

Decision on the Maximum Reserve Capacity price proposed by the Independent Market Operator for the 2016/17 Reserve Capacity Year

30 January 2014

Economic Regulation Authority

WESTERN AUSTRALIA

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DECISION

1. On 23 December 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 2016/17 Capacity Year.¹ The Authority approves the revised value for the MRCP for the 2016/17 Capacity Year of \$176,800 per MW, 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 for each Reserve Capacity Cycle. The IMO must propose a revised MRCP using the methodology described in the MRCP Market Procedure, and prepare a Draft Report describing how it has arrived at the proposed revised MRCP. Following a public consultation process, the IMO must propose a final MRCP to the Authority for approval.
4. Clause 2.26.1 of the Market Rules requires the Authority:
 - to review the 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 as to whether or not it has approved the revised value.

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/docs/default-source/rules/imo-wem-procedures-and-other-documents/pc_2012__08_final_amended_market_procedure__clean_.pdf?sfvrsn=2

5. The Authority notes that it published the *Review of methodology for setting the Maximum Reserve Capacity Price and the Energy Price Limits in the Wholesale Electricity Market* on 15 January 2014, as required under clause 2.26.3 of the Market Rules³. In that report the Authority recommended a number of changes to the methodology. However, for the purposes of this decision, as required under clause 2.26.1 of the Market Rules, the Authority is required to only consider whether the IMO's proposed value reflects the application of the existing methods and principles. Consequently the issues raised in the Authority's review are not considered in this decision.
6. Clause 2.26.2 of the Market Rules provides that, where the Authority rejects a revised 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

7. 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.
8. 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 and 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**).

Summary of input parameters and calculated values

9. The MRCP Market Procedure states that the IMO must use the following formulae to determine the MRCP.

$$\text{MRCP} = (\text{ANNUALISED_FIXED_O\&M}^4 + \text{ANNUALISED_CAP_COST}^5 / \text{CC}^6)$$

³ Review of methodology for setting the Maximum Reserve Capacity Price and the Energy Price Limits in the Wholesale Electricity Market, <http://www.erawa.com.au/cproot/12036/2/Review%20of%20methodology%20for%20setting%20the%20MRCP%20and%20the%20EPLs%20in%20the%20WEM.pdf>

⁴ Annualised fixed O&M cost is the annualised fixed operating and maintenance cost for a typical OCGT 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.

10. The value of CAPCOST must be calculated as:

$$\text{CAP_COST} = ((\text{PC}^7 \times (1+\text{M}^8) + \text{TC}^9) \times \text{CC} + \text{FFC}^{10} + \text{LC}^{11}) \times (1 + \text{WACC}^{12})^{1/2}$$

11. 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.

Table 1: Summary of input parameters and calculated values

	Value	Units	Market Procedure definition
Power station expected Capacity Credit allocation	150.5	MW	CC
Weighted Average Cost of Capital	7.01	%	WACC
Power station costs	878,792.83	\$/MW	PC
Factor for legal, financing, approvals, contingencies and other costs	20.10	%	M
Transmission connection works	141,910.00	\$/MW	TC
Fixed fuel costs	7,206,385.63	\$	FFC
Land costs	2,733,933.12	\$	LC
Total capital cost	196,690,722.71	\$	CAP_COST
Annualised capital cost	21,607,991.70	\$/year	ANNUALISED_CAP_COST
Annualised fixed O&M cost	33,238.01	\$/MW/year	ANNUALISED_FIXED_O&M
MRCP (rounded)	176,800.00	\$/MW/year	MRCP

12. The Authority has reviewed the IMO's Draft Report, the IMO's Final Report and the 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

⁵ Capcost is the total capital cost estimated for an OCGT power station. Annualised capcost is the total capital cost, expressed in Australian dollars, annualised over a 15 year period, using a Weighted Average Cost of Capital (WACC), as determined in step 2.9 of the MRCP Market Procedure.

⁶ CC is the expected Capacity Credit allocation determined in conjunction with power station costs in step 2.3.1(c) of the MRCP Market Procedure.

⁷ PC is the capital cost of an OCGT power station, expressed in Australian dollars per MW, as determined in step 2.3 of the MRCP Market Procedure for that location.

⁸ M is a margin to cover legal, approval, financing and other costs and contingencies as detailed in step 2.8 of the MRCP Market Procedure.

⁹ TC is the estimate of Total Transmission Costs as determined in step 2.4 of the MRCP Market Procedure.

¹⁰ FFC is the Fixed Fuel Cost as determined in step 2.6 of the MRCP Market Procedure.

