



# Minutes

<b>Meeting Title:</b>	BRCP Working Group meeting 1 - Discussion of preliminary procedure change proposal	
<b>Meeting Number:</b>	1/2020	
<b>Date &amp; Time:</b>	Tuesday, 18 August 2020 10:00am (AWST)	
<b>Location:</b>	Online Meeting	
<b>Attendees:</b>	Sara O'Connor Matt Shahnazari Chi Ong Rebecca Herbener Jason Dignard Laura Koziol Julian Fairhall Emma Forrest Oscar Carlberg Grace Liu Dimitri Lorenzo Neetika Kapani Patrick Peake Andrei Costache Devendra Singh Jo-Anne Chan Daniel Kurz Graham Pearson	Economic Regulation Authority (Chair) Economic Regulation Authority (Presenter) Economic Regulation Authority Economic Regulation Authority Economic Regulation Authority (Presenter) Economic Regulation Authority Economic Regulation Authority Economic Regulation Authority Alinta Energy Australian Energy Market Operator Bluewaters Power Australian Energy Market Operator Perth Energy Australian Energy Market Operator Collgar Wind Farm Synergy Bluewaters Power Australian Energy Council
<b>Apologies:</b>	John Nguyen Paul Arias	Perth Energy Bluewaters Power
<b>TRIM ref:</b>	D218307	

## 1. Welcome by Sara O'Connor

Sara O'Connor, Committee Chair, opened the meeting and welcomed everyone to the first meeting of the Working Group at 10:02 am.

Sara reminded attendees that they are participating as general industry representatives and not representatives of individual organisations and that the meeting was being recorded.

## 2. Meeting apologies / attendance

The Chair noted the attendance list as above.

## 3. Summary of the procedure change process:

- (a) requirements of the market rules
- (b) procedure change process
- (c) the terms of reference of the Working Group

Mr. Matt Shahnazari gave a presentation on the requirements of the market rules, the procedure change process and the terms of reference (TOR) of the Working Group.

A copy of the presentation is available on the Rule Change Panel's website.

Mr. Shahnazari advised that according to the Market Rules (4.16.9), the Economic Regulation Authority (ERA) is required to review the Benchmark Reserve Capacity Price (BRCP) at least once every five years and that the Market Rules allow the ERA to review the procedure after 31 October 2017.

#### **4. Project schedule**

Mr. Shahnazari advised the attendees that the ERA needs to follow the steps stipulated in the Market Rules and that is to prepare a procedure change proposal, seek the advice of the Working Group, consult with the public on the procedure change proposal and finally, after considering feedback, publish a procedure change report.

#### **5. Presentation on the preliminary procedure change proposal**

Mr. Shahnazari gave a presentation on the preliminary procedure change proposal. The following points were discussed:

- BRCP is the main anchor point for the capacity pricing curve and recently there was a change to this pricing curve. Currently, there are three inflection points, out of which two use the BRCP:
  - Point 1: the reserve capacity price is capped at 1.3 times the value of the BRCP at zero per cent excess capacity credits.
  - Point 2 (the economic zero point): the reserve capacity price is 50 per cent of the BRCP at 10 per cent excess capacity credits.

There is another point: above 30 per cent excess capacity credits the capacity credit price is zero.

- Energy Policy WA (EPWA) published a document for the development of the capacity pricing curve and it considered that the BRCP reflects the fixed costs of the marginal asset into an auction for the procurement of capacity credits. At 3.75 per cent level of excess capacity credits in the system, the price of capacity credits would be equal to the BRCP.
- A comprehensive review of the market procedure should consider the choice of reference facility, fixed investment costs, fixed operating and maintenance costs and a reasonable return on invested capital. The review must also consider the amount of capacity credits that is expected to be assigned to the reference facility. This is because the BRCP is expressed in terms of dollars for amount of capacity credits assigned. Taking these into consideration, the ERA found that there was substantial overlap with the current reform process and the review of the market procedure.
- Facilities with low cost per capacity credits appear to be suitable candidates for setting the BRCP. EPWA is currently reviewing the assignment of capacity credits under constrained network access model. The details are just emerging, and the rules are not yet implemented in the market rules. Furthermore, EPWA is developing capacity certification method for storage facilities, one of the other technology options that is likely to be available in the market. So, the problem is that the ERA cannot objectively assess the choice of that reference facility. Hence, the ERA considered to exclude the review of the reference facility from the scope of the review of the market procedure this year.

