14 January 2011

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Review of the Operation of the Wholesale Electricity Market
Economic Regulation Authority
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DISCUSSION PAPER ANNUAL WHOLESALE ELECTRICITY MARKET REPOR TO THE MINISTER FOR ENERGY

Alinta Sales Pty Limited (Alinta) appreciates the opportunity to provide a submission to the Economic Regulation Authority (the Authority) on the extent to which the WEM objectives have been, or are being achieved as part of the report it is preparing for the Minister for Energy on the effectiveness of the Wholesale Electricity Market pursuant to Market Rule 2.16.11.

Alinta did not provide a submission to the Authority in response to the Authority's Discussion Paper prepared to assist it in preparing the 2010 Annual Wholesale Electricity Market Report to the Minister for Energy. Nevertheless, the attached submission builds upon previous issues raised by Alinta regarding the functioning of the market in relation to the current market objectives.

Should the Authority require further information on any of the above issues, or those discussed in the attachment, I can be contacted on 9486 3749.

Yours sincerely

Corey Dykstra
Manager Regulatory Affairs
Alinta Sales Pty Ltd

Att.

ATTACHMENT

SUBMISSION IN RESPONSE TO THE DISCUSSION PAPER "ANNUAL WHOLESALE ELECTRICITY MARKET REPOR TO THE MINISTER FOR ENERGY"

Overview

Alinta considers that, on balance, while the Wholesale Electricity Market Objectives remain appropriate, there is emerging evidence that the WEM may no longer be effective in meeting these objectives.

Market Objectives

The Wholesale Electricity Market Objectives are as follows.

(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.

Alinta considers that, on balance, the Wholesale Electricity Market Objectives themselves remain appropriate.

However, whereas clause 2.5.7(d) requires that a rule change proposal submitted by a person, including the IMO, must describe how the proposed rule change would **better** address the Wholesale Market Objectives, clause 2.4.2 only requires that, in amending the Market Rules, the IMO be satisfied that the Market Rules, as proposed to be amended or replaced, would be **consistent** with the Wholesale Market Objectives. This raises two issues.

Firstly, it is very likely that a rule change proposal may be consistent with some, but not all, of the Market Objectives. The IMO has previously implied (in the Draft Rule Change report for RC_2008_31) that clause 2.4.2 precludes it from amending the Market Rules where a rule change proposal is not consistent with any one Market Objectives, for example where certain facilities are treated differently to other facilities. Nevertheless, it would appear that the intent of clause 2.5.7(d) is instead directed at ensuring that, in aggregate, the Market Rules, as amended or replaced, better achieve the objectives.

Secondly, recently two alternative proposals for rule changes to the methodology for establishing the level of capacity credits assigned to intermittent generators were submitted to the IMO, one by the IMO and the other by Griffin Energy. To the extent that both proposals are found to be consistent with the Market Rules, it is unclear whether the Market Rules would lead the IMO to implement the proposal that best addresses the Wholesale Market Objectives.

It may be necessary for the Market Rules to be amended to provide better guidance on the basis on which proposals to amend the Market Rules may be accepted, modified and accepted, or rejected.

Administration of the Market Rules

In its submission to the Authority's 2009 WEM Review Discussion Paper, Alinta commented that there existed significant potential for conflicts of interest to arise given the IMO's multiple roles in the WEM. Specifically, it noted that the IMO was responsible for determining whether or not to amend the Market Rules, for operating the WEM, and for enforcing the Market Rules. In the National Electricity Market, these three roles are performed by separate entities, being the AEMC, the Australian Energy Market Operator and the Australian Energy Regulator. Nevertheless, at the time Alinta considered that given the significantly smaller size of the WEM, the delineation of these responsibilities into separate entities might not be efficient or warranted, but that it might be appropriate to consider whether there was merit is more formally delineating these responsibilities.

That said, emerging evidence may indicate that the IMO's multiple roles are now leading to practises in the administration and operation of the WEM that may not be consistent with the Market Objectives.

Intermittent generation

In its previous report to the Minister, the Authority noted that significant changes to the treatment of intermittent generation in the WEM would have implications for investor certainty, and for this reason, recommended that consideration be given to a clear transition regime to manage changes in the treatment of intermittent generation.

At the December 2010 MAC meeting, the IMO submitted two discussion papers for rule changes to the methodology for establishing the level of capacity credits assigned to intermittent generators, and for allocating load following ancillary services costs. If approved, the effect of the changes would be to approximately halve the value of capacity payments to intermittent generators, and to increase the amount of load following ancillary services costs allocated to intermittent generators seventeen-fold.

In proposing an alternative methodology for establishing the level of capacity credits to be assigned to intermittent generators, the IMO appears to have discounted the advice of the independent consultant it engaged to advice it and the Renewable Energy Generation Working Group on the issue, and instead adopted a method proposed by the Office of Energy. Further, despite the detrimental commercial impact on existing intermittent generators, and in contrast with the Authority's recommendation, the IMO's proposal fails to provide for a clear transition regime to manage the significant commercial ramifications that would result from its proposals.

