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Simon Middleton  
Program Director  
Program Management Office of the Electricity Market Review  
Public Utilities Office  
Albert Facey House 469 Wellington Street  
Perth WA 6000  
Via email: [electricitymarketreview@finance.wa.gov.au](mailto:electricitymarketreview@finance.wa.gov.au)

Dear Simon,

### **Position Paper on Reforms to the Reserve Capacity Mechanism – 3 December 2015**

Alinta Energy (Alinta) welcomes the opportunity to comment on the Public Utilities Office's (PUO) Position Paper: Reforms to the Reserve Capacity Mechanism (RCM). The Position Paper (Paper) is a valuable contribution to the reform debate and development process; it provides industry with the first formal opportunity to provide input into Phase 2 of the reform process dealing with a cornerstone of the Wholesale Electricity Mechanism (WEM), being the RCM.

#### ***Key issues and summary response***

Alinta appreciates that at this time, and for a number of reasons, there is a mismatch between the resource requirement needed to meet system reliability targets and capacity accredited to supply load. To correct this mismatch, the Paper proposes a number of significant changes to the RCM design, that is:

- the immediate implementation of a set of transition arrangements to take effect from May 2016; and
- the introduction of a capacity auction from as early as 2017/18.

Both of these changes materially impact on capacity holders from next year, yet consultation with participants only commenced in December 2015 – just four months before the change in the Market Rules will need to be finalised and approved by the Minister for implementation.

Alinta is strongly of the view that Government must make a decision about retiring Synergy plant before any material changes to the market can proceed. This will not only immediately help achieve the Government's objective of decreasing excess supply, but also provide greater certainty to new and existing generators about the impact of any proposed change in RCM design. Furthermore, it also presents an opportunity for Government to deliver immediate benefit to consumers through lower aggregate capacity payments while ensuring that only the more efficient, modern and sustainable facilities continue to operate.

With respect to the proposed transition arrangements Alinta's view is that there are material reasons for the PUO to review certain elements of the proposed package.

Alinta has been actively involved in all industry consultation processes reviewing the administered price mechanism over the past three and a half years, and has been largely supportive of the original proposed changes put forward by the Reserve Capacity Mechanism Working Group (RCMWG) which would have resulted in an amended adjustment slope of minus 3.75. Alinta notes, however, that the Paper goes well beyond what was recommended by the RCMWG and puts forward two key amendments to the RCMWG proposal:

- A steeper slope of minus 5 which will have a *further* material negative impact on capacity holders beyond the minus 3.75 slope; and
- Changes to Demand Side Management (DSM) arrangements which will see a significant reduction in payments to DSM providers.

Alinta's view is that the four month consultation period to consider the further material change in slope is entirely inadequate, particularly given the change will start to impact generators from next year. Alinta therefore requests that if there is to be an immediate change contemplated, the only transition arrangements that could be considered in this timeframe are the extensively consulted on minus 3.75 slope changes. The consideration of any different slope must be delayed so that adequate consultation, engagement and impact assessment can occur.

In relation to DSM, given investments by demand side management service providers are less long term in nature and significantly lower in cost compared to a power plant which has a 30 year life, a shorter period to apply the changes can be justified.

In regard to the proposal to develop a capacity auction for the WEM, Alinta believes that this matter requires extensive consideration and consultation with industry as the Paper has not established a convincing cost/benefit case for implementation. Substantial issues concerning market power mitigation and gaming, both of which can distort market outcomes, must be shown to be able to be controlled in the context of the WEM before adoption of the model can be considered. Alinta notes that the internationally reputed The Lantau Group when advising the RCMWG about changes to the market design recommended against implementing a capacity auction in the WEM.

Alinta requests that a staged approach be taken by first implementing and bedding down a new administered pricing mechanism, as above, as well as the other proposed Electricity Market Review Phase 2 WEM Improvements (e.g. co-optimisation of Ancillary Services and Facility bidding by Synergy) and then at a later date a cost/benefit assessment be conducted in consultation with key stakeholders to determine whether the significant cost of establishing a capacity auction process and subsequent change in the perceived risk of investing in the WEM can be justified.

In relation to the reform objectives and principles listed in the Paper, Alinta supports the overarching objective of the RCM to be the sustainable delivery of capacity and energy that strikes an efficient balance between ensuring resource adequacy, to avoid exposing customers to highly disruptive shortfalls, and ensuring capacity providers have sufficient incentive to invest. In striking this balance, Alinta supports the key principle that the RCM should not be overly susceptible to volatility and deliver clear, consistent and sustainable medium term price signals.