- The ERA received feedback from stakeholders during previous reviews of the BRCP (which the Australian Energy Market Operator (AEMO) conducts annually). Stakeholders suggested that the components of the calculation of the Weighted Average Cost of Capital (WACC) have problems and are outdated.
- As per the TOR, the ERA's preliminary project timeline was to complete the procedure review by February 2021. A market participant raised concern that the updated procedure would not be available for the 2021 reserve capacity cycle and the shortcomings in the calculation of WACC would continue to influence the value of the BRCP for the 2021 reserve capacity cycle.
- Following this feedback, the ERA considered limiting the scope of the review this year to updating WACC parameters only. Limiting the scope might allow the market procedure to be reviewed more quickly and then applied in the calculation of the BRCP for the 2021 reserve capacity cycle. The ERA Secretariat will engage with AEMO to consider possible ways to achieve this.
- Mr. Patrick Peake agreed to the approach of just looking at the WACC at this stage as part of the review. He further mentioned that one of the big issues at the moment is that the demand side management is being offered the same price per megawatt as generators. Generators are looking for recognition and compensation for the fact that they have to be available 24/7, be able to run continuously and have adequate fuel stored onsite for long-term operation. Although this may be acknowledged through the Essential System Services mechanism. However, if this was not the case, then perhaps there ought to be some recognition of that in the reserve capacity price.
- Both Mr. Daniel Kurz and Mr. Oscar Carlberg agreed with Mr. Peake's comments and ERA's approach of limiting the scope of the review to WACC.
- Ms. Laura Koziol confirmed that with or without a meeting the Market Advisory Committee can be requested to provide a feedback for whatever decision the BRCP Working Group makes.

## 6. Discussion on the preliminary procedure change proposal

Mr. Jason Dignard gave a presentation on the review of the WACC.

A copy of the presentation is available on the Rule Change Panel's website. The following points were discussed:

- The market procedure requires AEMO to calculate expected inflation rate based on Reserve Bank of Australia's (RBA) method that takes a couple of years of forecasts, and then for the remainder of the ten-year term, the midpoint of forecasts. Stakeholders and AEMO have expressed concerns that this has led to negative real risk-free rates and low WACCs, and that this did not reflect Australian market conditions.
- There are several ways that the issue of high forecast inflation can be addressed. One of which is to update the method used to forecast the inflation rate. The ERA, across its various work responsibilities in electricity, gas and rail, uses a different approach to the RBA's forecast. This is based on market data for the treasury bonds and implied expected inflation, which uses a Fisher equation that takes market data on nominal government bonds and real government bonds to extract expected inflation rate implied in the data. By updating the method to estimate the expected inflation rate, forecast inflation and market parameter will not be inconsistent and a real WACC will not be as low as that determined recently.

- An alternative approach to address the current problem with the high inflation forecast is to use a nominal WACC. A nominal WACC already includes the market's expectations of inflation. If a nominal WACC is adopted in the calculation of the BRCP, the sensitivity of the BRCP to expected inflation rate will be removed. The ERA has not yet decided on the use of real or nominal WACC and seeks stakeholders' views.
- The AEMO currently uses generation costs and material escalators to estimate capital costs at the capacity year. Capital costs are not escalated by actual inflation.
- It is important to ensure investors are compensated for the effect of inflation. The choice of discount rate for calculating the BRCP must be considered in relation to the purpose of the BRCP and its role in the pricing of capacity credits.
- Mr. Carlberg mentioned that inflation will definitely be an issue and definitely a risk that investors will price for, but there is also a need to look at what is currently in the WACC calculation to suggest any kind of changes to how that risk is accommodated.
- Mr. Peake mentioned that there was a risk of foreign exchange and material costs which were linked to, like copper prices. In response to this, Mr. Shahnazari advised that foreign exchange rates move with differences between expected inflation rates between countries. Mr Dignard noted that this is relative inflation of the two countries, and also that foreign exchange rates move for many reasons including forecast terms of trade, differences in policy rates and economic growth rates between the countries, speculation and other factors.
- The risk-free rate is the rate of return an investor would expect when investing in an asset with no risk. Generally, the approach is to take and use Commonwealth Bonds as an approximation of a riskless asset. The market procedure uses ten-year Commonwealth Bonds, which is consistent with the long-term nature of a generation plant, to approximate a long-term rate of return. Mr. Carlberg highlighted what he thought AEMO had in its last report, and also what Alinta Energy had in its last submission, which is that the risk-free rate, being so low, did appear to result in a pretty irregular WACC. AEMO had noted that when this did happen, it had no recourse under the procedure to take a broader view and assess whether the impact that this had on the WACC resulted in a reasonable WACC. Mr Dignard advised that the WACC process uses the nominal risk free rate. A real rate is taken at the WACC level not at the level of the risk free rate.
- Mr Dignard discussed the market risk premium parameter. Mr. Peake informed the group that the reserve capacity market had actually been extremely risky over the last ten or 12 years. Every time there has been an excess capacity, there has been changes to the market pricing curve. In response, Mr. Dignard noted that the market risk premium is a market measure irrespective of industry.
- Mr. Peake mentioned that one of the big risks that they face is that Synergy does not respond to the financial incentives that have come through the reserve capacity mechanism which has depressed the price. In the future, this raises the question of whether the market power mitigation aspects of the new market will take that into account. Mr Peake suggested this was probably not a risk in the PJM Interconnection market in the United States, or some of these other markets where there is no dominant player who is able to actually control price outcomes.

