Independent Market Operator

Reserve Capacity Mechanism Working Group

Minutes

Meeting No.	2
Location:	IMO Boardroom Level 3, 197 St Georges Terrace, Perth
Date:	Tuesday 27 March 2012
Time:	Commencing at 2.00pm – 5.00pm
Attendees	
Allan Dawson	Chair
Suzanne Frame	IMO
Brendan Clarke	System Management
Andrew Sutherland	Market Generator
Ben Tan	Market Generator
Shane Cremin	Market Generator (Via phone)
Brad Huppatz	Market Generator (Verve Energy)
Amanda Rudd	Market Customer (Proxy)
Patrick Peake	Market Customer
Steve Gould	Market Customer
Stephen MacLean	Market Customer (Synergy)
Andrew Stevens	Market Customer/Generator
Jeff Renaud	Demand Side Management
Geoff Down	Contestable Customer
Justin Payne	Contestable Customer
Paul Hynch	Observer (Office of Energy)
Wana Yang	Observer (Economic Regulation Authority)
Additional Attendees	
Mike Thomas (The Lantau Group)	Presenter
Aditi Varma	Minutes
Fiona Edmonds	Observer
Jenny Laidlaw	Observer
Greg Ruthven	Observer
Apologies	
Corey Dykstra	Market Customer

Item	Subject	Action
1.	**WELCOME AND APOLOGIES / ATTENDANCE** The Chair opened the second meeting of the Reserve Capacity Mechanism (RCM) Working Group (RCMWG) at 2:05pm. The Chair welcomed the members in attendance and noted apologies received from Mr Corey Dykstra prior to the meeting. The Chair acknowledged Ms Amanda Rudd as a proxy for Mr Dykstra and Mr Shane Cremin linked via phone. The Chair also introduced Mr Mike Thomas from The Lantau Group.	
2.	**MINUTES ARISING FROM MEETING 1** The following changes were noted on page 8: • Mr Huppatz noted that ~~keeping~~ a discussion on the classification of Outages ~~in the out-of-scope list would limit the amount of attention given to~~ should have been included as a part of the scope of the dynamic refund regime. There was discussion among RCMWG members regarding the level of detail required in the recording of minutes. RCMWG members decided that it was important to retain some level of detail relating to the reasoning behind decisions taken and the various topics raised in discussions.	
3.	**ACTIONS ARISING** The Chair noted that all action points from the previous meeting had been completed.	
4.	**PRESENTATION ON RCM OPTIONS DISCUSSION FOR THE RCMWG: MR MIKE THOMAS, THE LANTAU GROUP** The Chair invited Mr Mike Thomas to present his paper on the over-supply of capacity in the Wholesale Electricity Market (WEM). The following points of discussion were noted: • Mr Stephen MacLean queried Mr Thomas's opinion on the consistency of a market-based approach with the administrative features of WEM. Mr Thomas responded that it was important to assess the level of governance in WEM. He also noted that WEM was similar to the Singapore market because of its administrative nature. • Mr Andrew Stevens noted that in the event of excess capacity, retailers are faced with increased costs in the form of an increased Shared Reserve Capacity cost. Discussion ensued amongst RCMWG members over how costs of excess capacity were shared in the market. Mr Thomas concluded that the key point was that the excess reserve capacity had to be paid for in some way by Market Participants. • Mr Thomas commented that the solution to the problem of excess capacity should not be such that it removes today's problem of excess only to create tomorrow's problem of shortage. Mr MacLean noted that the current market design may have the potential for future shortages in reserve capacity.	

