



INDEPENDENT
MARKET
OPERATOR

**Wholesale Electricity Market
Submission to Rule Change Proposal**

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

Submitted by

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Submission

Submissions for Rule Changes should be submitted to:

Independent Market Operator
Development and Capacity
Cloisters Square, Perth, WA 6850
Fax: (08) 9254 4399
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Attn: Group Manager,
PO Box 7096



Bluewaters Power owns and operates two 220MW coal-fired power stations in Collie, typically producing between 10% and 20% of the energy consumed daily on the SWIS. Bluewaters also operates as a retailer to large customers with ~6% of the retail load under contract and has 20MW of DSM certified reserve capacity.

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

Bluewaters supports the over-arching concepts behind these rule change proposals and is also supportive of the majority of IMO's rule changes as outlined. The WA WEM is attempting to create a 'natural' market which is bounded by core administered outcomes, such as the Reserve Capacity Price (in conjunction with energy prices limits), and Reserve Capacity Refunds. Bluewaters believes that in proceeding down the path of creating an 'artificial' or administered market, getting the underlying fundamental concepts and frameworks is the highest priority with settings adjusted over time to seek the most appropriate outcomes without fundamental change.

Bluewaters believes that there is an inherent obligation on the market operator to procure slightly more (installed) capacity than the "required" level if the only other option is to fall short of that level. While the market may not like to pay for that capacity it is unlikely to be available if there is not appropriate compensation for its availability and utility. In this regard Bluewaters believes the proposed rule changes are appropriate. Bluewaters does not believe the market should retain a system that supports excessive levels of excess capacity (wherever that blurred line is drawn). As such, our position is that there should be incentives as the reserve margin falls close to the required level and that payment should fall away swiftly in a materially over-capacity situation.

The IMO should seek to instil the 'cultural' changes these rule changes encourage soon as possible in order to bring forward the benefits to the market of incentivising capacity availability and participation. Bluewaters would like to see implementation earlier than the 2016/17 capacity year as outlined in the IMO's submission. While the net RCP/refund impact may be minimal relative to the status quo, the positive impacts of the behavioural changes as a result of Dynamic Refunds and the proposed Refund recycling should be a high priority.

Administered Reserve Capacity Price:

Bluewaters believes the current model of the administered RCP formula is fundamentally sound however the degree of responsiveness of the reference price to under or over supply of capacity, is inadequate, and in this regard Bluewaters is in agreement with the IMO's stance and the Lantau representations.

There has been argument that the choice of a -3.75 slope is arbitrary. Since it was roundly agreed by the RCM WG that -1 was inadequate and that a move from -1 to something of greater magnitude was a move in the right direction, the proposal to implement a -3.75 slope is not arbitrary, it is a step in the right direction. The exact impact over time should be acknowledged as uncertain, however it is certain that -3.75 will provide a much clearer investment signal in an over-supply situation than the current -1 slope. As such, Bluewaters agrees with the concept and supports a move to a -3.75 slope.

The current model effectively retains the status quo or better (in terms of the ultimate capacity price and total cost to Market Retailers) until excess capacity exceeds ~7.4%. Given the influx of excess capacity over the last four years under the current RCP formula Bluewaters has some reservations that the current adjustment to the mechanism may in fact have a slope that is still too gentle. This is a setting that should be formally reviewed

While acknowledging the significant time and effort of the RCM WG, the IMO and other participants to arrive at this point Bluewaters believes there are still areas which did not receive appropriate attention that could expand the scope of this review or perhaps more appropriately, form a 2nd stage of review.

Bluewaters believes a fundamental weakness embedded in the existing system is that *the price signal in general is effectively only a two-year price signal*. This provides a high degree of investment uncertainty – an undesirable element in a mechanism designed to provide the underlying foundation for large capital investment. This uncertainty

may provide an incentive to seek bilateral arrangements to under-write the investment or incentives to lock in supply certainty (in line with the bilateral intent of the market design) however it may also discourage or delay the provision of lower-cost capacity that is not conducive to bilateral offtake (eg. DSM and other peaking capacity).

We believe a clearer signal would be achieved if, in parallel with this rule change proposal, the RCP assigned to a new facility was fixed for a period (eg. 5 years) before then reverting to the prevailing RCP at the time. This sends a clear signal about the value at the time the unit is built and reduces investment speculation (which Bluewaters believes is a factor responsible for holding back larger reforms in our current market).

