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Position Paper on Reforms to the Reserve Capacity Mechanism

The Competitive Energy Association of Australia (CEA) welcomes the opportunity to make a submission to the Public Utilities Office's Position Paper on Reforms to the Reserve Capacity Mechanism.

The CEA represents the policy positions of 22 electricity and downstream natural gas businesses operating in competitive wholesale and retail energy markets. These businesses collectively generate the overwhelming majority of electricity in Australia and sell gas and electricity to over 10 million homes and businesses.

Balancing consumer cost and investment confidence

The CEA recognises the dilemma facing the WA government. On the one hand, there appears to be an excess of capacity in the WA's Wholesale Electricity Market (WEM). Under the current arrangements, the cost to consumers is not mitigated by capacity price signals that the market is oversupplied. On the other hand, the government recognises the long-term damage that can be done to investor confidence by the financial distress that can arise due to capital-intensive plant facing an abrupt loss of revenue to existing plant as a result of a change in the rules.

In this respect we consider that the government should take care in the speed at which it undertakes reforms and the severity of the changes as well as the thoroughness of its consultation. Previously, the Reserve Capacity Mechanism Working Group (RCMWG) identified many of the same issues with the RCM as the Electricity Market Review has done and after extensive consultation with market participants and other stakeholders recommended reforms to the RCM including an adjustment to the value of reserve capacity payments when capacity exceeds the forecast requirement using a slope of minus 3.75. The position paper proposes a much sharper adjustment mechanism with a slope of minus 5 as part of transitional arrangements to an auction mechanism. As the mechanism is still an administered price it is not possible to definitively say that one slope is better than the other (and the position paper does not present compelling evidence for its preferred slope). But the slope of minus 3.75 has the advantage that it has been widely socialised amongst market participants for some time and represents less of a shock and loss of investor value.

This is particularly important in the context of the speed at which the government is seeking to undertake consultation on this change and to implement it. There will be less than 6

months between the release of the position paper and the implementation of the transitional arrangements. These in turn will be rapidly superseded by the proposed auction allowing no opportunity to learn from the impact of the transitional arrangements, which may provide valuable insight into the ability of the market to process a reduction in capacity.

It is plausible that a rapid reduction in capacity payments, combined with the uncertainty over where an auction price might settle, may trigger financial distress in participants that leads them to be recapitalised at a lower value and able to participate in the market for a lower capacity credit value. In such a case, the capacity would not be removed from the market. While consumers and governments may see this as a bargain, the longer-term impact on investor sentiment could increase the cost of capital leading to higher payments being required in the future when incremental capacity is required.

Timing of further reforms

The transitional arrangements represent a significant set of reforms in the context of the WEM and are being implemented alongside a range of other reforms that may impact the wholesale market, including retail reforms, network regulatory reforms and governance reform. We welcome the government's commitment to reform overall, but reforms can take time to bed down and the interactions between different elements of reform also require time to become clear. We recommend that the government does not pre-commit itself to a fixed date to introduce the next stage of reform, a capacity auction mechanism. Rather, it should allow some time to learn from the outcomes of the reform to date and review at some future point, when certain indicators have been met. For example, it could wait until the forecast surplus capacity has reduced to, say, 5 per cent. It could also carry out more extensive analysis to confirm that introduction of an auction mechanism would be appropriate in a market with the characteristics of the WEM.

Discrimination between different types of capacity

The position paper proposes to reward Demand Side Providers (DSP) through a different mechanism during the transitional period, only to return the DSP to the supply mix with equal standing to generation under the auction mechanism. This does not appear consistent. If demand side resource is fundamentally different in character to supply side – for example because of more inherent limitations on its ability to be utilised for longer periods and more frequently than currently – then it is reasonable to reward it differently during the transition period and continue to do so following auction implementation. This approach has the potential to contribute to reducing the cost to consumers of procuring capacity in the WEM.

In doing so, the concerns of those who have invested in DSP capability are relevant, just as for those who have invested in supply. But the magnitude of capital at stake is different, so the demand side market is capable of tolerating a greater rate of change without risking financial distress.

I am happy to answer any questions about our submission and can be contacted by email to kieran.donoghue@esaa.com.au or by telephone on (03) 9205 3116.

Yours sincerely

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