Decision on the Maximum Reserve Capacity Price proposed by the Independent Market Operator for the 2015/16 Capacity Year

30 January 2013

Economic Regulation Authority
WESTERN AUSTRALIA

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DECISION

1 On 16 January 2013, the Independent Market Operator (**IMO**) provided the Economic Regulation Authority (**Authority**) with its final report on the Maximum Reserve Capacity Price (**MRCP**) for the 2015/16 Capacity Year.[1] The Authority approves the revised value for the MRCP for the 2015/16 Capacity Year of $157,000 per MW per year, as proposed in the IMO's final report.

2 This approval is granted pursuant to clause 2.26.1 of the *Wholesale Electricity Market Rules* (**Market Rules**). The approval is granted on the basis that:

- the revised value for the MRCP proposed by the IMO reasonably reflects the application of the method and guiding principles described in clause 4.16 of the Market Rules; and
- the IMO has carried out an adequate public consultation process.

REASONS

Background

3 Clause 4.16.3 of the Market Rules requires the IMO to develop a Market Procedure documenting the methodology it uses and the process it follows in determining the MRCP (**MRCP Market Procedure**).[2] The IMO must follow the MRCP Market Procedure to review the MRCP value for each Reserve Capacity Cycle. The IMO must propose a revised value for the MRCP using the methodology described in the MRCP Market Procedure, and prepare a draft report describing how it has arrived at the proposed revised value for the MRCP. Following a public consultation process, the IMO must propose a final revised value for the MRCP.

4 Where the IMO proposes a final revised value for the MRCP, clause 2.26.1 of the Market Rules requires the Authority:

- to review the final report provided by the IMO, including all submissions received by the IMO in preparation of the report;
- to make a decision as to whether or not to approve the revised value of the MRCP;
- in making its decision, to only consider:
  - whether the proposed revised value for the MRCP reasonably reflects the application of the method and guiding principles described in clause 4.16 of the Market Rules;
  - whether the IMO has carried out an adequate public consultation process; and
- notify the IMO that it has approved the revised value.

5 Clause 2.26.2 of the Market Rules provides where the Authority rejects a revised

[1] See IMO website, Maximum Reserve Capacity Price web page, http://www.imowa.com.au/mrcp

[2] See IMO website, *Market Procedure: Maximum Reserve Capacity Price*, http://www.imowa.com.au/f6711,3255856/PC_2012_08_Final_Amended_Market_Procedure_clean_.pdf

MRCP submitted by the IMO it must give reasons and may direct the IMO to carry out all or part of the review process under clause 4.16 again in accordance with any directions or recommendations of the Authority.

Maximum Reserve Capacity Price methodology

6 The MRCP Market Procedure sets out the principles to be applied and the steps to be taken by the IMO in order to develop and propose the MRCP.

7 The MRCP is intended to reflect the marginal cost of providing additional Reserve Capacity in each Capacity Year. The methodology for determining the MRCP as specified in the Market Procedure includes a technical costing of the following components:

- the capital cost of an industry standard, liquid-fuelled open cycle gas turbine (**OCGT**) with a nominal nameplate capacity of 160 MW with an inlet cooling system, located within the South West Interconnected System (SWIS);
- the land cost associated with developing and constructing the power station;
- the costs associated with the development of liquid fuel storage and handling facilities;
- the costs associated with the connection of the power station to the bulk transmission system;
- the fixed operating and maintenance (**O&M**) costs for the power station, fuel handling facilities and the transmission connection components;
- a margin for legal, insurance, financing and environmental approval costs plus contingencies; and
- the Weighted Average Cost of Capital (**WACC**).

8 Procedure Change Proposal PC_2012_08 (Changes to Market Procedure for Determination of the MRCP)[3] to amend the Market Procedure was approved since the publication of the IMO's draft report on the MRCP for the 2015/16 Capacity Year. The revised Market Procedure commenced on 15 January 2013. The IMO prepared the final report in accordance with the revised Market Procedure.