¹¹ LC is the Land Cost as determined in step 2.7 of the MRCP Market Procedure.

¹² WACC is the Weighted Average Cost of Capital as determined in step 2.9 of the MRCP Market Procedure.

the MRCP, in order to assess that these reports reasonably reflect the application of the method and guiding principles described in clause 4.16 of the Market Rules.

13. The Authority is satisfied that the IMO has calculated 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.
14. In particular, the Authority notes that the IMO has calculated the MRCP using the formula set out in section 2.10.1 of the MRCP Market Procedure.

1.1 Power station costs (PC)

15. Section 2.1.1 of the MRCP Market Procedure states that the power station upon which the MRCP is based must:
 - be representative of an industry standard liquid-fuelled Open Cycle Gas Turbine (**OCGT**) power station;
 - have a nominal nameplate capacity of 160 MW prior to the addition of any inlet cooling system;
 - operate on distillate as its fuel source;
 - have a capacity factor of 2%;
 - include low Nitrous Oxide (NO_x) burners or associated technologies, as would be required to demonstrate good practice in power station development;
 - include an inlet air cooling system and water receiveal and storage facilities to allow 14 hours of continuous operation, where in the opinion of the IMO this would be cost effective; and
 - include the minimum level of equipment or systems required to satisfy the Balancing Facility Requirements.
16. 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.
17. The IMO commissioned Sinclair Knight Merz (**SKM**) to provide estimates of generation plant capital costs for a 160 MW OCGT power station located within the SWIS. Based on SKM's capital cost estimate, escalated forward to 1 April 2016 dollars as required by the MRCP Market Procedure, the IMO has proposed a value of \$878,792.83 per MW for the capital cost of an OCGT.
18. In its report, SKM notes that there is now only one gas turbine make/model in production that is rated in close proximity to the 160MW nominal nameplate

capacity required by the MRCP Market Procedure.¹³ As the nameplate capacity of this machine is 173 MW, SKM has scaled the capital cost and expected Capacity Credit allocation to better represent a nominal 160 MW generator.

19. The Authority notes that SKM has identified the components of the capital costs that are likely to be scalable with generator size and those components that are likely to be fixed, and has only adjusted the scalable costs in estimating the capital cost for a nominal 160 MW power station.
20. Given that the MRCP Market Procedure requires that the capital cost of the notional power station be based on a 160 MW industry standard liquid-fuelled OCGT power station with inlet cooling, located within the SWIS, the Authority considers the scaling approach by SKM to be a reasonable application of the MRCP Market Procedure.
21. The Authority considers that the IMO, in adopting a value of \$878,792.83 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.

1.2 Factor for legal, insurance, approvals, other costs and contingencies (margin M)

22. Step 2.8 of the MRCP Market Procedure states that the IMO must engage a consultant to determine the value of margin M, which shall constitute the following costs associated with the development of the power station project:
 - a) legal costs associated with the design and construction of the power station.
 - b) financing costs associated with equity raising.
 - c) insurance costs associated with the project development phase.
 - d) approval costs including environmental consultancies and approvals, and local, state and federal licensing, planning and approval costs.
 - a) other costs reasonably incurred in the design and management of the power station construction; and
 - b) contingency costs.
23. As has been the case in each of the last five years, the IMO commissioned SKM to provide an estimate of the above costs. SKM estimated these costs associated with recent comparable developments, excluding any abnormal costs that may be particular to individual projects. SKM has scaled the costs for a 160 MW power station where relevant. SKM proposed a margin of 19.35 per cent, which is added as a fixed percentage of the capital cost of developing the power station.
24. As a result of issues raised by Merredin Energy during the IMO's consultation on its Draft Report, the IMO increased its proposed margin to 20.10 per cent. Merredin Energy's submission noted that:
 - changes to the excise regime had resulted in the cost of diesel fuel increasing

¹³ The Siemens SGT5-2000E power station.

by 8.52 c/L; and

- the commissioning test duration had increased to account for more stringent testing requirements.
25. The Authority is of the view that matters raised by Merredin Energy are valid and the IMO has appropriately taken these into account when proposing the value for margin M.
26. The Authority considers that the IMO, in adopting a value of 20.10 per cent for margin M, 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.

