

Independent Market Operator Reserve Capacity Mechanism Working Group

Minutes

Meeting No.	1
Location:	IMO Boardroom Level 3, 197 St Georges Terrace, Perth
Date:	Wednesday 15 February 2012
Time:	Commencing at 1.00pm – 5.00pm

Attendees	
Allan Dawson	Chair
Suzanne Frame	IMO
Brendan Clarke	System Management
Andrew Sutherland	Market Generator
Ben Tan	Market Generator
Shane Cremin	Market Generator
Brad Huppatz	Market Generator (Verve Energy)
Corey Dykstra	Market Customer
Patrick Peake	Market Customer
Steve Gould	Market Customer
Stephen MacLean	Market Customer (Synergy)
Andrew Stevens	Market Customer/Generator
Jeff Renaud	Demand Side Management
Geoff Down	Contestable Customer
Paul Hynch	Observer (Office of Energy)
Wana Yang	Observer (Economic Regulation Authority)
Additional Attendees	
Aditi Varma	Minutes
Fiona Edmonds	Observer
Jenny Laidlaw	Observer
Greg Ruthven	Observer
Apologies	
Justin Payne	Contestable Customer

Item	Subject	Action
1.	<p>WELCOME AND APOLOGIES / ATTENDANCE</p> <p>The Chair opened the first meeting of the Reserve Capacity Mechanism (RCM) Working Group (RCMWG) at 1:05pm.</p> <p>The Chair welcomed the members in attendance and noted apologies received from Justin Payne prior to the meeting.</p> <p>The Chair noted that consideration, development and assessment of changes to address the issues associated with the RCM were an important piece of work to be completed in 2012. The Chair acknowledged the level of interest shown by industry.</p>	
2.	<p>HISTORY OF THE RCM</p> <p>The Chair invited Mr Brendan Clarke, Dr Steve Gould, Mr Stephen MacLean and Mr Patrick Peake to inform the group about the history and guiding principles of the development of the Reserve Capacity Mechanism (RCM).</p> <p>Mr Peake informed the group that the RCM was originally driven by concern over electricity outages that were a consequence of the gas shortages in early 2004. He noted that it was believed at the time that an energy-only market would not have reliably met peak demand which is highly weather-dependent in Western Australia. Mr Clarke added that there was a fear that the price volatility that exists in an energy-only market could not only limit investment but also increase retailer risk.</p> <p>Mr MacLean added that it was decided that a centralised approach for the capacity market would be adopted to make the capacity product more tradeable. Mr MacLean added that bilateral contracts already existed in the energy market and were extended to the new capacity market. Mr MacLean further informed the group that the market was based on an auction process and a capped approach on capacity. It was much later during that process that the criteria for allocating capacity credits and therefore capping total capacity in the market were removed.</p> <p>Mr MacLean informed the group that the first version of the Wholesale Electricity Market (WEM) Rules differs from what was ultimately approved. The market had been redesigned in the interim to align with Western Power being a vertically integrated entity. Dr Gould confirmed that there was a period of discontinuity between the original design proposal and the approval of the final design.</p> <p>Mr Corey Dykstra reiterated that market design had been influenced by the peak events of February 2004 and that there seemed to be a political inclination towards having excess capacity at that time to deal with the concern caused by such events. Dr Gould added that the Office of Energy introduced the excess capacity factor some time after the implementation of Wholesale Electricity Market Rules.</p> <p>The Chair quoted the IMO Chairman Mr John Kelly's views on the original design taskforce - "From very early on, there was no real</p>	

