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Dear Ignatius

Thank you for providing Alinta Sales Pty Ltd (Alinta) an opportunity to comment on the *Annual Wholesale Electricity Market Report to the Minister for Energy – Discussion Paper* (dated 9 August 2007). Alinta's comments are set out below:

Discussion Point 1 - Given the current Wholesale Electricity Market design, the Authority invites comment on the extent to which the operation of the Reserve Capacity Mechanism is effective in achieving the objectives of the Wholesale Electricity Market.

In general, given the number of generation projects currently proposed it appears that the Reserve Capacity Mechanism is inducing capacity in to the South West Interconnected System. However, Alinta has a number of concerns with the recent operation of the Reserve Capacity Mechanism with regards to timing, forecasting and pricing. Alinta welcomes discussions with the relevant parties to ensure enhancement of the Reserve Capacity Mechanism so that it continues to work effectively into the future.

Forecasting and Reserve Capacity Pricing Mechanism

The Independent Market Operator, through its appointed consultant National Economics, forecasts the target Reserve Capacity requirement two years in advance that is to apply in the SWIS. The maximum demand forecasts produced so far have varied considerably from year to year. Although it is reasonable to assume that forecasts will be different than the actual amount, the forecasts have consistently been low over a number of years.

Prior to market start, a change to the Market Rules was made resulting in the Reserve Capacity Price being reduced in proportion to any excess of Reserve Capacity Credits acquired by the Independent Market Operator. Alinta is concerned that the Independent Market Operator has applied the Excess Capacity Adjustment to perhaps questionable forecasts. The Excess Capacity Adjustment effectively scales down the price Market Generators will receive for their Reserve Capacity Credits in two years time. Recent forecasts suggest that the actual supply/demand balance may be tighter than the capacity excess 'forecast' by the Independent Market Operator. Investment in generation plant is known to be lumpy and it appears unreasonable that the incumbent generators be penalised through the excess capacity factor. Excess capacity in the short term may turn out to be an optimal and efficient outcome due to the economies of scale and improved fuel efficiency provided by installing larger plant. This is also likely to provide opportunities for a more diverse generating plant mix.

Alinta is concerned that Market Generators will bear the financial implications associated with the reduced Reserve Capacity Price in 2008/2009 yet the Independent Market Operator may need to hold a supplementary auction to cover an expected capacity shortfall in 2007/2008.

Alinta proposes that the Reserve Capacity pricing mechanism, and more specifically the Excess Capacity Adjustment, be thoroughly reviewed and amended appropriately.

Two Year Reserve Capacity Cycle

Alinta highlights that there are only two years between the allocation of Certified Reserve Capacity and the date upon which Reserve Capacity Credit obligations apply to generation plant. The obligation on proponents to bring capacity online within two years of being accepted by the Independent Market Operator provides considerable limitations on the type of technology and the location of generation projects that are feasible.

Most notably, is the risk proponents face in committing to delivery of generation plant whilst waiting for Western Power to install or significantly reinforce its highly constrained transmission system. Alinta notes that applications for all new generation plant must include a letter from the Network Operator (Western Power) indicating it has made an access offer and that the generator can be connected prior to the date at which Reserve Capacity Credit obligations will apply. Although the generator may be installed it is possible that the associated network infrastructure may not be complete. This poses a considerable risk to Market Generators given that Western Power, the monopoly network provider, is unlikely to bear costs associated with the project being delayed and causing a Market Participant to be unable to meet their Reserve Capacity Credit obligations. This needs to be balanced with the difficulties in forecasting system load even greater than two years in advance.

Maximum Reserve Capacity Price – Inclusion of a gas lateral

Alinta's interpretation of the Market Rules requires the Independent Market Operator to assess the appropriateness of 'the capital cost of a pipeline lateral of reasonable length to connect to a main gas lateral (so as to allow for dual fuel capability)' when calculating the Maximum Reserve Capacity Price.

The Independent Market Operator has advised Alinta that the open cycle gas turbine which forms the basis for determining the Maximum Reserve Capacity Price is likely to run only for a limited number of hours each year, and therefore would be configured to run on distillate and not require a gas lateral.

