



INDEPENDENT
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Wholesale Electricity Market Rule Change Submission Form

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

Submitted by

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Submission

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

Background

In 2011 the IMO Board engaged The Lantau Group to conduct a comprehensive review of the design and performance of the Reserve Capacity Mechanism (**RCM**). The review concluded that while the RCM had promoted capacity development and reliability in the Wholesale Electricity Market (**WEM**), refinements were required to improve its responsiveness to changing market conditions.

To consider those issues raised, and recommendations made, by The Lantau Group, the IMO constituted the RCM Working Group (**RCMWG**) in early 2012.

RCMWG's deliberations

The RCMWG explored the following four major work streams relating to the WEM Rules:

- Adjustments to the Reserve Capacity Price (**RCP**);
- The obligations of Demand Side Programmes and the harmonisation with supply-side capacity resources (*RC_2013_10*);
- A dynamic Reserve Capacity refund regime; and
- The calculation of Individual Reserve Capacity Requirements (*RC_2013_11*).

Discussions with respect to the RCP focussed on the perceived issues associated with the lack of responsiveness of the existing RCP formula to changing market conditions. This was considered to lead to inefficient signals for investment in the WEM.

Likewise, those discussions with respect to the existing framework for determining capacity refunds focussed on the current lack of alignment between the refund values and actual market conditions. This was considered to lead to inappropriate incentives to capacity providers to present capacity to the market during times of greatest need.

The Lantau Group was engaged by the IMO to recommend solutions to these two particular issues. As the RCP and refund regime signal the attractiveness of investment in the WEM, the IMO determined to progress the recommendations from these two streams of work as a comprehensive package so as to avoid any unintentional perverse outcomes.

Proposed changes

Based on The Lantau Group's recommendations, the IMO proposes the following suite of changes relating to the RCP and refund regime:

Capacity Price

- Adjust the RCP formula (Issue 1) as follows:
 - Enable the RCP to move to 110% of the Maximum RCP (**MRCP**) when 97% of the Reserve Capacity Requirement (**RCR**) has been fulfilled; and
 - Steepen the slope function embedded in the excess capacity adjustment to -3.75 (currently -1) to enable the rate of downward adjustment to accelerate as excess capacity rises;
- Adjust the ceiling price in auction to 110% of MRCP (Issue 2);
- Rename the MRCP to Benchmark RCP to better reflect the fact that the MRCP signals the expected rather than maximum price for providing capacity (Issue 3);

Capacity refund regime

- Adjust the refund table such that the refund factor in a Trading Interval is calculated using a formula and equal to the lesser of:
 - Six; and
 - The greater of the dynamic refund factor (calculated based on spared capacity) and floor refund factor (calculated based on available capacity for dispatch which is based on the capacity for the Facility that was on Forced Outage during the previous 90-day rolling period).
- Replace the concept of off-peak and peak trading interval rates (currently reflected in the refund table) with the concept of an Interval Refund Rate (determined as the product of the applicable refund factor in the relevant Trading Interval and applicable Monthly RCP);
- Align the magnitude of refunds for generators and DSM;
- Recycle capacity refunds to generators rather than customers based on their eligibility (i.e. that they have generated a non-zero MW value in any one Trading Interval during the previous 30-day period).

Further consultation period

The consultation processes for RC_2013_20 occurred in early 2014. Following the close of the second submission period the IMO extended the timeframe for publishing the Final Rule Change Report to enable consideration of the outcomes of the State Government's Electricity Market Review (**EMR**), including specifically on the proposed changes.

On 18 March 2015, the IMO received advice from the Minister for Energy that the 2014 Reserve Capacity Cycle should be resumed (previously deferred by 12 months) and that the process for progression of RC_2013_20 should be expedited to provide certainty for applications made during the 2014 Reserve Capacity Cycle.

Given the significant period of time that has passed since the IMO's last consultation on RC_2013_20, the IMO determined to undertake a further round on consultation on any new or substantive issues.

