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## Wholesale Electricity Market Rule Change Proposal Submission Form

### RC\_2014\_05 Reduced Frequency of the Review of the Energy Price Limits and the Maximum Reserve Capacity Price

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#### Submission

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

#### Background

Clauses 4.16.3 and 6.20.6 of the Market Rules for the Wholesale Energy Market (WEM) require the Independent Market Operator (IMO) to undertake an annual review of the Energy Price Limits (EPL) and the Maximum Reserve Capacity Price (MRCP), respectively.

During its recent five yearly review of the methodology for setting these variables the Economic Regulation Authority (ERA) recommended that *“reducing the frequency of the EPL review and streamlining the review process will serve to promote greater efficiency in the market”*<sup>1</sup>.

#### Issues

In considering this recommendation the IMO has identified the costs that arise associated with the current annual review as being:

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<sup>1</sup> ERA report, “Review of methodology for setting the Maximum Reserve Capacity Price and the Energy Price Limits in the Wholesale Electricity Market” (2014), recommendation 152, page 34.

- Consultancy costs incurred by the IMO of around \$58,000 and \$66,000 per annum to review the EPL and the MRCP, respectively;
- Significant effort from IMO staff; and
- Costs imposed on the ERA and Market Participants to engage in the annual review.

The IMO has also identified that most of the input parameters that are used to calculate these prices do not change significantly on an annual basis. As such, the IMO considers that the costs and price uncertainties associated with continuing to conduct annual reviews are not commensurate with the benefits.

The IMO proposes to amend the Market Rules to move to a five-yearly review of the EPL and the MRCP. The IMO also proposes to:

- Change the naming conventions for these prices, referred to the currently named Maximum STEM Price and Alternative Maximum STEM Price as the Maximum Energy Price and the Alternative Maximum Energy Price, respectively given that these prices apply to both the STEM and Balancing Markets;
- Change the indexation of the Maximum STEM Price (Maximum Energy Price) and the non-fuel component of the Alternative Maximum STEM Price (Alternative Maximum Energy Price) quarterly while keeping the monthly indexation of the fuel component of the Alternative Maximum STEM Price (Alternative Maximum Energy Price) and to index the Maximum Reserve Capacity Price annually;
- Index the Maximum Energy Price and the Alternative Maximum Energy Price quarterly and the MRCP annual to the Producer Price Index (preliminary demand, total);
- Introduce the ability for the IMO to revise the EPL and MRCP outside the five-yearly review cycle in certain circumstances where the change may lead to a *significant and sustained* change in the MRCP (an intra-period review); and
- Not recommend to the Public Utilities Office (PUO) that the decision on whether to review the MRCP and EPL outside of the proposed five-yearly review be a Reviewable Decision.

The IMO has identified that these changes will reduce the IMO's costs by some \$500,000 over the five-year period and will also reduce the IMO's workload.

Given the application of the EPL and MRCP in providing price ceilings to the WEM and the Reserve Capacity Mechanism as well as the broader implications to the commerciality of participants and to market power monitoring, the IMO proposes to undertake a concurrent review of the methodology and the prices prior to setting the EPL and the MRCP for the proposed five-year period.

## Rule Change Proposal

The IMO submitted Rule Change Proposal 2014\_05 “Reduced Frequency of the Review of the Energy price Limits and the Maximum Reserve Capacity Price” on 2 December 2014.

The proposed amendments to the Market Rules include:

- 1. Improved clarity of the description of the prices:** The IMO proposes to amend Clauses 4.16.1 and 6.20.1 of the Market Rules as well as the definitions for the Maximum Reserve Capacity Price and the new terms Maximum Energy Price, Alternative Maximum Energy Price and Minimum Energy Price in the Glossary of the Market Rules to more explicitly articulate the purpose of these prices. The IMO also proposes to amend Clauses 4.16.2 and 6.20.2 of the Market Rules to clarify that the IMO must publish the applicable price, which is either the price approved by the ERA as a result of a five-yearly review or an intra-period review, or otherwise the result of an indexation.
- 2. Removal of the annual review and introduction of a five-yearly review:** The IMO proposes to delete the requirements in clauses 4.16.3 and 6.20.6 of the Market Rules under which the IMO must undertake an annual review of the EPL and the MRCP respectively, and amend clauses 6.20.5 and 4.16.4 of the Market Rules to require to the IMO to review these prices at least once every five years. The IMO also proposes to align the review of the prices with the review of the methodology and introduce transitional provisions in the new Clauses 1.14.1 to 1.14.9 and in Clauses 1.13.1 to 1.13.7 of the Market Rules to implement an initial review of the methodologies and the values of the input parameters before moving to a five-yearly review.
- 3. Introduction of an intra-period review to account for significant changes:** The IMO proposes amendments to Clauses 6.20.6 and 4.16.10 of the Market Rules to enable to the IMO to undertake an intra-period review of the EPL and the MRCP. The IMO also proposes amendments to Clauses 4.16.11 to 4.16.15 in order to incorporate the process of the proposed intra-period review for the MRCP while the intra-period review for the EPL is outlined in Clause 6.20.6.
- 4. Removal of Market Procedure for Maximum Reserve Capacity Price:** The IMO has proposed to remove the obligation for the IMO to have a Market Procedure to document the methodology MRCP as encapsulated within Clause 4.16.3 of the Market Rules, instead requiring the methodology to be included in the relevant report. The IMO also proposes to amend Clause 2.26.3 of the Market Rules to review the methodology used by the IMO to determine the MRCP by referring to this most recent report rather than as currently to the Market Procedure.
- 5. Introduction of Price Indexation:** The IMO has proposed to amend Clauses 6.20.3 and 4.16.3 of the Market Rules to introduce an equation to provide a quarterly indexation of the EPL (other than the fuel component of the Alternative Maximum Energy Price) and an annual indexation of the MRCP to the Producer Price Index in years where a five-yearly review or an intra-period review is not undertaken.