Alinta notes that the Independent Market Operator's treatment of the gas lateral does create inconsistencies. For example, the Independent Market Operator's estimate of generator O&M costs is based on the assumption that the turbine is running primarily on natural gas. Presumably if there is no gas lateral this cannot be the case. It also raises the question as to what fleet of generation the Independent Market Operator is enticing into the system. This is covered in more detail in discussion point 2.

Reserve Capacity Credit Refund Mechanism

The operation of the Reserve Capacity Credit refund mechanism is significantly impacted by the Independent Market Operators interpretation of the Market Rules and subsequent settlement. The outworkings of the Independent Market Operator's interpretation result in daily caps overriding interval penalties, and seasonal caps overriding daily caps. The resulting outcome is that Reserve Capacity Credit refunds are significantly less than originally intended when the mechanism was developed.

This interpretation results in a significant transfer of value from Market Retailers and Market Generators with good reliability to Market Generators whose plant has performed unreliably. The aforementioned interpretation and resultant transfer of value has meant that generators have a much lesser incentive to ensure that their plant is maintained and performing reliably. This has the flow on effect of providing a significant upward pressure on electricity market price, as evidenced in particular during the first three months of the Wholesale Electricity Market.

Alinta notes changes are being progressed but still feels settlement and interpretation is inconsistent with the intent of the rules.

Discussion Point 2

Bearing in mind the interaction of the capacity market and the energy market, the Authority invites comment on whether the current Wholesale Electricity Market provides adequate incentives for an efficient mix of generation plant.

Arguably the SWIS has an “efficient mix” of plant at present, however this has been committed and developed prior to the commencement of the Wholesale Electricity Market. At this point in time, it is too soon to say for certain whether or not the Wholesale Electricity Market provides adequate incentives for an efficient mix of generation plant.

A potential issue with the Maximum Reserve Capacity Price, is that it appears to promote installation of generation plant at the cheapest possible cost and in a relatively short time frame. Although this may have benefits in the short term, the mid to longer term efficiency and effectiveness may not be optimal. This has been demonstrated through recent proposed generation projects such as Bluewaters 1 and 2 that would not be considered efficient in a configuration and environmental sense. Although the short term capacity requirements of the SWIS may be met, this may be at the expense of longer term reliability of supply, additional emissions of carbon dioxide and noxious substances, and lower fuel efficiency.

The current interpretation of the Reserve Capacity Credit refund mechanism exacerbates the problem because unreliable plant in the SWIS is not making refund payments to the levels originally intended when the market was developed. This is covered in more detail at discussion point 18.

Discussion Point 3

The Authority invites comment on whether the Wholesale Electricity Market adequately promotes efficient location of generation facilities and promotes the efficient development of transmission and distribution networks.

Loss Factors

Western Power advise that ‘loss factors provide the market with a significant signal to locate load and generation at efficient locations.’ Alinta is concerned that the current loss factor methodology fails to provide and maintain the appropriate economic signal to promote efficient location of generation facilities.

For example, historically there has been insufficient generation in the North Country area as signalled by loss factors much greater than 1.0000 in the area. Alinta made a long term investment in the Alinta Windfarm at Walkaway. The nearby load loss factors at Three Springs, Golden Grove, Geraldton, Chapman and Eneabba are all still greater than 1.0000 signalling proponents there is still insufficient

generation in the area. The Alinta Windfarm's loss factor is now less than 1.000 signalling there is too much generation in the area. These two outcomes are obviously inconsistent.

Alinta would support a thorough review of the network loss factor methodology with the aim of providing and maintaining economic signals rather than the current approach which clearly removes the economic signal once the generation plant is installed.

Deep cost vs Shallow Cost

The connection of new generation plant to the transmission network can require significant network reinforcement.

Under a shallow approach, proponents would be required to pay only for the local assets specifically required to connect their generation plant to the transmission system. The costs of reinforcing the system beyond the connection assets would be recovered through use of system charges.

Alinta considers that shallow charging is advantageous because a new generation proponent can readily identify the connection assets and hence costs. Further, moving the cost of shared assets into common infrastructure benefits competition in generation as it removes some of the risk associated with sharing assets. This makes it easier for generators to enter the market and simplifies the charging arrangements. Shallow charging is also more transparent and has the further operational advantage that Western Power's assets would be under Western Power's control.