Item	Subject	Action
	<p>enthusiasm in the taskforce or the industry for a gross energy only market. High priority was placed on reliability and encouraging new plant investment. There was also a concern that price signals from an energy only market to incentivize the level of investment and reliability would have to be quite high. The small number of periods that would be affected implied that those high prices would not be palatable to various stakeholders". The Chair added that Mr Kelly's views were also that the Western Australian Electricity Market was not used to relying on private sector for investment and there was general unease around solely relying on energy market to incentivize this investment.</p> <p>The Chair further added Mr Kelly thought that the RCM had been successful. The RCM has been responsible for the capacity delivered in the market in recent years. Mr Kelly conveyed the Board's view that the processes surrounding the RCM were quite strong and there was confidence that capacity could be secured if required. The Board hoped to receive advice from the RCMWG to deal with present issues which had been identified.</p> <p>Mr MacLean briefly explained the original top-up and spill arrangements that were in place prior to market start. Dr Gould noted that the top-up and spill arrangements integrated quite well with the balancing market and the capacity market was in fact based on stand-by generation. The top-up and spill arrangement mapped very easily onto the new design.</p> <p>Mr Andrew Sutherland questioned if the IMO was concerned about the level of bilateral contracting to which the Chair replied that the rapid reduction in bilateral contracting in the market may signal that the regulated price of capacity may be overpriced. Mr Mike Thomas had also highlighted this concern. The Chair further added that the shift could also be driven by a change in strategy by Market Participants.</p> <p>Discussion ensued around auctions in capacity markets. Mr MacLean noted that price volatility was a concern for retailers as much as it was for generators.</p> <p>The Chair cited his concern that capacity auctions tend to result in a binary price, either close to zero or close to any price cap. Mr Thomas had highlighted this in his report. The Chair noted that having a regulated standard price ensured that technological innovation could enter the market whereas an auction-based market may not offer that. Mr MacLean suggested that the group should consider different auction approaches. Mr MacLean further explained the perverse consequence of an auction price of zero. Dr Gould agreed that perverse consequences also exist when retailers in the market try to game the market.</p> <p>There was further discussion about the adverse impacts of volatility in capacity prices, and the need for generators to have sufficient certainty to support long term investments. Mr MacLean and Mr Shane Cremin considered that capacity prices were less relevant to energy producing plant and more relevant to peaking plant.</p> <p>There was a discussion on the need to provide reliability at peak periods and on balancing political drivers against commercial drivers. Mr Dykstra noted that it was important to keep the objectives of the RCM in mind and that a solution based purely on economic efficiency</p>	

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	<p>may prove to not be implementable in practice.</p> <p>The Chair noted that the community seemed more accepting of load curtailment due to specific events such as hailstorms or bushfires, but not due to capacity shortfall on hot summer days. Mr Peake noted that it was even less palatable if shortfalls occur during the shoulder periods.</p> <p>Mr MacLean questioned the criteria used to plan for a 1-in-10 year peak demand event and ensuring reliability of supply. The Chair responded that the cost associated with not having enough capacity was significantly more than the cost associated with an extra unit of capacity. Mr Peake cited the Chamber of Commerce and Industry's work on significant economic losses that result due to power outages.</p> <p>Mr MacLean suggested that the group should consider reviewing the planning criteria for determining the Reserve Capacity Requirements as the IMO was not forming a separate group for that purpose. The Chair noted that the IMO would share the Scope of Work for that review with the RCMWG.</p> <p>Mr Peake and the Chair noted that the RCM is not just about costs, it also involved meeting market stakeholder expectations that have been built up over the years.</p> <p>There was a discussion around the competing nature of the Wholesale Electricity (WEM) Market Objectives. Mr Cremin noted that stakeholder expectations change over time. He cited the black outs in 2004 and shortages experienced in 2008 to note that the price must be dynamic and sensitive to stakeholder expectations. Mr Peake suggested that it might be useful to have a flexible Reserve Capacity Target.</p> <p>Mr MacLean noted that the discussions indicate the need to consider issues such as multiple prices for different types of capacity. Mr Cremin noted that the group should not get too focussed on differential capacity prices because they already exist to some degree as a result of the contractual nature of markets. Mr MacLean reiterated that Mr Thomas had also suggested that a dynamic capacity price should be considered in conjunction with a dynamic refund regime.</p>	
3.	<p>DEFINITION OF CAPACITY</p> <p>The Chair invited comments on the working definition of capacity provided in the IMO's paper.</p> <p>Mr Dykstra noted that the paper was useful but added that he was interested in assessing the characteristics of capacity in terms of what it provides to the market. The Chair proposed that the issue of differential characteristics of capacity should be dealt with after adequate consideration had been devoted to understanding what capacity actually is. He suggested that it was important as a first step to recognize the need to deal with capacity as a homogeneous product before its characteristics are discussed. Mr MacLean suggested that it would be important to consider both issues together because there was a danger of losing some level of economic efficiency if differential capacity prices were not considered. The Chair noted that there was also a risk of losing technological innovation by overly refining the price of capacity. Mr MacLean added that different approaches to defining capacity and its characteristics should be considered and that he would</p>	

