Submission to the Position Paper on Reforms to the Reserve Capacity Mechanism

Chamber of Commerce and Industry of Western Australia (Inc)

discount rate (15 per cent) is arbitrarily determined, and may not reflect market conditions.

All certified capacity receives the capacity price regardless of whether it is actually necessary. An adjustment factor reduces the price paid for capacity by one per cent for every one per cent of excess capacity above the reserve capacity requirement determined by the market operator, such that the total amount paid for capacity does not change to reflect changes in demand and supply.

Auctions are only held when the market operator assesses that there is insufficient capacity to satisfy the reserve capacity requirement. Because to date the market has always had excess capacity, this is yet to occur and the capacity price has never been marked to market.

Although the administered nature of the Reserve Capacity Mechanism is a weakness, forecasts of peak demand that have exceeded actual peak demand by a wide margin have played a significant role in forming the current market circumstances — more than half of the excess capacity in 2016-17 is a result of a 560 MW reduction in the forecast requirement.

The Electricity Market Review estimated the cost of forecasting errors to be $114 million per year on average, or a total of $1.03 billion in the period 2007-08 to 2015-16.[3] The Economic Regulation Authority estimates the cost of excess capacity excluding forecasting errors to be much less, about $35 million per year on average, or a total of $279 million over the period 2007-08 to 2014-15.[4]

The Phase One Electricity Market Review concluded that significant reform is necessary to the WEM and recommended that the SWIS do away with the capacity+energy design of the WEM and adopt an energy only market by becoming an unconnected region of the National Electricity Market (NEM). The NEM option was recommended because it was considered low-risk and was projected to result in decreases in energy costs of 30 per cent, equivalent to savings of $250 million a year.

The other option canvassed, the reformed WEM option, called for the continuation of the current WEM design but with a capacity auction. The reformed WEM option was not favoured because it was considered to be higher risk and would deliver fewer benefits — energy cost reductions of only 6 per cent or $50 million per year.

Contrary to the Review's recommendations, the State Government elected to proceed with the higher risk, lower return reformed WEM option.

Given the significance of the proposed reforms to the Reserve Capacity Mechanism and the certainty of significant financial implications for market participants, it is important that a robust rule change process is undertaken.

The consultation process for the proposed reforms has been truncated to achieve ambitious timeframes relative to the usual rule change process. The Position Paper was released in

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[3] Electricity Market Review Discussion Paper.

[4] Economic Regulation Authority 2013, *2012 Wholesale Electricity Market Report for the Minister for Energy*, April, Table 2.

December 2015 with consultation running for roughly two months until late January 2016, but including the festive season when many people take annual leave. The transitional arrangements are then to be approved and in place by May 2016, just three months after the end of the consultation period.

The truncated consultation process for the current reform proposals contrasts with the 15 month rule change process undertaken in 2014-15 for the proposed changes to Reserve Capacity Price (RC_2013_20). That rule change process included the publication of a rule change notice and proposal (January 2014), first submission period (February 2014), publication of a draft rule change report (March 2014), second submission period (May 2014), call for further submissions (March 2015), further submission period (April 2015), and publication of a final rule change report (April 2015).

The Position Paper on Reforms to the Reserve Capacity Mechanism (the Position Paper) outlines a high level proposal for the adoption of a reserve capacity auction. The design of the auction is important, however, the most pressing issue is the transitional arrangements proposed to commence in May 2016 and which may be in place for several years.

As identified in the Position Paper, because of the current large excess of capacity in the SWIS, were a capacity auction to be introduced at present, the price for capacity would be very low — almost zero. Although this would reflect a market outcome and may be expected to benefit some consumers in the short term, it would also cause significant disruption to market participants which have invested in the market.

Although investment risk is often cited as a reason not to undertake reform, if such considerations were applied to regulation across the economy, productivity enhancing reforms to correct regulatory imbalances would almost never be implemented. However, in the case of the WEM, special consideration should be given to the effect changes to the capacity mechanism may have on competition —

time to 5 per cent. Capacity payments for demand side resources would reduce considerably more, to $14,000 per MW in 2016-17 rising only slightly to be $16,000 in 2024-25.

Compared with the alternatives available and considered, for example those recommended by the IMO's Reserve Capacity Mechanism Working Group such as a minus 3.75 price adjustment slope, the Position Paper proposes the adoption of a set of reforms to the capacity mechanism that would set a more rapid path to an auction, result in more severe decreases in capacity prices and have higher risks for generation capacity which would otherwise only be required for very short periods of time during peak demand events. The contentious issue is how demand side resources should be procured.

Although there is some debate regarding the need to better harmonise generation and demand side capacity in the capacity mechanism, services that are comparable such as those provided by generators and demand side resources, should in principle receive similar prices in a market. The proposal to apply fundamentally different pricing mechanisms to different types of capacity raises significant equity issues.

Feedback received from market participants is that the transitional pricing arrangements proposed in the Position Paper would result in the complete exit of demand side resources from the capacity market.

The proposal to pay demand side resources significantly less than generators incorrectly presumes that either:

significant reduction in demand side resource capacity in the transition will not have future implications for the electricity market; or

the financial stability of providers of demand side resources will not be affected by significant loss of capacity payments or financial instability among these market participants is inconsequential.

impact all participants requiring additional investment in systems and development of new or changes to operating practices.

Policy makers, including the Electricity Market Review, frequently advocate economic reform in the long-term interests of consumers as this is a useful shorthand for identifying reforms that will enhance efficiency by lowering the total cost of a particular level of production or enhance equity by transferring economic rents to consumers.

However, with regard to reform of the capacity market, the efficiency gains from reform on the supply side are likely to be small in the short term. This is because the biggest costs of providing capacity, the cost of building generators, are largely fixed in the short term and so the efficiency gains (cost reductions) available from reform may be relatively small. As a consequence, some of the anticipated gains for consumers in the short term from a lower capacity price will actually reflect wealth transfers from capacity providers to consumers rather than efficiency gains per se.

On the demand side, the efficiency gains which might be expected to result from a lower capacity price, such as greater utilisation of the a1-8(t)9(y)9o3( )9s capacityrm ( )9(wsG /P /MC)7(r)ily fixed ilower customers".[7] Although full retail contestability (FRC) forms part of the Government's promised reform program, it would only be introduced after an election scheduled for March 2017. As State Labor has not announced its position on FRC, its introduction is not certain.

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[7] Electricity Market Review Options Paper, p. 110.