prior to the expected SRC crunch time of February 2009.
	Perth Energy	• Strongly supports the proposed change and the work undertaken by the IMO and MMA.
	Synergy	• Supports this rule change proposal in its current form and sees an urgent need for it to be given effect.
	Verve Energy	• Supports the IMO's draft decision to implement the proposed amendments.
The proposal and the Market Objectives	Perth Energy	• Notes that, if the rule change did not progress, Market Objective (b) would be negatively affected due to the reduction in competition. • For example: Market Customers may not be able to secure Capacity Credits bilaterally or may temporarily be uncontracted. Therefore they could be faced with a significantly higher proportion of SRC cost than its capacity credit obligation. Smaller participants could face severe economic stress if required to carry a substantial share of SRC costs and could lead to them being forced from the market.
	LGP	• Supports the IMO's contention that the proposal supports the market objectives 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, or benefit disproportionately from them. • Asserts that the rule change will also encourage competition among retailers by removing their exposure to

Issue	Submitter	Submission
		uncontrollable and uncapped liabilities and exposure to excessive capacity credit prices. • 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." • Notes that, if the rule change did not progress, Market Objective (b) would be negatively affected due to an anti-competitive dimension to the current rules. An example was of this was contained in page three of the LGP submission.
	Alinta	• Notes that in their view the rule change proposal on its own would be detrimental to achieving the market objectives (in particular it would not better achieve objectives (a) and (b) in relation to efficiency and competition) and as such should not be made. • Contends that the effect of the rule change may reduce incentives for managing the facilitation and efficient entry and exit of generation and load into the WEM (objective (b)). Alinta asserts that the rule change may remove incentives for retailers to efficiently contract with new entrant generators and therefore underpin long term investment. • Asserts that the rule change proposal (of itself) is not likely to promote the efficient supply of electricity as it removes incentives from new entrant retailers to effectively manage their contractual relationships with capacity providers (objective (a)). However, Alinta does note that the rule change proposal may support retail market entry (objective (b)). • Asserts that it is unclear whether it is prudent or permissible under the Market Rules to assess the extent to which a proposed rule change better achieves market objectives based on a current rule change proposal being supplemented at a later date by a further rule change proposal.
	Verve	• Agrees with the IMO's assessment that the rule change will better address market objectives (a) and (b) and is consistent with objectives (c) and (d). • Believes that the rule change will better address objective (e) as it will encourage all Market Customers to manage energy consumption when the use of SRC is likely, not just the small subset of customers currently exposed to SRC costs at present.
	Synergy	• Notes that the current rule can lead to inefficient outcomes and has the ability to over-penalise some retailers, making the WEM a risky environment to operate in. • Notes that if the rule change is not progressed that it has the potential to severely constrain the development of future retail competition (market objective (b)).
Participants ability to secure bilateral contracts for capacity credits	Alinta	• Notes that at the workshop a view was presented that retailers with long capacity positions would always seek to withhold capacity to ensure that someone else picks up the SRC cost. Alinta does not accept this view. • Notes that they maintain a long position on capacity credits and that a number of retailers have approached Alinta to discuss purchasing to cover their shortfalls in IRCR. • Asserts that in response to this, that they have offered to contract with these retailers at competitive prices based on the Administered Reserve Capacity Price and anticipated movements in that price over the contract term requested by the retailer.

Issue	Submitter	Submission
		• Notes that, to date, retailers have opted not to contract with Alinta. • Notes that the ERA and IMO have powers to monitor and investigate market behaviour. Alinta asserts that if participants are concerned with its behaviour then it should be raised.
	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. • Notes 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.
	Synergy	• Notes that given the limited suppliers of Capacity Credits in the WEM, spare Capacity Credits are highly likely to be vested with one or two participants, allowing these to extract scarcity pricing. Synergy notes that there is evidence of this.
Levels of bilateral contracting and associated timeframe uncertainty	Alinta	• Notes under the current rules retailers can avoid potential exposure to SRC costs by ensuring they have sufficient bilateral cover. • Asserts that the current treatment of SRC costs provides an incentive for retailers to enter in bilateral arrangements which provide long term certainty on cash flow for new generators. This underpins the long term investment in generation. • Posits that retailers with bilateral contracts pay an insurance premium to avoid exposure.
	LGP	• Notes that if the proposed rule change does not go ahead, 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 a number of factors (outlined in greater detail in LGP’s submission). • Asserts that 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

Issue	Submitter	Submission
		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. • Supports Synergy's contention that the capacity 'market' is more accurately a regulatory mechanism and that mechanism needs to be adjusted to avoid perverse outcomes.
	Synergy	• Asserts that the Reserve Capacity Mechanism is a centralised regulated facility and therefore not created to ensure each and every retailer is perfectly bilaterally contracted. • Argues that it is impossible for a retailer to perfectly cover its capacity exposure as uncertainty exists in every timeframe as to the quantum of that exposure. The further a retailer is away from an applicable month, the more uncertain its IRCR is, due to many factors outside its control.
Risk to Market participants	Synergy	• Notes that under the current rules if a SRC auction were called for 08/09, this cost would be passed onto those retailers not having their IRCR bilaterally covered. • Notes this creates a plausible risk of passing onto small retailers significant costs- one greater than their energy portfolio and beyond their ability to sustain operation. • Notes, that at the extreme, this could result in a single small retailer bearing the entire cost of SRC, although the entire market could benefit from the extra capacity cover. • Notes that there is an urgent need to rectify this. • The rule change will remove the exposure for small retailers and allow retailers to pass a manageable cost onto end consumers. • Notes that the WEM is a bilateral market, not a gross pool, and is subject to regulated price caps (i.e. the capacity mechanism). The characteristics of the WEM (small, isolated and few participants) mean that there is limited flexibility of supply options. Due to the bilateral nature of the WEM competition only occurs at the margins with derivative products not being freely offered. Within this, small retailers are critical to ensure a level of competition and choice.
	Alinta	• Notes small retailers have expressed concerns about their potential uncapped exposure to SRC, but considers that this risk could be easily managed at minimal cost by contacting bilaterally. As such Alinta does not consider that a change in market rules is necessary to protect small retailers.
	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. • There is a further issue about a retailer's ability to pass through to its customers the costs of SRC. Assuming that it has

