Wholesale Electricity Market
Rule Change Proposal Form

Change Proposal No: RC_2010_01
Received date: 12 February 2010

Change requested by

Name:	Wendy Ng
Phone:	9424 1888
Fax:	94241818
Email:	Wendy.Ng@verveenergy.com.au
Organisation:	Verve Energy
Address:	GPO Box F366, Perth WA 6841
Date submitted:	12 February 2010
Urgency:	Standard Rule Change Process
Change Proposal title:	Annual Review of Margin Values
Market Rule(s) affected:	3.13.3A

Introduction

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

This Change Proposal can be posted, faxed or emailed to:

> **Independent Market Operator**
> Attn: Manager Market Development and System Capacity
> PO Box 7096
> Cloisters Square, Perth, WA 6850
> Fax: (08) 9254 4339
> Email: market.development@imowa.com.au

The Independent Market Operator will assess the proposal and, within 5 Business Days of receiving this Rule Change Proposal form, will notify you whether the Rule Change Proposal will be further progressed.

imo Independent Market Operator

In order for the proposal to be progressed, all fields below must be completed and the change proposal must explain how it will enable the Market Rules to better contribute to the achievement of the wholesale electricity market objectives. The objectives of the market are:

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

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

(c) to avoid discrimination in that market against particular energy options and technologies, including sustainable energy options and technologies such as those that make use of renewable resources or that reduce overall greenhouse gas emissions;

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

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

Details of the proposed Market Rule Change

1. Describe the concern with the existing Market Rules that is to be addressed by the proposed Market Rule change:

Background

Ancillary Services are used to guarantee the safe, secure and reliable supply of electricity on the South West interconnected system (SWIS) by ensuring the system can adequately respond to real time changes in load and generation under a range of scenarios.

While Ancillary Services are required to support the Wholesale Electricity Market (WEM), they are not traded as part of the WEM. System Management has the responsibility of determining all Ancillary Services Requirements and procuring adequate quantities of these services, either from the Electricity Generation Corporation (Verve Energy) – the default option – or on a contestable basis from independent providers if they provide a lower cost option than Verve Energy's facilities.

Payments to both Verve Energy and independent providers for Ancillary Services are made by the IMO on behalf of System Management in accordance with clause 3.13.1 of the Market Rules. In particular, clause 3.13.1 includes an availability cost determined in accordance with clause 9.9.2, to which two key inputs are the Margin_Peak and Margin_Off-Peak parameters. These parameters reflect the payment margin, in peak and off-peak Trading Intervals, that, when multiplied by the volume of reserve provided and MCAP, will compensate Verve Energy for energy sales foregone and losses in generator efficiency resulting from backing off generation to provide Spinning Reserve. As clause 3.11.8 implies that any independent providers will have lower costs than Verve Energy, it is assumed that they would be adequately compensated by the margin values determined to compensate Verve Energy. Note that one of the matters for consideration identified by the Oates Review is the efficacy and costs and benefits of amending the Market Rules that allocate costs among participants, for example for ancillary services and the Balancing mechanism.

Currently the values to apply for the Margin_Peak and Margin_Off-Peak parameters are determined by the Economic Review Authority (ERA) for each three-year Review Period. In particular, clause 3.13.3A(a) of the Market Rules requires the IMO to submit to the ERA a proposal containing the reserve availability payment margin for both Peak and Off-Peak Trading Intervals. This proposal must be provided by 30 November of the year prior to the start of the Review Period. The ERA will undertake public consultation on the values as part of its determination of Allowable Revenue for the relevant Review Period. Following the conclusion of the public consultation process, the ERA will make a determination whether to approve the margin values to apply for the next Review Period.

Issue

There are a number of assumptions that are used in proposing the Margin Peak and Margin Off-Peak parameters and as such the market conditions on which these plant and fuel assumptions are based can change dramatically over a three-year period. The more time elapses, the more likely it is that changes will occur. Therefore the degree of confidence in an assumption for year three will be much lower than for year one. High margins of error associated with the input variables used in determining the Margin_Peak and Margin_Off-Peak parameters will reduce the appropriateness of these values in compensating Verve Energy and any independent suppliers of Ancillary Services.

With regard to the review of the margin values undertaken in 2009, McLennan Magasanik Associates (MMA)[1] assumed that Bluewaters 3 would be operational by September 2012. The uncertainty surrounding this assumption increased the margin of error of the values determined by MMA. This is because at the time of undertaking the 2009 review it was uncertain whether Bluewaters 3 would enter the market by September 2012 or may delay its entry. This issue with assumptions around the entry of new plant is true of all new entrants. In addition, further assumptions around the type of plant that would be available for a Capacity Year in advance would also be likely to affect the determination of the margin values.

