18 December 2012

Wana Yang
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Economic Regulation Authority
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Dear Wana

DISCUSSION PAPER: 2012 WHOLESALE ELECTRICITY MARKET REPORT TO THE MINISTER FOR ENERGY

Alinta Energy (Alinta) appreciates the opportunity to provide a submission to the Economic Regulation Authority (the Authority) on the strategic, policy and other high-level issues, including those raised in its Discussion Paper, that may be impacting on the effectiveness of Western Australia's Wholesale Electricity Market (WEM) in meeting the Wholesale Market Objectives (Market Objectives).

There are a number of important issues currently impacting on the effectiveness of the WEM that require further consideration. Alinta notes that in order to be successful in considering these, the following approach should be undertaken (in order of priority):

1. Restructuring the market governance functions; and
2. Conducting a broad review of the effectiveness of the current design of the WEM, with a particular focus on the following areas:
    - Removing unnecessary costs in the WEM; and
    - Ensuring appropriate incentives are provided to investors in generation facilities.

Specific details of Alinta's concerns with respect to issues impacting on the effectiveness of the WEM are also outlined in this submission; however Alinta notes that it is likely the broad review will identify other issues that also require consideration by the market.

The rationale for Alinta's proposed approach stems not only from concerns around the current market governance structure but also the lack of co-ordination in considering WEM based issues. In particular, there are currently a large number of work streams underway that are considering various aspects of the WEM, including:

- A review of electricity cost drivers by the Government of Western Australia in conjunction with the Roundtable of Energy Consumers and Industry;
- Consideration of the recommendations of the Lantau Group on a number of identified issues associated with the Reserve Capacity Mechanism by the Independent Market Operator (IMO) in conjunction with the Reserve Capacity Mechanism Working Group (RCMWG); and
- The current annual review of the effectiveness of the WEM being undertaken by the Authority.

While Alinta supports the progression of each of these work streams, it recommends that consolidation into one overarching review of the electricity market would be most effective going forward. At present it is unclear whether there is potentially overlap in the issues being considered. It is also unclear how recommendations from the various streams of work will be progressed and how these work streams are expected to interact with the IMO's recently completed Market Rules Evolution Plan 2013-16.

It is vital to the WEM's continued success that a governance structure that is free of conflicts of interest is implemented and that the newly created independent rule-maker, in conjunction with industry, develops a clear and consolidated approach to the further development of the WEM.

Alinta's specific comments on these matters are provided in the attached submission. If you would like to discuss this submission, please contact me on 9486 3762 or Fiona Edmonds on 9486 3009.

Yours sincerely

Michelle Shepherd
General Manager Regulatory and Government Affairs

Alinta Energy's Submission

The Economic Regulatory Authority's Discussion Paper: 2012 Wholesale Electricity Market Report to the Minister For Energy

There are a number of important issues currently impacting on the effectiveness of the WEM that require further consideration by the Authority. These issues are discussed below in order of priority.

Priority 1: Restructuring Market Governance functions

There exists potential for conflicts of interest to arise within the existing market governance functions for the WEM as the IMO is responsible for determining whether or not to amend the Market Rules, for operating the WEM, and for enforcing the Market Rules.

Consistent with its submission to the Authority's 2011 Annual WEM Report, Alinta remains of the view that structural separation of responsibility for determining whether or not to amend the Market Rules, for operating the WEM and for enforcing the Market Rules, is required to remove the current conflicts faced by the IMO. The most effective markets have a strong governance framework that separates the three functions to remove any potential conflict of interest and create an environment where there is full and transparent discussion of issues. It is timely and appropriate to reconsider the current market governance arrangements, as was recommended by the Authority in 2011.

The determination and implementation of the most appropriate governance structure, which should result in an independent rule maker from the market operator, would allow for a solid foundation for considering the effectiveness of the current WEM design and a pathway forward for the future development of the WEM.

Priority 2: Review of the WEM design

A holistic review of the current WEM design should be conducted with a view to providing a consolidated direction for the future development of the WEM.

Alinta considers the market has reached an important stage in its development and would now benefit from an independent holistic review of its effectiveness.

In this review, the appropriateness of the current market model should be considered along with whether any other market structures may have greater benefits to the state. The review should represent a consolidation of the existing reviews of the WEM structure and be undertaken by the new independent rule maker. This review should be completed prior to committing to any further significant market reform within the current market framework. For example, no further major changes to the market should be made, particularly given the Balancing and Load Following markets are still in their infancy and the focus over the next 12 months should be around refining and perfecting their functioning rather than supplementing the design with further changes.

Alinta notes that within the current market design there are significant interdependences between its features. The independent holistic review of these features should be conducted in conjunction with industry and should consider:

- the effectiveness of the current market design in producing efficient and cost-effective outcomes;
- alternative options for producing more efficient and cost-effective outcomes; and

- appropriate long term pathways towards achieving alternative market design options.

The outcomes of the review should ultimately result in the creation of a long term market development plan that is supported by government and provides transparency of the industry's future direction. Note that the development of such a plan should not be confused with the IMO's Market Evolution Plan which simply outlines areas of the Market Rules for further consideration during the next three years.

In considering options for the future development of the market, Alinta considers that the following two principles should be taken into account:

- Principle 1: Removing unnecessary costs for the WEM; and
- Principle 2: Ensuring appropriate incentives are provided to investors of generation facilities.

Further details of these two principles and their relevance to existing issues with the current market design are outlined below. Alinta acknowledges that other principles may be required and should be agreed with industry.

Principle 1: Removal of unnecessary costs for the WEM

To ensure the WEM is effective at meeting the Market Objectives the market design should provide appropriate investment signals, and that costs above and beyond those required to maintain a pre-determined level of system security and reliability are not incurred.

