Independent Market Operator

Independent Market Operator

Final Market Rule Change Report

Title: Funding of SRC in the event of Capacity Credit cancellation

Ref: RC_2008_34

Date: 26 June 2009

Contents

1. INTRODUCTION 4
2. THE RULE CHANGE PROPOSAL 5
2.1 Submission Details 5
2.2 Details of the Proposal 5
2.3 The Proposal and the Wholesale Market Objectives 6
2.4 The Amending Rules Proposed by the IMO 6
2.5 The IMO's Initial Assessment of the Proposal 8
3. FIRST SUBMISSION PERIOD 8
3.1 Submissions received 8
3.1.1 Submission from Alinta 8
3.1.2 Submission from Griffin 10
3.1.3 Submission from Landfill Gas & Power 11
3.1.4 Submission from Synergy 11
3.1.5 Submission from Verve Energy 12
3.2 Public Forums and Workshops 13
3.3 Technical Study 13
3.4 Additional Amendments 14
4. THE IMO'S DRAFT ASSESSMENT 16
5. THE IMO'S DRAFT DECISION 16
5.1 Reasons for the decision 17
6. SECOND SUBMISSION PERIOD 17
6.1 Addendum to Amending Rules 17
6.2 Public Forums and Workshops 18
6.3 Submissions received 19
6.3.1 Submission from Alinta 20
6.3.1.1 IMO's response to Alinta's submission 22
6.3.2 Submission from ANZ Infrastructure Services 22
6.3.3 Submission from ATCO Power 23
6.3.4 Submission from Aviva Corporation 24
6.3.5 Submission from Chamber of Commerce and Industry of Western Australia 24
6.3.6 Submission from Griffin Energy 25
6.3.7 Submission from Landfill Gas & Power 27
6.3.8 Submission from NewGen Power 27
6.3.9 Submission from Newmont Power and NP Kalgoorlie Pty Ltd 29
6.3.10 Submission from NP Power and RPV Developments 30
6.3.11 Submission from Perth Energy 31
6.3.12 Submission from Synergy 32
6.3.13 Submission from TransAlta Power 32
6.3.14 Submission from Verve Energy 33
7. THE IMO'S FINAL ASSESSMENT 34
7.1 Market Objectives 34
7.2 Practicality and cost of implementation 35
7.3 Views expressed in submissions and the public workshop 35
7.3.1 First submission period 35
7.3.2 Second submission period 36
7.4 Views expressed by the Market Advisory Committee 37
7.5 Technical Reviews 37

8. THE IMO'S FINAL DECISION..37
9. AMENDING RULES..38
10. GENERAL INFORMATION ABOUT RULE CHANGE PROPOSALS............................39

DOCUMENT DETAILS

IMO Notice No.:	RC_2008_34
Report Title:	Funding of SRC in the event of Capacity Credit cancellation
Release Status:	Public
Confidentiality Status:	Public domain

Published in accordance with Market Rule 2.7.8

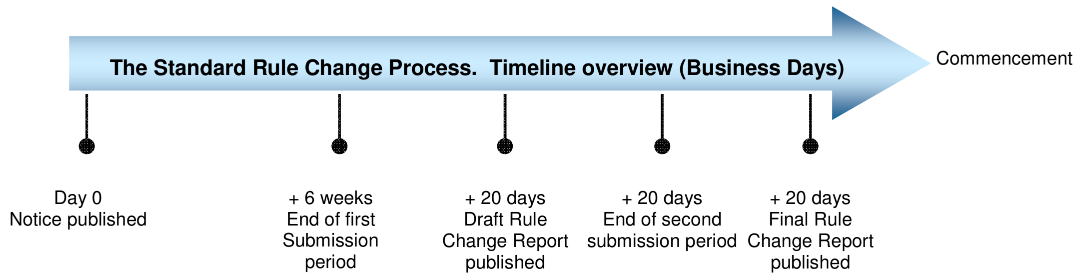
Independent Market Operator
Level 3, Governor Stirling Tower
197 St George's Terrace, Perth WA 6000
PO Box 7096, Cloisters Square, Perth WA 6850
Tel. (08) 9254 4300
Fax. (08) 9254 4399
Website: www.imowa.com.au

1. INTRODUCTION

On 2 October 2008 the Independent Market Operator (IMO) submitted a Rule Change Proposal regarding the amendment of clause 4.28.4 and the addition of new clauses 4.28.4A, 4.28.4B and 4.28.4C to the Wholesale Electricity Market Rules (Market Rules).

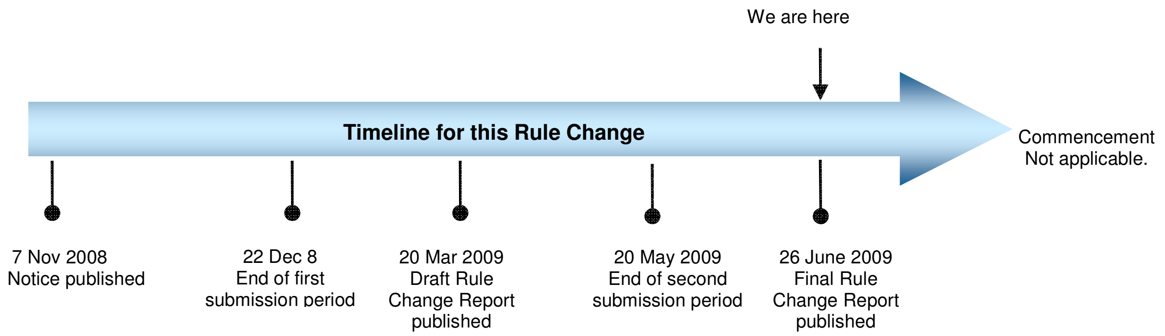
This Proposal is being processed using the Standard Rule Change Process, described in section 2.7 of the Market Rules.

The standard process adheres to the following timelines:



In accordance with clause 2.5.10 of the Market Rules the IMO extended the timeframes to prepare and publish the draft report and for the second submission period of this Rule Change Proposal. Extension notices, under clause 2.5.12, were published on the IMO website.

The key dates in processing this Rule Change Proposal, as amended in the extension notices, are:



The IMO's final decision is to reject the Rule Change Proposal. 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;
- practicality and cost of implementing the proposal;
- views of the Market Advisory Committee (MAC);

- results of the two technical studies commissioned regarding this Rule Change Proposal; and
- submissions received in both the first and second submission periods.

This Final Rule Change Report has been prepared by the IMO in accordance with clause 2.7.8 of the Market Rules.

2. THE RULE CHANGE PROPOSAL

2.1 Submission Details

Name:	Alan Dawson
Phone:	+61 8 9254 4300
Fax:	+61 8 9254 4399
Email:	imo@imowa.com.au
Organisation:	Independent Market Operator
Address:	Level 3, Governor Stirling Tower, 197 St George's Terrace
Date submitted:	2 October 2008
Urgency:	High
Change Proposal title:	Funding of SRC in the event of Capacity Credit cancellation

2.2 Details of the Proposal

On 1 January 2009 RC_2008_27: Funding of Supplementary Reserve Capacity was implemented. This rule change removed the net payments to be made by the IMO under Supplementary Capacity Contracts from the Targeted Reserve Capacity Cost and included it as a component in the Shared Reserve Capacity Cost (SRCC).

The SRCC is the cost of Reserve Capacity to be shared amongst all Market Customers for the Trading Month. With the implementation of RC_2008_27 SRCC encapsulates the cost for funding Supplementary Capacity Contracts, that is, the cost for funding Supplementary Reserve Capacity (SRC).

The SRC Working Group (Working Group), which held its final meeting on 22 September 2008, resolved that additional changes needed to be implemented to the funding of Supplementary Capacity Contracts to address the objectives of the Market Rules.

The majority view of the Working Group was that if a Market Participant has its Capacity Credits reduced, which results in a shortfall and SRC is called, the cost of SRC should be targeted at the Market Participant that caused the shortfall. That is, the Market Participant should pay to the IMO compensation due to Capacity Credits not being available to the market (see proposed insertion of clause 4.28.4(aA)(ii)).

The proposed new clause 4.28.4A stipulates how much a Market Participant must pay the IMO where the number of Capacity Credits held by that Market Participant for a Facility has been reduced and caused the need for SRC. Proposed clause 4.28.4A(a) specified that the amount to be paid must equal the cost of funding Supplementary Capacity Contracts for the capacity shortfall stemming solely from the unavailability of the Market Participant's Capacity Credits. Proposed clause 4.28.4A(b) limited the amount to the total value of Capacity Credit payments that would have been associated with the reduced Capacity Credits.

In addition, the Working Group resolved that a Market Participant holding Capacity Credits for a facility undergoing an extended Forced Outage should also recompense the market by an amount equal to the cost of funding Supplementary Capacity Contracts associated with a capacity shortfall brought on by the extended Forced Outage (see insertion of clause 4.28.4B(a)).

This would also include new Facilities which are not fully commissioned by 30 November of the Relevant Capacity Year and thus experience an extended Forced Outage until properly commissioned.

Proposed clause 4.28.4B(b) limited this amount to half of the total value of Capacity Credit payments associated with the capacity experiencing the delay or the Forced Outage.

In the case where a number of factors have contributed to a capacity shortfall, proposed new clause 4.28.4C would require the IMO to proportion the total cost of funding the Supplementary Capacity Contracts in such a way that each relevant Market Participant only pays the portion which is attributable to its capacity being unavailable to the market.

