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Discussion Paper: Annual WEM Report to the Minister
Economic Regulation Authority
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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) third annual Wholesale Electricity Market (WEM) Report to the Minister for Energy on the effectiveness of the market in meeting the Wholesale Market 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 52,000 people and contribute \$14.5 billion directly to the nation's Gross Domestic Product.

In responding to the discussion paper, esaa has focused on network access issues (items 4.1, 4.6 and 5.1), efficient dispatch of generation (items 4.2, 4.3, 4.5 and 4.8), the Short Term Energy Market (items 5.2 and 5.3), the Reserve Capacity Mechanism (item 5.4), incentives for Demand Side Management (item 5.5), rule change processes (item 4.9) and the industry structure and regulatory settings (item 6).

Over recent years, substantial reforms have been implemented to increase competition in energy supply while at the same time maintaining high levels of reliability. As the market matures, and the effects of these reforms can be assessed, there are a number of design features that are exhibiting stress and may warrant further analysis to determine whether further reform is needed.

esaa considers that it is important that continued ongoing assessment of market performance continues to take place to ensure the effective operation of the market in the longer term. However, it is esaa's view that a long-term, whole-of-supply-chain State energy policy is also required to establish the context for market evolution and to underpin the development of an efficient and effective energy market for Western Australia that will be well-positioned to meet the State's future energy needs.

It is important, however, that the full costs and benefits of any market changes be considered so as not to undermine the investment certainty arising from a stable market design.

If you have any questions or require any further information, please contact Clare Savage, Executive General Manager, at clare.savage@esaa.com.au or 03 9670 0188.

Yours sincerely

Brad Page
Chief Executive Officer

Network access (items 4.1, 4.6 and 5.1)

The Paper discussed the concerns of some stakeholders with respect to delays surrounding network applications and regarding capital contributions for shared network assets and noted that the problems could be seen as resulting from the interaction between the Reserve Capacity Mechanism (RCM), the Access Code and the physical nature of network augmentation.

It has been suggested that the network planning processes are insufficiently integrated with the RCM process, which may impede the ability for the market to appropriately interpret the investment requirement and locational signals to co-optimize generation connections and network augmentation. Furthermore, delays in obtaining a network access offer can delay participation in the RCM process.

The Market Rules require new facilities to demonstrate that they have secured a firm network access offer from Western Power in order to secure certification of capacity. Generators contribute to augmentation funding to the extent that the augmentations do not satisfy the new facilities investment test. In assessing connection applications, network planning is undertaken on an “unconstrained” basis. That is, a new generation connection should not compromise the reliability and security of the network or the ability of other (existing) generators delivering their certified capacity through the network.

Long network access lead times may be an impediment to efficient generation investment. The unconstrained network planning model may not accurately represent the likely coincidence of output from connected generators at time of maximum demand, particularly in the case of intermittent generation. Consequently, this approach may add unnecessary complexity to the planning process, increasing the time taken to assess connection applications, and may result in economically inefficient over-investment in the transmission network.

Network access lead times may also be exacerbated by the current queuing policy and its current inability to distinguish credible applications in the queue.

It is recognised that the role of the queuing policy as it currently stands, is not to pick “winners” or “losers” from prospective generation proponents. However, an inadvertent consequence of the queuing policy may be that it impedes productive efficiency by precluding connection of the most cost-effective new generation in the appropriate (least-cost) order. esaa therefore agrees that a methodology enabling sensible desegregation of applications in the queue for a more efficient assessment of applications could be warranted. For example, such a methodology might include criteria that favours (if necessary) the selection of some non-intermittent renewables to ensure a more diverse mix of generation. In this way the system can hedge against being too reliant on any one form of generation and overcome the problems of too much intermittency set to be exacerbated by the adoption of the expanded RET.

esaa notes that Western Power has reformed the administration of the queuing policy as much as it can within the current market rules and would welcome reform of these rules to enable this process to continue.

It is noted that the Australian Energy Market Commission, in its Review of Energy Market Frameworks in light of Climate Change Policies Second Interim Report, has

indicated that it will recommend that options be considered in respect of connecting new generation and optimising utilisation of the network.

On this basis, esaa supports such a review to be carried out as part of the Office of Energy road map for market reform process. The analysis should also consider the interaction of the network connections process and reserve capacity mechanism in providing market signals to ensure the most efficient mix of generation capacity that is located appropriately. As the review may ultimately recommend fundamental reform of these processes, change should be made cautiously and on the basis of careful cost-benefit analysis and industry consultation.