Deep charging, as is currently adopted by Western Power, can lead to significant connection charges associated with transmission network items are the responsibility of the network provider, for example provision of reactive power to support loads with poor power factors due to the transmission network being unable to transfer reactive power effectively. Furthermore, the charges for subsequent generator connections are likely to be lower than those paid by the initial contributor resulting in equity issues.

Network Capacity Constraints

There are a number of challenges generation proponents face in finding a suitable location for generation plant, especially due to the capacity constraints that are prevalent throughout the SWIS. Without the necessary network infrastructure in place the ability to transfer power is restricted adversely affecting the development of generation projects.

For example, Western Power advise through their *Transmission and Distribution Annual Planning Report* that the North Country network is not capable of connecting large customers or generators. Given that the mid-west region is expected to have substantial economic growth in the coming years a proponents ability to develop a project is severely restricted due to the time taken to install or reinforce the transmission and distribution network, especially within the requirements of the Independent Market Operator's two year Reserve Capacity Cycle.

Queuing Policy

Although Western Power's queuing policy associated with the recent Access Arrangement is relatively new and untested, Alinta is concerned that it will hinder the development of generation at efficient locations.

For example, a proponent may be willing to invest in generation plant in a particular area of the network with existing network capacity. However, there may be another proponent with another, less advanced, generation project ahead in the queue. It appears that the first proponent effectively uses the existing spare capacity while the second proponent is required to incur significant network reinforcement costs to progress their project.

Discussion Point 4

The Authority invites comment on whether the Wholesale Electricity Market adequately promotes investment in an efficient amount of generation capacity.

Alinta suggests that applying the Excess Capacity Adjustment is unlikely to promote investment in an efficient amount of generation plant. If the Wholesale Electricity Market is only promoting investment in 120MW generators in line with the annual increase in maximum demand, by applying the Excess Capacity Adjustment, then eventually there will be a large number of smaller generators with sub-optimum efficiency, as compared to an optimal mix and size of generation plant.

In general, and up to a point, there is a tradeoff between the size of generation plant and its efficiency. Investment in generation plant tends to be lumpy due to the optimum size of plant to achieve economies of scale and optimum fuel efficiency. The optimum size of the next generator is likely to be larger than the annual increase in load on the system. There is an optimum balance that needs to be achieved and Alinta welcomes further discussions with the relevant parties to ensure this is achieved.

Discussion Point 5

The Authority invites comment on whether there are other issues with the Reserve Capacity Mechanism that materially impact on the effectiveness of the Wholesale Electricity Market.

The issues related to the Reserve Capacity Mechanism that Alinta believe materially impact on the effectiveness of the Wholesale Electricity Market are:

- Current interpretation and settlement of the Reserve Capacity Credit refund mechanism
- Impact of forecasting and subsequent application of the Excess Capacity Adjustment

These issues have been discussed further under discussion points 18 and 1 respectively.

Discussion Point 6

Recognising that the Short Term Energy Market (STEM) is a net pool system, and that the Vesting Contract impacts on liquidity in the market, the Authority invites comment on any aspects of the STEM design that discourage Rule Participants from trading in the Wholesale Electricity Market.

Alinta believes that the Vesting Contracts significantly reduce liquidity in the STEM, however monitoring the STEM volumes over time as the Vesting Contracts are displaced will be required to verify this.

Discussion Point 7

The Authority invites comment on the day-ahead feature of the Short Term Energy Market (STEM). In particular, does the day-ahead feature of the STEM discourage Rule Participants from trading in the STEM and would introducing two gate closures, or gate closures closer to real time, encourage greater participation?

In the event the day-ahead arrangement is replaced by a real-time arrangement or the arrangement where the 'gate closure' time to offer and bid into the STEM is closer to real time events, the Authority invites comment on how the potential exercise of market power by larger participants could be mitigated.

One of the limitations of bidding day ahead into the STEM is that participants are locked into their positions irrespective of changes that may occur during the following day. For example, availability of gas may change due to a curtailment on the gas pipeline. The outworking of this is that Market Participants face higher uncertainty when making STEM submissions day ahead. Introducing a two gate closure, or gate closures closer to real time would allow more certainty in decision making resulting in greater participation and a more efficient outcome.

Alinta would support the move to a two gate process within the next 2 to 3 years.

The potential exercise of market power by larger participants would be mitigated by the existing requirement of participants to bid in at their SRMC, greater liquidity and more transparent and timely presentation of bidding data.