2.3 The Proposal and the Wholesale Market Objectives

In the Rule Change Proposal the IMO submitted that this rule change would better address market objective (a).

(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 submitted that the proposal supported this objective by promoting the economically efficient and reliable supply of electricity in the South West interconnected system (SWIS). This will be achieved by ensuring that:

- the cost of SRC is targeted at the participant that causes that cost, which is the participant that can best manage the risk of capacity not being available to the market when required; and

- the reliability of electricity supply is maintained by providing strong incentives for participants to apply for realistic Capacity Credit levels and commissioning schedules as part of certification applications.

2.4 The Amending Rules Proposed by the IMO

The IMO proposed the following amendments to the Market Rules (~~deleted text~~, <u>added text</u>):

4.28.4. For each Trading Month, the IMO must calculate a Shared Reserve Capacity Cost being the sum of:

(a) the cost defined under clause 4.28.1(b); and

(aA) the net payments to be made by the IMO under Supplementary Capacity Contracts less:

(i) any amount drawn under a Reserve Capacity Security by the IMO and distributed in accordance with clause 4.13.11(a); less

(ii) any amount paid to the IMO in accordance with clause 4.28.4B; less

(b) the Capacity Cost Refunds for that Trading Month; less

(bA) the Intermittent Load Refunds for that Trading Month; less

(c) any amount drawn under a Reserve Capacity Security by the IMO and distributed in accordance with clause 4.13.11(b)

and the IMO must allocate this total cost to Market Customers in proportion to each Market Customer's Individual Reserve Capacity Requirement.

4.28.4A. Where the number of Capacity Credits held by a Market Participant for a Facility have been reduced in accordance with clause 4.25.4 or 4.25.4C, the Market Participant must pay to the IMO, as compensation to the market, an amount:

(a) equal to the cost of funding Supplementary Capacity Contracts for any capacity shortfall stemming entirely from the reduced Capacity Credits not being available to the market; and

(b) not greater than the total value of the Capacity Credit payments associated with the reduced Capacity Credits that would have been paid to the relevant Market Participant for the 12 Trading Months commencing at the start of the Trading Day of the most recent 1 October, assuming the IMO acquires all of these Capacity Credits and the cost of each Capacity Credit so acquired is determined in accordance with clause 4.28.2(d).

4.28.4B. Where a Facility, including a new Facility, suffers an extended Forced Outage, the Market Participant holding Capacity Credits for that Facility must pay to the IMO, as compensation to the market, an amount:

(a) equal to the cost of funding Supplementary Capacity Contracts for any capacity shortfall stemming entirely from the capacity suffering the Forced Outage not being available to the market; and

(b) not greater than half of the total value of the Capacity Credit payments associated with the capacity experiencing the Forced Outage that are due to the relevant Market Participant for the 12 Trading Months commencing at the start of the Trading Day of the most recent 1 October, assuming the IMO acquires all of these Capacity Credits and the cost of each Capacity Credit so acquired is determined in accordance with clause 4.28.2(d).

4.28.4C. For the purpose of clauses 4.28.4A and 4.28.4B, where there are a number of factors contributing to the expected amount of a shortfall determined in accordance with clause 4.24.1, the IMO must proportion the total cost of funding Supplementary Capacity Contracts (acquired by the IMO to address the shortfall) so that the amount paid by the Market Participant under clause 4.28.4A or 4.28.4B offsets only that portion of the total cost stemming entirely from the relevant capacity not being available.

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. This preliminary assessment was published in the Rule Change Notice on 7 November 2008.

3. FIRST SUBMISSION PERIOD

The first submission period for this Rule Change Proposal was between 10 November 2008 and 22 December 2008.

3.1 Submissions received

The IMO received five submissions on the Rule Change Proposal from:

- Alinta;
- Griffin Energy (Griffin);
- Landfill Gas & Power (LGP);
- Synergy; and
- Verve Energy (Verve).

The full text of each submission is available on the IMO website: http://www.imowa.com.au/Attachments/RuleChange/RuleChange_2008_34.html.

3.1.1 Submission from Alinta

Alinta supported the point of the amendments to the Market Rules that would result from RC_2008_34 in principle. However, Alinta considered that the proposed amendments required further consideration and that as currently worded they may not better contribute to the achievement of the market objectives. Alinta submitted that in principle, when taken together, RC_2008_27 and RC_2008_34 are likely to better contribute to the achievement of market objectives (a) and (b), which relate to efficiency and competition.

However, Alinta suggested some amendments to clause 4.28.4A (a) (see relevant section below) and submitted that if a consequential amendment is not made to the rule change, it may not better contribute to the achievement of the market objectives, in particular:

- Market objective (c): The rule change may discourage retailers from offering Demand Side Management (DSM) products, which may potentially discriminate against particular energy options and technologies;

- Market objective (d): If the rule change discourages retailers from offering DSM products the long term cost of electricity supplied to customers is unlikely to be minimised; and

- Market objective (e): the risk that retailers offering DSM products may be exposed to SRC costs, even when there is no net change in the number of Capacity Credits available may discourage retailers from offering DSM products. This may discourage the taking of measures to manage the amount of electricity used and when it is used.

Alinta considered that the guiding principle for allocation of costs should be to target those costs as far as possible to those that caused the costs and are therefore best placed to manage the associated risk factors. For this reason Alinta did not support RC_2008_27 as it considered that the proposed rule change in isolation would not better contribute to the achievement of the market objectives[1]. Alinta submitted that RC_2008_34 would overcome these main shortcomings, as it would target costs at those directly responsible for the requirement to procure SRC.

Market Rule 4.28.4A and Demand Side Programmes

Alinta noted that under clause 4.8.3, loads comprising DSM programmes are registered as a Curtailable Load, and the IMO is required to (individually) assign Certified Reserve Capacity and Reserve Capacity obligations to the Facilities.

Alinta was concerned that under the proposed clause 4.28.4A, the churn of a customer that is participating in a DSM programme, and is therefore registered as a Curtailable Load, may expose a Market Participant to SRC costs. This is even if the Market Participant registered an equivalent amount of new Curtailable Load to replace the amount of churned Curtailable Load (and the new relevant Facilities were assigned CRC and Reserve Capacity obligations by the IMO).

Alinta noted that under this scenario there would be no net change in the Curtailable Load or the number of Capacity Credits that the Market Participant is making available to the market, although the specific Facilities that provided those Capacity Credits would have to be changed.

Alinta commented that it was unclear whether under the proposed clause 4.28.4A(a) the mere changing of loads that were registered as Curtailable Load could expose the Market Participant to potential SRC costs.

Alinta requested that the IMO consider that the proposed clause 4.28.4A(a) be clarified to ensure that it does not expose a Market Participant to potential SRC costs as a result of the mere changing of Facilities providing the Capacity Credits.

[1] See Alinta's submission for its comments on RC_2008_27, and the IMO's Final Rule Change Paper for RC_2008_27 for the IMO's response to these comments.

Market Rule 4.24.4B and the definition of an extended Forced Outage

Alinta submitted that the proposed new clause 4.24.4B referred to an "extended Forced Outage" which was not a defined term in the Market Rules (although the term is also used in clause 4.12.2(d)). Alinta considered that, in order to provide clarity, the Market Rules should define when a Forced Outage (or multiple Forced Outages) constitutes an extended Forced Outage.

3.1.2 Submission from Griffin

Capacity Credit Reduction Scenario

Griffin agreed that the rule change was warranted for the scenario where the Market Participant has its Capacity Credits reduced, which results in a shortfall and SRC is called. In this case Griffin contended that the cost of SRC should be targeted at the Market Participant which caused the shortfall (proposed clause 4.28.4A). Griffin contended that it was acceptable for these generators to incur some costs if SRC is called, as the fact an SRC event is being called must necessarily be attributed (at least in part) to the generator that has withdrawn what would be spare capacity from the market.

Forced Outage Scenario and impact against the Market Objectives

Griffin Energy did not consider that the allocation of SRC costs to generators (including new generators) that undergo a Forced Outage was a sensible outcome for the market. Griffin noted that the refund mechanism is meant to offer incentives to generators to maintain reliability (in the form of refunds for Forced Outages).

Griffin contended that allocating another cost to generators resulting from the same event (i.e. a Forced Outage) renders the current refund mechanism redundant, as the price signals incorporated under the present regime are implicitly being altered by this proposed rule change.

Griffin did not believe that allocating SRC costs to generators undergoing a Forced Outage would better facilitate any of the market objectives, and might negatively impact some:

(a) Griffin contended that the rule change would unlikely improve the reliable and/or safe production of electricity but would potentially lead to higher wholesale costs (or a loss of economic efficiency). Griffin noted that this would result from the manner in which the costs of SRC are met, for example, new entrant generators will price in the cost of meeting SRC events whether they are triggered or not. Griffin considered that this type of risk (which occurs periodically and is unlikely to be influenced by ex-ante action) is better managed by an ex-post allocation of costs. This rule change will incentivise ex-ante risk management and costs;

(b) Griffin noted that there is unlikely to be impacts on this objective, other than new entrant generation may tend to favour organisations with either a higher appetite for risk, or with the financial means to manage it. This may add a barrier to entry to smaller potential new generation entrants;

(c) Griffin posited that new entrant generation, that is more likely to incur costs through late commissioning (i.e. capital intensive plant or new technology), are discriminated by this proposed rule change. This is because new entrant generators are more likely to incur the SRC costs and more likely to require ex-ante risk financing; and

(d) Griffin contended that (as set out in (a) above), the cost of wholesale electricity will increase without any resultant benefit to the SWIS.

