imo Independent Market Operator

# Wholesale Electricity Market
# Rule Change Proposal Submission Form

# RC_2008_34 Funding of SRC in the event of capacity credit cancellation

## Submitted by



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## Submission

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

Generators who fail to make available the full amount of generation for which they are in receipt of capacity credit payments within a Reserve Capacity Cycle are required by the WEM Rules to refund up to 100% of those payments. Depending on the time of an outage, this “annual” penalty can be incurred in a matter of weeks. This market mechanism provides substantial incentive for the generator to properly maintain and continue to make available its generating equipment. Arguably this penalty mechanism itself is too strong and so suffers the same flaws described in this response, but is not a subject for this response.

When capacity credit refund payments are made to the IMO, the proceeds are distributed amongst retailers regardless of whether the failure to make available generation capacity led to a capacity shortfall or not. NP/RPV understands the market need to provide a general signal to generators to be available and accordingly NP/RPV believes this is balanced given that in the event of Supplementary Reserve Capacity being required, it is presently the retailers who bear the cost of the unregulated STEM prices that result when an SRC event is called by the IMO.

The market design and in particular the concept of Reserve Capacity is such that an SRC event is anticipated to occur once every ten years. NP/RPV accepts that an SRC event brings considerable costs to the market that are borne by the retailers (and ultimately end-users), noting that the retailers have also benefited from the distribution of capacity credit refund payments in the period since the previous SRC event.

Generators are required to invest substantial capital to construct generating equipment, and prior to that investment being made the providers of capital (ie debt and equity providers) will need to be satisfied that the key commercial risks that may diminish a generator's ability to securely make debt repayments or provide an adequate return on equity have been addressed. Indeed, it is likely that in the foreseeable future capital providers are likely to pay even more focus on risk / return trade-offs given the current global capital markets. The implementation of the proposed rule change creates the prospect for a generator of bearing a significant cost to its business through being required to pay for an SRC event up to the proposed cap, potentially very substantial costs. Generators will accordingly seek to mitigate this risk in one of three ways:

(a) take out insurance to cover the prospect of an SRC event;
(b) build in increased levels of redundancy in generating equipment;
(c) increase the amount of working capital provided (ie operational contingency); or
(d) spread the risk among its portfolio of plant and generation contract positions.

Option (a) provides minimal protection for the generator as insurance policies to cover this risk will typically require a 45 day deductible period and in many instances the cause of the outage may not be insurable at all. Given the unregulated pricing in relation to supplementary capacity, the generator will very quickly accumulate a liability that it is unable to meet with free cashflows. Additionally, assuming insurance was available, then it is likely that insurance companies would be extremely risk averse approach when setting the premium which will lead to the generator paying a premium over a given period that is far greater than the expected SRC liability. The generator will seek to build this cost into its bilateral contracts and STEM bidding so that it is the market that ultimately bears the cost of this risk mitigation action.

Option (b) provides the simplest protection for the generator as the likelihood of incurring an SRC event is significantly reduced. However, the provision of increased levels of redundancy will mean an increase in capital expenditure which needs to be recovered by the generator. As the generator will not apply for capacity credits for this redundant generation, one income stream has been removed and the plant is exposed to the STEM pricing to provide the return on investment. Given the likelihood that debt and equity providers will discount STEM forecasts when making their investment decision, the plant costs are not fully recovered, with the generator forced to recover the capital costs by seeking higher prices in bilateral contracts or through its STEM bidding. As with option (a), the result is increased costs to the market with a decrease in economic efficiency.

Option (c) requires the generator to source additional funding when initiating a project and to proceed with the expectation that this funding will be required in time to fund an SRC event. The generator will seek to cover the cost of servicing this capital through increasing its other available income streams, and therefore increasing wholesale electricity costs.

Option (d) requires the generator to have a large portfolio of plants and so does not encourage competition in the market.

The allocation of SRC costs to the generator when that generator is already refunding capacity credit payments is essentially penalising the generator twice for the same infringement. The purpose of the capacity credit market is to provide sufficient incentive for the generator to maximise availability. NP/RPV believes that the current Market Rules already adequately creates incentives for this behaviour in the WEM .