Issue	Submitter	Submission
		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.
	Perth Energy	• Notes that the current advantage with the status quo is that it encourages Market participants to trade bilaterally in order to insure against the costs of SRC. However, Perth Energy notes that this benefit is outweighed by several major disadvantages. • Notes Market Customers may not be able to secure Capacity Credits bilaterally or may temporarily be uncontracted. Therefore they could be faced with a significantly higher proportion of SRC cost than its capacity credit obligation. • Smaller participants could face severe economic stress if required to carry a substantial share of SRC costs and could lead to them being forced from the market. • This reduces competition and it is also likely that the exiting participant would have uncovered trading losses that would then have to be assigned to the remaining participants.
Inequitable allocation of SRC costs and comparison with the cost allocation for surplus capacity	Perth Energy	• Notes that where SRC has been called to cover the non-availability of generating plant it is possible that this plant be excluded from contributing towards the costs. Notes that a generator that experiences a major forced outage will generally retain any assigned capacity credits. Where these have been bilaterally traded to a market customer which is fully contracted, the customer will make no contribution towards SRC, even though "its" generator caused the capacity shortfall. Also notes that where the out of service generator is owned by a generator retailer, the participant may gain a significant benefit in that it pays nothing towards the SRC costs, while its competitors carry the full cost. Notes that this is inequitable that such a benefit accrues to the participant that has caused the shortfall. • Notes that where the IMO has secured excess capacity the cost is spread across all participants through the SRCC. This excess capacity adjustment also ensures that the impact is spread across all market generators. Considers that SRC costs be treated in a similar manner i.e. spread without regard to bilateral contracts.
	LGP	• Asserts that if a 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 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 WEM in proportion to their share of the total number of capacity credits sold by the WEM to participants.
	Verve	• Agrees with the IMO's assessment that the current allocation of SRC costs is inequitable. Considers that this inequity should be addressed immediately given the potential impact on small market customers should SRC be required this year. • Believes the rule change provides a more equitable distribution of risks and costs, recognising that the primary SRC cost

Issue	Submitter	Submission
		offsets (i.e. refunds, reduction in IRCR's or excess capacity cost) are already shared across all market participants.
• Long term investment in the WEM (central planning vs levels of bilateral contracting)		•
		•
		•
Linkages with RC_008_34	Alinta	• Notes that the IMO has proposed RC_2008_34, which in its draft report has assumed will be implemented. • Contends that the shortcomings of this rule change proposal were recognised by the SRC working group, which concluded that there are a number of different drivers that could lead to a shortfall and that in certain circumstances, individual Market Customers should be exposed to any resultant SRC costs. Alinta notes that some of these changes will be implemented if RC_2008_34 is implemented. • Asserts that it is unclear whether the IMO is able (or whether it is prudent) to asses the extent to which this rule change meets the market objectives based on it being supplemented at a later date by an additional rule change proposal. • Requests that if the IMO come to a conclusion that differs to Alinta's view, that the IMO consider the implementation timetable for this rule change be set to coincide with RC_2008_34.
Additional work needed	Verve	• Notes that the current market rules and proposed amendment recover SRC costs through the reserve capacity market based on IRCR's and/or net capacity positions. Notes this solution ignores the fact that activation of SRC is largely determined by energy demand on the day and measures taken by participants to manage their demand at that time. • Believes consideration be given to further rule amendments that facilitate recovery of some or all of the SRC activation costs via the market, possibly on deviations from net contract position.
	LGP	• Considers that the 2 year lead time for capacity certification to be the most significant impediment to its ambitions to build further generation. • Considers that the WEM 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 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 capacity trading mechanism, once enhanced by the proposed rule change, will 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

Issue	Submitter	Submission
		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.
IT system and cost implications	IMO	• As noted in the draft report, the IMO noted that it will be necessary to make some changes to the WEM 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.
	Alinta	• Notes that no significant cost impacts on its own systems has been identified.
	Verve	• Notes that minor system changes will be required, however there are unlikely to be any significant costs associated with this.
	LGP	• LGP would incur no organisation cost.
Time required for implementation	Alinta	• Notes that they do not require and specific lead time to allow implementation of the proposal. • Alinta requested that, should the IMO conclude differently to its submission, the implementation timetable for RC_2008_27 be set so that it coincides with the likely implementation timetable for RC_2008_34. This recognises the linkages that the IMO has already drawn between the two rule change proposals.
	LGP	• LGP would be able to implement immediately.
	Verve	• Verve can meet any rule change implementation schedule.