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	The Chair highlighted that in 2008-09, the market faced shortages and the IMO procured Supplementary Reserve Capacity (SRC). • Mr Thomas talked about the analysis on the indicative value of lost load. He noted that the analysis showed that the difference between the administrative value and the economic value of capacity credits was high. On this point, Mr Huppatz noted that the Planning Criterion is not only based on the probability of exceedence, the market also places high value on unserved energy. Mr Thomas acknowledged that the current analysis did not delve deeper into that issue. However, he noted that the issue around value creation in a few number of hours remained. • On the issue of excess capacity, Mr Sutherland highlighted that it was important for the group to understand the make-up of the capacity surpluses. Mr Stevens and Mr MacLean noted that this was an important question to consider. Mr Thomas observed that in a pure market-based mechanism, it is never possible to know what caused the problem and only the effects are visible. Mr Peake noted that in a market-based scenario, older, inefficient plants might be retired whereas in RCM, older plants continued to produce power. Mr Thomas noted this point. He added that the causes of excess capacity could potentially change in the future and therefore, it would be more useful to think of the problem as active or passive behaviour of participants. Active behaviour is characterized as participants actively making commercial decisions in the market and passive behaviour is characterized as participants' exposure to decisions made by other stakeholders. • Discussion ensued on uncontracted Capacity Credits. Mr Sutherland mentioned that large OCGT plants do not generally rely on the RCM to be built because they have large capital costs. In his opinion, a lot of the uncontracted Capacity Credits present in the market might be supplied by projects with low capital costs or low debt-to-equity ratios. He added that retailers would prefer contracting for the long term to match their capacity requirements. He also observed that there are potentially other hedges working outside of the RCM. Mr MacLean added that retailers are also concerned with volatility in the market and their preference is to hedge their risks by locking in contracts. He added that retailers would prefer to contract to meet their energy requirements and would contract for capacity only if they perceive a discount was being offered on the prevailing Reserve Capacity Price (RCP). However, the RCM offered generators a higher expected price. Mr Peake added that the volatility in the RCP has made participants contract outside the market. Mr Sutherland added that the RCP is a blunt instrument as it tends to attract capacity that can be offered by projects that have low capital costs. Mr MacLean suggested that the Maximum Reserve Capacity Price (MRCP) should be sensitive to the type of capacity that the market needs at a given time. Mr Cremin observed that the market would buy energy if it is needed irrespective of the RCM. He noted that it should only be the peak capacity on which an administrative control might be needed. • Mr Thomas proceeded to talk about the five-yearly MRCP review. He further discussed the corrective action that could be	

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	taken to discourage excess capacity. He mentioned that the RCP setting process did not allow for the RCP to adjust enough in response to excess capacity in the market. Mr MacLean queried if the purpose of the adjustment was to only discourage excess capacity or also to act as an administrative method to create an efficient price that could be received in an auction. Mr Thomas responded that the RCP did not have any connection with a reserve capacity auction outcome. Mr Shane Cremin noted that the adjustment mechanism was not only to discourage excess capacity but also to encourage bilateral contracting. Mr Tan observed that a problem with increasing the slope of the sliding scale was that it would perversely incentivise retailers to increase capacity because the book value of a capacity credit may decrease. This implied that the sliding scale would need a floor price to stop a massive injection of capacity in the market. Mr Sutherland argued that the sliding scale would imply that more expensive capacity such as those supplied by coal fired plants or combined cycle plants would get priced out of the market till only DSM capacity was left as the cheapest option. • Mr Thomas proceeded to present his recommendations on the excess capacity adjustment slope. Mr Thomas added that preference should be given to adjusting the RCM in ways that could make it more consistent with market-based outcomes rather than considering a replacement of the current mechanism. Mr MacLean noted that he had been working on an option that would not be a complete overhaul of the market but would still be closer to a market based mechanism. Mr Peake mentioned that it was important to consider that a shortfall of capacity would be less acceptable than excess. Mr Sutherland mentioned that it is difficult to fine-tune the mechanism without knowing the cause and effect. Mr Thomas responded that market mechanisms always work in information asymmetry where exact causes are not known and market players tweak their decisions and then assess the consequences • Mr Thomas also presented a spigot-control mechanism as an alternative solution to the excess capacity issue. The Chair mentioned that a spigot control mechanism creates barriers for new technologies to enter the market. He added that perverse behaviours like not voluntarily decommissioning old plants would be incentivised. Mr Peake added that such a mechanism could also create situations where peaking generators could drive out generators that have low fuel costs. This would then flow to the energy market in terms of higher prices. • Mr Sutherland argued that the same issue existed with the steep sliding scale. If too much excess capacity existed in the market then projects with large capital costs face high entry barriers. He added that low capital cost, high variable cost capacity is affecting the energy prices. Mr Thomas observed that a similar situation exists in Korea. Mr Huppatz and Mr Stevens argued that a steeper discount factor will create a distortion in the capacity market. Mr Sutherland argued that without a cap on the sliding scale, lower capital cost capacity like DSM would persist providing more capacity as long as the price is high enough. • Mr Stevens argued that the most efficient outcome was only	

