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Discussion Paper: Annual WEM Report to the Minister  
Economic Regulation Authority  
Via e-mail: [SubmissionMinReport@era.wa.gov.au](mailto:SubmissionMinReport@era.wa.gov.au)

### **Discussion Paper: Annual Wholesale Electricity Market Report to the Minister for Energy**

The Energy Supply Association of Australia (esaa) welcomes the opportunity to comment on the Economic Regulation Authority's ("the Authority") second annual Wholesale Electricity Market (WEM) assessment of the effectiveness of the WEM in meeting the Wholesale Market Objectives (the "Objectives").

esaa is the peak industry body for the stationary energy sector in Australia and represents the policy positions of the Chief Executives of over 40 electricity and downstream natural gas businesses. These businesses own and operate more than \$120 billion in assets, employ 49,000 people and contribute \$14.5 billion directly to the nation's Gross Domestic Product.

It is noted that for this second report to the Minister, the Authority has taken a more focused consideration of fundamental issues affecting the effectiveness of the WEM in achieving the market Objectives than the first report. The Authority has focussed on areas including:

- Fuel supply issues
- Network issues
- The reserve capacity mechanism
- The STEM
- Balancing market
- Wind energy
- Demand-side management
- Rule change processes
- System management
- Bilateral contracts transparency
- Retail market arrangements
- Ministerial directions and the Vesting Contract; and
- Longer term market development

In responding to the discussion paper, esaa has focused on fuel supply issues and the STEM, the balancing market, reserve capacity mechanism and bilateral markets. We also note the importance of network issues, wind energy, demand side management and retail market arrangements in the context of the introduction of a national Carbon Pollution Reduction Scheme (CPRS) and expanded National Renewable Energy Target (NRET).

## **Fuel supply issues**

Fuel supply availability, prices and delivery constraints were highlighted by stakeholders as having considerable impact on the market, particularly with regard to gas supply. esaa agrees with the Authority's view that increases in fuel prices do not necessarily reflect a flaw in the WEM design and that investors are best placed to determine the most appropriate generation fuel mix in light of available fuel resources, prices and opportunity costs in the longer term.

However, to enable the WEM to efficiently respond to changes in fuel costs and availability, it is important to ensure there is sufficient flexibility to allow increased costs to be reflected in energy prices and to facilitate switching to alternative fuel supplies where appropriate.

Currently energy price limits are set annually to reflect fuel prices, therefore short-term fuel constraints – such as the recent Varanus Island incident – may result in short-run fuel prices exceeding the cap. This issue may be exacerbated by the separate price limits for liquid and non-liquid fuels. For example, for a generator with both liquid and non-liquid fuel usage capability, short-run costs for non-liquid fuels may exceed the non-liquid fuel price cap, but remain below the liquid fuel alternative. Under the current arrangement, the market participant would bid in assuming liquid fuel usage, which may not be its least cost option.

Additionally, in the case of gas supply, firm fuel supply is not known until after the STEM gate closure. Thus, a market participant may bid into the STEM on the basis of a particular fuel being available, and must accept the risk of short-term unavailability causing it to use a higher cost alternative or not meeting its reserve capacity obligations.

Inflexible and separate liquid and non-liquid price limits and the inability to rebid into the STEM are likely to act as a deterrent to efficient trading in the STEM. esaa therefore supports the IMO reviewing the merit of the current fuel based price caps and the potential need for the introduction of rebidding provisions in the development of the "Market Rules Evolution Plan" for the Market Advisory Committee.

## **The reserve capacity mechanism**

The Authority notes that some stakeholders have questioned the appropriateness of the reserve capacity mechanism and whether it provides efficient investment signals. In particular, some stakeholders suggest that a move to a market determined capacity price would provide a more economically efficient capacity pricing mechanism than the current arrangements, where the capacity price is set administratively when there is excess capacity and a reserve capacity auction is not required. The administered price is set currently at 85% of the maximum reserve capacity price; this will be reduced on a pro-rata basis from 1 October to ensure the total capacity payment is not more than if there was no surplus capacity.