### ***Robust consultation – inadequate time to consider and engage stakeholders***

A number of generators, including Alinta, made significant investments in the SWIS following the announced introduction of a Reserve Capacity Mechanism. These investments were made in good

faith on the basis of sound, defined and well understood consultation processes for any material rule changes.

The current Rule Change process involves:

- The discussion of all proposed rule changes by the Market Advisory Committee (MAC) where all generators and user groups are represented; and
- A 6 month plus rule change process from the time the original rule change proposal is considered by the MAC. For material rule changes resulting in pervasive impacts, typically this process includes the opportunity to submit in response to a Concept Paper, Pre-Rule Change Proposal, Rule Change Proposal and Draft Report prior to the finalisation of the Report implementing the changes.

Following the above consultation process, rule changes which impact capacity revenue would take nearly three years to flow through to generators allowing investors time to adjust their businesses to take into account any required changes. This is a result of all capacity being certified just under 3 years in advance of the relevant capacity year.

Alinta notes the EMR is not proposing to follow the above consultation process and that the proposed change in rules impacting the capacity mechanism would apply just 5 months after the proposals were first published to the market for consideration/consultation. In addition, following the Minister's Direction in 2014, which saw capacity certification delayed by 12 months, generators will have less than 18 months before changes to capacity revenue flow through.

Alinta believes given the long-lived and costly nature of the investments made by generators, an unprecedented circumvention of the robust consultation process contained in the current Rules cannot be *justified*. Implementing a price adjustment mechanism with a minus 5 slope is a significant change with far reaching implications for asset values and on-going investor confidence and as such must, at a minimum, be subject to the standard review processes set out in the Rules.

### ***Transition arrangements – uncertainty, risk and instability***

Key among the proposed transition arrangements is the adoption of a new administered pricing mechanism. The mechanism would determine the Reserve Capacity Price (RCP) applicable from next year based on a much steeper adjustment slope than is currently the case and steeper than previously canvassed within the market through the deliberations of the RCMWG which made a series of carefully considered recommendations to the Independent Market Operator (IMO) to improve market efficiencies.

Alinta notes the RCMWG's proposed minus 3.75 adjustment slope will result in material downward pressure on forecast capacity revenue – estimated at \$17,000/MW. A slope of minus 5 will place *further* downward pressure on revenue but this is very difficult to forecast given the amount of capacity seeking certification from 2017 is unknown (both demand and supply side) because of the Paper's proposed changes. However, the further impact of the change in slope could be as much as a further 14% or \$13,000/MW reduction in 2017/18.

When applied against a plant portfolio, this represents a material drop in capacity payments; one that will not have been contemplated in market pricing or business forecasting which has the potential to adversely impact financing arrangements, possibly resulting in participant financial distress, and all for potentially no change in supply capacity.

If this were to occur, it will raise investors' concerns about the level of sovereign risk attached to this market which hitherto has implemented substantial change through extended consultative processes and provided 3 year adjustment arrangements where appropriate allowing participants to better manage the impact of price shock/value loss resulting from required changes. For example RC\_2010\_25, Calculation of the Capacity Value of Intermittent Generation, included a 3 year adjustment timeframe to moderate the financial impact on participants of reducing the number of Capacity Credits assigned to Intermittent Generators.

Alinta is generally supportive of the proposal to restructure DSM certification and payment processes such that a lesser amount of DSM capacity may be credited and payments reduced while simultaneously implementing a series of "harmonisation" requirements that increase its market obligations.

Despite the fact that both DSM and plant retirements materially impact excess capacity and hence the RCP for 2017/18, credible modelling about the energy and capacity impact of these changes has not been shared with the market in order for the industry to understand the possible scenarios and impacts on generators, retailers and customers.

Alinta notes the type capacity exiting the market on account of potential changes will impact total costs paid by customers in different ways. Alinta believes the PUO should make available to key stakeholders its modelling to demonstrate the net impact on both market efficiencies and on individual stakeholder segments of its proposed reform package. As it stands, Alinta is very concerned about the potential for inequitable impacts of these proposed changes to certain private sector participants, including Alinta, compared to other participants and this needs to be addressed.

In the absence sufficient time and adequate information for capacity providers to assess and reasonably determine RCP outcomes under the new administered pricing mechanism at a minus 5 slope, and subsequently understand the resultant impact on participant finances, retailers and customers, Alinta believes it is *unreasonable* for the PUO to implement the proposed transition arrangements.