3.1.3 Submission from Landfill Gas & Power

LGP supported the Rule Change Proposal (conditional on the implementation of RC_2008_27) on the grounds that it more equitably allocates the costs of SRC to causers and thereby provides financial signals to motivate compliance with the intent of the Capacity Credit obligation. LGP noted that in the event of RC_2008_27 not being implemented, it advocated reconvening the Working Group and reviewing its outcomes.

LGP supported the capping of the cost to the amount that would have been paid to a generator (or 50% in the case of an existing facility) had it been available as initially contracted.

LGP supported the IMO's contention that the proposal supports market objective (a) by allocating the costs of SRC to the causers and thereby motivating them to comply with capacity contracts.

3.1.4 Submission from Synergy

Synergy supported the Rule Change Proposal. In its submission Synergy confirmed, as the Chair of the Working Group, that it was the majority view of that group that if a Market Participant has its Capacity Credits reduced, which results in a shortfall and SRC is called, the cost of that capacity should be targeted at that Market Participant. That is, the Market Participant should pay to the IMO compensation due to Capacity Credits not being available to the market.

Synergy accepted the IMO's view that the Rule Change Proposal supports the operation of the Market Objectives.

In its submission Synergy stressed that the use of the SRC process has the potential to place a substantial financial burden on Market Customers and in turn, on end-use customers. Synergy asserted that the original market design contemplated SRC as being a very rare event. Synergy therefore strongly supported a review (as outlined in RC_2008_28) following any call for SRC, which would assess the appropriateness of the SRC mechanism and seek to make improvements for any future application of SRC.

Clause 4.28.4A

Synergy noted (consistent with the underlying causer pays principle) the proposed clause 4.28.4A stipulates how much a Market Participant must pay the IMO where the number of Capacity Credits held by that Market Participant for a Facility has been reduced and caused the need for SRC. This clause effectively limits the amount to the total value of Capacity Credit payments that would have been associated with the reduced Capacity Credits.

Clause 4.24.4B

Synergy noted that this Rule Change Proposal extends the requirement to recompense the market for cancelation of Capacity Credits to those plants that are subject to an extended Forced Outage or delay. Synergy supported that in these instances the amount should be limited to half of the total value of Capacity Credit payments associated with the capacity experiencing the delay or the Forced Outage.

3.1.5 Submission from Verve Energy

Verve did not support the Rule Change Proposal. Verve contended that the current Market Rules provide adequate and significant incentives for participants to ensure plant is made available to the market. Verve contended that the Market Rules also provide Market Customers with significant revenue streams that can be used to offset the potential cost of SRC resulting from the unavailability of capacity. Verve considered the imposition of further penalties proposed under this rule change to be an unnecessary and punitive measure that is unlikely to reduce the occurrence of extended Forced Outages or Capacity Credit reductions.

Forced Outage Scenario

Verve noted that for a Facility undergoing an extended Forced Outage, the relevant Market Participant is already required to pay Capacity Cost Refunds to the market, the proceeds of which are shared amongst Market Customers. Verve noted that these refunds are significant in February and March, when SRC is most likely to be required, and represent a substantial offsetting revenue stream for Market Customers should the Forced Outage contribute to the need for SRC.

Verve also considered the refunds, combined with lost energy market revenue, out-of-merit generation costs and bilateral contract penalties, already provide sufficient incentive to ensure plant is made available to the market and that additional incentives are therefore not justified.

Capacity Credit Reduction Scenario

Similarly, Verve contended that in the case where a Market Generator has its Capacity Credit allocation reduced, Market Customers receive a benefit through lower Individual Reserve Capacity Requirements (IRCR) and/or excess capacity costs. Verve Energy considered this to be more than adequate compensation to the market and that the additional targeted costs proposed by the rule change are not justified.

Clause 4.28.4A and 4.28.4B

Verve noted that if the IMO implements the rule change then the relevant SRC cost charged to the participant under clauses 4.28.4A(a) and 4.28.4B(a) should be reduced by the value of Capacity Cost Refunds or Capacity Credit reduction incurred, or expected to be incurred.

Verve requested consideration be given to setting the upper limit for targeting SRC costs under clauses 4.28.4A (b) and 4.28.4B (b) at the same level. Verve noted that the reason for this is that both Capacity Credit reductions and extended Forced Outages are equally likely to contribute to the need for SRC. In both cases the offsetting cash flows received by Market Customers, being refund payments or IRCR reductions, are capped at the market value of the annual Reserve Capacity payment. Verve contended that it would therefore seem appropriate to set the limits on liability at the same level.

Clause 4.28.4C

Verve was concerned that the determination of targeted SRC costs only considers a participant's contribution to the Reserve Capacity shortfall under clause 4.24.1. Verve requested consideration be given to amending clause 4.28.4C such that availability-based SRC costs be allocated based on contribution to the expected shortfall under clause 4.24.1 while activation costs are allocated based on contributing factors in the relevant trading interval. Verve considered that this would also be more consistent with the broader market design consisting of separate capacity and energy markets.

Proposal against the Market Objectives

Market objective (a): Verve agreed that the proposal provides strong incentives for participants to apply for realistic Capacity Credit levels and commissioning schedules. However it was the view of Verve that sufficient incentives already exist and that the proposal is unlikely to improve system reliability. Furthermore, Verve considered it may lead to inefficient production as customers have a reduced incentive to manage demand.

Verve considered the proposal will adversely impact market objective (e) as Market Customers will have a reduced incentive to manage demand if SRC is procured solely as a result of a Capacity Credit reduction or extended Forced Outage.

3.2 Public Forums and Workshops

No public forums or workshops were held in relation to this Rule Change Proposal during the first submission period.

3.3 Technical Study

McLennan Magasanik and Associates (MMA) was engaged to conduct an assessment of the Rule Change Proposal and of the responses received through the first consultation period. A copy of MMA's assessment is available on the IMO's website:
http://www.imowa.com.au/Attachments/RuleChange/RuleChange_2008_34.html

MMA identified a number of issues to be addressed prior to progressing the Rule Change Proposal. The issues identified by MMA are summarised below, together with actions taken by the IMO for each issue:

- The use of the term "extended Forced Outage" was not defined, nor distinguished from the existing term "Forced Outage". It is not clear in the proposed Rule Change whether this is intended as a new and mutually exclusive class of Forced Outage;
    - Action Taken: The IMO provided a definition of the term extended Forced Outage for the purposes of these provisions and made subsequent amendments in

respect of clause 4.24.4B. These amendments are presented in section 3.4 of this report.

- A discount for extended Forced Outages was originally intended to remove perceived double counting of refunds which does not occur under the proposed Rule Change. The discount is not recommended because it would provide perverse incentives for generators to over-state the risks of future outages and delays so as to reduce exposure to penalties. This would cause IMO to incur additional expenditure for SRC that would then not be fully required. This would impose additional costs on Market Customers.
  - Action Taken: The IMO removed the discount provided in clause 4.28.4B. The IMO held discussions with the original proposer of the discounting provisions and identified that the original basis for inclusion in the clause was unjustified. Clause 4.28.4B(b) was modified with the amendments presented in section 3.4 of this report.
- Alinta's concern about the treatment of DSM resources associated with customer churn should be addressed in finalising the rule change. A transfer of a generation resource or a DSM resource among Market Participants under a DSM programme should not give rise to a refund under clauses 4.28.4 to 4C unless the DSM capability is disabled due to the transfer. In such a case the refund should be attributable to the retailer causing the disablement of the DSM capability.
  - Action Taken: The IMO included an additional clause (now 4.28.4C) to remove doubt that Market Customers with Demand Side Programmes will not be exposed to SRC costs in respect of these programmes in the case that it has replaced loads that have churned.
- The proposed changes should be finalised and implemented before 1 May 2009 when Expressions of Interest are requested for the next Reserve Capacity Cycle.

3.4 Additional Amendments

Based on the recommendations of MMA in its assessment of the proposed rule change and in response to the issues raised during the first public submission period, the IMO made the following changes to the proposed Amending Rules (~~deleted text~~, <u>added text</u>):

4.28.4. For each Trading Month, the IMO must calculate a Shared Reserve Capacity Cost being the sum of:

(a) the cost defined under clause 4.28.1(b); and

(aA) the net payments to be made by the IMO under Supplementary Capacity Contracts less:

(i) any amount drawn under a Reserve Capacity Security by the IMO and distributed in accordance with clause 4.13.11(a); less

(ii) any amount paid to the IMO in accordance with clause <u>4.28.4A;</u> less

(iii) any amount paid to the IMO in accordance with clause 4.28.4B; less

(b) the Capacity Cost Refunds for that Trading Month; less

(bA) the Intermittent Load Refunds for that Trading Month; less

(c) any amount drawn under a Reserve Capacity Security by the IMO and distributed in accordance with clause 4.13.11(b)

and the IMO must allocate this total cost to Market Customers in proportion to each Market Customer's Individual Reserve Capacity Requirement.