Summary of input parameters and calculated values

9 A summary of the input parameters to the MRCP calculation, and the values calculated according to the formulae set out in section 2.10 of the MRCP Market Procedure, is provided in Table 1.

[3] The Procedure Change Proposal included two changes that may impact the calculation of the MRCP: the franking credit value would be amended from 0.5 to 0.25; and changes to the calculation of the power station that are consistent with the Balancing Facility Requirements.

Table 1: Summary of input parameters and calculated values

	Value	Units	Market Procedure definition[4]
Power station inputs			
Power station expected Capacity Credit allocation	159.6	MW	CC
Capital cost			
WACC	5.95	%	WACC
Power station costs	829,446.75	$/MW	PC
Factor for legal, financing, approvals, contingencies and other costs	18.87	%	M
Transmission connection works	115,124.00	$/MW	TC
Fixed fuel costs	7,069,232.08	$	FFC
Land costs	2,693,872.28	$	LC
Total capital cost[5]	190,938,543.97	$	CAP_COST
Annualised capital cost[6]	**19,599,805.92**	**$/year**	**ANNUALISED_CAP_COST**
Annualised fixed O&M cost[7]	**34,238.67**	**$/MW/year**	**ANNUALISED_FIXED_O&M**
MRCP (rounded)[8]	**157,000.00**	**$/MW/year**	**MRCP**

10 The Authority has reviewed the IMO's draft report, the IMO's final report and submissions received by the IMO in response to its draft report. The Authority has also reviewed reports commissioned by the IMO in regard to input parameters for the MRCP, in order to confirm that these reports reasonably reflect the application of the method and guiding principles described in clause 4.16 of the Market Rules.

11 The Authority is satisfied that the IMO has calculated the value of the MRCP according to a methodology that reasonably reflects the application of the method and guiding principles described in clause 4.16 of the Market Rules and the MRCP Market Procedure.

12 In particular, the Authority notes that the IMO has calculated the value of the MRCP using the formula set out in section 2.10.1 of the MRCP Market Procedure.

[4] Step 2.10.1 of the MRCP Market Procedure.

[5] Total capital cost (CAPCOST) = ((PC x (1+M) + TC) x CC + FFC + LC) x (1 + WACC)^0.5

[6] Annualised capital cost is the total capital cost, expressed in Australian dollars, annualised over a 15 year period, using a WACC as determined in step 2.3.1(c) of the MRCP Market Procedure.

[7] Annualised fixed O&M cost is the annualised fixed operating and maintenance cost for a typical open cycle gas turbine power station and any associated electricity transmission facilities determined in step 2.5 of the MRCP Market Procedure and expressed in Australian dollars, per MW per year.

[8] MRCP = (annualised fixed O&M cost + annualised total capital cost / CC)

Power station costs

13 The MRCP Market Procedure states that the power station upon which the MRCP shall be based is a 160 MW OCGT, operating on liquid fuel, with a capacity factor of 2 per cent, utilising low Nitrous Oxide (**NOx**) burners, an inlet air cooling system and water receival and storage facilities to allow 14 hours of continuous operation (where in the opinion of the IMO this would be cost effective).

14 The MRCP Market Procedure states that the IMO must engage a consultant to provide an estimate of the costs associated with: engineering, procurement and construction of the power station as at April in Year 3 of the Reserve Capacity Cycle; a summary of any escalation factors used in the determination; and likely output at 41 degrees Celsius which will take into account available turbine and inlet cooling technology, likely humidity conditions and any other relevant factors, which represents the expected Capacity Credit allocation of the power station.

15 The IMO commissioned Sinclair Knight Merz (**SKM**) to provide generation capital costs for a 160 MW OCGT power station located within the SWIS. The process for calculating the 2013 MRCP power station capital costs is the same as the process applied in last year's proposal, except that the facility now needs to meet the Balancing Facility Requirements as implemented from 1 July 2012. Based on SKM's capital cost estimate, escalated forward to 1 April 2015 dollars, the IMO has proposed a value of $829,446.75 per MW for the capital cost of an OCGT.