In Alinta's view, recognising current circumstances warrant change to the administered pricing mechanism is needed to send better investment signals to the market, proceeding with the option outlined in our summary response would be appropriate. However, Alinta maintains its position, outlined in previously regulatory submissions, that a price floor must be included in the mechanism to reduce investor uncertainty.<sup>1</sup>

In addition, Alinta notes a cornerstone EMR objective is to encourage private sector investment to facilitate long-term generation investment not underpinned by Government backed arrangements. This objective must be reconciled with the impact on investors of a Government decision to unilaterally impose a radical change in the price adjustment slope to bring about plant exit in circumstances where Government owned plant, some of it old, inefficient and costly to maintain, potentially remains in the market. Alinta believes the Government must make a decision about retiring Synergy plant before any changes to the market can proceed. This will not only immediately help achieve the Government's objective of decreasing excess supply, but also provide greater certainty to new and existing generators about the impact of the proposed change in RCM design.

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<sup>1</sup> Refer to Alinta first and second round submissions to RC\_2012\_20 that sought to introduce a steeper slope.

### **Reserve Capacity Auction – defer for detailed consideration**

Alinta notes auctions are used in some electricity markets to procure capacity to satisfy resource adequacy requirements in a contestable environment that leads to efficient price discovery. Typically, such markets are not small, isolated or impacted by the entry/exit of lumpy thermal plant; they tend to have deep liquidity and are generally not characterised by highly concentrated ownership that can lead to inefficient outcomes.

In contrast, on a market size continuum scale, the WEM would be located at the smaller end and be characterised by very concentrated ownership (dominated by a Government owned entity). It does not have deep liquidity and is not particularly sophisticated if the availability, variety and use of hedging products were used as a measure.

It is not surprising, therefore, that the primary consultant to IMO's RCMWG recommended *against* developing a capacity auction for WEM<sup>2</sup>. Specifically, the recommendation noted that the WEM was a small lumpy market, that auctions would have volatility and risk implications and controls required to mitigate the zero/infinity problem makes auctions look more like a managed solution. Given this advice, the RCMWG recommended it was sufficient, for the purposes of better aligning the RCP to market conditions, to adopt a new administered price mechanism with an adjustment slope of minus 3.75<sup>3</sup>, rather than proceed with developing the auction concept.

In Alinta's view the Paper has not presented sufficient evidence that an auction, potentially based on those employed in other markets such as the massive PJM<sup>4</sup> will, after considering the implications across all stakeholders and taking account of all the controls required to mitigate market power and minimise opportunities for unproductive gaming, achieve a superior outcome to that that can be delivered through the new administered mechanism which has resulted from a thorough and exhaustive consultation process.

History shows the WEM as taking a staged approach to its evolution: significant changes only implemented following careful consideration of alternatives and rigorous analysis of the proposed solution prior to implementation. Given the capital intensive and sunk cost nature of the industry, this is a sound approach, one that directly addresses investor concerns about sovereign risk.

Noting this well established precedent Alinta recommends continuing with a staged development approach by implementing the new administered price mechanism at a minus 3.75 slope with a price floor and also proceeding with the other elements of the Wholesale Electricity Market Improvements program. After these very considerable changes have been bedded down and efficiencies optimised, Alinta believes scope would then exist to examine the potential for further restructuring of the RCM into a yearly capacity auction.

In due course, Alinta would be pleased to be part of any working group established to develop the cost/benefit assessment of the merits of implementing a capacity procurement auction in the WEM.

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<sup>2</sup> Refer Reserve Capacity Mechanism: Recommendation, page 7, presented by Mike Thomas of The Lantau Group at the RCMWG Meeting 8, 11 October 2012.

<sup>3</sup> Subsequently became Rule Change RC\_2013\_20.

<sup>4</sup> The PJM (Pennsylvania-New Jersey-Maryland System) is the largest centrally dispatched power system in North America pooling generation and transmission facilities of over 500 utilities in 13 states and collectively servicing more than 51 million people.

### **Reform objectives and principles – alternatives suggested**

Electricity supply is a capital intensive industry characterised by a mix of expensive long life generation plant fulfilling different roles in meeting the supply requirements of the market's load duration curve. Once made, investment is effectively sunk<sup>5</sup> with returns reflecting market arrangements and risk allocations.