Efficient dispatch of generation (items 4.2, 4.3, 4.5 and 4.8),

It is understood that there are increasing amounts of “must-run” thermal generation plant (such as cogeneration) on the system, as well as increasing volumes of wind energy spilling into the grid, creating potential over-supply conditions during times of low demand. This condition can trigger System Management to issue discretionary security-related dispatch instructions to de-commit or cycle thermal plant. The Authority is inviting comment on the extent to which these dispatch instructions are efficient and transparent.

Balancing and ancillary service support is provided almost exclusively by Verve Energy. Cycling baseload thermal plant is likely to result in suboptimal technical operation of the plant, which is likely to increase production costs, which may not be fully recoverable from the balancing and ancillary service mechanisms. Furthermore, suboptimal operation could shorten the life of that plant, and lower the value of those assets, which has implications for cash flows and access to debt funding.

There is also a concern that suboptimal technical operation of baseload plant could also have broader system reliability implications.

Verve Energy’s balancing actions are settled at the Marginal Cost Administered Price (MCAP). Because MCAP and deviation prices are based on bids and offers into the day-ahead Short Term Energy Market (STEM), an information asymmetry occurs in the market which means that the impact any real-time events may have on short-run costs are not considered in balancing settlement. Additionally, because the costs of suboptimal operation of baseload plant are externalised, these may not be reflected in the MCAP calculation. Subsequently, MCAP may not be economically efficient in light of actual output.

In this light, esaa supports a more detailed assessment of the cost of balancing and ancillary services to inform potential reform of these services to ensure greater cost reflectivity and least-cost dispatch.

In considering potential reform options, increasing competition should be the first preference where practicable to ensure least-cost provision of the services. esaa also supports the principle that the costs of such services should be recovered from those parties causing the need for them.

Short Term Energy Market (items 5.2 and 5.3)

The STEM is an energy-only forward market operated a day ahead of real time to facilitate trading around bilateral contract positions.

Generators are obligated to make their capacity available in the market via bilateral trades and/or participation in the STEM. Thus, while the STEM is not a mandatory market, generators not participating in the STEM may be required to provide Reserve Capacity Refunds should their net bilateral positions be insufficient to cover their reserve capacity obligations.

The Authority has invited comment on the gate closure timing in the STEM, in particular views as to whether the STEM gate closure should remain as is or be moved closer to the start of the trading day.

As discussed in the previous section, an information asymmetry occurs in the market that results in an inability for the market to respond efficiently to short-term issues outside of the reasonable control of the market participants – such as unforeseen weather events and short-term fuel shortages – which may only be identified in the period between STEM gate closure and real-time. This information asymmetry can culminate in inefficient balancing dispatch of generation and inefficient settlement prices.

On this basis, esaa would support a measure to increase flexibility for market participants to adjust their portfolio schedules to account for bona-fide short-term constraints to better enable efficient dispatch and pricing in real time.

The discussion paper also commented on a perceived overlap between the price caps and bidding rules in the market and the need for two price caps. The Authority has therefore sought comment on the appropriateness of the price caps and bidding rules in the Wholesale Electricity Market.

To minimise pricing volatility and to mitigate the opportunity for abuse of market power, generators are required to offer prices that reflect a “reasonable expectation of the short-run marginal cost of generating the relevant electricity” when the generator holds market power. As an additional measure to limit potential market manipulation, there are two upper-limit price caps in the STEM: the Maximum STEM price (\$286/MWh), which is applicable to non-liquid fuelled facilities; and the Alternative Maximum STEM price (\$439/MWh), which is applicable to liquid fuelled facilities.

The use of separate STEM price caps to prevent market manipulation, along with STEM short-run marginal cost (SRMC) bidding rules, could potentially constrain prices below short-run costs during times of scarcity and may lead to inefficient bidding behaviour, which in turn impedes efficient price discovery.

esaa would endorse a review of the bidding rules and prices caps in the Office of Energy road map for market reform process to assess whether market power concerns can be addressed more appropriately to avoid consequential market distortion.

Reserve Capacity Mechanism (item 5.4)

The Reserve Capacity Mechanism (RCM) is intended to ensure that the SWIS has adequate capacity available to meet future demand with contingency for reliability purposes. It has been questioned whether the RCM is delivering the most dynamically efficient mix of generation to meet the demand requirement and serve the load requirement throughout the year to achieve allocative and productive efficiency in production.

It has been suggested that the network planning processes are insufficiently integrated with the RCM process, which may impede the ability for the market to appropriately interpret the investment requirement and locational signals to co-optimize generation connections and network augmentation.

As discussed in the network access section above, esaa is of the view that further analysis of the interaction of the RCM and network planning model in providing market signals to ensure the most efficient mix of appropriately located, and variably sourced, generation capacity is warranted.