1.3 Transmission connection works (TC)

27. Step 2.4 of the MRCP Market Procedure states that Western Power must provide an estimate of the total transmission costs, in accordance with the methodology to connect the generator and deliver the output to loads, consistent with the relevant planning criteria in the Technical Rules.¹⁴
28. The estimate of the transmission connection cost was provided by Western Power based on actual connection costs and Access Offers that have been determined by Western Power.¹⁵ The Transmission Connection Cost calculation uses actual connection costs for projects within a five-year window, and weights each connection cost according to the year that the facility commenced, or is expected to commence, operation.
29. For any year for which no project data is available, Western Power is required to estimate the shallow connection cost.¹⁶ Western Power reported no project data for the latest offer year and so has included its estimated shallow connection charge in the five year weighted average calculation, consistent with the MRCP Market Procedure. Western Power notes that the estimated shallow connection cost is higher than the actual capital contributions for facilities within the current five-year window.
30. In accordance with the requirement of the MRCP Market Procedure, Western Power has provided an audit report to the IMO verifying the connection cost data used in its calculation. Based on this, the IMO has proposed a value of \$141,910 per MW for transmission connection costs.
31. The Authority considers that the IMO, in adopting a value of \$141,910 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.

¹⁴ See Western Power website, *Technical Rules web page*, http://www.westernpower.com.au/aboutus/accessArrangement/Technical_Rules.html

¹⁵ 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.

¹⁶ Shallow connection cost refers to the cost that new generators have to pay that solely covers the direct infrastructure costs to connect their plant to the existing transmission system.

1.4 Fixed fuel costs (FFC)

32. Step 2.6 of 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, including foundations and spillage bund; facilities to receive fuel from road tankers; and all associated pipework, pumping and control equipment.
33. The IMO commissioned SKM to estimate the fixed fuel costs. SKM has developed its estimate based on its recent project experience in WA.
34. In its submission on the IMO's Draft Report, Merredin Energy pointed out that the net excise charges paid by generators should be included in the fuel cost component of the MRCP. SKM reviewed the recent changes to the excise regime and included an allowance for an increase of 8.52 c/L in its estimate.
35. The Authority acknowledges that the excise rebates have recently changed and generators are required to pay a portion of excise. The Authority is of the view that it is reasonable to include an allowance for excise in the fixed fuel costs estimate.
36. Based on SKM's estimates, escalated to 1 April 2016 as required by the MRCP Market Procedure, the IMO has proposed a value of \$7.206 million for fixed fuel costs. This is slightly higher than the 2013 value of \$7.069 million, with the main reason for the increase being the change in excise charges.
37. The Authority considers that the IMO, in adopting a value of \$7.206 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.

1.5 Land costs (LC)

38. The MRCP Market Procedure states that the IMO must retain Landgate under a consultancy agreement to provide valuations on parcels of industrial land. The regions in which the analysis is to be conducted will include:
 - a) Collie Region
 - b) Kemerton Industrial Park Region
 - c) Pinjar Region
 - d) Kwinana Region
 - e) North Country Region (Geraldton and Eneabba); and
 - f) Kalgoorlie Region
39. These areas represent the regions within the SWIS where generation projects are most likely to be proposed and should provide a broad cross-section of options. The IMO may include additional locations if it considers appropriate.

40. 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 (where the minimum land size is greater than three hectares, the minimum available land size shall be used); and
 - the summation of multiple smaller parcels of land, as appropriate to meet these requirements.
41. The Authority notes that three hectare sites were used for all locations except Kemerton, for which the smallest available lot is five hectares. This approach is identical to that used in the 2013 MRCP review. The Authority also notes that Landgate has provided its estimate of the cost of each land parcel as at 30 June 2013 excluding transfer duty, and that the IMO has added the applicable transfer duty to each land parcel cost, as in last year's MRCP review. The Authority recognises that the inclusion of the transfer duty is not explicitly specified in the MRCP Market Procedure but considers that it is appropriate to include the transfer duty as part of the land costs calculation, as has been the case in previous years.
42. Pursuant to the MRCP Market Procedure, the IMO has calculated the mean of the seven valuations, and has escalated the land cost to 1 April 2016 as required in the MRCP Market Procedure. The IMO has proposed a value of \$2.733 million for land costs. This price represents an increase of 1.4 per cent from the corresponding value for the 2013 MRCP, which is predominantly due to an increase in the estimated land costs at Pinjar and Kwinana.
43. The Authority considers that the IMO, in adopting a value of \$2.733 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.

1.6 Fixed operating and maintenance costs (Annualised fixed O&M)

44. 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 and/or ongoing charges, which are to be provided by Western Power; and
 - an estimate of annual insurance costs as at 1 October in Year 3 of the relevant Reserve Capacity Cycle, in respect of power station asset replacement, business interruption and public and products liability insurance, as required under network access arrangements with Western Power.
45. The IMO must determine the annualised fixed O&M costs in accordance with step 2.5 of the MRCP Market Procedure. The IMO may engage a consultant to assist in this process.
46. As in previous years, the IMO commissioned SKM to provide an estimate of fixed O&M costs for the power station and the associated transmission connection works. SKM used the same methodology as last year.

