

The background of the lower half of the page is a photograph of a wind farm and power lines, overlaid with a semi-transparent blue filter. On the left, several white wind turbines are visible, with their blades extending outwards. On the right, a tall, lattice-structured power line tower stands prominently. The overall scene is set against a clear sky.

Independent Market Operator

**Final Rule Change Report:
Annual Review of Margin Values**

Ref: RC_2010_01

Date: 25 June 2010

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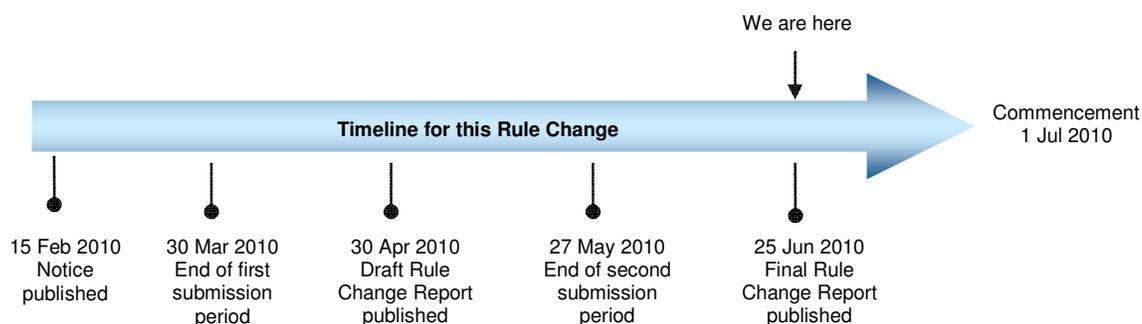
1. INTRODUCTION

On 12 February 2010 Verve Energy submitted a Rule Change Proposal regarding amendments to clause 3.13.3A of the Wholesale Electricity Market Rules (Market Rules).

The proposal was processed using the Standard Rule Change Process, described in section 2.7 of the Market Rules. The standard process adheres to the following timelines:



The key dates in processing this Rule Change Proposal are:



The IMO's final decision is to accept the Rule Change Proposal in a modified form. The detailed reasons for the IMO's decision are set out in section 7 of this report.

In making its final decision on the Rule Change Proposal, the IMO has taken into account:

- the Wholesale Market Objectives;
- the practicality and cost of implementing the proposal;
- the views of the Market Advisory Committee (MAC); and
- the submissions received.

All documents related to this Rule Change Proposal can be found on the IMO website: http://www.imowa.com.au/RC_2010_01

2. THE RULE CHANGE PROPOSAL

2.1 Submission Details

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Organisation:	Verve Energy
Address:	GPO Box F366, Perth WA 6841
Date submitted:	12 February 2010
Urgency:	Standard Rule Change Process
Change Proposal title:	Annual Review of Margin Values
Market Rule affected:	3.13.3A

2.2 Summary Details of the Proposal

Payments to both Verve Energy and independent providers for Ancillary Services are made in accordance with section 3.13 of the Market Rules. In particular, clause 3.13.1 includes an availability cost determined in accordance with clause 9.9.2, to which two key inputs are the parameters Margin_Peak and Margin_Off-Peak. Currently, the values for these parameters are determined for each three year Review Period, in accordance with clause 3.13.3A.

Verve Energy's Rule Change Proposal sought to amend the Market Rules so that the values for Margin_Peak and Margin_Off-Peak are reviewed annually rather than every three years. Verve Energy considered that this would allow for the margin values to be updated more frequently and therefore better reflect actual operating conditions.

Full details of the Rule Change Proposal are available in Appendix 1 of this report.

2.3 The Proposal and the Wholesale Market Objectives

Verve Energy submitted that the proposed Amending Rules will better achieve Wholesale Market Objectives (a) and (b) by ensuring the economically efficient, safe and reliable production and supply of electricity related services in the South West interconnected system (SWIS) through pricing that is reflective of current costs. Furthermore, Verve Energy considered that the proposed Amending Rules should encourage Market Participants to participate in the provision of electricity related services as the price signals will be reflective of current market conditions.

2.4 The Amending Rules Proposed by Verve Energy

The amendments to the Market Rules originally proposed by Verve Energy are available in the Rule Change Notice and presented in Appendix 2 of this report.

2.5 The IMO's Initial Assessment of the Proposal

The IMO decided to proceed with the proposal on the basis of its preliminary assessment, which indicated that the proposal was consistent with the Wholesale Market Objectives.

3. FIRST SUBMISSION PERIOD

The first submission period for this Rule Change Proposal was between 16 February 2010 and 30 March 2010.

3.1 *Submissions received*

The IMO received submissions from Alinta, Landfill Gas & Power (LGP), Perth Energy and Synergy. A copy of the full submissions received is available on the IMO website.

In summary, LGP, Perth Energy and Synergy all supported the Rule Change Proposal. They agreed that the proposed amendments better address Wholesale Market Objective (a) by making payments for Ancillary Services more cost reflective. Perth Energy and Synergy considered that the proposed amendments also better address Wholesale Market Objective (b).