Reserve capacity refunds

Generators are obligated to make available their capacity in the market via bilateral trades and/or participation in the STEM. Any generator failing to offer all its capacity through these mechanisms, including where this is due to forced and consequential outages, will be required to pay a reserve capacity refund which values capacity most highly during summer peak periods. 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 and other consequential impacts on the market would provide greater incentive to achieve high reliability compliance when it is most needed.

Rule Change Processes (item 4.9)

The IMO is responsible for both rule making and market administration, with procedures set out in the Market Rules to address potential conflicts of interest arising from the joint roles.

Effective and efficient market governance would be better facilitated by a clear demarcation in the roles of rule making and market administration. It is noted that cost considerations were a factor in making the IMO responsible for rule change proposals in the Western Australian market in addition to market administration, however, administrative separation is necessarily suboptimal to structural separation, and may result in perceived conflicts of interest which would be avoided if the roles were clearly separated.

This may not be adequately counteracted by the protected provisions processes¹ or Energy Review Board processes. In this case, rule change decisions by the IMO can only be overturned if the IMO has failed to follow correct *process* – it is not a merits review process.

Incentives for Demand Side Management (item 5.5)

The Authority invited comment on the extent to which the regulatory arrangements surrounding the incentives for parties to engage in DSM are appropriate.

One of the key barriers to implementation of DSM measures is network and retail pricing that is not reflective of the costs of providing network capacity and energy during peak periods and does not provide end users with efficient signals to engage in DSM activity. As such, esaa strongly contends that pricing should be fully reflective of the impact of demand on network capacity in order to provide appropriate signals for end use behavioural change.

¹ Where any rule changes with direct conflict of interest for the IMO must be signed off by the Minister.

Additionally, the full benefits of implementing a DSM measure – such as delayed network investment – may not be able to be captured and rewarded through the RCM. It is also important that the wholesale assessment of DSM opportunities considers the full costs and benefits of DSM, including network benefits.

One of the most significant barriers to DSM is the challenge of ensuring that regulation provides adequate recognition of legitimate expenditure on DSM initiatives. Network businesses may be reluctant to invest in research and development in such activities if the regulator does not allow the business to recover those costs through time.

The lack of firmness of external DSM options also increases the risk to the market if the measure fails to deliver the appropriate response when called upon.

Industry Structure and Regulatory Settings (item 6)

The Authority invited comment on how broader structural and regulatory settings impact on the extent to which the market can achieve its objectives. In particular, it was seeking comment on the potential merger of Verve Energy and Synergy and the impact of the Vesting Contract, and the impact of the retail tariff arrangements.

To facilitate the competitive market, the structural composition of the market should be such that potential competitors in the market are not deterred from entering the market. The generation and retail sectors are currently highly concentrated, and this would be exacerbated by the potential merger of Verve Energy and Synergy. In a market the size of the SWIS, such substantial market concentration is very likely to deter new entrants into the market to the detriment of competition and investor confidence in the market. Furthermore, the proposed merger introduces sovereign risk into the Western Australian energy markets, which could potentially threaten the private sector investments that have been made since disaggregation. esaa strongly discourages the Government to implement this proposal.

Despite recent increases in retail tariffs, retail prices remain capped significantly below the long-run marginal cost of supply. This will be exacerbated by the introduction of the CPRS and expanded RET. Achieving full cost reflectivity in the retail market is therefore of utmost importance and should be addressed as a matter of priority.

Retail price suppression below long-run cost reflective levels is a major impediment to new generators and retailers entering the market; and if sustained over a long period, may lead to existing competitors exiting the market or – in the case of government-owned enterprises – incurring substantial losses if market exit is not an option.

In the absence of the introduction of full retail contestability with energy prices determined by competitive market processes and outcomes, esaa considers that retail price regulation in WA would be more effective if decisions were arrived at under a transparent, nationally consistent, framework for price setting. Furthermore, to assist this transparency and avoid inherent conflicts of interest, esaa supports the removal of price setting decisions from the Minister for Energy and transferring the decision making powers to an independent authority such as the Authority, with a process for formal and regular tariff reviews to ensure that tariffs are set at efficient levels.

A Vesting Contract is in place between Verve Energy and Synergy, and covers the energy relating to all tariff customers (franchise and contestable), and all customers on retail contracts that Synergy inherited from Western Power Corporation. The Vesting Contract applies “netback pricing” whereby Verve Energy is paid the residual of Synergy’s sales revenue less efficient retail, networks and other costs. Thus, esaa agrees with the view that the Vesting Contract will result in non-commercial payment terms from Synergy to Verve Energy as long as the regulated tariffs are below cost-reflective levels.

Similarly, below-cost pricing for contestable tariff customers may provide a disincentive for those customers to accept new competitive contract offers, which extends the time that such customers are supplied under the existing Vesting Contract, which further deters new entrant retailers into the market.