There are a number of drivers of costs in the WEM which should be subject to a review. These issues are outlined below.

Reserve Capacity Mechanism

There was a significant increase in the supply of capacity from 2012/13 to 2013/14 that has resulted in costs being incurred by the market that do not necessarily equate with the value provided by that capacity in meeting reliability requirements. The RCMWG has been considering refinements to how the Reserve Capacity Price is determined with an aim to ensuring that the methodology appropriately responds to capacity over and under-supply situations in the future, thereby avoiding unnecessary costs being incurred by the market.

However, Alinta believes the market would be better served by a consolidated review of the current structure and design of the WEM, including the Reserve Capacity Mechanism, before focussing on any detailed solution to this issue.

Load Following Market

Since the introduction of the competitive Load Following market on 1 July 2012 there has been a significant increase in the costs of procuring these services. For example during the 2011 Capacity Year the total cost of Load Following services was approximately $15.5 million however since the introduction of the new market the cost was $6.6 million in July 2012 and $7.4 million in August 2012[1].

Alinta is concerned with the excessive costs being incurred for Load Following services and contributes these to the following issues:

[1] Since the introduction of Verve Energy's new High Efficiency Gas Turbines a decrease in costs has occurred.

- Restricted competition in the LFAS market to date;
- Lack of transparency over whether the most efficient facilities are currently providing Load Following services. In particular it is currently unclear which facilities in the Verve Energy Balancing Portfolio are these services; and
- The overall quantity of Load Following services being procured by System Management may be overly conservative. Options to more dynamically amend the quantity of required services in each Trading Interval could potentially result in cost savings to the market.

As has been discussed recently by the Market Advisory Committee there may be an opportunity to reduce the costs associated with Load Following if the market is willing to accept a higher security risk. Ultimately this is a decision that will need to be made by the Government given the implications to system security and reliability.

In addition, while a review of the effectiveness of the current WEM design is being undertaken there are efficiencies that can be achieved by further refining the current Balancing market arrangements, such as moving towards 5 minute gate closure. To the extent that these represent "low hanging fruit" they should be considered by the rule maker with a view to expediting any necessary changes to the Market Rules that would promote greater efficiency whilst not incurring significant costs.

Principle 2: Ensuring appropriate incentives are provided to investors of generation f**acilities**

Incentives should be provided to new and existing generation facilities through the ability to earn an adequate return on investment through a combination of the energy market and Reserve Capacity Mechanism

The Market Rules should ensure that an investor who develops a new 160 MW OCGT Facility can recover its total costs from a combination of trading in the energy market and the Reserve Capacity Mechanism. Other technologies, such as baseload coal generators, will need to utilise bilateral contracting to ensure it is profitable to enter the WEM.

Alinta is concerned that currently a new 160MW OCGT facility (the reference technology for the Maximum Reserve Capacity Price) would be unable to recover its total costs operating in the WEM over a period of 30 years.

This issue should therefore be considered in a review with a view to ensuring that adequate compensation is provided for a 160MW OCGT via:

- the energy market, to recover variable costs; and
- the capacity mechanism, to recover fixed costs.

In addition, given the inter-relationship between the energy market and capacity mechanism it's vital that the impact to investors' returns of changes to one market are countered by changes to another. For example, if the Reserve Capacity Price falls, there should be a corresponding increase in the energy market price cap.

To the extent that there are differences in the 'value' of capacity to the market then an adjustment to the quantity of capacity or the price paid for capacity should be made.

The Market Rules should also account for the relative value of different types of capacity to the market to ensure appropriate incentives are provided to respond with the most valuable technologies.

Given the objective of the Reserve Capacity Mechanism is to ensure there is adequate capacity to meet peak system requirements including a reserve margin, an assessment of the value of different capacity types should focus on their ability to contribute to this objective. While the market design should ensure that appropriate compensation is provided overall, any unnecessary costs should be avoided.

In this regard Alinta notes that capacity which is provided at short notice to meet system peaks, and in the case of emergency situations, should be valued more highly than capacity which is not as certain. For example, a dual fuel gas/diesel generator provides the highest level of reliability given it is available at short notice including in the case of a gas emergency. However, this is an expensive plant to build and maintain and the current pricing mechanisms do not provide adequate incentive for an investor to commit to such a valuable facility.

In regards to Demand Side Management (DSM), Alinta acknowledges that it can be valuable where the existing supply of generation can not meet system demand. However, currently DSM is less valuable than generation given its restricted availability. Moves to harmonise the requirements for DSM and generation will ensure a similar value to the market. However to ensure complete harmonisation DSM should be subject to market fees and required to bid into the Balancing market. To the extent that complete harmonisation can not be achieved an adjustment to either the quantity or price for capacity from DSM should be made to reflect its reduced value.

To ensure that unnecessary costs are not incurred via the Reserve Capacity Mechanism differential pricing for DSM should be introduced.

Despite harmonisation of DSM, due to its high opportunity costs it will remain unlikely that it is dispatched frequently meaning its value is only realised on a limited number of occasions. While the frequency of dispatch of DSM is not dissimilar to that of a peaking generator, the fixed costs associated with DSM are significantly lower than with developing a peaking generator. Likewise it is unlikely that through the electricity market alone DSM would be able to recover its variable costs.

Consistent with the principle of ensuring DSM is appropriately compensated for its value to the market while ensuring that unnecessary costs are not incurred, Alinta supports the introduction of differential pricing for DSM. That is DSM should receive a lower capacity payment (via either a reduced price or quantity) and a higher energy payment (for example based on an administratively set price cap that would allow DSM to recover its reasonable variable costs).