16 The Authority considers that the IMO, in adopting a value of $829,446.75 per MW for the capital cost of an OCGT, has selected a value that reasonably reflects the application of the method and guiding principles described in clause 4.16 of the Market Rules and the MRCP Market Procedure.

Factor for legal, financing, approvals, contingencies and other costs

17 The MRCP Market Procedure states that the IMO shall determine an estimate of legal costs, financing costs, insurance costs, approval costs, contingency costs and other costs reasonably incurred in the design and management of the power station construction.

18 The IMO commissioned SKM to provide an estimate of the cost factor for legal, financing, approvals, contingencies and other costs. SKM estimated these costs on the basis of in-house data and knowledge of recent comparable developments, excluding any abnormal costs that may be particular to individual projects. SKM proposed a margin of 18.87 per cent. Based on SKM's estimate, the IMO has proposed a margin of 18.87 per cent for legal, financing, approvals contingencies and other costs.

19 This value has increased from the value of 18.77 per cent in the IMO's Draft Report in response to a submission by Merredin Energy. The IMO consulted with SKM, which has increased the allowance for construction insurance from 0.4 per cent to 0.5 per cent, due to the changes in insurance premiums and with regard to the likelihood that premiums may not reduce significantly in the next few years.

20 The Authority considers that the IMO, in adopting a value of 18.87 per cent for the margin for legal, approval, financing, contingency costs and other costs reasonably incurred in the design and management of the power station construction, has

adopted a value that reasonably reflects the application of the method and guiding principles described in clause 4.16 of the Market Rules and the MRCP Market Procedure.

Transmission connection works

21 The MRCP Market Procedure states that Western Power must provide an estimate of the total transmission costs in accordance with the methodology in the MRCP Procedure to connect the generator and deliver the output to loads consistent with the relevant planning criteria in the Technical Rules.[9]

22 The estimate of the transmission connection cost for the proposed revised MRCP was provided by Western Power based on actual connection costs and Access Offers that have been determined by Western Power.[10] In accordance with the requirement of the MRCP Market Procedure, Western Power has provided an audit report verifying the accuracy of the connection cost data used in its calculation. Based on this, the IMO has proposed a value of $115,124 per MW for transmission connection costs.[11]

23 The Authority considers that the IMO, in adopting a value of $115,124 per MW for transmission connection costs, has adopted a value that reasonably reflects the application of the method and guiding principles described in clause 4.16 of the Market Rules and the MRCP Market Procedure.

Fixed fuel costs

24 The MRCP Market Procedure states that the IMO must engage a consultant to determine an estimate of the costs for the liquid fuel storage and handling facilities of the power station. The costs should be those associated with a fuel tank of 1,000 tonne capacity, facilities to receive fuel from road tankers and all associated pipe work, pumping and control equipment.

25 The IMO commissioned SKM to estimate fixed fuel costs, which was previously calculated by GHD Pty Ltd, with costs that reflect those in 2012. Based on SKM's estimates, escalated to 1 April 2015, the IMO has proposed a value of $7.069 million for fixed fuel costs.

26 This represents a 122 per cent increase compared to last year. The IMO notes in its final report that SKM has reviewed this estimate for the first time, based on the same scope as previous estimates provided by GHD. SKM has developed its estimate based on its recent project experience in WA. The IMO advised that the main driver of the significant increase is the inclusion of civil and structural costs[12] in SKM's estimate, which was not included last year. SKM's estimate was based

[9] See Western Power website, *Technical Rules web page*, http://www.westernpower.com.au/aboutus/accessArrangement/Technical_Rules.html

[10] In this context, Access Offers refer to transmission costs derived from capital contributions either paid historically or expected to be paid to Western Power in accordance with the *Electricity Networks Access Code 2004* and Western Power's Capital Contribution Policy, for generators that are capable of being gas or liquid fuelled. Facilities excluded from the Access Offers calculation are stipulated in section 2.4.1 of the Market Procedure.

[11] The connection transmission cost was $109,821 per MW in last year's review.