4.28.4A. Where the number of Capacity Credits held by a Market Participant for a Facility have been reduced in accordance with clause 4.25.4 or 4.25.4C, the Market Participant must pay to the IMO, as compensation to the market, an amount:

(a) equal to the cost of funding Supplementary Capacity Contracts for any capacity shortfall stemming entirely from the reduced Capacity Credits not being available to the market; and

(b) not greater than the total value of the Capacity Credit payments associated with the reduced Capacity Credits that would have been paid to the relevant Market Participant for the 12 Trading Months commencing at the start of the Trading Day of the most recent 1 October, assuming the IMO acquires all of these Capacity Credits and the cost of each Capacity Credit so acquired is determined in accordance with clause 4.28.2(d).

4.28.4B. Where a Facility, including a new Facility, suffers an extended Forced Outage, the Market Participant holding Capacity Credits for that Facility must pay to the IMO, as compensation to the market, an amount:

(a) equal to the cost of funding Supplementary Capacity Contracts for any capacity shortfall stemming entirely from the capacity suffering the Forced Outage not being available to the market; and

(b) not greater than the total value of the Capacity Credit payments associated with the capacity experiencing the Forced Outage that are due to the relevant Market Participant for the 12 Trading Months commencing at the start of the Trading Day of the most recent 1 October, assuming the IMO acquires all of these Capacity Credits and the cost of each Capacity Credit so acquired is determined in accordance with clause 4.28.2(d).

For the purposes of this clause 4.28.4B, an extended Forced Outage is a Forced Outage that extends for a period of greater than one month in duration.

4.28.4C In respect of DSM for a Curtailable Load holding Capacity Credits, clauses 4.28.4B and 4.28.4C apply to the Facility and in respect of a Demand Side Programme, apply in respect of that Demand Side Program.

4.28.4D For the purpose of clauses 4.28.4A and 4.28.4B, where there are a number of factors contributing to the expected amount of a shortfall determined in accordance with clause 4.24.1, the IMO must proportion the total cost of funding Supplementary Capacity Contracts (acquired by the IMO to address the shortfall) so that the amount paid by the Market Participant under clause 4.28.4A or 4.28.4B offsets only that portion of the total cost stemming entirely from the relevant capacity not being available.

4. THE IMO'S DRAFT ASSESSMENT

In preparing its Draft Rule Change Report, the IMO assessed the Rule Change Proposal in light of clause 2.4.2 and had regard to clause 2.4.3 of the Market Rules.

Market Rule 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 noted that there has not been any applicable policy direction from the Minister in respect of this Rule Change Proposal.

The IMO's assessment, as contained in its Draft Rule Change Report can be viewed on the IMO's website:
http://www.imowa.com.au/Attachments/RuleChange/RuleChange_2008_34.html

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 Market Rule 2.7.7(f), was to accept the proposed amendment of clause 4.28.4 and the addition of new clauses 4.28.4A, 4.28.4B, 4.28.4C and 4.28.4D to the Market Rules. This was as proposed in the Rule Change Proposal and amended during the first submission period (noted in section 3.4 and 3.5).

5.1 Reasons for the decision

The IMO made its decision on the following basis:

- The Amending Rules:
  - Would allow the Market Rules to better address the Wholesale Market Objectives (a);
  - Were considered to be consistent with the remaining Wholesale Market Objectives;
  - Had the general support of the MAC and Working Group; and
  - Addressed the issues identified in the technical study conducted by MMA.

6. SECOND SUBMISSION PERIOD

Following the publication of the Draft Rule Change Report on the IMO website, the second submission period was between 23 March 2009 and 20 May 2009.

During this period the IMO published an addendum due to an incorrect rule reference in the proposed Amending Rules and to clarify the intent of the rule.

The second submission period was extended in order to hold the public workshop.

6.1 Addendum to Amending Rules

After publishing the Draft Rule Change Report the IMO noted that there was an incorrect rule reference in the proposed replacement Amending Rule 4.28.4C. Additionally, as worded in the Draft Rule Change Report, the intent of the rule was not clear.

Therefore, the IMO published an addendum and proposed the following amendment (added text, ~~deleted text~~):

~~4.28.4C In respect of Demand Side Management for a Curtailable Load holding Capacity Credits, clauses 4.28.4C and 4.28.4B apply to the Facility and in respect of a Demand Side Programme, apply in respect of that Demand Side Program.~~

4.28.4C Clauses 4.28.4A and 4.28.4B apply:

(a) to the Facility, in respect of Demand Side Management for a Curtailable Load holding Capacity Credits; and

(b) to the Demand Side Programme, in respect of a Demand Side Programme.

The IMO acknowledged that, as this was not contained in the Draft Rule Change Report, the addendum had no formal standing. However, the IMO invited Market Participants to make submissions on the Draft Rule Change Report and, if considered appropriate, the proposed replacement of clause 4.28.4C contained in the addendum.

6.2 Public Forums and Workshops

In response to requests from Market Participants the IMO held a workshop to discuss RC_2009_34. The workshop, facilitated by MMA, was held on 28 April 2009. It was attended by a range of Market Participants:

- Alinta
- ATCO
- CCIWA
- Economic Regulation Authority
- Griffin
- IMO
- LGP
- MMA
- NewGen
- Office of Energy
- Perth Energy
- Synergy
- TransAlta
- Verve
- WES Resources

There was significant discussion at the workshop, with the results summarised in a second technical report from MMA[2]. In its report, MMA recommends that RC_2008_34 not proceed and the issue be referred back to an industry Working Group to consider the issues more broadly, with a focus on:

- The expected incidence of calling for SRC;
- The level of reserve margin for which SRC should be requested;
- The defining events that determine the distribution of SRC costs;
- The level of performance that the Reserve Capacity Mechanism is intended to deliver in terms of risk management for customers and for which generators are responsible;
- The economic distribution of SRC costs among Market Generators and Market Customers;
- The extent to which Capacity Cost Refunds should first fund SRC before imposing any specific SRC costs on specific participants; and
- An assessment process that determines the SRC cost/volume that maximises economic efficiency based on prevailing market conditions.

[2] http://www.imowa.com.au/Attachments/MarketProcedures/MMAReport_11052009.pdf

MMA consider that these matters are fundamental to the design of the Reserve Capacity Mechanism and the management of SRC. Therefore it was recommended that a new process examine the broader issues regarding the framework for SRC provision and the management of extreme capacity shortages on an economic basis before submitting any rule change. MMA consider that this would assist in limiting the exposure to SRC costs and provide a more robust framework for risk assessment by Market Participants.

6.3 Submissions received

The IMO received 14 submissions during the second submission period, from:

- Alinta;
- ANZ Infrastructure Services Ltd (ANZIS);
- ATCO Power (ATCO);
- Aviva Corporation (Aviva);
- Chamber of Commerce and Industry of Western Australia (CCIWA);
- Griffin;
- LGP;
- NewGen Power (NewGen);
- Newmont Power and NP Kalgoorlie Pty Ltd;
- NP Power and RPV Developments (NP/RPV);
- Perth Energy;
- Synergy;
- TransAlta Energy; and
- Verve.

Of the 14 submissions received, just one submission supported implementation of the Rule Change Proposal, and this was only partial support. Alinta supported the Rule Change Proposal for the scenario where a participant has its Capacity Credits reduced, but not for extended Forced Outages.

The 13 dissenting submissions all cited similar arguments against the implementation of the Rule Change Proposal (summarised in section 7.3.2 of the paper). As the IMO has decided to reject the Rule Change Proposal the IMO has not responded to each issue raised in the dissenting submissions.

The IMO has responded to Alinta's suggestion to implement the Rule Change Proposal for just the reduction in Capacity Credit scenario (outlined in section 6.3.1.1 of this paper).

The submissions are summarised below, with the full text available on the IMO website.

6.3.1 Submission from Alinta

Proposed clause 4.28.4C

Alinta notes that some of the revisions contained in the Draft Rule Change Report were, in part, to address the suggested revisions identified in its initial submission on the Rule Change Proposal. Alinta considers there may still be some ambiguity in the wording of the proposed clause 4.28.4.C and considers the intent may be able to be further clarified (~~deleted text~~, added text):

4.28.4C For the avoidance of doubt, ~~C~~clauses 4.28.4A and 4.28.4B apply:

(a) to ~~the~~ a Facility holding Capacity Credits, in respect of Demand Side Management ~~for a Curtailable Load holding Capacity Credits~~; and

(b) to ~~the~~ a Demand Side Programme holding Capacity Credits~~, in respect of a Demand Side Programme~~.

Causer pays principle

Alinta reiterates that it considers that the guiding principle for allocation of SRC costs should be to target costs as far as possible to those parties which cause SRC and are therefore best placed to manage the associated risks. For this reason, Alinta supports the Rule Change Proposal, in principle.

Alinta acknowledges that the issues associated with the amendment of the Market Rules to target potential SRC costs in circumstances where a Facility's Capacity Credits are reduced differ from a situation where a Facility suffers an extended Forced Outage. These two circumstances are discussed in turn below.

Reduction in Capacity Credits

Alinta notes that the reduction in Capacity Credits appears to be based on the inability of the Facility to provide the level of capacity for which it had been certified. Alinta considers that this appears to be most likely the result of design and/or operational constraints that are best managed by the Market Participant that owns and/or controls the Facility in question (that is, the Market Generator rather than the Market Customer). Alinta notes that other than the submission from Verve, the IMO's Draft Rule Change Report indicates that all other submissions supported this element of RC_2008_34.

