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2012 Annual Wholesale Electricity Market Report to the Minister for Energy: Discussion Paper

The Energy Supply Association of Australia (esaa) welcomes the opportunity to make a submission to the 2012 annual Wholesale Electricity Market (WEM) Report to the Minister for Energy on the effectiveness of the market in meeting the Wholesale Market Objectives.

The esaa is the peak industry body for the stationary energy sector in Australia and represents the policy positions of the Chief Executives of 36 electricity and downstream natural gas businesses. These businesses own and operate some $120 billion in assets, employ more than 51,000 people and contribute $16.5 billion directly to the nation's Gross Domestic Product.

In November 2009, the esaa released its Western Australian Energy Market Study, which was undertaken in consultation with our Western Australian members. The study covered the South West Interconnected System, the North West Interconnected System and the natural gas market. It made around 40 recommendations to contribute to the Western Australian Government's ongoing energy market reforms. The 2009 Study was provided to the Authority in the context of its 2009 Report to the Minister.

In November 2011 the Association released a *2 Year Update* of the 2009 Study to examine where there has been positive progress against the Study recommendations, where continued reform effort is required and where there are issues of material concern. This Update was provided to the Authority as part of our response to its 2011 WEM Report to the Minister.

The ERA's 2012 Report covers several issues which were raised in this update. In particular, the 2012 Report discusses the Reserve Capacity Mechanism (RCM). The esaa made several recommendations relating to the RCM as part of the *2009 WA Energy Market Study* and as such, this submission draws from the positions put forward at this time.

The RCM may not be delivering the right mix of power plant

It has been questioned whether the RCM is delivering the appropriate mix of generation to serve load throughout the year. For example, it has been suggested that the RCM may incentivise low-merit plant with relatively short lead-times, such as open-cycle gas turbines and wind generation, ahead of mid-merit and baseload generation, although this pattern of investment could also reflect the demands of the Renewable Energy Target and the load profile of the SWIS.

The pattern of generation in the SWIS also reflects the displacement mechanism under the Vesting Contract arrangement, which may have led to an oversupply of baseload plant. This issue was examined as part of the Verve Energy Review process.

A central issue is the lack of a mechanism to prevent the oversupply of additional capacity to meet peak demand growth. Where the prevailing capacity price exceeds the fixed costs of qualifying capacity, such as peaking plants and Demand Side Management, there is no real check built into the mechanism that ensures that no more than the efficient level of such capacity is provided. The IMO is introducing a new price mechanism that decreases prices if excess capacity increases but this may not provide a strong enough price signal to disincentivise further capacity additions above the efficient level required to meet reserve margins at peak times.

Going forward, the effectiveness of the RCM in delivering the right mix of capacity should be reviewed. Such a review would examine the design and operation of the RCM to ensure it is providing effective signals that deliver an appropriate mix of capacity to ensure a secure and reliable supply of electricity in the SWIS, and the role of the Statement of Opportunities in providing information to the market on the mix of capacity. It would also consider whether different types of capacity should be treated the same way when their underlying cost structure and their dispatchability may be quite different.

Reserve capacity refunds are not reflective of the capacity situation

Generators that fail to offer all accredited capacity to the market via bilateral trades and/or the STEM must pay a reserve capacity refund. Under the rules, reserve capacity refunds are based on multiples set out in section 4.26.1 of the rules, which values capacity most during summer peak periods and does not take account of the actual impact of the outage on the system.

It has been argued that this approach is overly formulaic, punitive and may lead to perverse outcomes. For instance, given the practice of generators scheduling planned outages during the cooler months, it is possible that the cooler months, and not summer, is when capacity is most scarce. Yet there is no signal provided to generators that reliability is more highly valued during these periods. This is because refund penalty multipliers are fixed and are relatively lower in cooler months. It has also been noted that the RCM can lead to higher market costs as generators attempt to recover the costs of higher refund charges from their off takers.

While incentives to encourage capacity to be available are appropriate, there is merit in exploring measures to ensure disincentives to withdraw capacity are calibrated to the prevailing supply situation. This would encourage capacity to be available when it is most valued. This could be at times when the current multipliers are lowest. It would also prevent capacity credit holders from being disproportionately penalised when their accredited capacity is unavailable at times when capacity is relatively abundant.

The IMO's Rules Development Implementation Working Group investigated a more dynamic refund system that would reflect current system conditions and capacity reserves which informed the Lantau Group's Review of the RCM. The Lantau Group's Review recommended changes to make the reserve capacity refund system more dynamic. The ERA's 2012 WEM Report queries whether incentives for plant availability could be improved. In light of this, the esaa contends that the reserve capacity refund system should be adjusted to better reflect the impact of unavailable capacity on the system in line with our recommendation from the 2009 *WA Energy Market Study*.

Prices for reserve capacity may not reflect its value to the market

Currently capacity credits can be traded bilaterally and through the IMO, with administered prices for capacity credits set based on the costs of a liquid fuelled peaking plant. The ERA's 2012 WEM Report discusses several issues relating to the RCM and the role of auctions in procuring sufficient capacity. Rather than bilateral trading and administratively determined prices, the Association suggests that there may be merit in considering a mandatory reserve capacity auction to determine a market price for capacity credits.

As a significant reform, a mandatory reserve capacity auction should only be considered after a comprehensive analysis of the issues, including auction design options and rules, any transitional issues and the need to ensure that sufficient reserves in the SWIS are not compromised.

A possible advantage of a market mechanism is that the price paid by consumers for capacity each year could more closely reflect the value of that capacity to consumers, given the prevailing supply demand balance, rather than be determined by an administrative system. This could lead to a more efficient price discovery process for capacity and provide signals to the market about the need, or otherwise, to invest in new plant.

In the medium term, the esaa considers that the Western Australian Government should explore the merits of a mandatory, annual centralised capacity auction following a comprehensive review.

Conclusion

The ERA's 2012 WEM Report poses a range of questions around how to improve the operation of the RCM. The esaa has highlighted several areas which could be improved through changes to the existing mechanism. The Association has consistently argued for these changes over several years to improve the efficiency of the market.

Any questions about our submission should be addressed to Kieran Donoghue, by email to kieran.donoghue@esaa.com.au or by telephone on (03) 9205 3116.

Yours sincerely

Matthew Warren
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