However, Perth Energy noted that in an environment where these parameters are reset annually, and as such the volatility of Ancillary Services costs faced by Market Participants may potentially increase, it is essential that all generators who wish to offer Ancillary Services are able to do so.

Alinta did not support the Rule Change Proposal, although it expressed support for the general principle underlying it. In particular, Alinta stated that the proposed amendments appear both premature and unnecessary, given the proposed scope and timing of the work being undertaken by the Market Rules Design Team (Oates Review). Alinta considered that the proposed amendments are unlikely to meet Wholesale Market Objectives (a), (b) and (d).

3.2 *The IMO's response to submissions received during the first submission period*

During the first submission period a number of points were raised regarding the proposed amendments to the Market Rules. The IMO's response to each of the issues is presented in the table over the page:

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Clause	Submitter	Comment/Change Requested	IMO's response
3.13.3A	Alinta	<p>The first Oates Review Implementation Concept Paper identified a number of alternative market design options that were considered to better achieve the recommendations of the Oates Review relative to the current Market Rules, including broader participation in the provision of Ancillary Services.</p> <p>Given the IMO has indicated that a full detailed design is to be finalised by mid-2010, and that drafting of Amending Rules is to take place between July 2010 and September 2010, the amendments contemplated by this proposal appear both premature and unnecessary.</p> <p>This is even more so given that the ERA has only recently determined updated values for the coming Review Period. It appears unlikely that the amendments contemplated by this proposal would result in the ERA reviewing the values to apply for any year earlier than 2011/12.</p>	<p>Market changes arising from the work of the Market Rules Development Team (Oates Review) may affect the way in which participants are compensated for Ancillary Services. However, the Amending Rules proposed by Verve Energy should be progressed as they are not in conflict with the initial conclusions of the Working Group.</p> <p>Additionally, as outlined in section 5.1 of the Draft Rule Change Report, the Rule Change Proposal in its own right better addresses Wholesale Market Objectives (a) and (b) and is consistent with the remaining Wholesale Market Objectives.</p> <p>Alinta is correct in that the amendments contemplated by this proposal would not result in the ERA reviewing the values to apply for any year earlier than 2011/12.</p>
3.13.3A	Alinta	<p>Alinta suggested that the IMO cannot be satisfied that the proposal is consistent with the Wholesale Market Objectives, and in any event is likely to be inconsistent with the Wholesale Market Objectives.</p> <p>In particular, Alinta considers that the proposed amendments are unlikely to meet Wholesale Market Objectives (a), (b) and (d).</p>	<p>As outlined in section 5.1 of the Draft Rule Change Report, the proposed amendments are consistent with the Wholesale Market Objectives, and in particular will better address Market Objectives (a) and (b), by removing a barrier to broader participation in the provision of Ancillary Services. However, further changes may also be required to address other issues surrounding the provision of Ancillary Services.</p>
3.13.3A	Perth Energy	<p>In an environment where Ancillary Service peak parameters are reset annually and as such the volatility of Ancillary Services costs faced by Market Participants may potentially increase, it is essential that all generators who wish to offer such services are able to do so – providing themselves with an opportunity to hedge these costs in the marketplace.</p>	<p>The need for broader participation in the provision of Ancillary Services was raised as a key concern by the MAC as part of the Market Rules Evolution Plan and by the Oates Review. The IMO acknowledges Perth Energy's concerns and considers that they fall within the Terms of Reference of the Market Rules Design Team (Oates Review).</p>

3.3 Public Forums and Workshops

No public forums or workshops were held in relation to this Rule Change Proposal.

3.4 Additional Amendments to the Amending Rules

Following the first public submission period the IMO made some minor changes to the proposed Amending Rules to clarify that the values for Margin_Peak and Margin_Off-Peak will be determined for each Financial Year. These additional amendments are contained in Appendix 3 of this report.

4. THE IMO'S DRAFT ASSESSMENT

The IMO's draft assessment, against clauses 2.4.2 and 2.4.3 of the Market Rules, and analysis of the Rule Change Proposal can be viewed in the Draft Rule Change Report (available on the IMO's website).

5. THE IMO'S DRAFT DECISION

Based on the matters set out in the Draft Rule Change Report, the IMO's draft decision, in accordance with clause 2.7.7(f), was to accept the Rule Change Proposal as modified following the first submission period.

The IMO made its decision on the basis that the Amending Rules:

- will allow the Market Rules to better address Wholesale Market Objectives (a) and (b);
- are consistent with the remaining Wholesale Market Objectives;
- have the general support of the MAC members; and
- have the general support of the majority of submissions received during the first submission period.

6. SECOND SUBMISSION PERIOD

Following the publication of the Draft Rule Change Report on the IMO website, the second submission period was between 30 April 2010 and 27 May 2010.

6.1 Submissions received

The IMO received submissions from Alinta, LGP and Synergy. The full submissions are available on the IMO website.