6. **Clarifying the calculation of the Energy Price Limits:** The IMO has proposed to move the monthly indexation of the fuel component of the Alternative Maximum Energy Price from Clause 6.20.3 of the Market Rules to improve the logical sequencing of the obligations associated with this process. The IMO also proposes to restructure Clauses 6.20.3 and 6.20.4 of the Market Rules to clearly articulate how each of the price limits is indexed. Further, the IMO proposes to explicitly include risk margin in the definition of the Maximum Energy Price and the Alternative Maximum Energy Prices within Clause 6.20.1 of the Market Rules by stating that the short run average cost is recovered 80 per cent of the time, which reflects the current determination of the risk margin in the EPL calculation. The IMO also proposes to change the obligation on the ERA in Clause 2.26.3 of the Market Rules to review the methodology used by the IMO to determine the EPL, by referring specifically to the most recent report published under Clause 6.20.10 of the Market Rules, following a review under Clause 6.20.5 of the Market Rules, instead of currently referring to Section 6.20 of the Market Rules more generally.
7. **Remove the explicit ability for the IMO to undertake further consultation:** The IMO proposes to remove Clause 6.20.A9 of the Market Rules as it is viewed as redundant, given that the IMO is not precluded under the Market Rules generally from undertaking such consultation.
8. **Other minor amendments:** The IMO proposes to correct a number of typographical errors that currently exist within Clauses 2.26.3, 4.16.6, 4.16.7 and 6.6.10, cross referencing errors in Clause 4.1.19 and language inconsistencies in Clause 2.26.1 of the Market Rules.

## Perth Energy's Views

On 6 March 2014, the Minister for Energy initiated a broad-ranging review of the structure, design and regulatory regime of the electricity market in the South West of Western Australia (the Electricity Market Review). Phase 1 of the Electricity Market Review - to examine the current industry structure, market institutions and regulatory arrangements and to recommend options for reform - has been completed and the industry awaits a response from Government.

The Minister is therefore expected to respond to the Electricity Market Review as well as being required under Clause 2.8.3 of the Market Rules to approve the Amending Rules arising from this Rule Change Proposal.

Perth Energy is not supportive of this Rule Change Proposal at this time and strongly recommends that the IMO awaits the Government's response to the Electricity Market Review report, which is expected to be released shortly. This Rule Change Proposal could become redundant should the Government pursue a particular industry restructure option.

For instance, if the Government pursued the option of phasing out the Reserve Capacity Mechanism, this Rule Change Proposal as it relates to the MRCP would become irrelevant. Likewise, a move to disaggregating Synergy into multiple generation entities, coupled with the adoption of an energy-only market regime, would ensure a different setting regime for the EPL.

Notwithstanding the above timing issue, Perth Energy stresses that the EPL and the MRCP can have significant implications for security of supply, market efficiency and the ongoing sustainability of Market Participants in the WEM.

Since Market Commencement, the MRCP (in particular) has been subject to significant non-market driven volatility, with this concern being raised with the IMO on a number of occasions. While Perth Energy is pleased to see the IMO giving this volatility matter appropriate consideration, the Rule Change Proposal retains the administered pricing approach that has been the cause of unjustifiable volatility in the past. As per our submission to the Electricity Market Review Committee, Perth Energy advocates a market-based pricing regime for reserve capacity, such as with IMO calling for annual auctions whereby clearing prices are applied to incremental capacity for 1 to 10 years, at the Market Participant's option. This would alleviate many of the concerns raised by Market Participants as to the unpredictability of the changes in the administered prices.