[12] Civil and structural works include: (a) fuel oil road tanker unloading and oil spill containment area; (b) bulk fuel oil storage tank foundations and concrete containment bund area; (c) fuel unloading and forwarding pump area foundations and spill containment area; (d) weather protection canopies or similar structures; and (e) miscellaneous equipment and piping supports and structures.

on a review of previous projects which included fixed fuel systems and allows for bund[13] forming complexity and sealing, and the costs associated with this are higher than installation of a simple ground slab due to the nature of the bund having equipment foundations, walls and other complex footings.

27 The Authority considers that the IMO, in adopting a value of $7.069 million for fixed fuel costs, has selected a value that reasonably reflects the application of the method and guiding principles described in clause 4.16 of the Market Rules and the MRCP Market Procedure.

Land costs

28 The MRCP Market Procedure states that the IMO must retain Landgate under a consultancy agreement to provide valuations on parcels of industrial land in regions within the SWIS where generation projects are most likely to be proposed.

29 The MRCP Market Procedure states that the IMO will provide an indication as to the size of land required, which should be limited to: a three hectare parcel of land in an industrial area of a standard size with consideration given to any requirements for a buffer zone in that specific location; and the summation of multiple smaller parcels of land as appropriate to meet these requirements.

30 The Authority notes that Landgate has provided its estimate of the cost of each land parcel as at 30 June 2012 excluding stamp duty, and that the IMO has added the applicable stamp duty to each land parcel cost as in last year's MRCP review. The Authority recognises that the inclusion of the stamp duty is not explicitly specified in the MRCP Market Procedure but considers that it is appropriate to include the stamp duty as part of the land costs calculation.

31 Pursuant to the MRCP Market Procedure, the IMO has calculated the mean of the land costs in the seven prescribed regions within the SWIS, and has escalated the land cost to 1 April 2015. The IMO has proposed a value of $2.694 million for land costs.

32 The Authority considers that the IMO, in adopting a value of $2.694 million for land costs, has selected a value that reasonably reflects the application of the method and guiding principles described in clause 4.16 of the Market Rules and the MRCP Market Procedure.

Fixed operating and maintenance costs

33 The MRCP Market Procedure states that:

- the IMO must determine fixed O&M costs for the power station and the associated transmission connection works;
- fixed O&M costs must also include fixed network access charges[14] and an estimate of annual insurance costs[15] as at 1 October in Year 3 of the Reserve

[13] The bund describes the overall fixed fuel oil unloading, storage and processing facility's oil spillage and equipment failure containment compounds and structures, including the main above ground storage tank compound.

[14] Which are to be provided by Western Power.

[15] The MRCP Market Procedure provides for power station asset replacement, business interruption and public and products liability insurance as required under network access arrangements with Western Power.

Capacity Cycle; and

- fixed O&M costs shall be converted into an annualised amount.

34 The IMO commissioned SKM to provide an estimate of fixed O&M costs for the power station and the associated transmission connection works.

35 The IMO has calculated the power station fixed O&M costs based on the annual generation fixed O&M costs determined by SKM which was converted to a present value using the Weighted Average Cost of Capital (**WACC**). This is escalated to 1 October 2015, providing an annualised value of $14,740.56 per MW per year.

36 The fixed O&M costs for transmission connection works include the switchyard and the transmission line O&M costs. The IMO has calculated the annual transmission connection works O&M costs determined by SKM and converted to a present value using the WACC. This is escalated to 1 October 2015, providing an annualised value of $425.15 per MW per year.

37 In regard to the fixed network access charge, the IMO has calculated the relevant charge from Western Power's published 2012/13 Price List. These charges are escalated to 1 October 2015 using the CPI in accordance with the MRCP Market Procedure, providing an annualised value of $13,687.07 per MW per year.

38 For the insurance cost in the fixed O&M costs, the IMO sought updated advice from three insurance brokers, including the same brokers that had previously provided quotations in last year's review. The insurance cost is escalated to 1 October 2015, providing an annualised value of $5,385.90 per MW per year.