Alinta points out that in its first round submission Verve claimed that where a Market Generator has its Capacity Credits reduced, Market Customers would receive a benefit through lower IRCR and/or excess capacity costs. It claimed that these benefits would be more than adequate compensation and that the additional targeted costs proposed by the rule change are not justified.

Alinta does not agree with Verve's assessment.

Firstly, Alinta contends the scenario envisaged by Verve would require excess Reserve Capacity in the market and that the Capacity Credit reduction did not immediately trigger a requirement for SRC (that is, there remained excess Reserve Capacity in the market after the reduction in Capacity Credits).

Secondly, Alinta notes that Market Customers generally contract bilaterally for capacity, so even with excess Reserve Capacity, only one Market Customer (or a small number) would be directly affected by the reduction in capacity from a Facility. Alinta considers it more probable that affected Market Customers would in the short run be required to 'purchase' any shortfall in Capacity Credits from the IMO at the administered price, thus increasing overall market costs.

Alinta considers that it is more probable that a reduction in Capacity Credits would not result in a reduction in costs incurred by Market Customers and that Market Customers would not benefit from any form of compensation (direct or indirect). On this basis, and given the previous support of other submitters, Alinta considers that the Market Rules should be amended so that the cost of Supplementary Capacity Contracts are targeted at specific Market Participants where:

- a Facility fails a second Reserve Capacity test and the IMO reduces the number of Capacity Credits held by the Market Participant for that Facility; or
- a Market Participant applies for a reduction in the number of Capacity Credits held by the Market Participant for a Facility.

Extended Forced Outage

Alinta accepts that the exposure of Facilities to potential SRC costs as a result of RC_2008_34 in circumstances where the Facility was subject to an extended Forced Outage would affect a project's risk profile.

Alinta also acknowledges that mechanisms exist within the Market Rules to incentivise Market Generators to ensure Facilities are available to the market when required.

Consequently, Alinta agrees that it would be appropriate to further consider whether the Market Rules should be amended so that the cost of Supplementary Capacity Contracts are targeted at a specific Market Participant for this scenario.

As a result, Alinta considers that the proposed Amending Rules in the IMO's Draft Rule Change Report should be further amended to delete proposed clause 4.25.4B and all references to it. Full details of Alinta's proposed Amending Rules are contained in its submission on the IMO website: http://www.imowa.com.au/Attachments/RuleChange/RC_2008_34_Alinta.pdf

MMA Report

Alinta does not support MMA's recommendation that the proposal not proceed in its entirety pending a broader review of the framework for SRC provision and the management of extreme capacity shortages on an economic basis. Alinta considers that the Rule Change Proposal should continue for the reduction in Capacity Credits scenario.

The Rule Change Proposal and the Wholesale Market Objectives

Alinta considers that the Market Rules, as proposed to be amended or replaced in its submission, would be consistent with the Wholesale Market Objectives (in particular objective (a) and (d)). Alinta considers that there is no evidence to suggest that the amended Market Rules would be inconsistent with Market Objectives (b), (c), and (e).

6.3.1.1 IMO's response to Alinta's submission

Alinta suggests that the Market Rules be amended so that the cost of Supplementary Capacity Contracts is targeted at specific Market Participants where its Capacity Credits are reduced.

The IMO has considered modifying the Amending Rules to take into account Alinta's suggestion. However, the IMO considers that solving the question of how to fund SRC for only one scenario is not an ideal outcome, particularly given the range of other issues that have been raised throughout the Rule Change Process.

Several participants have raised a number of fundamental issues for the IMO to consider regarding the Reserve Capacity and Refund Mechanisms, which if resolved may partially solve the question of how to best fund SRC. Such as, funding SRC out of Capacity Cost Refunds, before allocating costs to specific Market Participants.

Finally, the IMO considers that allocating costs to the Market Generator in the event of Capacity Credit reduction may provide unintended consequences. Allowing participants to apply for a reduction in Capacity Credits to reflect a Facilities actual capabilities enhances the certainty about the amount of Reserve Capacity available in the SWIS. This enables the IMO to address any reliability issues in a timely manner. Participants may be reluctant to voluntarily reduce Capacity Credit levels if by doing so it exposes them to the risk of SRC costs.

6.3.2 Submission from ANZ Infrastructure Services

ANZIS considers that this Rule Change Proposal will adversely affect generators in that it will have an unfair impact on privately-owned generators who are unable to adjust or renegotiate capacity contracts. ANZIS considers that this Rule Change Proposal introduces an element of regulatory risk to the market and will affect the value of investments already made by delivering a windfall gain or tax on different participants.

ANZIS states that new generation in Western Australia is increasingly being provided by private developers funding investments with project debt. Those debt arrangements require long term certainty of revenue and costs. ANZIS considers that this proposal will introduce a new element of risk into the financing of future projects by increasing capital costs.

ANZIS notes that although the proposal may provide current retailers with an unexpected gain, it will only drive up the future cost of generation leaving retailers back where they started.

ANZIS considers that the need for SRC is an anomaly in a market-based electricity trading system. ANZIS considers that the IMO should conduct a complete review of SRC before proposing rule changes.

The Rule Change Proposal and the Wholesale Market Objectives

ANZIS considers that this proposal does not promote economic efficiency by allocating generators with a potentially large, uninsurable cost for an event it cannot efficiently avoid. ANZIS notes that although it may be argued an individual generator is 'responsible' for such a cost, the efficient market outcome would be to distribute that cost as broadly as possible across the entire market.

ANZIS asserts that by creating this risk for all generators (privately-owned and project-financed) the proposal will impose a cost on all generators. Generators and financiers will seek to mitigate this risk. ANZIS considers that, over time, this proposal will not have the effect sought as new contracts by generators will move to shift the risk of the proposed rules to customers.

6.3.3 Submission from ATCO Power

ATCO does not support the proposed rule change. ATCO supports the MMA recommendation that:

- Rule Change RC_2008_34 should not proceed pending a broader review of the framework for SRC; and
- If the rule change were to proceed, the clauses relating to extended Forced Outages should be removed.

ATCO agrees that the issue should be referred back to an industry Working Group to consider the issues broadly focusing on:

- The expected incidence of calling for SRC and the level of performance that the Reserve Capacity Mechanism is intended to deliver;
- The level of reserve margin for which SRC should be requested;
- The defining events that determine the distribution of SRC costs;
- Ensuring there are sufficient incentives in the Market Rules for generators to manage plant availability; and
- That Capacity Cost Refunds should first fund the SRC before allocating any specific SRC costs on generators.

The Rule Change Proposal and the Wholesale Market Objectives

ATCO considers that sufficient incentives already exist for participants to apply for realistic Capacity Credit levels and that the proposal is unlikely to improve system reliability (market objective (a)).

ATCO asserts that the proposal may reduce the incentive for Market Customers to manage demand if SRC is procured solely as a result of a Capacity Credit reduction or an extended Forced Outage (market objective (e)).

6.3.4 Submission from Aviva Corporation

Aviva does not support the Rule Change Proposal.

Aviva considers that the Rule Change Proposal would discourage investment by new entrant generators in the market as it moves the financial risk for mitigating or compensating for Forced Outage costs disproportionately to the generator. In a constrained or difficult investment climate Aviva considers that this makes it even more difficult to finance new generation projects.

Aviva notes that the market is still evolving and one of the main design features and policy goals of the market was to make it attractive for private investment in new generation capacity. Aviva considers that the market has been successful to date in attracting new investment.

Aviva contends that as a bilateral market, the allocation of costs associated with Forced Outages should be handled by the contracting parties. Aviva notes that generators are required to pay Capacity Cost Refunds despite the fact that bilateral contracts could include the payment for Capacity Credits within them and also deal with Forced Outages.

Aviva considers that being subject to the additional risk of SRC costs (in addition to refunds) will force new entrant generators to load those risks into the capital funding structure for new generation projects. This will in turn lead to increased wholesale electricity costs.

Aviva notes that new entrant generators to date have generally entered the market through single plant projects. As new generators generally do not have portfolios, or any retail hedge capability they are considered to be the most vulnerable Market Participants in respect of managing Forced Outage risks. Aviva asserts that adding additional risks in respect to funding SRC costs makes it more difficult as new generators have the least ability to manage those risks.

Aviva asserts that the existing refund mechanism has led to windfall revenues to some participants and losses to others. Aviva notes that the financial impact of this is disproportionate both ways. Aviva contends that the proposal will exacerbate this impact.

The Rule Change Proposal and the Wholesale Market Objectives

Aviva contends that the proposal will increase the cost of wholesale electricity without improving the reliability or safe production of electricity (market objective (a)). This will lead to only larger utility type new entrant generators being able to manage the increased financial risk (market objective (b)).

Aviva considers new entrant generation that is more exposed to late commissioning risks will be discriminated against as they are more likely to incur the SRC costs (market objective (c)). As a result, the costs of wholesale electricity will increase without any resulting benefit to the market (market objective (e)).

6.3.5 Submission from Chamber of Commerce and Industry of Western Australia

CCIWA notes a concern that the current proposal may have detrimental impacts on current and future market participants, particularly generators.

While CCIWA supports the concept of 'causer pays', CCIWA notes that the causer in this Rule Change Proposal is assessed to be the generator. CCIWA contends that the true causer is the end-user, who in fact should bear the long-term cost of capacity through regular tariff charges.