In summary, LGP and Synergy support the Rule Change Proposal. While agreeing that the substance of the change may not be acted upon before being superseded by the outcomes of the Oates Review, LGP advocates the principle that efficient administration of market development should not be suspended on the basis of potential future initiatives. Further, LGP notes that the proposed change is simple to implement.

Synergy agrees that enabling the margin values to be updated more frequently will ensure that they better reflect actual operating conditions, resulting in more efficient market outcomes for both generators and consumers. Synergy agrees with the IMO that

the proposed changes will enable the Market Rules to better address Wholesale Market Objectives (a) and (b). Synergy suggests a minor enhancement to the proposed wording of the Amending Rules (refer to section 6.2 for details).

Alinta does not support the Rule Change Proposal. Alinta considers that the proposed amendments are inconsistent with Wholesale Market Objectives (a), (b) and (d), changing only the frequency with which the margin values are determined by the ERA, and not the manner in which Ancillary Services are priced or how Ancillary Services might be procured from providers other than Verve. Alinta considers that the proposed Amending Rules will continue to inhibit the broader provision of Ancillary Services and so will fail to promote Wholesale Market Objectives (a) and (b).

Alinta concludes that the increase in uncertainty generated by more frequent margin value reviews is likely to result in generators and retailers increasing the risk margin factored into wholesale and/or retail prices, a result not consistent with Wholesale Market Objective (d).

6.2 The IMO's response to submissions received during the second submission period

During the second submission period a number of points were raised regarding the proposed amendments to the Market Rules. The IMO's response to each of the issues is presented in the table over the page:

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Clause	Submitter	Comment/Change Requested	IMO's response
All	Alinta	Where pricing mechanisms are allowed to operate to set prices at cost reflective levels, the market for such services must be contestable to ensure that the price reflects the economically efficient cost of these services.	<p>There is general agreement that a competitive market will be necessary to achieve greater economic efficiency in the provision of Ancillary Services. The IMO considers that the proposed amendments align with this goal. The proposal seeks to improve the accuracy of the margin values used to calculate availability prices for Ancillary Services by increasing the frequency of their review. The IMO considers that this will result in more cost-reflective availability prices for Ancillary Services, making them more attractive to potential additional providers of Ancillary Services.</p> <p>Further amendments are expected to address other issues regarding increased competition in the provision of Ancillary Services, and it is possible that these may eventually supersede the amendments in this Rule Change Proposal. However, even while Verve Energy remains the supplier of Spinning Reserve Ancillary Services, the provision of these services at a cost-reflective price will ensure the correct prices signals are provided to both Verve Energy (as the supplier) and end users.</p>
All	Alinta	<p>The proposed amendments would not address any of the barriers to the broader provision of Ancillary Services that were identified by System Management's expressions of interest (EOI) process for the provision of load following Ancillary Services. These impediments were as follows:</p> <ol style="list-style-type: none"> 1. Lack of certainty surrounding the pricing mechanism given linkage to MCAP, which is unknown at the time non-Verve generators would be offering to provide the Ancillary Service. 2. Requirement for non-Verve generators to offer to provide Ancillary Services at a discount to this unknown price. 3. Upfront costs that would be incurred by some non-Verve generators for installing generation control devices (and uncertainty about the ability to recover these costs). 4. Physical and contractual ability of plant to at all times provide the minimum "blocks" of Ancillary Service specified in the EOI. 	<p>The IMO acknowledges the issues listed by Alinta, and considers that they fall within the scope of work of the Market Rules Design Team (Oates Review) and the additional work proposed by System Management regarding the future procurement on Load Following and Spinning Reserve Ancillary Services (contained in the 16 June 2010 MAC meeting papers). However, this Rule Change Proposal addresses the issue of margin values failing to adequately reflect current operating conditions, a problem which also contributes to uncertainty around Ancillary Services pricing and therefore inhibits the broader provision of Ancillary Services.</p>
All	Alinta	The proposed amendments change only the frequency with which the margin values are determined by the ERA, but do not change the manner in which Ancillary Services are priced, nor how Ancillary Services might be procured	<p>The proposed amendments do not seek to address any other issues identified in how Ancillary Services are either priced or procured. These issues fall under the scope of the Market Rules Design Team (Oates Review) and the additional work proposed by System Management regarding the</p>