47. 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 2016, providing an annualised value of \$15,579.62 per MW per year.
48. The fixed O&M costs for transmission connection works include the switchyard and the transmission line O&M costs. The IMO has converted the annual transmission connection works O&M costs (determined by SKM) to a present value using the WACC. This is escalated to 1 October 2016, providing an annualised value of \$470.32 per MW per year.
49. The fixed network access charge is based on the relevant charge from Western Power's Price List. These charges are escalated to 1 October 2016 using the Consumer Price Index (**CPI**) in accordance with the MRCP Market Procedure, providing an annualised value of \$11,383.40 per MW per year.
50. The IMO sought updated advice from two insurance brokers who provided advice for last year's review. However, the IMO was not able to obtain any advice on insurance costs from these insurance brokers or engineering companies. As the IMO was not able to obtain any new advice on insurance costs, it has used the estimates obtained last year from brokers and escalated them by the CPI.
51. The insurance cost in the fixed O&M costs is escalated to 1 October 2016, providing an annualised value of \$5,804.67 per MW per year, compared with the 2013 value of \$5,385.90 per MW per year.
52. The Authority acknowledges the difficulty encountered by the IMO in obtaining advice on insurance cost estimates. It is of the view that the IMO, in adopting an estimate based on last year's review, has adopted a value that reasonably reflects the method and guiding principles described in the MRCP Market Procedure.
53. Based on the cost estimates discussed above, the IMO has proposed a value for the total annualised fixed O&M costs of \$33,238 per MW per year.
54. The Authority considers that the IMO, in adopting an annualised value of \$33,238 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.

1.7 Weighted average cost of capital (WACC)

55. Step 2.9 of 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.
56. The MRCP Market Procedure states that in determining the WACC, the IMO must review and determine values for the annual components. It may also 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.

57. The IMO commissioned PricewaterhouseCoopers (**PwC**) to calculate the Debt Risk Premium (**DRP**) and calculated the remaining WACC components from publicly available information.
58. The IMO has calculated the WACC according to the Capital Asset Pricing Model, with bond yields considered in both the costs of equity and debt. The nominal risk free rate is determined from observed yields of Commonwealth Government bonds, while the DRP is derived from observed yields of corporate bonds.
59. 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 MRCP, the IMO calculated the DRP using the bond-yield approach developed by the Authority, which is consistent with the 2013 MRCP. The Authority considers that this methodology represents current accepted Australian regulatory practice and hence, the IMO has determined the DRP in accordance with the MRCP Market Procedure.
60. The Authority has also examined the other annual WACC components determined by the IMO and considers these to be calculated in accordance with the MRCP Market Procedure.
61. The Authority notes that the IMO's last review of the five-yearly WACC components concluded in October 2011. The MRCP Market Procedure permits discretion to review the five-yearly WACC components if, in the IMO's opinion, a significant economic event has occurred since this review. Alinta Energy proposed that economic conditions continue to differ significantly from those that prevailed in 2011. The IMO cited various macroeconomic indicators such as Gross Domestic Product, the CPI, unemployment, the exchange rate and stock market index and concluded that no compelling evidence exists to suggest that a significant economic event has taken place since October 2011. The Authority considers this conclusion to be reasonable.
62. The Authority considers that the IMO, in adopting a value of 7.01 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.

Public consultation process

63. The IMO published a Draft Report in October 2013, which described how the IMO arrived at the proposed revised value for the MRCP and called for submissions by 27 November 2013. 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. The Draft Report and supporting documents, including reports from SKM, PwC, Landgate and Western Power were published on the IMO's website.¹⁷
64. The IMO received three submissions through the public consultation process on the Draft Report from Alinta Energy, Community Electricity and Merredin Energy.

¹⁷ IMO website, MRCP web page, <http://www.imowa.com.au/mrcp>

65. 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.
66. 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

67. The Authority is satisfied that the IMO has met the requirements of the Market Rules in proposing the MRCP for the 2016/17 Reserve Capacity Year for the following reasons:
 - the Authority is satisfied that the proposed revised value of the MRCP 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.
68. Based on the above assessment, the Authority approves the proposed revised value for the MRCP for the 2014 Reserve Capacity Cycle of \$176,800 per MW per year, effective from 1 October 2016 to 1 October 2017.