INDEPENDENT MARKET OPERATOR

Wholesale Electricity Market
Rule Change Proposal Submission Form

RC_2013_20 Changes to the Reserve Capacity Price and the dynamic Reserve Capacity refunds regime

Submitted by

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Submission

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

Background

A key objective for the Wholesale Electricity Market (WEM) is to ensure that electricity and electricity related services are provided reliably and economically. The provision of capacity in Western Australia is achieved through the Reserve Capacity Mechanism (RCM) - a set of processes through which the IMO determines the amount of generation and Demand Side Management capacity required to meet future demand and reliability requirements.

The RCM is a price based mechanism whereby the number of potential Capacity Credits is not fixed. Price based markets use administered price curves where the price adjusts formulaically as the amount of "excess" capacity varies in order to send signals to the market to "start" or "stop" investment as appropriate[1].

[1] In comparison, quantity based mechanisms use administered demand curves and rely on auctions involving forward price discovery.

As such, there can be too many or too few Capacity Credits assigned – when either occurs the Reserve Capacity Price must adjust accordingly to signal whether more or less capacity is required. Therefore, the basis and extent of any price adjustments are key. If the Reserve Capacity Price stays above the cost of new entry (even where there is sufficient capacity) then investors may build additional capacity that is not needed, and customers will be required to pay for that additional capacity and receive virtually no benefit.

The challenge with either type of market (price based or quantity based) is sending the right signal to the new investor without significantly impacting on current market participants.

The WEM has experienced increasing excess capacity for a number of years due to a range of both external (demand growth rate variation) and internal (policy-driven) events. The events include the Global Financial Crisis and subsequent economic slowdown - including the deferral of several large loads, mandatory renewables, Demand Side Programmes, a 46.6% increase in the Maximum Reserve Capacity Price across two years[2], the Vesting Contract/Replacement Vesting Contract and uptake of rooftop solar PVs.

In 2011 the IMO commissioned The Lantau Group to undertake a review of the RCM. The RCM review considered a wide range of issues but primarily focussed on fixing the issues while not creating winners and losers. In doing so, the review looked to enhance market responsiveness of key RCM mechanisms in order for the market to self-correct appropriately.

In considering the results of The Lantau Group's review the IMO Board concluded that the RCM had promoted capacity development and supply reliability in the WEM, but that refinement was needed to improve its responsiveness to changing market conditions. As such, the IMO Board requested that The Lantau Group prepare a paper[3] outlining the key areas identified for further review by the Market Advisory Committee (MAC).

The MAC then formed the RCM Working Group (RCMWG) to consider, assess and develop changes to the Market Rules associated with the issues and recommendations made by The Lantau Group in its report. The RCMWG focussed on four work streams:

- Reserve Capacity Price (RCP);
- Harmonisation of Demand Side and Supply Side Resources;
- Reserve Capacity Refunds; and
- Individual Reserve Capacity Requirement.

[2] The Maximum Reserve Capacity Price increased from $164,100 in 2011/12 to $240,600 in 2013/14 which was associated with excess capacity spiking to 14.6% in that year compared with just 5.8% two years earlier.
[3] See: Review of RCM: Issues and Recommendations. Available on the IMO's website: http://www.imowa.com.au/docs/default-source/Governance/Market-Advisory-Committee/MAC-Working-Groups/09-_agenda_item_8_lantau_report.pdf?sfvrsn=2

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The outcomes from the RCMWG's deliberations were presented to the MAC at its 20 March 2013 meeting[4]. Due to the interrelated nature of the RCP and Reserve Capacity Refunds streams, these recommendations were presented as one package.

Summary of this proposal

The IMO has proposed the following amendments:

RCP formula:

- RCP to move above the Maximum Reserve Capacity Price (MRCP) as capacity supply and demand approach balance (such that the RCP is 110 percent of the MRCP when 97 percent of the Reserve Capacity Requirement has been fulfilled);
- Slope of the RCP formula to be increased to -3.75 (from the current -1 slope) so that the rate of downward adjustment is accelerated as excess capacity increases; and
- Rename the 'Maximum' RCP to the 'Benchmark' RCP.

Reserve Capacity Refund regime:

- A dynamic Reserve Capacity refund regime to be implemented, where the refund factor is determined from the capacity margin available in each Trading Interval;
- Refund revenue to be recycled to eligible available capacity in the form of rebates; and
- Eligibility for rebates is proposed to be based on an assessment of actual dispatch of a Facility in the previous 30-day rolling period.

Synergy's[5] views on the Rule Change Proposal

While Synergy has been concerned about the excess capacity prevalent in the WEM over the past few years, Synergy reiterates its views from the first submission period in that this Rule Change Proposal should be deferred until the outcomes of the State Government's Electricity Market Review are published.

Synergy understands that the role and functioning of the RCM will form a significant part of the Electricity Market Review, and as such, Synergy considers that it is inappropriate to continue with this proposal in the face of further significant review.