39 The IMO received advice from one broker that premiums in respect of asset replacement and business interruption insurance had increased by a median of approximately 22.5 per cent, driven by recent adverse domestic claims experience in the area of electricity generation and an increase in re-insurance costs worldwide. The premium would be increased to 0.28 per cent of the limit of liability in 2012 as the premium in 2011 was 0.23 per cent of the limit of liability. This broker also suggested that public and products liability insurance premiums were at similar levels to last year. Another broker contacted by the IMO suggested a premium for asset replacement and business interruption insurance of 0.30 per cent of the limit of liability. Based on the advice, the IMO calculated asset replacement and business interruption insurance as 0.29 per cent of the limit of liability as at 1 April 2015.

40 The IMO increased the limit of liability to include the cost of fuel and has included an allowance of $20,000 to meet the cost of an annual insurance survey in its final report (in response to Merredin Energy's submission). The IMO consulted with two well-known insurance brokers on these issues and they confirmed that it is common practice for power station operators to insure liquid fuel stock at a predefined level. The same brokers confirmed that it was common industry practice for an annual site survey to be performed. The IMO considered it reasonable to include these extra costs.

41 Based on the cost estimates discussed above, the IMO has proposed a value for the total annualised fixed O&M costs of $34,239 per MW per year.

42 The Authority considers that the IMO, in adopting an annualised value of $34,239 per MW per year for fixed O&M costs, has adopted a value that reasonably reflects the application of the method and guiding principles described in

clause 4.16 of the Market Rules and the MRCP Market Procedure.

Weighted average cost of capital (WACC)

43 The MRCP Market Procedure states that the IMO must determine the cost of capital to be applied to various cost components of the MRCP. The MRCP Market Procedure sets out the parameters and a formula for calculating the WACC in real pre-tax terms. The WACC parameters are classified into two categories in the MRCP Market Procedure, i.e. the annual components and the five-yearly components.

44 The MRCP Market Procedure states that in determining the WACC, the IMO must review and determine values for the annual components; and may review and determine values for the five-yearly components that differ from those in step 2.9.8 of the procedure if, in the IMO's opinion, a significant economic event has occurred since undertaking the last five-yearly review of the MRCP in accordance with clause 4.16.9 of the Market Rules.

45 For the 2013 Reserve Capacity Cycle, the IMO commissioned PricewaterhouseCoopers (**PwC**) to calculate the Debt Risk Premium (**DRP**) and calculated the remaining WACC components itself.

46 The MRCP Market Procedure provides that, in determining the WACC, the IMO must determine the methodology to estimate the DRP which, in the opinion of the IMO, is consistent with current Australian accepted regulatory practice. For the 2014/15 MRCP the DRP was determined from the seven-year Bloomberg BBB fair value curve, extrapolated to ten years using the difference between the AAA seven-year and ten-year fair value curves. In June 2012 the Australian Competition Tribunal (**ACT**) upheld the "Bond-Yield Approach" methodology developed by the Authority. Consequently, the IMO considers that the Authority's 'Bond-Yield Approach' now represents current accepted regulatory practice in Australia, and PwC has applied this approach in determining the DRP.

47 In the IMO's final report on the MRCP for the 2015/16 Capacity Year, it calculated the DRP from BBB rated bonds only with a term to maturity of at least two years. The Authority considers that the IMO has determined the DRP in accordance with the MRCP Market Procedure.

48 The IMO invited members of the Market Advisory Committee and former members of the MRCP Working Group to a workshop on 1 November 2012 to discuss its proposed change in franking credit value (gamma). The franking credit value is a five-yearly component in the MRCP Market Procedure. The IMO proposed to amend the franking credit value used in the calculation of the WACC from 0.5 to 0.25. The IMO's reason for this change was that following a decision by the ACT in May 2011, both the Australian Energy Regulator and the Authority have regularly applied a franking credit value of 0.25 in regulatory decisions.

49 The IMO noted that there had not been any recent significant economic event to warrant a change in the five-yearly WACC components specified in the MRCP Market Procedure. The IMO also noted at the workshop that amendment to the five-yearly WACC components may be made through the Procedure Change Process, which includes public consultation.