Item	Subject	Action
	<p>put forth some examples for the group to consider as work progressed.</p> <p>Mr Cremin highlighted that homogeneity in the capacity market did not exist presently as the market dealt with capacity resources from differing sources differently. The challenge was to decide if the Market Rules should apply discount factors depending on the technological features of different capacity resources or should the market be allowed to set the price.</p> <p>Mr Andrew Stevens proposed a definition of capacity that differentiates generation and DSM resources. He suggested that DSM effectively reduced the level of peak demand which should ideally translate into cost savings as a reduced level of generation capacity would then be required to serve the potential reduced demand level. The Chair queried as to how the market would incentivize the DSM owners to reduce their demand to which Mr Stevens replied that differential capacity and energy payments should be made. Mr Jeff Renaud argued that Mr Stevens' point actually implied a higher price for DSM.</p> <p>Mr MacLean added that efficiency gains could be made by pricing DSM lower as it is used less frequently and has a lower fixed cost than generation capacity. Mr Dykstra clarified that the level of peak demand would technically remain the same regardless of whether DSM is dispatched as the system demands would not have changed.</p> <p>At this point there was a discussion on the availability of DSM for limited periods during the year. The Chair responded that going forward DSM would likely be dispatched more frequently if there were no operational impediments in doing so.</p> <p>The group discussed the value provided to the market by DSM. Mr MacLean observed that DSM provided a lower cost product to the market. Mr Tan highlighted that the market must price the product according to the value it delivers.</p> <p>At this point the Chair noted that while there was some merit to the point about limited availability of DSM, it was offset to some extent by the high level of reliability it provided.</p> <p>Mr Sutherland highlighted the difference between generators and DSM with regard to the penalties for non-performance. In support of his argument, he compared the magnitude of lost revenue for DSM with capacity refunds for generators in the event of non-performance. Mr Renaud highlighted that costs were irrelevant and attention must be paid to the value provided to the market by DSM.</p> <p>The Chair stressed that it was important to understand the difference between cost and value. Mr Cremin observed that the value propositions of different capacity resources were different. He gave an example of capacity offered by a baseload generator at all times versus capacity offered by DSM at peak times. Mr Sutherland believed that given different availability factors, it seemed that differential pricing would be the best way forward. The Chair considered that capacity resources should be remunerated at the same level because the product they provide is equivalent. Mr Cremin used the example of a gross energy pool market to make the point that in a market situation, retailers would use the cheapest option to hedge their risk. This implied that retailers would contract for DSM rather than a peaking generator</p>	

Item	Subject	Action
	<p>because the price would be applied differently. Mr MacLean agreed that such a price signal did not exist in the RCM. He further added that alternative approaches such as those offered by the New York- ISO capacity market should be evaluated with a degree of simplification.</p> <p>Mr Cremin concluded even if capacity was considered a homogeneous product, it was important to recognize that there is a misallocation of revenues to different technologies because of the absence of a market mechanism. Mr MacLean offered to present to the group different approaches to the treatment of this matter.</p> <p>Mr Stevens re-raised his point that peak demand should exclude the sum of the reductions that demand side options are willing to offer in the market at any time. The Chair brought the members' attention to the value of lost load and the significant cost of load-shedding to the economy. Mr Greg Ruthven also explained using an example that dispatched DSM capacity still constitutes demand though this demand has been served in a different manner.</p> <p>Mr Peake added that the capacity price worked as an insurance to cover the 1-in-10 year event peak demand forecast and it was possible that the value of that capacity would reduce significantly as the actual requirement became evident closer to the delivery year. This volatility in price would create risks for investment.</p> <p>Mr Dykstra focused members' attention on the definition provided in the paper and suggested that the group should begin by adopting a homogenised concept of capacity and then re-evaluating this definition at a later date.</p> <p>The Chair agreed with Mr Dykstra. The Chair asked if the members supported this approach and the members agreed.</p>	
4.	<p>ISSUES FOR CONSIDERATION / PRIORITISATION</p> <p>The Chair introduced various issues for prioritisation.</p> <p>The Chair noted that significant amount of work had already been done on the dynamic Reserve Capacity refund regime. The capacity refunds design that was recommended during the Market Evolution Project process would be presented for the group's consideration. Mr Sutherland, Mr MacLean and Mr Dykstra noted that there were certain issues with the design of the refund regime that should be revisited as the report did not address them adequately.</p> <p>On the impact of surplus capacity, Mr Dykstra suggested that a whole package of issues such as price volatility and investment uncertainty should be evaluated and not just price adjustments alone. The Chair added that since The Lantau Group report was completed, the Maximum Reserve Capacity Price (MRCP) had been determined and this price reduction should be taken into consideration. The Chair confirmed that Mr Thomas would be invited to revisit various recommendations.</p> <p>Discussion on the reasons for oversupply of capacity in the market ensued. Mr Cremin argued that the problem was not excess capacity itself but the manifestation of a number of factors that created the incentive for oversupply. He cited transmission costs, unconstrained network among other factors in support of his argument.</p>	