A participant certifying capacity at a time capacity is not required (which might for example be reflected by a \$75,000/MW capacity price) will commit that year to 5 years at \$75,000 foregoing the opportunity to capture higher prices if the price rises but also locking in \$75,000 against a further fall in price in proceeding years. Likewise, an investor building at a time the price is \$225,000/MW (in this example reflecting low reserve margin and greater need for capacity) will secure 5 years at \$225k/MW, and avoid potential price downturns if in subsequent years other investors join the market, devaluing an investment made when capacity was in fact required.

Refund Recycling:

Bluewaters supports the proposal to recycle refunds to market Generators on the basis of relative certified capacity credits (of the facilities that have exported in the previous 30 days) and believes refund recycling to generators will provide additional incentives (of varying degrees to various participants) to be more available and to more actively participate in the STEM and Balancing Markets. Additionally, Bluewaters believes this will provide an additional level of enterprise valuation and send additional signals (to asset owners) regarding the viability of their facilities over time.

Bluewaters believes refund recycling to generators is an acknowledgement that generators bear the great majority of on-the-day physical and market risk with a large portion of that risk being the chance that, after making commitments to generate, that another generator will trip increasing their own market risk profile.

In recycling refunds to generators where they were previously paid to retailers, Bluewaters believes there is now a greater incentive for retailers to enter into bilateral arrangements to avoid exposure to market prices. We believe this, in conjunction with the proposed changes to the RCP formula, are steps that enhance viability of participants bilateral contracting in line with the intended market design.

Dynamic Refunds:

While to a certain degree the current regime provides clarity of when capacity refund multiples will be high (and low) there is a fundamental flaw in that those multiples typically do **not** reflect the actual value of a MW of capacity, nor the importance of a MW of capacity as indicated by the reserve margin at the time. The evidence is quite clear over the last 5-7 years that the root cause of low reserve margin periods has not been high demand versus inadequate installed capacity, but rather, it has been caused by either high outage periods (in shoulder and winter periods) and/or gas (fuel) supply interruptions (eg. Varanus Island explosion). As such, Bluewaters strongly supports the concept of dynamic refunds since they will reflect actual market conditions and the value of capacity at that time.

Bluewaters remains a strong advocate of retaining a refund factor less than 1x (ie. the proposed 0.25x) and maximum refund of 6x and welcomes the IMO's proposal to retain this within the mechanism. Bluewaters believes the practical outcomes are appropriate since the periods when the penalties are applied - 0.25x when only base load plant is likely to be required and 6x when peaking capacity is likely to be required - compliment the natural incentives to be available and producing energy. Base load capacity has an inherent incentive to produce at all times (regardless of reserve margin) while all capacity should be aggressively incentivised when the reserve margin is so low that a 6x multiple is in effect. Bluewaters believes that higher multiples are either unlikely to provide any greater incentives to be more available, or if they do, are likely to result in inefficient maintenance activities which are disproportionate to any additional availability which *might* be achieved (and less often actually required).

Bluewaters supports the proposal to place a rolling 90-day availability check on all facilities and where the market-

wide refund factor is less than 1x, applying a minimum of 0.25x or the rolling 'unavailability factor' of that facility.

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

Bluewaters believes the proposed rule changes will better facilitate the achievement of the Market Objectives, in particular "A" (the economically efficient, safe and reliable production of electricity) and "D" (minimise the long-term cost of electricity supplied to customers).

- The RCP mechanism will be more responsive to the demand-supply ratio and as such should refine and narrow the investment proposition. The clearer price signals should result in more efficient capacity investments through less excess capacity costs.

- The implementation of a dynamic refund mechanism will incorporate a stronger element of economic rationale into the refund mechanism which is currently missing with resultant behaviour better aligned to the prevailing conditions. Higher refunds penalties will be applied when capacity is most required . We also believe the dynamic refund regime complements the *natural* availability incentives to the various load factor of facilities

- Bluewaters believes refund recycling will encourage higher availability and higher participation (competition). It is therefore inherent in such an outcome that the market should, over time, see some differentiation in asset and enterprise value. The signal to consider retirement in low availability units should be strengthened by the introduction of the proposed recycling rules.

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.

Bluewaters expects some settlement and trading system changes as a result of the change in refund regime however we do not expect the changes to be onerous (either in labour or costs)

Bluewaters expects the proposed changes will have some operational and investment decision implications, the most significant being the evaluation of the implications of the more responsive RCP on current (to some degree) and future (to a larger degree) bilateral contracts and the change in viability of potential future capacity investment.

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

Bluewaters anticipates a testing and implementation time (for trading and settlements systems) of ~3 months.