50 On 12 November 2012, the IMO submitted a Procedure Change Proposal PC_2012_08 (Changes to Market Procedure for Determination of the MRCP). In

the Procedure Change Proposal, the IMO proposed to amend the franking credit value used in the calculation of the WACC from 0.5 to 0.25 to align with recent Australian regulatory practice. The IMO has followed the required steps in clause 2.10 of the Market Rules in processing the Procedure Change which came into effect on 15 January 2013.

51 The MRCP Market Procedure does not allow changing a five-yearly component unless, in the IMO's opinion, a significant economic event has occurred since undertaking the last five-yearly review of the MRCP. The Authority has concerns that rather than changing a five-yearly component according to the requirements under the MRCP Market Procedure, the IMO changed a five-yearly component through a Procedure Change Proposal. This is not consistent with providing continued confidence to investors that a five-yearly component will not change unless a significant economic event has occurred. In approving the IMO's proposed MRCP, the Authority notes its concerns over the manner in which the IMO has changed the MRCP Market Procedure.

52 The primary reason for the IMO to propose the change in franking credit value was the decision by the ACT in May 2011 to change the franking credit value to 0.25, and that both the Australian Energy Regulator and the Authority have applied a franking credit value of 0.25 in regulatory decisions since the ACT's decision. The IMO conducted the five-yearly methodology review and submitted the Procedure Change Proposal to revise the MRCP Market Procedure in September 2011, with the final report subsequently being published in October 2011. The Authority is of the view that the proposed change in franking credit value should have been reviewed as part of the IMO's five-yearly methodology review.

53 Pursuant to clause 2.26.3 of the Market Rules, the Authority must review the methodology for setting the MRCP no later than October 2013. The Authority will examine this matter regarding the appropriateness of the parameters for calculating the MRCP as part of this review.

54 The Authority considers that the IMO, in adopting a value of 5.95 per cent for the real pre-tax WACC, has adopted a value that reasonably reflects the application of the method and guiding principles described in clause 4.16 of the Market Rules and the MRCP Market Procedure, including the formulae for the calculation of the real pre-tax WACC set out in the MRCP Market Procedure.

Public consultation process

55 The IMO published a draft report in November 2012, which described how the IMO arrived at the proposed revised value for the MRCP and called for submissions by 19 December 2012. Rule Participants and other industry stakeholders were advised by the IMO that the draft report had been published. Announcements were also published in the Australian Financial Review newspaper and the West Australian newspaper on 22 November 2012. The draft report and supporting documents, including reports from SKM, PwC, Landgate and Western Power were published on the IMO's website.[16]

56 As part of the IMO's public consultation, the IMO conducted a workshop on 1 November 2012 to present the results of the review of WACC used in the MRCP for the 2015/16 Capacity Year.

[16] IMO website, *MRCP web page*, http://www.imowa.com.au/mrcp

57 The IMO received five submissions through the public consultation process on its draft report – from Alinta Energy, Community Electricity, Merredin Energy, Perth Energy and Verve Energy.

58 The IMO has summarised the comments it received from stakeholders and its responses to the comments in section 5 of the IMO's final report.

59 The Authority is satisfied with the public consultation process undertaken by the IMO. In the context of the application of the method and guiding principles described in clause 4.16 of the Market Rules and the MRCP Market Procedure, the Authority is of the opinion that the IMO has appropriately addressed the comments raised by stakeholders.

CONCLUSION

60 The Authority is satisfied that the IMO has met the requirements of the Market Rules in proposing the MRCP for the 2015/16 Capacity Year for the following reasons:

- the Authority is satisfied that the proposed values of all the input parameters reasonably reflect the application of the method and guiding principles described in clause 4.16 of the Market Rules;
- the Authority is satisfied that the application of the MRCP methodology reasonably reflects the application of the method and guiding principles described in clause 4.16 of the Market Rules; and
- the Authority is satisfied that the IMO has carried out an adequate public consultation process.

61 Based on the above assessment, the Authority approves the proposed revised value for the MRCP for the 2013 Reserve Capacity Cycle of $157,000 per MW per year, effective from 1 October 2015 to 1 October 2016.