In principle, esaa supports the view that prices should be determined by competitive market processes wherever practical, and would therefore support further careful consideration of the process and timing for such a transition. However, to ensure ongoing investment confidence, it is important that in considering the introduction of market determined prices that investments made on the basis of the existing pricing mechanism arrangements are not adversely impacted.

In its current format the reserve capacity refund calculation methodology explicitly favours reliability during summer peaks, however, reliability may also be highly valued at other times – for example, when there is a significant amount of plant on planned outages.

Therefore, a calculation methodology that reflects the marginal cost impact on the market would provide greater incentive to achieve high reliability compliance when it is most needed.

### **Balancing market**

It is understood that under the current balancing arrangements, Verve Energy may not fully recover its costs as the Balancing Generator in the market as a result of differences between real-time dispatch and day-ahead forecasts of dispatch.

It is important that the balancing market has cost-reflective pricing to ensure efficient market outcomes, and in particular so as not to distort bidding behaviours in the STEM. It is acknowledged that it may take some time for the WEM to develop to a point where there is sufficient generator competition to allow a competitive balancing market to be developed, however, it is important that the balancing market move to allow full cost reflectivity as rapidly as possible. Ensuring cost-reflectivity in the current balancing market will minimise distortions and encourage participation in any competitive balancing market mechanism that may be introduced at a later date.

### **Bilateral contract price transparency**

The Authority invited comments on measures to improve price transparency in the bilateral contracts market. The bilateral market is, and is intended to be, comprised of individual commercial agreements between electricity producers and consumers. In the absence of a compelling market failure it would be highly inappropriate for government to intrude in the operation of this market, particularly through exposing confidential contractual prices. In addition to being intrusive and unnecessary, open exposure of contractual prices can reduce the competitive tension necessary for efficient market operation. As there are multiple willing sellers and buyers in the SWIS, there appears to be sufficient competitive tension in the market and no case for additional regulatory intervention.

Greater price information can best be provided for all market participants through ensuring efficient, transparent and competitive Short Term Energy and Reserve Capacity Markets.

In the National Energy Market (NEM) for comparison, although all energy is traded through the spot market with a high degree of price transparency, the bilateral hedging contract arrangements that reflect the long term positions between individual generators and market customers are not publicly available.

There may be benefit in the IMO, or other relevant body, providing the market with additional information through the preparation and publication of a regular report on new entrant generation costs in the SWIS, noting that NEMMCO currently produces such a report annually.

### **Network issues, wind energy, demand-side management and retail market arrangements**

The introduction of a national CPRS, along with the expanded NRET, is likely to have significant impacts on the development of all Australian energy markets in the near term. As a result, renewable energy technologies – such as wind energy – and demand-side management (DSM) can be expected to play increasingly larger roles in the SWIS over the coming years.

For example, a recent esaa study of the impact of an emissions trading scheme on the energy supply industry<sup>1</sup> indicates that an emissions reduction target of 10 per cent below 2000 levels combined with an expanded NRET would increase real prices in the STEM by over 90% relative to business as usual, and result in approximately an additional 800 MW of wind capacity in the SWIS by 2020.

Retail market arrangements therefore have important implications for the ongoing effectiveness of the WEM. For DSM to be appropriately valued in this environment, it is imperative that retail prices are fully cost reflective as soon as is practical. It is also important that the wholesale assessment of DSM opportunities considers the full costs and benefits of DSM, including network benefits.

Efficient technical and economic regulation, coupled with effective environmental and planning processes, will be required to ensure optimal investment in network infrastructure and generation plant to meet both the expanded NRET and continued load growth in the SWIS.

In conclusion, the market is still in its relatively early stages. Continued ongoing assessment of market performance, and removal of identified impediments to competition, is supported to ensure the effective operation of the market in the longer term and realisation of the WEM Objectives. It is important, however, that the full costs and benefits of any major structural market changes be considered so as not to undermine the investment certainty arising from a stable market design.

Yours sincerely

**Brad Page**  
Chief Executive Officer

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<sup>1</sup> The impact of an ETS on the energy supply industry, July 2008  
(<http://www.esaa.com.au/images/stories/Report/20080723esaaatreport.pdf>)