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Clause	Submitter	Comment/Change Requested	IMO's response
		<p>from providers other than Verve. Alinta concludes that the proposed Amending Rules will continue to inhibit the broader provision of Ancillary Services. If Verve remains as the exclusive provider of Ancillary Services, the proposed amendments would simply result in more frequent adjustments to the quantum of the financial transfers between Verve and non-Verve Market Participants, and would not affect the economic efficiency, safety or reliability of the production or supply of electricity and electricity related services in the SWIS (Wholesale Objective (a)).</p>	<p>future procurement on Load Following and Spinning Reserve Ancillary Services (contained in the 16 June 2010 MAC meeting papers).</p> <p>While it is acknowledged that proposed amendments will affect only the frequency of margin value updates, the increased frequency of review will allow these parameters to better reflect actual operating conditions, resulting in prices for Ancillary Services that better reflect the true costs of providing the services. Cost reflectivity is an important step towards the efficient acquisition and provision of any service.</p> <p>As previously stated, it is expected that the changes will eventually help to encourage the entry of new competitors to the Spinning Reserve and Load Following Ancillary Services market. The IMO considers that even if Verve Energy was to remain the sole supplier of Spinning Reserve services, by making the prices more cost-reflective this would promote Market Objective (a).</p>
All	Alinta	<p>The IMO suggests that RC_2010_01 will ensure providers of Ancillary Services will be appropriately compensated for energy sales forgone and losses in generator efficiency resulting from backing off generation to provide Spinning Reserve. However, this conclusion would only hold if a generator was providing Ancillary Services consistently throughout the year, and if the actual MCAP was consistent with the forecast underpinning the ERA's determination of the values of the Margin_Peak and Margin_Off-Peak parameters.</p>	<p>In the Draft Rule Change Report the IMO considered that "by annually reviewing the margin values there will be greater certainty that both Verve Energy and independent providers will be appropriately compensated for energy sales forgone and losses in generator efficiency resulting from backing off generation to provide Spinning Reserve". This statement was not intended to suggest that the proposed amendments guarantee full compensation for all Ancillary Service providers under all circumstances. A number of factors will affect these outcomes, including the characteristics and actions of the provider, variations in MCAP and the accuracy of the forecasts used in the determination of the margin values. However, in determining the margin values it is anticipated that on average over the year a provider of Spinning Reserve and Load Following Ancillary Services would be compensated adequately for provision of those services.</p>
All	Alinta	<p>Given the Rule Change Proposal does not change the way in which Ancillary Services are priced, Alinta concludes that the Market Rules will continue to inhibit the broader provision of Ancillary Services. That is, there is no evidence to support a conclusion that the proposed amendments would encourage competition among generators and retailers in the SWIS, or that it would facilitate the efficient entry of new competitors (Wholesale Market Objective (b)).</p>	<p>As outlined above, the proposed amendments address one of the barriers inhibiting the broader provision of Spinning Reserve and Load Following Ancillary Services, and as such promote Wholesale Market Objective (b). However, the IMO acknowledges that further changes are also required, to address other issues surrounding the provision of Ancillary Services.</p>

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Clause	Submitter	Comment/Change Requested	IMO's response
All	Alinta	The increase in uncertainty generated by more frequent margin value reviews is likely to result in generators and retailers increasing the risk margin factored into wholesale and/or retail prices. That is, the available evidence suggests that RC_2010_01 will not minimise the long-term cost of electricity supplied to customers from the SWIS (Wholesale Market Objective (d)).	<p>While stability of Ancillary Services prices is desirable, this should not require Ancillary Service providers to provide their services at non cost-reflective prices. The IMO notes that the proposed annual review period for margin values is consistent with the review periods for other key pricing parameters in the WEM, for example the Energy Price Limits and Maximum Reserve Capacity Price.</p> <p>A final market design for the competitive provision of Ancillary Services is yet to be determined. This Rule Change Proposal may represent an initial step towards the eventual solution, in that cost-reflectivity is an important element of a competitive market. Alternatively, it may be a short-term measure that is superseded by the eventual solution. In either event, the IMO considers that the proposal is unlikely in itself to detrimentally affect the long-term cost of electricity supplied to customers from the SWIS.</p>
3.13.3A	Synergy	<p>Synergy suggests the following clarification (<u>added text</u>, deleted text):</p> <p>3.13.3A For each Financial Year, by 31 March of the year prior to the start of that Financial Year in which the <u>Financial Year commences</u>, the Economic Regulation Authority must determine values for the parameters Margin_Peak and Margin_Off-Peak, taking into account the Wholesale Market Objectives and in accordance with the following:</p>	The IMO agrees with Synergy's suggestion, and has updated both this paragraph and the first paragraph of clause 3.13.3A(a) in the proposed Amending Rules. Refer to section 6.3 for further details.

6.3 Additional amendments to the Amending Rules

Following the closure of the second submission period, the IMO made some additional changes to the proposed Amending Rules, in response to a suggestion made by Synergy. The purpose of the changes is to further clarify the timing of the key dates (31 March and 30 November) in clause 3.13.3A in relation to a Financial Year. The additional amendments are contained in Appendix 4 of this report.

7. THE IMO'S FINAL ASSESSMENT

In preparing its Final Rule Change Report, the IMO must assess the Rule Change Proposal in light of clauses 2.4.2 and 2.4.3 of the Market Rules.

Clause 2.4.2 outlines that the IMO “*must not make Amending Rules unless it is satisfied that the Market Rules, as proposed to be amended or replaced, are consistent with the Wholesale Market Objectives*”.

Additionally, clause 2.4.3 states, when deciding whether to make Amending Rules, the IMO must have regard to the following:

- Any applicable policy direction from the Minister regarding the development of the market;
- The practicality and cost of implementing the proposal;
- The views expressed in submissions and by the MAC; and
- Any technical studies that the IMO considers necessary to assist in assessing the Rule Change Proposal.