If market arrangements excessively skew risk towards capacity providers then investment premiums must rise, to attract capital from competing opportunities, resulting in the achievement of the overarching resource adequacy objective being challenged. In Alinta's view, the objectives and principles of the reform package must take this reality into account when striking the balance between capacity providers and customers.

The Paper lists the objectives of the RCM reform package as:

- 1) Capacity market incentives and outcomes are conducive to a least cost, sustainable delivery of capacity and energy to customers;
- 2) The RCM is to provide strong incentives to introduce capacity when there is a forecasted undersupply and strong incentives to remove capacity in times of oversupply;
- 3) The RCM is to appropriately provide signals for the efficient retirement of plant; and
- 4) The RCM is to encourage the efficient utilisation of capacity.

Alinta supports a primary purpose of the RCM being to signal to capacity providers opportunities to meet forecast market requirements to ensure supply adequacy is maintained at a level to meet customers' reasonable expectations about supply reliability.

However, Alinta cannot support as an objective that the RCM design be structured to cause capacity to exit from the market on account of what amounts largely to load forecasting error<sup>6</sup>; to do so fails to adequately recognise the sunk cost nature of capacity investment and will necessarily result in high levels of RCP volatility impacting capacity suppliers and customers alike.

Financiers will require higher funding premiums to reflect the perceived increased risk of investing in the WEM resulting in project deferral and/or competing investment opportunities elsewhere becoming relatively more attractive – supply adequacy may suffer. Customers will ultimately bear the impact of increased volatility levels through higher prices and will also wear the cost of any decreases in system reliability.

Alinta contends a skewed risk allocation inherent in the second objective is contrary to achieving the first reform objective i.e. sustainable delivery of capacity; it will dampen private sector appetite to invest and provide capacity to customers in a small and isolated market. Furthermore, Alinta questions how this approach supports the EMR's overarching objective to encourage private sector investment to facilitate long-term stability.

In Alinta's view a better match with the characteristics of generation capacity would see the objective re-expressed as "...when there is a forecasted undersupply and strong incentives to deter new capacity in times of oversupply".

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<sup>5</sup> This truth is acknowledged in the Paper: "...that is, when constructed a generation facility does not readily leave the market.": Position Paper on reforms to the Reserve Capacity Mechanism, 3 December 2015, Pg 16.

<sup>6</sup> For example, the Reserve Capacity Target for 2016/17 was reduced by 560MW from the 2015/16 level, immediately increasing excess capacity by the same amount.

The Paper lists the principles as:

1. The capacity price should reflect the marginal economic value of capacity;
2. The RCM should not be overly susceptible to volatility but delivers clear and consistent medium term price signals;
3. The RCM should be not susceptible to distortion by the exercise of market power; and
4. Changes to the RCM must be consistent with acceptable system security limits.

The principles should guide the redesign of the RCM to achieve the agreed objectives. Principles 2, 3 and 4 are sound, in that they effectively establish a framework against which to test the redesign for stability in price signalling within acceptable volatility limits, capability of market power controls to avoid distorted price outcomes and consistency in delivering outcomes that meet resource adequacy requirements.

However, Alinta believes the first principle needs careful consideration. It suggests at the margin, based on a downward sloping adjustment curve, that the value of the next capacity increment reduces and at some point resolves to zero. As Alinta perceives it, at this point all capacity would be valued at zero by the RCM. Alinta does not accept this as a reflection of real world values; installed capacity does not suddenly have a zero value to customers, it does not suddenly transform into a free good for which no economic exchange is required to consume.

In Alinta's view, a more appropriate principle, one that more closely aligns with reform objectives and better signals to capacity providers changes in market requirements, should be considered. Alinta offers the following for consideration: "The capacity price should reflect the market need for capacity investment." That is, where supplied capacity starts to exceed resource adequacy requirements the price adjustment mechanism signals investment deferral is required; conversely where capacity is short the mechanism signals investment advancement is required.

However, whatever the resource adequacy requirement and capacity supply balance in the small isolated SWIS, the mechanism must not determine installed capacity at a zero value; to do so would unreasonably destroy investment values and threaten the industry's on-going ability to sustain its capability to meet customer supply requirements. Alinta contends this circumstance is best managed by including a price floor in the pricing mechanism.

If you would like to discuss this submission please don't hesitate to contact myself on 9486 3762 or John Rhodes on 9486 3306.

Yours sincerely



**Michelle Shepherd**  
General Manager Regulatory and Government Affairs