CCIWA does not consider it equitable for the burden of risk to lie with generators where, in many cases, they are either unable to manage the risks associated with extended Forced Outages. Alternatively the management of these risks is only achieved at high cost, for example incorporating inefficient redundancy or transferring the risk to retailers through higher wholesale charges.

CCIWA suggests that the IMO reassess the Rule Change Proposal to ensure that consumer price signals accurately reflect all costs of electricity production and supply. This should include provision for SRC funding.

6.3.6 Submission from Griffin Energy

Griffin strongly objects to the Rule Change Proposal and notes that it does not believe the concept of allocating the costs of SRC to generators to be in accord with efficient market pricing principles.

Griffin considers that generators have sufficient incentive to maintain availability in the market and that the Capacity Refund Mechanism is specifically designed to do this.

Griffin asserts that SRC will be uninsurable for project financed generators. Griffin contends that reallocating costs from end users (via the Market Customer) to generators would reintroduce the issue of a loss in competition in the market. Griffin considers that generation proponents may either exit the market due to insolvency, or be dissuaded from entering a high risk environment.

Griffin argues that generators, in effect, already contribute to SRC costs through the refund mechanism. When refunds are paid while there is a surfeit of capacity in the market, and that this is a windfall gain to Market Customers.

Griffin considers that the allocation of SRC costs to generators undermines the price signals of the existing refund mechanism. Griffin asserts that the signals this proposal sends to new investment proponents are severe, in that every new facility entering the market will be exposed to increased risks during the first four months of operation.

Griffin suggests the IMO consider present refund mechanism and how these payments might be most efficiently distributed or applied within the market to better achieve capacity adequacy. Griffin asserts that RC_2008_34 cannot progress without a thorough examination of the existing regime.

The IMO workshop and MMA report

Griffin considers that the IMO workshop was a necessary additional step in the Rule Change Process and that a number of important issues were raised and discussed. Griffin agrees with MMA’s recommendation that the proposal should not proceed pending a broader review of the SRC framework.

Griffin provided comments on some of the analysis and observations contained in the MMA report. In particular:

- Griffin notes that MMA correctly states that Griffin raised the issue of insurance (and the apparent lack of appetite in the insurance market to offer appropriate products to cover generator SRC costs).

  Griffin contends that MMA misinterpreted its comments and provides a correction in its submission. Griffin notes that its position with regard to insurance was implied for all (project financed) generation Facilities, and that it may be more relevant to large peaking Facilities. Griffin notes that the issue was raised to point out a flaw in the proposal – that generators would face additional, uninsurable risks that would likely lessen competition in the generation sector.

- Griffin notes section 3.5 of the MMA report discusses capacity pricing issues. MMA proposes that the Reserve Capacity Price might include a benchmark cost component for Forced Outages – based on the premise that capacity can never be 100% firm.

  Griffin comments that this concept has merits, but considers it serves to highlight the flaws of a capacity market in a predominantly bilaterally traded electricity market – where all providers of capacity are treated equally.

  Griffin notes that the Reserve Capacity Price sets the value of refunds, so making capacity prices higher increases the liabilities of a base load plant. Griffin considers that this highlights the issues with trying to incentivise non-peaking plant using rules and cost-templates based on peaking facilities.

The Rule Change Proposal and the Wholesale Market Objectives

Griffin does not consider that allocating SRC costs to generators undergoing a Forced Outage will better facilitate any of the market objectives and will negatively impact some:

Market objective (a): Griffin asserts that it is unclear if the cost incurred by generators of SRC events (which may be only a portion of the actual cost to the market) is an efficient allocation of costs. Griffin notes that the SRC cost might actually be incurred as a result of other market events – such as forecasting or transmission failure, meaning the market incurs the cost of SRC as well as the cost of generator risk mitigation measures. Griffin considers that there is no evidence that allocating this risk to generators will actually lead to any improvement in reliability of capacity (and hence reduction in potential SRC costs).

Market objective (b): Griffin considers that the proposed changes will have the effect of lessening competition as project financed generators may exit the market through insolvency events, or are disincentivised to invest. Griffin considers that this is an unacceptable risk for a potential new entrant generator.

Market objective (c): Griffin notes that any rule that has the potential to penalise one type of generation over another does not better advance this objective.

Market objective (d): Griffin contends that the potential exists to double up on costs by both incurring SRC costs from forecast error (or other non-generation related capacity shortfalls) as well as generators passing through costs it incurs through ex-ante risk mitigation (insurance or increased plant redundancy). Additionally, Griffin considers that lowering competition between generation proponents is likely to lead to higher long term wholesale prices.

Market objective (e): Griffin contends that current practices (of generators subsidising SRC costs through capacity refunds when capacity is available) dampens the price signals associated with the marginal cost of supply by increasing the average cost of wholesale electricity. Griffin considers that making generators contribute further by directly allocating SRC costs to them will exacerbate this.

6.3.7 Submission from Landfill Gas & Power

LGP notes that it supported the Rule Change Proposal in the first round of submissions and previous discussions at the MAC. This support was on the grounds that it more equitably allocates the costs of SRC to causers and thereby provides financial signals to motivate compliance with the intent of the Capacity Credit obligation.

LGP considers that the IMO's subsequent adoption of recommendations from MMA (outlined in the Draft Rule Change Report) enhanced the proposal.

LGP notes that it no longer supports the Rule Change Proposal. This is on the grounds that this specific issue is a second order effect of the broader issues associated with the Reserve Capacity Mechanism. In particular, LGP stands by the original reasoning for the proposal, however it perceives there is little merit in remedying this particular issue (with a solution that does not have broad support) while leaving other important issues unaddressed.

LGP notes a comment raised at the workshop that the rule change permitting Capacity Credit reduction was intended to give flexibility to generators with loads of unpredictable magnitude. LGP considers that it may be more constructive to permit such generators to offer capacity at short notice rather than to withdraw it at short notice.

LGP asserts that generators that suffer Forced Outages compensate the market via the refund mechanism and should not incur the further impost of contributing to SRC costs.

LGP advocates a broader review of the Reserve Capacity Mechanism, including matters raised at the public forum. Additionally, LGP advocates processes for expediting the allocation of Capacity Credits outside the cycle for small and renewable generators.

6.3.8 Submission from NewGen Power

NewGen does not support the Rule Change Proposal.

NewGen considers the Market Rules currently expose Facilities, particularly Scheduled Market Generators, to significant cost and risk associated with any Forced Outage, namely:

- Capacity Refunds;

- Downward Unauthorised Deviation Payments; and
- Exposure to purchasing energy through the Short Term Energy Market (STEM) for bilateral commitments, where the Market Generator does not have spare generation capacity in a portfolio of generation.

NewGen notes that the likely impact to a of a Forced Outage is not just Capacity Refunds and possible loss of security deposit for new generators, but significant costs in the STEM for sourcing replacement energy for bilateral contracts. NewGen submits the quantum of risk associated with this is significant for an extended Forced Outage, and provides adequate incentive for Market Generators to maintain reliable supply.

NewGen submits that the imposition of additional costs on generators for Forced Outages will not achieve outcomes consistent with the Wholesale Market Objectives. In particular, NewGen is concerned the medium to long term impacts of the proposed rule change on investment in new generation, viability of existing Scheduled Market Generators and the inevitable increased cost to end users of electricity have not been adequately assessed.

NewGen notes that if the proposal is progressed, it will result in a transfer of risk and cost from Market Customers to Market Generators. As a result, NewGen believes new investors will view regulatory risk associated with market change as a large consideration when seeking and obtaining finance for future projects.

NewGen considers that the proposal is a significant change to the design of the Market Rules and as such, SRC mechanisms should not be considered in isolation, but rather be considered in a broader review of changes to the Reserve Capacity Mechanism and Market Rules.

The Rule Change Proposal and the Wholesale Market Objectives

Market objective (a): NewGen submits that the proposed rule change will not result in economically efficient supply of electricity as:

- Market Generators will ultimately pass through the potential cost of triggering SRC to retailers through increased insurance costs (if this is possible) or increased project returns;
- Investment in capital intensive, long lead time generation equipment will be discouraged due to the increased risk of triggering SRC. Consequently, there is likely to be a shift to lower efficiency, plant with higher short run marginal costs;
- Entry of new competitors among generators will be discouraged; and
- Incentive provided under the current Market Rules for retailers to procure the lowest cost SRC (most likely DSM) is lost.

Market objective (b): NewGen submits that the proposed rule change will not facilitate entry of new competitors among generators as:

- Smaller new entrant generators may be discouraged from entering the market due to the significant financial consequence;

- Financing for new projects will become more difficult due to allocation of risk associated with triggering a SRC event. It is not clear whether insurance products are available to cover such an event; and
- Regulatory risk signified by acceptance of the proposed rule change will affect financing of new projects.

Market objective (c): NewGen Power submits that the proposed rule change will increase the long-term cost of electricity supplied to customers as:

- DSM is likely to be the most effective way of procuring SRC, however the proposed rule change discourages this approach and will increase the cost of procuring; and
- New Facilities will pass on the cost of risks associated with SRC to retailers. This pass through of cost is unlikely to be efficient.

Market objective (d): NewGen Power submits that the proposal will discourage the taking of measures to manage the amount of electricity used and when it is used as Market Customers will have reduced incentive to manage demand when SRC is triggered as a result of an extended Forced Outage.