The IMO notes that there has not been any applicable policy direction from the Minister in respect of this Rule Change nor has it commissioned a technical review in respect of this Rule Change Proposal.

The IMO's assessment is outlined in the following sections.

7.1 Market Objectives

The IMO considers that the Market Rules as a whole, if amended, will be consistent with the Wholesale Market Objectives.

Wholesale Market Objective	Consistent with objective
(a) to promote the economically efficient, safe and reliable production and supply of electricity and electricity related services in the South West interconnected system	Yes
(b) to encourage competition among generators and retailers in the South West interconnected system, including by facilitating efficient entry of new competitors	Yes
(c) to avoid discrimination in that market against particular energy options and technologies, including sustainable energy options and technologies such as those that make use of renewable resources or that reduce overall greenhouse gas emissions	Yes
(d) to minimise the long-term cost of electricity supplied to customers from the South West interconnected system	Yes
(e) to encourage the taking of measures to manage the amount of electricity used and when it is used	Yes

Further, the IMO considers that the Market Rules if amended would not only be consistent with the Wholesale Market Objectives but also allow the Market Rules to better address Wholesale Market Objectives (a) and (b):

Impact	Wholesale Market Objectives
Allow the Market Rules to better address objective	a, b
Consistent with objective	c, d, e
Inconsistent with objective	-

- (a) *to promote the economically efficient, safe and reliable production and supply of electricity and electricity related services in the South West Interconnected System*

The IMO considers that the proposed Amending Rules will promote the economically efficient supply of electricity and electricity related services in the SWIS. The proposed changes will ensure that payments for Ancillary Services are more cost reflective, by ensuring that the values for Margin_Peak and Margin_Off-Peak better reflect current operating conditions. By removing one of the barriers to competition the changes should also help ensure continuing reliability in the SWIS, by potentially expanding the range of options available for the provision of Ancillary Services.

- (b) *to encourage competition among generators and retailers in the South West interconnected system, including by facilitating efficient entry of new competitors*

The IMO considers that the changes will better achieve Market Objective (b) by encouraging the entry of new competitors into the Ancillary Services market. In particular, by annually reviewing the margin values there will be greater certainty that both Verve Energy and independent providers will be appropriately compensated for energy sales forgone and losses in generator efficiency resulting from backing off generation to provide Spinning Reserve. The IMO considers the Rule Change removes one of the impediments to broader participation in the provision of Ancillary Services, although the IMO acknowledges the existence of other issues that may also need to be addressed to achieve this goal.

The IMO considers that the proposed changes are consistent with the remaining Market Objectives.

7.2 **Practicality and cost of implementation**

Cost: The proposed changes will impose additional costs on the IMO and the ERA, due the increased frequency of the reviews. The IMO's costs associated with an annual review are approximately \$30,000 for an external consultant plus 0.1 of an FTE on an annualised basis. The ERA has estimated its annual review costs at approximately \$5,000 for a technical consultant plus 0.07 of an FTE.

The proposed amendments do not require any change to the Wholesale Electricity Market Systems operated by the IMO or any of the systems operated by System Management. In addition there have been no identified changes to other Rule Participant's compliance costs.

Practicality: The IMO has not identified any issues with the practicality of implementing the proposed changes.

7.3 Views expressed in submissions

The IMO received submissions in support of the Rule Change Proposal from LGP and Synergy, in both the first and the second submission periods. They agreed that the proposed amendments better addressed Wholesale Market Objective (a), by making payments for Ancillary Services more cost-reflective. Synergy also considered that the proposed amendments better address Wholesale Market Objective (b). In its second submission, Synergy suggested a minor change to the drafting of the proposed amendments, which has been adopted by the IMO.

During the first submission period, the IMO also received a submission supporting the Rule Change Proposal from Perth Energy. Perth Energy considered that the proposed amendments better address Wholesale Market Objectives (a) and (b), but noted that in an environment where margin values are reset annually, and as such the costs faced by Market Participants may potentially increase, it is essential that all generators who wish to offer Ancillary Services are able to do so.

The IMO received submissions from Alinta in both submission periods. Neither submission supported the Rule Change Proposal. Alinta considered that the proposed amendments appeared to be both premature and unnecessary, given the proposed scope and timing of the work being undertaken by the Market Rules Design Team (Oates Review). Further, Alinta considered that the proposed amendments were inconsistent with Wholesale Market Objectives (a), (b) and (d).

7.4 Views expressed by the Market Advisory Committee

The MAC discussed the proposal at the 10 February 2010 MAC meeting and noted the proposal at the 10 March 2010, 12 May 2010 and 16 June 2010 meetings. An overview of the MAC discussion is presented below. Further details are available in the MAC meeting minutes available on the IMO website: <http://www.imowa.com.au/MAC>

February 2010 MAC meeting

Verve Energy presented the Pre Rule Change Discussion Paper to MAC members.