In NP/RPV's view, in the WEM retailers are best placed in the market to manage customer demand. Thus, retailers are in a position to mitigate the costs of an SRC event by increasing demand side management during the event and lowering the overall liability to the market. Generators are not able to influence the market demand and thus cannot provide cost mitigation for an SRC event. Whilst NP/RPV accepts that generators are best placed to manage the risk of plant individual availability, adequate incentives are already in place to achieve this objective. Retailers are best able to manage the financial impact of an SRC event across a portfolio of contracts and the additional burden of generators funding an SRC event will only serve to have the generators pursue recovery of a potential cost before the risk is realised.

NP/RPV, like many other participants, is a comparatively small generator in the WEM and is concerned that the proposed rule change will unfairly disadvantage the smaller generators. Such generators are not able to significantly influence overall levels of supply, which is a key factor in determining whether an SRC event is to be called. However, the SRC liabilities that NP/RPV (and other small generators) are likely to incur in the event that the outage of a larger generator has created an SRC event is unreasonably high in proportion to its contribution to the event.

NP/RPV strongly believes that the cost of wholesale electricity will increase as a result of this proposed rule change.

NP/RPV believes that the present system in relation to the capacity market and the allocation of excess funds and costs should be retained. That is, the retailer benefits from capacity credit refund distributions but bears the cost of increased STEM pricing during an SRC event. Should the IMO proceed with the proposed rule change NP/RPV proposes that any capacity credit refund payments made by a generator during a period when it is offline should be netted off the costs being allocated to the generator as a result of the SRC event that has been called. It is unreasonable for the retailers to fully benefit from the avoidance of SRC costs yet still be given the distribution of capacity credit refunds from the generator.

NP/RPV believes that a better solution exists whereby the funds accumulated over a period between SRC events as a result of capacity credit refund payments can be used to cover the additional costs in the market resulting from the occurrence of an SRC event. The current proposed rule change firstly penalises the generator for failing to make capacity available at any time, regardless of whether a true cost has been incurred by the market, and secondly requires the generator to pay the additional SRC costs without any offset from the refund payments it has previously made.

Finally, NP/RPV notes that since the creation of the WEM the private sector has invested significant amounts in bringing new generation capacity to market. The WEM has benefited from the relative stability created by the market rules. While the market is continually

evolving, the IMO needs to exercise caution in introducing rule changes that have the potential to change the risk / reward balance to market players after they have already invested that capital.

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

As a general principle, the costs faced by entities in the supply chain will ultimately be reflected in the cost to end-customers. The market design should aim to reduce the costs to participants through the supply chain, and hence deliver the lowest costs to customers. The result of allocating costs to parties less able to manage them will result in greater aggregate risk premia being applied by parties to their respective cost structures. These risk premia will ultimately be passed through the chain to end-users. New entrants and uncontracted generators will price the premia into their asking prices, and existing generators with contracted positions will rely on change in law provisions to re-open contract prices.

NP/RPV believes the proposed rule change will have the following impacts on the facilitation of each market objective contained in the WEM Rules clause 1.2.1:

(a) The proposed rule change will not better facilitate the economically efficient production of electricity in the South West Interconnected System, and will have no impact on the safe and reliable production of electricity on the network. Generators are already incentivised by capacity credit refunds. New entrant generators will factor in the possibility of experiencing an SRC event which will lead to higher wholesale electricity pricing to ensure return on investment is preserved.

(b) The proposed rule change will not better facilitate competition amongst generators or retailers, as it is simply the transference of costs from the retailers to the generators and would be borne by generators proportionally to the amount of generation for which capacity credit payments are received. Further, generators who incur the liability of an SRC event without adequate cashflows face insolvency and may potentially exit the market, thus reducing competition. The rule will favour established generators with larger portfolios of generation plant.

(c) The proposed rule change will have no impact on the existence and new entrance of different energy options as all technology types will bear the cost of the SRC funding proportionally to the amount of generation for which capacity credit payments are received.

(d) Referring to (a) above, the long term of cost of electricity in the South West Interconnected System is likely to increase as a result of increasing wholesale electricity costs brought about by the proposed rule change. The shareholders of NP/RPV are also in the process of developing additional generating facilities in the SWIS and will need to factor in the potential cost of an SRC event when making an investment decision.

(e) The proposed rule change will have no impact on the facilitation of this market objective.

## 3. Please indicate if the proposed change will have any implications for your organisation (for example changes to your IT or business systems) and any costs involved in implementing these changes.

The proposed rule change is expected to result in a minor administrative cost to NP/RPV. The broader implications of the proposed rule change will have far greater costs as highlighted in the previous section.

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

The proposed rule change can be implemented as soon as it is introduced. However, it would be highly preferable not to introduce the rule change at all.