If a pricing regime is market based, participants will accept the associated volatility since they will be able to make their own judgement about supply and demand in the market and select pricing terms that best align with their project finance tenor. This would help participants obtain the lowest cost of finance and relieve the IMO from the costs and work load which is currently embedded in the administered price determination processes.

Besides volatility, the adequacy of the absolute level of the EPL and the MRCP is of significant concern to Market Participants. Setting the EPL and the MRCP for a period of five years without giving Market Participants the right to choose would create a risk that the underlying cost components within these price limits may not adequately reflect the true costs confronting Market Generators from time to time. Without intervention, efficient participants may still suffer revenue erosion and cost pressures which arise through no fault of their own.

Adopting the Perth Energy proposed auction regime would deal with the issue of price term, with participants choosing the term to fit their risk management profile.

Perth Energy considers the IMO's proposed approach to establishing the prices, the provision of a definition for the MRCP and the application of an escalator to the prices over intervening periods<sup>2</sup>, as being inadequate. While we support the notion of the intra-period review as a means of intervening should there be material and sustained changes in the cost components of the EPL and the MRCP, the IMO is giving itself too wide a berth in terms of decision over whether to proceed with such a review, or not. This makes the five-year term useless for Market Participants - it would be no different to current conditions where the IMO has used its powers to materially modify the components of the MRCP with little regard to Market Participants' views.

The Reserve Capacity Mechanism is intended to ensure the South West Interconnected System (SWIS) has sufficient installed capacity from generators at all times. It is designed in broad terms to:

- Meet the expected peak demand plus a margin to cover generation outages; and

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<sup>2</sup> Periods between the five-year reviews.

- Remove the need for high and volatile energy prices that are required in markets like the National Electricity Market (NEM) to provide adequate revenue for peaking facilities and to trigger new investments. Energy prices in the WEM are capped at very low levels (relative to the NEM) with the RCM contributing to generators' capital costs. In this market design, the RCM must fully fund the capital costs for peaking facilities.

The most critical issue with the setting of the EPL and MRCP remains that the initial price limits must reflect the principles for the Reserve Capacity Mechanism outlined above in order to underpin sustainable generation investment over the longer term. We do not have confidence that an IMO determined process would deliver such initial price limits.

The IMO's proposal, seeking to address the risk of the EPL and MRCP diverging from appropriate levels by incorporating discretion for the IMO to conduct an intra-period review of the RCM, continues the poor governance practices by giving the IMO a free hand to conduct its Rule making function while being a Rule operator.

The Rule Change Proposal includes amending the Market Rules to include obligations to underpin a review process, including:

- Detailed methodology review, including explanation of the rationale and value of input parameters;
- Intra-period review triggers for the IMO; and
- Indexation of certain prices utilising the Producers Price Index.

Perth Energy is concerned that the triggers and processes for intra-period reviews as proposed by the IMO are insufficient to provide Market Participants with sufficient revenue safeguards.

An option may be to have a requirement that the IMO must conduct an intra-period review if there is at least three Market Participants requesting the IMO to do so. But this must be accompanied by a requirement that the IMO publish the reasons for not undertaking the review. Any decision of the IMO should be a Reviewable Decision.

Perth Energy also questions the efficacy of using the Producer Price Index as the escalator to be applied during the five-year period. The Consumer Price Index, which is used in many fuel and construction contracts and for tariff setting purposes, would provide a better proxy. In addition, given generation investments are long-lived, it is appropriate that the indexation methodology be directed at only incorporating positive changes. Negative values should be excluded from the indexation process, with the value of the relevant price limits remaining unchanged until the next indexation process.

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

Perth Energy considers that the Rule Change Proposal as it stands will not facilitate achievement of Market Objectives.

If amended as we outline above, the Proposal might better address the Wholesale Market Objectives (a)<sup>3</sup> and (d)<sup>4</sup>. The amendments discussed in this submission will reduce the risk to peaking generators (in particular) which serves to underpin efficient investment over the long term.

However, our view is even with amendments this Rule Change Proposal should not proceed and the IMO should wait for the Government to respond to the Electricity Market Review report.

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<sup>3</sup> Market Rule Change (a): to promote the economically efficient, safe and reliable production and supply of electricity and electricity related services in the South West Interconnected System.

<sup>4</sup> Market Rule Change (d): to minimise the long term cost of electricity supplied to customers from the South West Interconnected System.

- 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.**

This Rule Change Proposal will have implications for Perth Energy as Perth Energy will need to update some of its business processes. We are yet to quantify the impact of these potential changes.

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

As above.