6.3.9 Submission from Newmont Power and NP Kalgoorlie Pty Ltd

In its joint submission Newmont and NP Kalgoorlie notes its does not support the Rule Change Proposal.

Newmont and NP Kalgoorlie note that, if implemented, the change will act to reduce competition and efficiency of the market, and increase the cost of electricity.

Newmont and NP Kalgoorlie consider there is already a suitable mechanism to incentivise generator reliability. Newmont and NP Kalgoorlie consider that making generators liable for SRC costs adds significantly to individual generators financial risk (and significantly alters price signals in the market) without improving reliability.

Newmont and NP Kalgoorlie notes that the IMO has undertaken to review the Reserve Capacity Mechanism, and consider it would be sensible to delay any decisions on fundamental changes until after this review takes place.

Newmont and NP Kalgoorlie commented that if the proposal is implemented it would reconsider offering its share of generation to the market.

The Rule Change Proposal and the Wholesale Market Objectives

Market objective (a): Newmont and NP Kalgoorlie note that one of the fundamental design features of the market is that electricity consumers pay for the electricity, including sufficient capacity for most conditions. Newmont and NP Kalgoorlie submit that the design intended that the SRC process would only be incurred infrequently (once every 10 years). In this event the cost of such a measure would be shared across all consumers, consistent with the fundamental concept of ‘users pays’.

Newmont and NP Kalgoorlie assert that the proposal will result in generators needing to provide for large contingent liability which the chances of occurring is unlikely, but may lead to an insolvency event at any time if it does. Such a provision may be via insurance or as a balance sheet item; in either case adding a cost to generation. Newmont and NP Kalgoorlie consider that this could lead to costs many times more than the expected costs of SRC being borne by the market – which Newmont and NP Kalgoorlie consider to be inefficient.

Market objective (b): Newmont and NP Kalgoorlie consider competition will decrease as new entrants will be discouraged from entering the market due to the substantive additional risk arising from the rule change.

Market objective (d): Newmont and NP Kalgoorlie consider that the proposal will raise the price of electricity as a result of lessened competition and the need for individual generators to fully provide for the contingent liability in every year.

6.3.10 Submission from NP Power and RPV Developments

In its submission NP/RPV notes that the market needs to provide a signal to generators to be available. NP/RPV accepts that an SRC event brings considerable costs that are borne by the Market Customers (and ultimately end-users), noting that the Market Customers have benefited from the distribution of Capacity Cost Refunds in the period since the previous SRC event.

NP/RPV notes that generators are required to invest substantial capital to construct generating equipment. NP/RPV considers that the proposal creates the prospect for a generator of bearing a significant additional cost to its business through being required to pay for an SRC event up to the proposed cap. Generators will accordingly seek to mitigate this risk by:

- seeking insurance to cover the prospect of an SRC event (NP/RPV considers insurers will be risk averse and that the high premiums will be far greater than the expected SRC liability over time);
- building in increased levels of redundancy in generating equipment (which will mean an increase in capital expenditure which needs to be recovered by the generator);
- increasing the amount of working capital provided (the generator will seek to cover the cost of servicing additional capital through increasing its other available income streams, and therefore increasing wholesale electricity costs); or
- spreading the risk among its portfolio of plant and generation contract positions (which requires the generator to have a large portfolio of plants and so does not encourage competition in the market).

NP/RPV accepts that generators are best placed to manage the risk of individual plant availability, and suggests that the Market Rules contain adequate incentives for ensuring capacity availability.

NP/RPV asserts that retailers are in a position to mitigate the costs of an SRC event by increasing DSM during the event and lowering the overall liability to the market. Generators are not able to influence the market demand and thus cannot provide cost mitigation for an SRC event.

NP/RPV comments that, like many other participants, it is a comparatively small generator and is concerned that the proposal will unfairly disadvantage the smaller generators.

NP/RPV strongly believes that the cost of wholesale electricity will increase as a result of this proposed rule change.

NP/RPV proposes that any Capacity Cost Refunds made by a generator should be netted off the costs being allocated to the generator as a result of the SRC event that has been called. Additionally, NP/RPV considers that funds accumulated over a period between SRC events as a result of refunds could be used to cover the additional costs in the market resulting from the occurrence of an SRC event.

The Rule Change Proposal and the Wholesale Market Objectives

Market objective (a): NP/RPV notes that the proposal will not better facilitate this objective. NP/RPV considers generators are already incentivised by refunds. New entrant generators will factor in the possibility of experiencing an SRC event which will lead to higher wholesale electricity pricing to ensure return on investment is preserved.

Market objective (b): NP/RPV notes the proposal will not better facilitate competition amongst generators or retailers, as it is a transfer of costs from the retailers to the generators and would be borne by generators proportionally to the amount of generation for which Capacity Credit payments are received. Further, generators who incur the liability of an SRC event without adequate cash flows face insolvency and may potentially exit the market, thus reducing competition.

Market objective (d): NP/RPV notes that the long term of cost of electricity is likely to increase as a result of increasing wholesale electricity costs brought about by the proposed rule change.

6.3.11 Submission from Perth Energy

Perth Energy does not support the Rule change Proposal. Perth Energy concludes that, as a result of the forum and the second MMA report, a new process is required to discuss the broader issues with the Reserve Capacity Mechanism.

Perth Energy notes:

- That it is hard to identify the full outcomes from the proposal, therefore it is difficult to adequately assess against the market objectives;
- The concerns raised by Market Customers in that they fund SRC even though they are not the causer;
- The potentially severe financial impacts if SRC costs are to be paid by an individual generator;
- That the frequency of a SRC event needs to be examined; and
- That the impacts of smaller generators with fewer units is potentially higher than on bigger generators with a large portfolio.

6.3.12 Submission from Synergy

Synergy considers that SRC funding needs to be addressed and resolved before the next Hot Season to provide better market cost and risk certainty.

Synergy notes two concerns:

- There is no mechanism within the Market Rules addressing the uncapped cost to Market Customers resulting from SRC. Synergy asserts that SRC is likely to be infrequent and small in scale and unlikely to result in extreme costs. Though the IMO could call on SRC resulting from existing or new plant failure just before a Hot Season that had extreme weather and low plant availability. Synergy considers that this will result in multiple usage and heightened SRC cost. In this situation the application of SRC during a given Hot Season would directly deliver a considerable unbudgeted cost to either the Market Customer or its customers; and

- Applying a SRC liability directly to a Market Generators on the basis of causer pays, thereby protecting the Market Customer, unavoidably creates an additional fixed cost that the Market Generator would pass onto the market. This is even if that cost is unlikely to materialise. If this liability applied against the causer were to be uncapped, the resulting fixed cost to the market could be unreasonably high.

Synergy proposes that the causer pays should apply but this be tempered by capping that exposure on the causing Market Generator to no more than the annual capacity cost. Beyond that capped amount the SRC costs would be passed on to Market Customers. Synergy notes that this approach is clearly a compromise; partly resolving Synergy's concerns by avoiding Market Customer exposure to SRC and limiting Market Generator costs to insurable level.

Synergy considers this issue is yet resolved and requires further assessment and review.

6.3.13 Submission from TransAlta Power

TransAlta does not support the Rule Change Proposal and considers that it is in conflict with the market objectives.

TransAlta considers that the market rules already contain appropriate incentives to generators to make registered capacity available to the market. TransAlta contends that introducing further penalties will provide further incentives for generators. TransAlta considers that the additional costs will be punitive and introduce further risks that will discourage existing market participants from further investing in the market. TransAlta asserts that the proposed rule change is not aligned with the promotion of economically efficient outcomes and does not contribute to market objective (a)

TransAlta considers that the additional penalties will also discourage new entrants from entering the market. TransAlta notes the proposed rule change is not aligned with the need to encourage competition and does not better contribute to market objective (b).

TransAlta contends that the proposed rule change is not aligned with the need to encourage the taking of measures to manage the amount of electricity used and when it is used and does not better contribute to market objective (e).

TransAlta's view is that SRC should not need to be contracted to cover equipment failures and should only be needed when supply cannot meet demand because of unforeseen circumstances. .

TransAlta notes that Market Customers demand capacity and should pay for the capacity they demand from a power system. If reserve margins are too small it is unreasonable and inequitable for Market Customers to be getting access to capacity they are not paying for.

It is TransAlta's view that the cost of procuring Reserve Capacity and SRC should always be allocated to Market Customers.

6.3.14 Submission from Verve Energy

Verve thanked the IMO for facilitating the public forum, noting that the IMO should be commended for its willingness to ensure that arguments regarding the proposal are appropriately considered.

Verve maintains the position it took in its first submission, that it does not support the Rule Change Proposal. Verve agrees with MMA's conclusion that a new process be established to examine the issues raised in submissions, and canvassed at the forum, before finalising the Rule Change. Verve considers that the proposed Rule Change should be rejected so that the issue of SRC funding can be appropriately revisited in a time frame not impacted by the Rule Change Process for RC_2008_34.

Verve considers that the key issue to be determined is the extent to which generators offering plant into the Reserve Capacity Mechanism are guaranteeing the availability of that plant and underwriting the reliability of the system. Verve asserts that it is correct to assume that no plant is reasonably capable of achieving 100% availability and the Reserve Capacity payment does not include a premium to achieve that level of performance. Accordingly, Verve considers that it is reasonable to conclude that the refund mechanism is the limit to which generators should be exposed in relation to unplanned outages.