Additionally, Mr. Peake highlighted that no one's actually tried to invest in the capacity market for the last ten years, which indicates that investors see this as quite a risky market. Most of the new plant entering the market at present is

driven by energy prices. The reserve capacity mechanism is seen as being a risky business because it has had so many unilateral changes over the last period of time, over the last ten years probably, three or four fairly significant ones.

- In the WACC calculation, equity beta captures market specific risk. Given market participants observations of the degree of risk inherent in the WEM capacity mechanism, the ERA invites submissions to provide evidence to justify a change to the value of equity beta?
- The ERA has refined and further developed publicly available tools for its Debt Risk Premium (DRP) method. This method allows for dynamic current estimates and is based on market information. The ERA Supports AEMO's use of the revised bond yield approach on corporate bonds that have a 10-year term, with the DRP updated annually as well as seeks views on the continued use of a benchmark sample of BBB corporate bonds.
- The ERA also supports the recovery of direct costs of debt-raising, updating the debt issuance costs to 0.100 per cent and fixing the market risk premium until the next BRCP review.
- Mr. Carlberg queried as to what drove the parameters to increase or decrease in regard to debt raising. Mr. Dignard clarified that in managing an entity's debt portfolio, they have certain refinancing costs that they do on a regular basis and provided an example.
- When determining the gearing ratio, the ERA selects a relevant benchmark sample of businesses and observes the gearing levels of these firms. The use of a benchmark sample of firms is consistent with the estimation of equity beta. The ERA considers the benchmark sample approach provides incentives to service providers to adopt efficient gearing structures.
- The ERA invites submission to provide evidence to justify a change from 40 per cent gearing.
- The ERA estimates gamma as the product of the distribution rate and the utilisation rate to provide a gamma of 0.5 and it supports fixing the value of gamma until the next BRCP review.
- Mr. Carlberg seconded what Mr. Peake had mentioned earlier in that the BRCP needed to be calculated appropriately to incentivise enough investment in electricity, and that investing in electricity generation is inherently risky, particularly at the moment. Furthermore, Mr Carlberg's concern was whether there was a way to trigger or sense check a WACC value calculated as part of the BRCP annual process? Mindful that this was a complex process and that if something is missed, it potentially would take quite a bit of analysis to see what it is and check to see if that could be added to the procedure? Mr. Jason Dignard replied that the risk faced by a new generator are accounted through several components: the equity beta, credit rating, and gearing ratio.
- Mr. Dignard encouraged participants to form a view around the inflation rate issue and how it could best be addressed to ensure that a new entrant is not disincentivised.

## 7. General business

Grace Liu queried if ERA had a potential timeline for conducting the review on other aspects of the BRCP methodology. The Chair responded that she does not have a firm timeline. The ERA is awaiting EPWA's consideration of the timing for all of the

reviews that ERA has to undertake, of which BRCP and Energy Price Limits (EPL) method is one.

At the beginning of the meeting the Chair had suggested, that although the scope for the review of the BRCP market procedure had been reduced, there was still an opportunity for the BRCP working group to communicate its concerns with all aspects of the BRCP method and calculation. This could take place after the working group had considered the procedure change proposal and would be useful information for when the ERA did undertake its review of the BRCP/EPL methodology.

ERA's preference is to review the methods used to calculate the BRCP and EPL as quickly as possible after the new market commences. The review would encompass the BRCP calculation method, including the fixed operating and maintenance costs of the reference facility, the inflection points on the capacity demand curve and the EPL calculation methods.

The Chair requested attendees to forward their comments on the presentation as soon as possible.

The recommendation from the Working Group was to proceed with a fast-tracked procedure change proposal, concentrating on WACC parameters only. The Secretariat will now liaise with AEMO to establish a timeline that enables AEMO to use the revised BRCP procedure to calculate the 2021 BRCP.

Once the draft change proposal has been drafted it would be circulated to the Working Group members for comments and if needed a meeting would be called if there are disparity of comments and also once it is out for formal consultation, another session could be held to view other aspects of the whole BRCP method.

**Meeting closed at 11:19am**