Discussion Point 8

The Authority invites comment on the effectiveness of the Independent Market Operator in carrying out its functions.

The Independent Market Operator has performed admirably in implementing and administering the WEM to date during which staff members have remained approachable and helpful despite large work loads and pressing deadlines.

There are however some areas that need improvement, they include:

Settlement

Alinta notes that the settlement process in particular has been problematic. The information provided by the Independent Market Operator is frequently incorrect and varies by substantial amounts from the initial invoice to subsequent monthly adjustments. There is considerable difficulty in determining the root cause of the variances primarily due to a lack of transparency in the supporting data and calculations forming the invoices.

Further complicating the process is the delay in implementing rule changes in the settlement systems. For example, rule change *C11 – Applying Tolerances to Dispatch Schedule* was approved to commence from December 1st, 2006 and as of September has not been taken into account for settlement.

This problem has flow on effects on working capital for Market Participants as the IMO holds disputed amounts until resolved. There should be an emphasis on resolving large disputed amounts to ease the burden on Market Participant working capital.

Prudential Requirements

Alinta is supportive of appropriate prudential requirements to ensure all Market Participants are reasonably protected if a participant defaults. Although prudential requirements can be increased at short notice, there does appear to be some instances where it seems logical that the prudential requirements could similarly be reduced at short notice. For example, where a Market Participant who

is a net purchaser from the market installs significant generation plant and becomes a net supplier to the market.

Discussion Point 9

The Authority invites comment on the effectiveness of the System Management in carrying out its functions.

Alinta has generally been satisfied with its dealings with System Management. There is, however, a lack of transparency associated with System Management activities that would enable Market Participants to determine how efficient System Management are performing, for example in:

- economic dispatch of plant
- economic provision of ancillary services

Discussion Point 10

The Authority invites comment on any further steps that could be taken to assist Rule Participants in understanding the Market Rules.

No comment

Discussion Point 11

The Authority invites comment on any aspects of the participation of Demand-Side Management in the Wholesale Electricity Market that remain unclear to Rule Participants.

Alinta shares the view that certain aspects of Demand Side Management within the Market Rules are unclear and welcomes any future stakeholder consultation aimed at integrating DSM more effectively into the overall Wholesale Electricity Market.

More specifically, the Market Rules do not clearly define what notice periods and continuous hours of availability are required to constitute DSM. Large consumers are typically able to provide an amount of load reduction by altering their operations, but they can only do this given sufficient notice of the requirement and a maximum duration for each event. These limitations are not clearly stated within the rules, leaving making it more difficult for Market Participants to contract for DSM.

There is also a lack of clarity on how the provision of DSM interacts with the individual Reserve Capacity requirement (IRCR) for the customer who delivers DSM. This leads to further issues when consumers try to contract for DSM directly with the IMO, as retailers could be unfairly treated in terms of IRCR for a customer who has contracted directly with the IMO for the provision of DSM.

Discussion Point 12

The Authority invites comment on the adequacy of the existing rule change process. In particular, the Authority is interested in whether or not the current process achieves an appropriate balance between cost, timeliness and transparency.

It is important that Market Participants have confidence in the Market Rules to underpin long term investment in the SWIS. Having confidence in the change process and its administration forms a very important part of the overall confidence in the Market Rules.

Since market start the rule change process has largely achieved these objectives however on two notable occasions, one prior to market start and one since market start there was an apparent lack of balance in the process. These incidents relate specifically to the following rule changes:

- Reserve Capacity Mechanism refund process
- Reserve Capacity Price and the Excess Capacity Adjustment

Given the significant financial impact associated with these rule changes if it were repeated then future investment in the WEM would be jeopardised.

Alinta is aware that the rule change process needs to provide an appropriate balance between cost, timeliness and transparency. In some cases there is an obvious and fundamental problem with the Market Rules that can significantly impact a Market Participant. In these cases an appropriate rule change process needs to be in place to provide a timely remedy. Even under the fast track scenario, the rule change process can be quite slow resulting in considerable financial impact until the rule change is implemented.

The effectiveness of the current Fast Track Rule Change Process could be improved by the Independent Market Operator holding Market Participants more accountable to the timeframes designated.