While Alinta is yet to be persuaded that the Market Rules and empirical evidence provide any support for establishing the level of capacity credits to be assigned to intermittent generators using the methodology proposed by the IMO, of greater concern is that the IMO's proposal significantly increases the perceived level of regulatory risk in the WEM. As a result, it is likely that the proposal will undermine the efficient entry of new competitors, lessen competition among generators, and fail to promote the economically efficient, safe and reliable production and supply of electricity and electricity related service in the South West interconnected system.

Curtailable loads

That the IMO's multiple roles and potential conflict of interest may be leading to practises in the administration and operation of the WEM that are not be consistent with the Market Objectives may be reflected by its practices in relation to the registration of curtailable loads. Since May 2010, the IMO has indicated publicly on a number of occasions that its practice of allowing a Load that is a Non-Dispatchable Load for a Market Participant to be registered as a Curtailable Load by another (unrelated) Market Participant is not permitted by the Market Rules. In December 2010, it submitted a rule change proposal that would permit it to continue this practise.

Alinta considers that, given the apparent acknowledgement by the IMO that its practise was not permitted by the Market Rules, and the significant financial impact on Market Generators, it is important that the circumstances of the apparent breach of the Market Rules be independently investigated so that Market Participants and potential investors can be assured of the integrity of the administration of the WEM. In particular, if the IMO has breached the Market Rules, the investigation should identify mechanisms, including governance or structural arrangements, through which the risk of future breaches might be avoided.

Consequently, in November 2010 Alinta wrote to the Minister for Energy, requesting that:

1. he appoint a person to be responsible for investigating alleged breaches by the IMO of the Market Rules (and Market Procedures), as is permitted under clause 2.13.1 of the Market Rules; and
2. on appointment, Alinta's letter be provided to the appointed person and treated as a notice provided under clause 2.13.5 of the Market Rules of an alleged rule breach by the IMO.

Alinta considers that in the two above examples, structural separation of responsibility for determining whether or not to amend the Market Rules, for operating the WEM, and for enforcing the Market Rules, would assist in avoiding at least a perception that the potential conflicts faced by the IMO may be resulting in outcomes that do not best achieve the Market Objectives.

Reserve Capacity Mechanism

In its submission to the 2009 WEM Review Discussion Paper, Alinta noted that, in response to the Market Rules Evolution Plan Issues Paper presented by the IMO the June 2009 MAC meeting, electricity Market Participants had ranked a review of the RCM as the second highest priority for the next phase of market development. While aspects of the RCM, including for example capacity refunds feature in the IMO's current Market Evolution Plan, it has indicated that a comprehensive review of the RCM will not commence until mid-2011.

As outlined below, Alinta considers that a number of changes to the RCM may be warranted in order to better achieve the market objectives of:

- promoting the economically efficient, safe and reliable production and supply of electricity and electricity related services in the South West interconnected system; and
- avoiding 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; and
- minimising the long-term cost of electricity supplied to customers from the South West interconnected system.

Generation fuel diversity

In response to the Authority's 2009 WEM Review Discussion Paper, Alinta noted that, in assigning capacity credits to schedulable facilities, and in setting the Maximum Reserve Capacity Price (MRCP), the RCM does not differentiate between facilities based on fuel type, or the ability of facilities to operate using more than one type of fuel. It suggested that the economically efficient, safe and reliable production and supply of electricity might be promoted if this were the case, and that it might be desirable for the IMO to consider whether the RCM should financially incentivise dual fuel facilities and/or to discriminate in the allocation of capacity credits to facilities based on fuel type.

The report of the Gas Supply Emergency Management Committee, published in September 2009, also recommended that the necessary regulatory frameworks be introduced (or presumably amended) to provide an incentive for electricity generators to install or retro-fit dual-fuel generation capacity and maintain an adequate strategic stock of diesel to meet abnormal fuel requirements associated with a gas supply disruption.

In contrast, currently facilities that are certified as dual-fuel facilities through the RCM currently incur higher costs than facilities that are certified on only one fuel. This occurs because dual-fuel facilities are tested on both fuels and, in addition to needing to have an uninterruptible supply of the primary fuel for peak periods, such facilities must also have on-site storage, or uninterruptible supply, of the secondary fuel for 12 hours of operation (at maximum output). Further, the quantum of capacity credits assigned to a dual-fuel facility is determined by the lowest maximum output across the alternative fuel types, which generally results in a lower level of capacity credits being assigned to the facility than would result based on the maximum output from the facility's primary fuel source.

As noted earlier, the MRCP does not differentiate between capacity provided by facilities based on fuel type, or the ability of facilities to operate using more than one type of fuel. Consequently, the Market Rules do not appear to recognise the contribution that dual-fuel facilities may make to:

- enhancing the economically efficient, safe and reliable production and supply of electricity and electricity related services in the South West interconnected system; and
- minimising the long-term cost of electricity supplied to customers from the South West interconnected system.