The IMO noted that following the 2009 margin value review annual compensation to Verve Energy for Spinning Reserve services is projected to increase from approximately \$15m to \$40m. The IMO considered that the quantum of this change supports a move towards more frequent review of margin values. Further, the IMO advised that its costs associated with an annual review are approximately \$30,000, which can currently be accommodated within the IMO's normal budgetary processes.

Alinta noted that in principle it has no issue with the Pre Rule Change Discussion Paper, but stated its preference would be for the issue to be set aside until the broader issues around Ancillary Services are resolved via the Oates Review. Alinta did not consider that there was any urgency in making the proposed changes and that the proposal could be revisited if required.

LGP noted that from an efficiency point of view the proposed changes may be negated by the broader outcomes of the Oates Review. However, LGP also noted the contra argument in that the outcomes of the Oates Review are largely unknown and, as Verve Energy had identified the impacts of less frequent review of the Margin Values as being significant, the Rule Change Proposal should proceed. In particular, LGP noted the uncertainty around the contribution of carbon tax is likely to have a large impact on the appropriateness of the margin values in future.

LGP noted the benefits of proceeding appear to outweigh the costs and the Rule Change Proposal, if implemented, would be relatively easy to administer.

Verve Energy was in agreement with LGP and stated that the uncertainty surrounding the introduction of a carbon reduction scheme was a significant issue for it. Further, Verve Energy noted that it considers that there is a risk to the Market if the margin values are not reviewed more frequently.

The ERA noted that a more comprehensive review of the provision of Ancillary Services may be required. Alinta agreed and noted that it considers there are some barriers to achieving a competitive Ancillary Service outcome at present.

It was noted that the Rule Change Proposal gives Verve Energy some comfort that it is appropriately recompensed using up to date values, which in turn minimises some of Verve Energy's risks.

The IMO noted that the proposed amendments send a positive signal to those interested stakeholders considering the financial impact on the Balancing generator. Additionally, the IMO considered that the amendment is important from a market integrity perspective.

The MAC supported the progression of the Rule Change Proposal.

8. THE IMO'S FINAL DECISION

Based on the matters set out in this report, the IMO's final decision, in accordance with clause 2.7.8 (e), is to accept the Rule Change Proposal as modified by the amendments outlined in sections 3.4 and 6.3 and specified in Appendices 3 and 4 of this report.

8.1 *Reasons for the Decision*

The IMO has made its decision on the basis that the Amending Rules:

- will allow the Market Rules to better address Wholesale Market Objectives (a) and (b);
- are consistent with the other Wholesale Market Objectives;
- have the general support of the MAC members; and
- have the general support of the majority of submissions received in the first and second submission periods.

Additional detail outlining the analysis behind the IMO's decision is outlined in section 7 of this Final Rule Change Report.

9. AMENDING RULES

9.1 *Commencement*

The amendments to the Market Rules resulting from this Rule Change Proposal will commence at **8.00am** on **1 July 2010**.

9.2 *Amending Rules*

The IMO's final decision is to amend the Market Rules. The following clauses are amended (~~deleted wording~~, new wording):

3.13.3A For each ~~Review Period~~ Financial Year, by 31 March ~~of the year in which the Review Period commences~~ prior to the start of that Financial Year, the Economic Regulation Authority must determine values for the parameters Margin_Peak and Margin_Off-Peak, taking into account the Wholesale Market Objectives and in accordance with the following:

- (a) by 30 November ~~of the year~~ prior to the start of the ~~Review Period~~ Financial Year, the IMO must submit a proposal for the ~~Review Period~~ Financial Year to the Economic Regulation Authority:
 - i. for the reserve availability payment margin applying for Peak Trading Intervals, Margin_Peak, the IMO must take account of:
 - 1. the margin the Electricity Generation Corporation could reasonably have been expected to earn on energy sales forgone due to the supply of Spinning Reserve during Peak Trading Intervals;
 - 2. the loss in efficiency of the Electricity Generation Corporation Registered Facilities that System Management has scheduled to provide Spinning Reserve during Peak Trading Intervals that could reasonably be expected due to the scheduling of those reserves;
 - ii. for the reserve availability payment margin applying for Off-Peak Trading Intervals, Margin_Off-Peak, the IMO must take account of:
 - 1. the margin the Electricity Generation Corporation could reasonably have been expected to earn on energy sales forgone due to the supply of Spinning Reserve during Off-Peak Trading Intervals;
 - 2. the loss in efficiency of the Electricity Generation Corporation Registered Facilities that System Management has scheduled to provide Spinning Reserve during Off-Peak Trading Intervals that could reasonably be expected due to the scheduling of those reserves;
- (b) the Economic Regulation Authority must undertake a public consultation process, which must include publishing an issues paper and issuing an invitation for public submissions.

APPENDIX 1: FULL DETAILS OF THE PROPOSAL

Background

Ancillary Services are used to guarantee the safe, secure and reliable supply of electricity on the SWIS by ensuring the system can adequately respond to real time changes in load and generation under a range of scenarios.