Discussion Point 13

The Authority invites comment on any fuel supply constraints faced by Market Participants, and the impact that any such constraints have on the effectiveness of the Wholesale Electricity Market. In particular, what impact, if any, do fuel supply constraints have on the operation of markets for capacity and energy?

Due to the timing requirements of the STEM Market Generators are required to bid their plant after making an assumption on fuel availability. For example if there was a constraint on the gas pipeline then Market Participants may be locked in to a gas price but be required to generate using their secondary fuel source, generally more expensive distillate. Ideally, Market Generators should have an opportunity to re-bid into the STEM in response to intra day changes in fuel supplies.

Alinta and a number of other Market Participants, have obligations operationally to both the Wholesale Electricity Market and the Dampier to Bunbury Natural Gas Pipeline. Currently there appears to be limited alignment between the two systems which may impact the overall efficiency of the market. Alinta and other Market Participants are bound to DBNGP requirements and STEM requirements which are sometimes incompatible. Alinta would welcome enhances to the market to achieve a better alignment between these two systems.

Discussion Point 14

The Authority invites comment on the materiality of the financial impact of consequential outages.

The Authority also invites comment on the extent to which participants are able to manage their exposure to consequential outages through commercial arrangements. If participants are unable manage their consequential outages through commercial arrangements, the Authority invites comment on the impact of consequential outages on the effectiveness of the Wholesale Electricity Market.

No comment.

Discussion Point 15

The Authority invites comment on whether the process for scheduling network outages affects the achievement of the objectives of the Wholesale Electricity Market.

Alinta believes the scheduling of network outages can affect the Wholesale Electricity Market. The effectiveness of network outages could be improved by:

- aligning network outages with generation outages
- timing network outages to occur during non-peak time or during the shoulder seasons.
- advising generators if the network outage has the potential to trip a generator

Discussion Point 16

The Authority invites comment on whether the confidentiality of information has impacted on the effectiveness of the Wholesale Electricity Market and, if so, how?

No comment.

Discussion Point 17

The Authority invites comment on whether a more competitive process for the supply of ancillary services would promote the effectiveness of the Wholesale Electricity Market. In particular, do the current requirements under the Market Rules for an ancillary service contract prevent or deter participants from supplying ancillary services and, if so, how?

Alinta supports the principle that a market based response should form the core of any solution to provide a range of ancillary services to the Wholesale Electricity Market.

Given the idiosyncrasies of the SWIS and Verve Energy's portfolio they are the obvious choice for provision of ancillary services in the initial stages of the Wholesale Electricity Market, however it is Alinta view that the provision of ancillary services could now be opened to competition for various services such as spinning reserve, frequency control and black start.

Discussion Point 18

The Authority invites comment on any specific events, behaviour or matters (not covered elsewhere in this Discussion Paper) that have impacted on the effectiveness of the market. In particular, the Authority invites comments on any specific events, behaviour or matters that are relevant to the achievement of the objectives set out in clause 1.2.1 of the Market Rules.

Alinta provides further detail on two events that it believes have had significant impact on the effectiveness of the market and welcomes changes to process and administration to ensure similar situations do not arise in the future.

Rule Change – Calculation of Reserve Capacity Price and Excess Capacity Adjustment

This is covered in more detail in discussion point 1.

Rules change – Reserve Capacity Credit refund mechanism

When the Market Rules were prepared, it is Alinta's understanding that generators undergoing an unplanned outage were to pay Reserve Capacity Credit refunds in line with the following:

- Relatively high rates to apply in the initial trading intervals.
- A lower cap to apply for outages lasting a full day.
- A further reduction to apply to refunds applied over a full season.

The Independent Market Operator IT systems for settlements have been built such that the seasonal cap actually overrides the other refund rates. The result of the Independent Market Operator's interpretation of the market rule is that Market Generator's with less reliable plant face significantly less refunds as a result of outages than was originally intended – this has resulted in significant value transferred from Market Retailers and Market Generators with reliable plant to other less reliable Market Generators.

I hope the above comments are of assistance and would appreciate the opportunity to participate in any future stakeholder consultation process to improve the Wholesale Electricity Market. Please call me on 08 6213 7304, or Mark McKinnon on 08 6213 7316 if you would like to discuss any of the issues in this letter further.

Yours sincerely

Victor Browner
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