Due to both higher operating costs and the reduction in the level of capacity credits that result under the current RCM, Alinta has decided that for future RCM cycles it will not apply to certify its Wagerup as a dual-fuelled facility (i.e. it will apply to have Wagerup certified as only a gas-fuelled facility). While this would not prevent Wagerup being made available to operate on distillate, the fact that the facility might no longer be routinely run (or tested) on distillate, and the absence of any requirement to hold a minimum amount of distillate fuel, potentially reduces the contribution that the Wagerup facility might make to the economically efficient, safe and reliable production and supply of electricity and electricity related services in the South West interconnected system.

Because the current RCM also appears not to recognise that dual-fuel plant have the potential to result in an increased level of reliability at a lower cost, the RCM may also not be effective in minimising the long-term cost of electricity supplied to customers from the South West interconnected system.

Demand side management

Alinta is supportive of efforts to ensure that the RCM appropriately incentivises the provision of capacity by loads that may be curtailable, as the ability to curtail specific loads provides a potentially valuable option to System Management to avoid otherwise unplanned load shedding during periods of peak system demand.

However, Alinta is concerned that the RCM currently fails to recognise that the characteristics of capacity provided by curtailable loads differs from that provided by scheduled generators. Specifically, capacity provided by curtailable loads might not be available for more than 96 hours per year but may be paid the MRCP, the same price as that paid for capacity provided by a scheduled generator that is required to be continuously available (other than approved planned outages).

In addition, when issuing dispatch orders, the WEM requires that System Management take account of the limited availability of curtailable loads, and that issuing an order to curtail such a load at any time might mean that the load is not available to be curtailed at a later time when it might provide greater benefit with respect to maintaining power system security and reliability.

Alinta considers that by failing to recognise that capacity provided by curtailable loads differs from that provided by scheduled generators, the RCM currently:

- undermines the economically efficient, safe and reliable production and supply of electricity and electricity related services in the South West interconnected system; and

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

Firstly, applying the same price to capacity provided by curtailable loads may not be appropriate as it appears to be an inferior capacity 'service' when compared with that provided by scheduled generators and, if this were the case, doing so would overstate the value of capacity provided by curtailable loads. To the extent that the current RCM provides inefficient price signals for capacity provided by curtailable loads, this could account for the significant increase in capacity credits assigned to curtailable loads registered by non-retail market participants in recent years.[1] As shown in the table below, the amount of capacity provided via curtailable loads registered by non-retail market participants has more than doubled every year for the last 4 years.

Capacity Year	Reserve Requirement	Total Capacity Credits assigned by IMO	Surplus	Non-Retail Curtailable Loads
2008/09	4,322	4,599.88	277.88	21.11
2009/10	4,609	5,136.43	527.43	23.65
2010/11	5,146	5,258.55	112.55	66.50
2011/12	5,191	5,493.49	302.49	151.50
2012/13	5,501	5,995.61	494.61	316.49

Secondly, the continuing increase in the amount of capacity provided by curtailable loads in an environment where there is already an oversupply of capacity suggests that the RCM may not be effectively meeting the market objectives. While the overall cost of capacity is capped, the over supply of capacity has led to both a reduction in the Monthly Reserve Capacity Price and a transfer of capacity payments from traditional providers of capacity to curtailable loads registered by non-retail market participants. Alinta estimates that the aggregate value of these transfers will amount to around $93 million.

Alinta has previously noted that anecdotal evidence available to it indicated that large industrial customers would be more likely to consider participating in a voluntary DSM scheme that provided payment for real-time reductions in load. That is, DSM was an energy, rather than capacity, service. In addition, these customers have indicated that payment for DSM should reflect the real time reduction in demand at the point DSM is called, not from some deemed historical level of peak demand as currently occurs.

Competitive provision of Balancing and Ancillary Services

That the current arrangements in the WEM for the provision of balancing and ancillary services may no longer best achieve the Market Objectives has been apparent for at least the last 18 months.

[1] A Market Customer that has a Demand Side Programme that is comprised of Curtailable Loads that are not supplied with energy by that Market Customer is referred to as a 'non retail Market Customer.

In October 2009, the IMO finalised a Market Rules Evolution Plan that prioritised potential changes to the Market Rules that had been identified by Market Participants. Improving the balancing mechanism, with a view to supporting generators other than Verve Energy contribute towards balancing and improving the mechanism to handle unexpected events between clearing of the Short Term Energy Market (STEM) and real time. Reviewing the procurement of ancillary services process and assessing whether the provision of Ancillary Services should be opened up to competition for spinning reserve, frequency control and black start was deemed to be the fifth most important priority.

In addition, the Verve Energy Review (the 'Oates Review') report released in late 2009 also recommended that the WEM rules be revised with particular emphasis on a number of areas, including broader participation in the balancing market and the provision of ancillary services.

Since mid-2010, the IMO appears to have engaged and allocated significant resources to its Market Evolution Plan, which in large part is directed at addressing the priorities identified in the original Market Rules Evolution Plan and by the Oates Review. However, currently it appears that unless there were to be fundamental changes in the relationship between System Management and Verve Energy, there may be limited opportunities for broader participation in the balancing market and the provision of ancillary services within the WEM.

Alinta understands that more detail on the options that may be available for broader participation in the balancing market and the provision of ancillary services within the WEM will be provided to Market Participants via the Rules Development Implementation Working Group in early 2011.

Alinta Sales Pty Ltd
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