Verve requests that if its position is not supported Capacity Cost Refunds should first fund any SRC costs. Verve contends that the generator should only have to pay the cost over and above what the market would otherwise have paid in the absence of SRC. Verve notes that the exposure should be capped at an appropriate level, and the period that SRC is called for should be clearly defined.

Verve suggests that the IMO adopt the MMA recommendation that the proposed Rule Change should not proceed pending a broader review. This review to comprise an industry Working Group to consider the matters identified in MMA's 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.

Market Rule 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 Proposal.

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

7.1 Market Objectives

According to clause 2.4.2 of the Market Rules *"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".*

The IMO initially considered that the Market Rules as a whole, if amended, would be consistent with the Wholesale Market Objectives. Additional detail on this assessment is contained in section 2.3 of this paper.

The IMO notes the differing opinions and significant debate on the proposal against the market objectives in the submissions that have been received in both the first and second submission periods.

The IMO's initial assessment against the market objectives was based on the premise that the 'causer pays' principle was widely endorsed. Given that there is significant debate over whether SRC should be funded on a user pays or causer pays basis (and if 'causer pays' who the causer of SRC actually is) the IMO notes that its initial assessment against the market objectives may differ to those presented in submissions.

As the IMO has decided to reject the Rule Change Proposal, it has not undertaken a final assessment against the Wholesale Market Objectives, as there are no Amending Rules to assess.

7.2 Practicality and cost of implementation

In accordance with clause 2.4.3(b) of the Market Rules, in deciding whether or not to make Amending Rules, the IMO must also have regard to the practicality and cost of implementing the Amending Rules.

The proposed changes would require amendments to both the Wholesale Electricity Market System and the Settlements System operated by the IMO. An estimate of this cost is $61,000 AUD. This quote covers development, implementation, testing and auditing costs.

Submissions received have suggested that the proposal could be accepted for the reduction in Capacity Credit scenario (clause 4.28.4A) only. The IMO estimates that the cost of implementing part of the rule change to be approximately $50,000 AUD.

Some Market Participants noted that, should this proposal be implemented, minor administrative costs will be incurred.

7.3 Views expressed in submissions and the public workshop

In accordance with clause 2.4.3(c) of the Market Rules, in deciding whether or not to make Amending Rules, the IMO must have regard to the views expressed in submissions on the Rule Change Proposal.

7.3.1 First submission period

The response to the Rule Change Proposal was mixed, as shown below.

	Alinta	Griffin	LGP	Synergy	Verve
Support	Yes, in principle. Consider that further clarifications required.	Partial support. Supported for the scenario where a participant has its Capacity Credits reduced, but not for Forced Outages.	Supported, conditional on the implementation of RC_2008_27.	Supported.	Did not agree with the rule change. It considers that the current penalties for capacity outages are sufficient compensation to Market Customers.

A number of issues were raised during the first submission period. The issues, the IMO's response and subsequent amendments to the Amending Rules can be found in the Draft Rule Change Report, available on the IMO website:
http://www.imowa.com.au/Attachments/RuleChange/RuleChange_2008_34.html

7.3.2 Second submission period

Of the 14 submissions received, only one supported implementation of the Rule Change Proposal, and this was only partial support. Alinta supported the Rule Change Proposal for the scenario where a participant has its Capacity Credits reduced, but not for extended Forced Outages. This view was supported by Griffin in the first submission period.

All other submitters did not support the Rule Change Proposal. Notably, both LGP and Synergy withdrew the full support shown during the first round of submissions, and Griffin withdrew its partial support from the first submission period.

Common arguments against Rule Change Proposal were:

- Generators have sufficient incentives to maintain availability in the market. The Capacity Refund Mechanism is designed to do this;
- The Rule Change Proposal is penalising the generator twice i.e. the generator refunds capacity payment and then is responsible for the cost of SRC;
- Generators funded by debt will face greater risks and possibly insolvency in the extreme case;
- Many generators note that the proposal will have significant impacts on financing for future projects;
- There was debate over whether SRC should be funded on a user pays or causer pays basis;
- There was debate over who the causer of SRC is; and
- A SRC liability on Market Generators unavoidably creates an additional fixed cost that the Market Generator would pass onto the market.

Common recommendations received were:

- Capacity Cost Refunds should first fund any SRC costs;
- The Rule Change Proposal should be rejected and reassessed as part of a broader review of the capacity mechanism.

Alinta requested that the IMO consider implementing the Rule Change Proposal for just the reduction in Capacity Credits scenario. As outlined in section 6.3.1.1 of this paper the IMO does not consider that it is appropriate to modify the Rule Change Proposal for just this scenario. The IMO considers that:

- solving the question of how to fund SRC on a piecemeal basis (i.e. for one scenario) is not an ideal outcome for the market;

- allocating costs to the Market Generator in the event of Capacity Credit reduction may provide unintended consequences, in that participants may be reluctant to voluntarily reduce Capacity Credit levels if by doing so exposes the Market Generator to the risk of SRC costs; and
- a broader review of the fundamental issues raised by Market Participants and MMA may partially solve the question of how to best fund SRC.

7.4 Views expressed by the Market Advisory Committee

In accordance with Clause 2.4.3(d) of the Market Rules, in deciding whether or not to make Amending Rules, the IMO must have regard to the views expressed by the Market Advisory Committee (MAC), where the MAC met to consider the Rule Change Proposal.

The Market Advisory Committee (MAC) discussed the proposed Rule Change at the 8 October 2008 meeting. At this meeting it was noted that this Rule Change Proposal was borne out of the deliberations of the SRC Working Group. Following lengthy discussion the Working Group made the determination that if a Market Participant has its Capacity Credits reduced, which results in a shortfall and SRC is called, the cost of SRC should be targeted at the Market Participant that caused the shortfall. Following this discussion, MAC members agreed to progress the proposed rule change.

7.5 Technical Reviews

MMA were engaged to conduct two assessments of the Rule Change Proposal:

- An initial assessment of the proposal and of the responses received through the first consultation period. The IMO used this initial assessment in preparing its Draft Rule Change Report (as outlined in section 3.3 of this paper); and
- An assessment of the Workshop held in relation to this rule change (as outlined in section 6.1 of this paper). MMA also facilitated this workshop.

The second report from MMA recommended that this Rule Change Proposal not proceed and the issue be referred back to an industry Working Group to consider the issues more broadly.

8. THE IMO'S FINAL DECISION

While there is general agreement that the funding of SRC is an issue the IMO considers that it would be imprudent to accept this Rule Change Proposal (either in its entirety or in part). This is on the basis that supporting evidence received in the latter stages of the Rule Change Process, including submissions received, the public workshop and the technical report, indicate that there are substantive issues still requiring resolution. In particular, the underlying premise (causer pays) of the Rule Change Proposal has been subject to significant debate.

The IMO's final decision is to reject the amendments to clauses 4.28.4, 4.28.4A, 4.28.4B, 4.28.4C and 4.28.4D of the Market Rules as proposed in the Rule Change Proposal and subsequently amended following the first submission period.

8.1 Reasons for the decision

In summary, the substantive reason for the IMO's decision is that:

- There is significant debate over the 'causer pays' versus 'user pays' principles, which was a fundamental premise of the original Rule Change Proposal. If the 'causer pays' principle were adopted, there is debate over who actually is the causer of SRC.

There are a number of supporting reasons for the IMO's decision, these are:

- There is significant debate regarding the impact of the Rule Change Proposal on the market objectives. In particular, evidence from the Rule Change Process indicates that:
    - The proposal has the potential to significantly affect investment decisions;
    - There is conflicting evidence as to the effect on reliability;
    - The proposal may reduce competition in the Market Generator class; and
    - May discourage the taking of measures to manage the amount of electricity used and when it is used.

  The IMO considers that the assessment against market objectives is dependent on the resolution of the 'causer pays' versus 'user pays' principles and who the 'causer' of SRC may be.

- The Rule Change Proposal does not have the support of a wide variety of submitters:
    - Support was mixed during the first submission period, with some Market Participants only supporting part of the Rule Change Proposal;
    - Of the 14 submissions received during the second submission period, 13 did not support the Rule Change Proposal with the fourteenth submitter only supporting one of the two scenarios presented in the Rule Change Proposal; and
    - The technical reviewer, MMA, did not support the Rule Change Proposal, recommending additional work.

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

9. AMENDING RULES

The IMO has rejected the proposed Amending Rules.

10. GENERAL INFORMATION ABOUT RULE CHANGE PROPOSALS

Clause 2.5.1 of the Market Rules provides that any person (including the IMO) may make a Rule Change Proposal by completing a Rule Change Proposal Form and submitting this to the IMO.

In order for the proposal to be progressed, the change proposal must explain how it will enable the Market Rules to better contribute to the achievement of the Wholesale Market Objectives. The market objectives are:

(a) to promote the economically efficient, safe and reliable production and supply of electricity and electricity related services in the South West interconnected system

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

(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

(d) to minimise the long-term cost of electricity supplied to customers from the South West interconnected system

(e) to encourage the taking of measures to manage the amount of electricity used and when it is used

A Rule Change Proposal can be processed using a Standard Rule Change Process or a Fast Track Rule Change Process. The standard process involves a combined 10 weeks public submission period. Under the shorter fast track process the IMO consults with Rule Participants who either advise the IMO that it wishes to be consulted or the IMO considers have an interest in the change.