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[4] See the combined MAC meeting papers: 20 March 2013 meeting. Available on the IMO's website: http://imowa.com.au/docs/default-source/Governance/Market-Advisory-Committee/combined_papers_mac_meeting_58_complete_set.pdf?sfvrsn=2

[5] Effective from 1 January 2014, the Electricity Generation Corporation trading as Verve Energy changed its name to Electricity Generation and Retail Corporation trading as Synergy. This name change was instituted to reflect the merger of Verve Energy and the Electricity Retail Corporation trading as Synergy as detailed in the Electricity Corporations Amendment Bill 2013 (WA) (passed by the parliament of Western Australia on 12 December 2013 and received Royal Assent on 18 December 2013).

Synergy notes that the RCM is a complex administrative mechanism and changing too many aspects of such a mechanism, or changing the aspects too frequently creates significant regulatory uncertainty and investment risk. As such, Synergy suggests that the prudent approach of deferring this work would be the most appropriate outcome under the current circumstances.

Synergy considers that regulatory change should occur when it can be shown to offer overall net benefit. In order to assess net benefit every substantive regulatory policy change should be subject of a cost benefit assessment.

This proposal is a substantive change, may incur implementation costs of up to $440,000[6] and does not include any supporting evidence that the changes will result in overall net benefit to the market. Consistent with best practice regulation, Synergy considers it appropriate for the IMO to provide evidence that the benefits of this proposal outweigh the cost. This is especially relevant for this proposal given the potential benefits may only accrue over a short period of time (or even not at all) as a result of the Electricity Market Review and the recent Ministerial direction to defer the 2014 Reserve Capacity Cycle.

The IMO has indicated that under clauses 2.4 – 2.8 of the Market Rules, it must make a decision to either accept or reject a Rule Change Proposal at each stage of the process, and that it does not have the discretion to cease the progress of a proposal once it has been submitted into the rule change process. Noting this, Synergy highlights that the IMO is able to extend the timeframes for each step of a Rule Change Process. As such, Synergy suggests that the IMO could defer its final decision until the outcomes of the Electricity Market Review are published.

There is precedence for this approach, the IMO significantly extended the time to make a decision on “RC_2010_08: Removal of DDAP uplift when less than facility minimum generation” while the Rules Development Implementation Working Group (and latterly the Market Evolution Programme) undertook its review of UDAP and DDAP (among other things). The draft decision for RC_2010_08 was eventually extended for just under two years following an assessment of the expected costs and benefits of the proposal in which the IMO “identified that while there would be financial benefits to Independent Power Producers associated with the changes these are likely to be negated by the costs of implementation of the Amending Rules when spread over a two year period”[7].

However, should the IMO decide to continue with this proposal, Synergy’s general comments on the proposed amendments are below.

<u>Synergy requests that the IMO specifically consider a price floor in order to limit the extent to which the administered capacity price can be adjusted downward</u>

As outlined above, the RCM is a price based mechanism whereby the number of potential Capacity Credits is not fixed. Price based markets use administered price curves where the price adjusts formulaically as the amount of “excess” capacity varies in order to send signals

[6] The IMO’s preliminary estimates indicate a range of $285,000 - $440,000.
[7] See: http://imowa.com.au/rules/rule-changes/wem-rule-changes/rejected/rule-change-rc_2010_08

to the market to “start” or “stop” investment as appropriate. Therefore, the basis and extent of any price adjustments are key to achieving desired investment outcomes. Despite including an excess capacity adjustment the WEM has experienced increasing excess capacity for a number of years, indicating in part that the form of the price adjustment has not functioned as initially intended.

Synergy recognises that this proposal seeks to make the RCP more responsive to the capacity balance – a concept that Synergy supports in principle. However, with greater responsiveness comes greater volatility (an unavoidable result of using price to ration supply). Due to this increased volatility risk Synergy again requests that the IMO specifically considers the inclusion of a price floor in order to limit the extent to which the administered capacity price can be adjusted downward. This will ensure alignment with the inclusion of a price ceiling and provide greater investment certainty regarding the minimum price an investment may receive from Capacity Credits (if traded through the IMO).

Synergy considers that without a price floor there is significant investment uncertainty as to the minimum level of income a generator could assume under all market conditions (i.e. in times of either excess or a shortage of capacity). Synergy considers that the risk of a price potentially adjusting to zero (while very unlikely) is an unacceptable risk for any rational investor to take. Synergy considers that future investors need the assurance of a minimum funding flow necessary to secure financial close (i.e. meet lending criteria). Reducing investment uncertainty is an important rationale for the adoption of price floors. Generation investment involves long term horizons and price floors give investors the certainty needed regarding the minimum return on an investment. Without this assurance the level of market risk is higher which may result in difficulty being experienced in attracting future investors to the WEM.

As such Synergy strongly reiterates its position that the IMO specifically considers the inclusion of a price floor in order to limit the extent to which the administered capacity price can be adjusted downward. Synergy considers that a specific level for the floor should be consulted on, but a level of 70% of the MRCP is suggested as being a reasonable level which balances the objective of achieving a low enough price to ensure there is no residual investment signal with providing a floor price that caps potential downside thus reducing investment risk in the market. A market with a lower investment risk profile ultimately translates into reduced costs for end use consumers.