In light of the substantial amount of time and resources that Market Participants dedicated to the EMR, Alinta considers that undertaking a further round of consultation on the significant changes to the existing WEM design contained within RC_2013_20 provides an important opportunity for impacted parties to provide any revised views. Details of Alinta's revised views are provided below. We encourage you to read this submission in conjunction with our submission on the EMR's Issues Paper and previous submissions on RC_2013_20.

Alinta's views on the proposed new RCP formula following the EMR

During Phase 1 of the EMR a number of issues with the current WEM design were outlined and a clear impetus for change was established. Subsequently Alinta recognised that maintaining the existing arrangements was no longer an option. This was reflected in Alinta's submission on the EMR's Issues Paper¹.

Alinta however is firmly of the view that the WEM design doesn't need to be revolutionarily transformed to address these issues. A number of modifications to the existing design can be implemented to improve the operation of the market through ensuring its ongoing efficiency and appropriateness for the unique market settings in West Australia.

Details of Alinta's suggested modifications to the WEM design, including its dynamic reserve mechanism, were provided in its submission on the EMR's Issues Paper. Adoption of these changes would:

- enable the EMR's broader objectives to be achieved while avoiding introducing significant sovereign risk; and
- expressly address the concern identified by the EMR that the RCP formula is not overly responsive to market conditions.

We also note that the changes generally align with the IMO's proposed alternative RCP formula (as progressed by RC_2013_20) and so on this basis Alinta supports the adoption of the IMO's proposed new RCP formula.

¹ A copy of Alinta's submission is available via the following webpage:
http://www.finance.wa.gov.au/cms/Public_Utility_Office/Electricity_Market_Review/Electricity_Market_Review_Documents.aspx

Alinta extensively considered the current issues with the WEM market design and potential solutions as part of the EMR, including the options for adopting a significantly different market design to ensure pricing more appropriately reflects market conditions i.e. an energy only market and capacity auction. Alinta also engaged independent consultants Oakley Greenwood and The Lantau Group to provide advice on these matters.

On the basis of the work that was undertaken during Phase 1 of the EMR we consider that the IMO's proposed changes represent a suitable solution to the current market issues as they will ensure that a more appropriate amount of capacity enters the market and that it is appropriately priced. The proposed changes are well aligned with the EMR's broader objectives, will immediately result in cost savings for the market and minimise any associated sovereign risk.

Incorporating a Price Floor into the RCP formula

Alinta considers that the inclusion of a price floor into the new RCP formula would provide greater certainty to investors as to the minimum price their investment may receive from Capacity Credits if traded through the IMO and is warranted in order to obtain the benefits of more dynamic pricing. We note that to the extent that the price formula places greater weight on economic signalling (via a steeper slope) it becomes progressively more important that a backstop is provided via a price floor so as to bridge the gap until such time as effective alternative risk mitigation options are in place in the WEM.

Alinta notes that internal work it conducted during the EMR identified that a price floor is already naturally incorporated into the proposed RCP formula. Regardless Alinta considers that a price floor should be expressly incorporated into the Amending Rules to ensure consistency with the EMR's objective of attracting private sector investment and more generally promote greater transparency.

It's important that any price floor be set in a way that encourages the most efficient form and type of capacity needed in the WEM at the time. One potential option for determining a price floor would be to calculate the MRCP using only a return on debt (rather than the Weight Average Cost of Capital) as this would represent the minimum level of return that would be required to enable a generator to repay its debts and ensure banks will still continue to provide funding for generation projects. This is particularly important as moving away from the current administered price formula will introduce more risk for investors which will result in higher risk premiums and pose a potential issue for acquiring debt for new investments in the WEM.

Other proposed changes contained within RC_2013_20

For the purposes of completeness, Alinta notes that it has not changed its views on:

- the introduction of dynamic reserve capacity refund factors; and
- recycling of capacity cost refund revenue.

If you require any further clarification of the matters raised in this submission please directly contact Fiona Wiseman, Wholesale Regulation Manager.