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	possible if the proportion of baseload generation, mid-merit and peaking generation capacity existed in the shape of a pyramid. He argued that a higher percentage of DSM and peaking capacity in the market indicated inefficiencies. The Chair emphasized that the load profile in the SWIS was such that a healthy mix of plants was required. Mr Jeff Renaud added that DSM in WEM is almost at its saturation point. He noted that irrespective of the price, there was only a finite amount of demand response. Discussion ensued on the risks created by the sliding scale. Mr Peake noted that with a steeper sliding scale, risks to a large capital investment are increased but that does not necessarily mean that the technology would face entry barriers. Companies would look for a higher margin before investing in new projects. Mr Thomas noted that changing the risk profile is at the heart of the steep sliding scale. The idea is to discourage excess investment in harder to finance projects as well as undermine investment in easily financed unnecessary projects. Mr Down noted that a variable price will also motivate contestable customers to consider changes to their capacity mix. He added that sustainable technologies will become more important. Mr Thomas acknowledged the importance of this point and added that this alternative adds a little more volatility to the market which will drive both generators and customers in the market to reconsider their positions. • Discussion ensued on the potential magnitude of impact of a shortage in capacity. The Chair reiterated that loss of load is a major cost to the market. • Mr Thomas concluded his presentation with a discussion on active and passive behaviours in the RCM and his recommendations. • The Chair reiterated the IMO Board's view that the RCM has provided benefit to the WEM since 2004. He noted that the WEM started with a shortage of capacity and has dealt with significant economic growth in Western Australia. The Board's perspective was that this mechanism should be adjusted rather than restructured to provide better economic incentives for existing and new capacity. • Mr Sutherland cautioned that the market could potentially become unattractive to investors given the recent MRCP reduction, the impending forecasting methodology review and peak demand reductions. The Chair noted that the RCMWG's advice may be to do nothing. However he observed that some ideas in Mr Thomas's recommendation would appear attractive and should be given adequate consideration. • The Chair concluded the discussion by inviting Mr Thomas to evaluate the concepts of a steeper sliding scale and expected value of capacity for the consideration of the RCMWG at its April meeting. Mr MacLean offered to provide details to the RCMWG on the topic of excess capacity costs to retailers. Mr Sutherland, Mr Payne and Mr Stevens asked if analysis could be provided on the composition of existing excess capacity. • Ms Yang noted that forecasting uncertainty is indispensable and that the last Statement of Opportunities (SOO) had shown a significant reduction in the load forecast. She noted that any discussion on the RCM should adequately consider the	

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	reductions introduced by the SOO. *Action Points:* • *The IMO to conduct analysis on the composition of excess capacity in the RCM and provide updates at the April RCMWG meeting.* • *Mr Thomas to conduct further analysis on his recommendations for the RCM and provide updates at the April RCMWG meeting.* • *Mr MacLean to circulate his analysis on costs of excess capacity to the market among RCMWG members.*	**IMO** **Mr Thomas** **Mr MacLean**
5	**PROPOSED SCHEDULE OF WORK FOR RCMWG** The Chair noted some participants had requested that the timing of the discussion on the alignment of a dynamic reserve capacity refund regime should be brought forward and lengthened to about 5 months. The Chair noted that the IMO will endeavour to accommodate this request. However, he mentioned that the plan for the next RCMWG meeting was already finalised and it would include Dr Tooth's presentation on harmonisation of DSM with generation capacity. He also noted that Mr Thomas would be invited to the next meeting to elaborate his ideas further. *Action Point:* • *The IMO to reissue the proposed work schedule for RCMWG with the changed timing for the discussion on the Dynamic Refund regime.* • *The IMO to invite Mr Thomas to April RCMWG meeting.*	**IMO** **IMO**
6	**CLOSED** The Chair thanked all members for attending and declared the meeting closed at 5.05 pm.	