Additionally, MMA noted in its report that carbon price assumptions to apply in determining the margin values can be made only with considerable uncertainty regarding the start date of any adopted scheme and the price in subsequent years. If a scheme that differed from the one assumed by MMA – a 5% reduction target and a maximum introductory price of \$10/tCO_2e – were to be implemented early in the Review Period, then the margin values to apply in the final years would be based on assumptions that would probably be incorrect by that time, and would not correctly compensate Verve Energy and other independent providers.

The assumptions relating to the gas prices for the three year Review Period are likely to result in the largest potential margin of error associated with the determined margin values. This is due to the large level of volatility associated with fuel prices in the WEM, as evidenced during the consultation periods for the reviews of both the margin values and the Energy Price Limits during 2009. Verve Energy notes that the IMO will be undertaking a more thorough review of the gas prices in the WEM, which will feed into the Energy Price

[1]MMA was engaged by the IMO to assist in determining the appropriate margin values to apply for the next Review Period commencing 1 July 2010,

Limits review for 2010. Verve Energy considers that the outcomes of this review should also feed into the margin values process.

For further details of the assumptions made by MMA in undertaking its review of the margin values during 2009, please refer to MMA's Assumptions and Methodology Report available on the following webpage: http://www.imowa.com.au/Fuel-Price-Assumptions-2009

Proposal

To allow for the margin values to be updated more frequently and therefore better reflect actual operating conditions, Verve Energy proposes that the review of margin values be conducted annually.

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2. Explain the reason for the degree of urgency:

Verve Energy proposes that this Rule Change Proposal be progressed through the Standard Rule Change Process.

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3. Provide any proposed specific changes to particular Rules: (for clarity, please use the current wording of the Rules and place a ~~strikethrough~~ where words are deleted and underline words added)

3.13.3A ~~For each Review Period, by 31 March of the year in which the Review Period commences, the~~ The Economic Regulation Authority must annually determine values for the parameters Margin_Peak and Margin_Off-Peak, taking into account the Wholesale Market Objectives and in accordance with the following:

(a) by 30 November ~~of the~~ each year ~~prior to the start of the Review Period~~, the IMO must submit a proposal ~~for the Review Period~~ to the Economic Regulation Authority:

i. for the reserve availability payment margin applying for Peak Trading Intervals, Margin_Peak, the IMO must take account of:

1. the margin the Electricity Generation Corporation could reasonably have been expected to earn on energy sales forgone due to the supply of Spinning Reserve during Peak Trading Intervals;

2. the loss in efficiency of the Electricity Generation Corporation Registered Facilities that System Management has scheduled to provide Spinning Reserve during Peak Trading Intervals that could reasonably be expected due to the scheduling of those reserves;

ii. for the reserve availability payment margin applying for Off-Peak Trading Intervals, Margin_Off-Peak, the IMO must take account of:

1. the margin the Electricity Generation Corporation could reasonably have been expected to earn on energy sales forgone due to the supply of Spinning Reserve during Off-Peak Trading Intervals;

2. the loss in efficiency of the Electricity Generation Corporation Registered Facilities that System Management has scheduled to provide Spinning Reserve during Off-Peak Trading Intervals that could reasonably be expected due to the scheduling of those reserves;

(b) the Economic Regulation Authority must undertake a public consultation process, which must include publishing an issues paper and issuing an invitation for public submissions.

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4. Describe how the proposed Market Rule change would allow the Market Rules to better address the Wholesale Market Objectives:

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

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

Verve Energy submits that the proposed Amending Rules will better achieve market objectives (a) and (b) by ensuring the economically efficient, safe and reliable production and supply of electricity related services in the SWIS through pricing that is reflective of current costs. Furthermore, the proposed Amending Rules should encourage Market Participants to participate in the provision of electricity related services as the price signals will be reflective of current market conditions and are not outdated.

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5. Provide any identifiable costs and benefits of the change:

Costs:

The proposed change will:

- Increase administrative costs to the IMO associated with annually undertaking a review of the margin values, and to the ERA in annually undertaking a public consultation process on the IMO's proposed margin values;

- Increase costs to Market Participants associated with reviewing the proposed margin values;

- Potentially increase the volatility of the margin values between years; and

- Potentially increase the level of uncertainty regarding the margin values to apply in future years.

Benefits:

The proposed changes will:

- Ensure that the margin values reflect current operating conditions and gas prices through more frequent updates of the assumptions underpinning the determined margin values; and

- Potentially encourage greater penetration of the Ancillary Services market by independent providers via ensuring payments are calculated using annual cost reflective margins, enabling optimisation of bids for provision of such services.

Level 3 Governor Stirling Tower, 197 St Georges Terrace, PERTH WA 6000 • PO Box 7096, Cloisters Square, Perth WA 6850
Telephone (08) 9254 4300 • Facsimile (08) 9254 4399 • Email imo@imowa.com.au • www. imowa.com.au