While Ancillary Services are required to support the WEM, they are not traded as part of the WEM. System Management has the responsibility of determining all Ancillary Services Requirements and procuring adequate quantities of these services, either from the Electricity Generation Corporation (Verve Energy) – the default option – or on a contestable basis from independent providers if they provide a lower cost option than Verve Energy's facilities.

Payments to both Verve Energy and independent providers for Ancillary Services are made by the IMO on behalf of System Management in accordance with clause 3.13.1 of the Market Rules. In particular, clause 3.13.1 includes an availability cost determined in accordance with clause 9.9.2, to which two key inputs are the Margin_Peak and Margin_Off-Peak parameters. These parameters reflect the payment margin, in peak and off-peak Trading Intervals, that, when multiplied by the volume of reserve provided and MCAP, will compensate Verve Energy for energy sales foregone and losses in generator efficiency resulting from backing off generation to provide Spinning Reserve. As clause 3.11.8 implies that any independent providers will have lower costs than Verve Energy, it is assumed that they would be adequately compensated by the margin values determined to compensate Verve Energy. Note that one of the matters for consideration identified by the Oates Review is the efficacy and costs and benefits of amending the Market Rules that allocate costs among participants, for example for ancillary services and the Balancing mechanism.

Currently the values to apply for the Margin_Peak and Margin_Off-Peak parameters are determined by the ERA for each three-year Review Period. In particular, clause 3.13.3A(a) of the Market Rules requires the IMO to submit to the ERA a proposal containing the reserve availability payment margin for both Peak and Off-Peak Trading Intervals. This proposal must be provided by 30 November of the year prior to the start of the Review Period. The ERA will undertake public consultation on the values as part of its determination of Allowable Revenue for the relevant Review Period. Following the conclusion of the public consultation process, the ERA will make a determination whether to approve the margin values to apply for the next Review Period.

Issue

There are a number of assumptions that are used in proposing the Margin Peak and Margin Off-Peak parameters and as such the market conditions on which these plant and fuel assumptions are based can change dramatically over a three-year period. The more time elapses, the more likely it is that changes will occur. Therefore the degree of confidence in an assumption for year three will be much lower than for year one. High margins of error associated with the input variables used in determining the Margin_Peak and Margin_Off-Peak parameters will reduce the appropriateness of these values in compensating Verve Energy and any independent suppliers of Ancillary Services.

With regard to the review of the margin values undertaken in 2009, McLennan Magasanik Associates (MMA)¹ assumed that Bluewaters 3 would be operational by

¹MMA was engaged by the IMO to assist in determining the appropriate margin values to apply for the next Review Period commencing 1 July 2010,

September 2012. The uncertainty surrounding this assumption increased the margin of error of the values determined by MMA. This is because at the time of undertaking the 2009 review it was uncertain whether Bluewaters 3 would enter the market by September 2012 or may delay its entry. This issue with assumptions around the entry of new plant is true of all new entrants. In addition, further assumptions around the type of plant that would be available for a Capacity Year in advance would also be likely to affect the determination of the margin values.

Additionally, MMA noted in its report that carbon price assumptions to apply in determining the margin values can be made only with considerable uncertainty regarding the start date of any adopted scheme and the price in subsequent years. If a scheme that differed from the one assumed by MMA – a 5% reduction target and a maximum introductory price of \$10/tCO₂e – were to be implemented early in the Review Period, then the margin values to apply in the final years would be based on assumptions that would probably be incorrect by that time, and would not correctly compensate Verve Energy and other independent providers.

The assumptions relating to the gas prices for the three year Review Period are likely to result in the largest potential margin of error associated with the determined margin values. This is due to the large level of volatility associated with fuel prices in the WEM, as evidenced during the consultation periods for the reviews of both the margin values and the Energy Price Limits during 2009. Verve Energy notes that the IMO will be undertaking a more thorough review of the gas prices in the WEM, which will feed into the Energy Price Limits review for 2010. Verve Energy considers that the outcomes of this review should also feed into the margin values process.

For further details of the assumptions made by MMA in undertaking its review of the margin values during 2009, please refer to MMA's Assumptions and Methodology Report available on the following webpage: <http://www.imowa.com.au/Fuel-Price-Assumptions-2009>

Proposal

To allow for the margin values to be updated more frequently and therefore better reflect actual operating conditions, Verve Energy proposed that the review of margin values be conducted annually.

APPENDIX 2: PROPOSED AMENDING RULES IN THE RULE CHANGE PROPOSAL

Verve Energy proposed the following amendments to the Market Rules in its Rule Change Proposal (~~deleted text~~, added text):

3.13.3A ~~For each Review Period, by 31 March of the year in which the Review Period commences, the~~ The Economic Regulation Authority must annually determine values for the parameters Margin_Peak and Margin_Off-Peak, taking into account the Wholesale Market Objectives and in accordance with the following:

- (a) ~~by 30 November of the~~ each year ~~prior to the start of the Review Period,~~ the IMO must submit a proposal ~~for the Review Period~~ to the Economic Regulation Authority:
 - i. for the reserve availability payment margin applying for Peak Trading Intervals, Margin_Peak, the IMO must take account of:
 - 1. the margin the Electricity Generation Corporation could reasonably have been expected to earn on energy sales forgone due to the supply of Spinning Reserve during Peak Trading Intervals;
 - 2. the loss in efficiency of the Electricity Generation Corporation Registered Facilities that System Management has scheduled to provide Spinning Reserve during Peak Trading Intervals that could reasonably be expected due to the scheduling of those reserves;
 - ii. for the reserve availability payment margin applying for Off-Peak Trading Intervals, Margin_Off-Peak, the IMO must take account of:
 - 1. the margin the Electricity Generation Corporation could reasonably have been expected to earn on energy sales forgone due to the supply of Spinning Reserve during Off-Peak Trading Intervals;
 - 2. the loss in efficiency of the Electricity Generation Corporation Registered Facilities that System Management has scheduled to provide Spinning Reserve during Off-Peak Trading Intervals that could reasonably be expected due to the scheduling of those reserves;
- (b) the Economic Regulation Authority must undertake a public consultation process, which must include publishing an issues paper and issuing an invitation for public submissions.

APPENDIX 3: ADDITIONAL AMENDMENTS MADE BY THE IMO FOLLOWING THE FIRST SUBMISSION PERIOD

The IMO made some amendments to the Amending Rules following the first submission period, to clarify that the values for Margin_Peak and Margin_Off-Peak will be determined for each financial year. These changes are as follows (~~deleted text~~, added text):

3.13.3A For each Financial Year, by 31 March of the year in which the Financial Year commences, the ~~The~~ Economic Regulation Authority must ~~annually~~ determine values for the parameters Margin_Peak and Margin_Off-Peak, taking into account the Wholesale Market Objectives and in accordance with the following:

- (a) by 30 November of the each year prior to the start of the Financial Year, the IMO must submit a proposal for the Financial Year to the Economic Regulation Authority:
 - i. for the reserve availability payment margin applying for Peak Trading Intervals, Margin_Peak, the IMO must take account of:
 - 1. the margin the Electricity Generation Corporation could reasonably have been expected to earn on energy sales forgone due to the supply of Spinning Reserve during Peak Trading Intervals;
 - 2. the loss in efficiency of the Electricity Generation Corporation Registered Facilities that System Management has scheduled to provide Spinning Reserve during Peak Trading Intervals that could reasonably be expected due to the scheduling of those reserves;
 - ii. for the reserve availability payment margin applying for Off-Peak Trading Intervals, Margin_Off-Peak, the IMO must take account of:
 - 1. the margin the Electricity Generation Corporation could reasonably have been expected to earn on energy sales forgone due to the supply of Spinning Reserve during Off-Peak Trading Intervals;
 - 2. the loss in efficiency of the Electricity Generation Corporation Registered Facilities that System Management has scheduled to provide Spinning Reserve during Off-Peak Trading Intervals that could reasonably be expected due to the scheduling of those reserves;
- (b) the Economic Regulation Authority must undertake a public consultation process, which must include publishing an issues paper and issuing an invitation for public submissions.

APPENDIX 4: ADDITIONAL AMENDMENTS MADE BY THE IMO FOLLOWING THE SECOND SUBMISSION PERIOD

The IMO made additional amendments to the Amending Rules following the second submission period, to clarify the timing of the key dates (31 March and 30 November) in clause 3.13.3A in relation to a Financial Year. These changes are as follows (~~deleted text~~, added text):

- 3.13.3A For each Financial Year, by 31 March ~~of the year in which the Financial Year commences~~ prior to the start of that Financial Year, the Economic Regulation Authority must determine values for the parameters Margin_Peak and Margin_Off-Peak, taking into account the Wholesale Market Objectives and in accordance with the following:
- (a) by 30 November ~~of the year~~ prior to the start of the Financial Year, the IMO must submit a proposal for the Financial Year to the Economic Regulation Authority:
 - i. for the reserve availability payment margin applying for Peak Trading Intervals, Margin_Peak, the IMO must take account of:
 - 1. the margin the Electricity Generation Corporation could reasonably have been expected to earn on energy sales forgone due to the supply of Spinning Reserve during Peak Trading Intervals;
 - 2. the loss in efficiency of the Electricity Generation Corporation Registered Facilities that System Management has scheduled to provide Spinning Reserve during Peak Trading Intervals that could reasonably be expected due to the scheduling of those reserves;
 - ii. for the reserve availability payment margin applying for Off-Peak Trading Intervals, Margin_Off-Peak, the IMO must take account of:
 - 1. the margin the Electricity Generation Corporation could reasonably have been expected to earn on energy sales forgone due to the supply of Spinning Reserve during Off-Peak Trading Intervals;
 - 2. the loss in efficiency of the Electricity Generation Corporation Registered Facilities that System Management has scheduled to provide Spinning Reserve during Off-Peak Trading Intervals that could reasonably be expected due to the scheduling of those reserves;
 - (b) the Economic Regulation Authority must undertake a public consultation process, which must include publishing an issues paper and issuing an invitation for public submissions.