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	<p>The Chair agreed that the Reserve Capacity Price was a key issue particularly in last couple of years, driven by the calculation of the transmission connection cost in the MRCP. The Chair opined that the situation could have been quite different if say, large loads indeed connected before the Global Financial Crisis or DSM had not developed in the market. Mr Renaud argued that there is a finite opportunity for DSM to enter into a market. DSM providers in the market have not reacted to price signals but rather market opportunities. He suggested that in most international markets, DSM is generally at about 8-9% of total capacity.</p> <p>Mr MacLean noted that excess capacity was a problem because the price was not competitively set. He suggested that the discount factor that should create a price signal was too sluggish to limit over supply. There was a discussion among members on bilateral contracting and sensitivity of the MRCP.</p> <p>The Chair pointed out that Mr Thomas's suggestion that the MRCP is too high may be demonstrated by the fact that no one had incurred transmission costs that were included in previous MRCP determinations and inlet cooling for thermal generators had not previously been taken into account in MRCP determinations. He also added that The Lantau Group report did not take into account the new reduced MRCP. Mr Tan noted that the level of bilateral contracting was also reducing and the effect of pre-existing contracts was wearing off. Mr Cremin added that the capacity market was an artificial market. Mr Peake argued that in real terms, the total capacity was declining over the years. Mr Renaud added that excess capacity in the WEM included excess baseload generation capacity, not only DSM or peaking generation capacity. The Chair noted that external factors (e.g., renewable incentives) and not just market forces, acted as drivers for the situation of oversupply.</p> <p>The Chair asked if members were comfortable with the prioritisation of issues presented. The Chair confirmed that IMO will invite Mr Mike Thomas to present a paper on oversupply at the next meeting.</p> <p>Mr Tan asked for inclusion in this paper of a direct control mechanism by the IMO on the amount of capacity entering the market. Mr Brad Huppatz asked the data on bilaterally contracted capacity to be updated as the uncontracted proportion may have reduced since the previous results were presented.</p> <p>Mr Peake voiced two concerns around the effects of an excessive drop-off in the MRCP on investment certainty and potential gaming in the market because of the size of the single largest retailer.</p> <p>Mr Huppatz noted that keeping a discussion on the classification of Outages in the out-of-scope list would limit the amount of attention given to <u>should have been included as a part of the scope of the dynamic refund regime.</u> The Chair suggested that the IMO would be happy to share the recommendations of the Outage Planning Review. The Chair noted his encouragement for greater transparency around Outages in the market. Mr Andrew Sutherland queried if Supplementary Reserve Capacity (SRC) would be considered in the discussions. The Chair welcomed him to put it on the agenda as the group's work progressed. This was followed by a discussion on the creation of a SRC fund.</p> <p>Mr Sutherland asked if the MRCP methodology would be reviewed. The Chair confirmed that the MRCPWG will be reconstituted to review specifically, the determination of the Weighted Average Cost of Capital.</p>	

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	<p>He confirmed that this work would however, not affect the MRCP determination for this year.</p> <p>Mr MacLean queried if the scope of work for the forecasting methodology would be shared with this group. The Chair confirmed that it would.</p> <p><i>Action: The IMO to invite Mr Mike Thomas to the next meeting to present a paper on the oversupply of capacity and to include the requests of the members on a) a direct control mechanism by the IMO on the amount of capacity entering the market and b) updating data on bilateral contracting of capacity</i></p> <p><i>Action: The IMO to share scopes of work for the five-yearly review of the Planning Criterion and the IMO's forecasting processes</i></p>	
5	<p>PROPOSED RCMWG MEETING DATES 2012</p> <p>The IMO tabled proposed alternative RCMWG meeting dates to those distributed previously in the meeting papers, to ensure there was no overlap with the Gas Advisory Board's scheduled meetings. Working Group members were generally comfortable with the revised dates.</p> <p>Mr MacLean requested if meeting start times could be changed to 2.30pm. The Chair confirmed that the IMO will try to accommodate Mr MacLean's request.</p>	
6	<p>GENERAL BUSINESS</p> <p>No general business was discussed</p>	
7	<p>CLOSED</p> <p>The Chair thanked all members for attending and declared the meeting closed at 3.45pm.</p>	