WA Independent Power Association Inc.

'An independent voice for a competitive power industry'

RESPONSES TO POSITION PAPER: REFORMS TO THE RESERVE CAPACITY MECHANISM

General Discussion

The Position Paper on Reforms to the Reserve Capacity Mechanism ("Position Paper") proposes a number of interesting and some worthwhile changes to the Reserve Capacity Mechanism (RCM), while maintaining the fundamental characteristics of a capacity market.

While many of these proposed changes are worth considering, the Position Paper does not deal with the major problem in the WA electricity market, which is the lack of competition at the wholesale and retail level and the continuing dominance of Synergy.

The WA Independent Power Association welcomes the opportunity to comment on the Position Paper bearing in mind that there are a number of different views on the WA capacity market within the WAIPA, and an even wider variety of views from other market participants.

At a high level, it is worth making the point that the RCM has actually done a good job in delivering what it was intended to do – provide signals to invest in capacity for the market and ensure that the lights stay on. This is still an important objective in a small isolated grid like the SWIS.

It is also worth stating that there was not an overwhelming push for major changes to the RCM from private sector market participants – most of the drive for fundamental change has come from Synergy and from its owner, the WA Government.

However, it is acknowledged that there is excess capacity in the WEM and that steps need to be taken to address this. The excess capacity is not unique to WA or to capacity markets: the NEM has a significant problem of excess generation and it is an energy only market.

A number of the reforms proposed in this Position Paper to address excess capacity were actually developed by the Independent market Operator in consultation with market participants, and were supported at the time and will likely be supported again. It is a pity they were not implemented at the time: a couple of years have been wasted, which would have reduced costs and reduced some excess capacity.

In its submission to the Electricity Market Review Discussion Paper in September 2014, the WAIPA said:

"A fundamental problem of the current mechanism has simply been that that the price for capacity has not reflected supply. Other capacity markets have steep price curves which drop off quickly when sufficient capacity to meet forecast load plus a reserve margin are met. Steepening the price curve in the WEM is an obvious way to address the cost of excess capacity. In the short term, this is a preferred method, because it addresses an immediate problem, but it allows time to consider other ways of allocating capacity which move closer towards a proper market mechanism. Other alternatives are listed below, but are not exhaustive, and could include for example capacity auctions".

In principle, the WAIPA is not opposed to introducing a capacity auction, as it is one way of pricing capacity that reflects market needs. The WAIPA has consistently argued that the RCM should evolve towards a proper market mechanism. However, the WAIPA's major concern is that moving quickly to an auction without changes to the industry structure could serve to reinforce the market dominance of Synergy and do nothing to enhance competition.

Again, the WAIPA stated in September 2014:

"In order to challenge the status quo, the very first thing that needs to be reviewed is this structure. While it is a necessarily slow process in making major structural changes, it is of vital importance that such changes are clearly articulated along with a well-defined pathway for realising them. Without clarity of future structure, reforms are little better than a shot-in-the-dark attempt to create a better outcome than is already being achieved."

The EMR itself said that reforming the industry structure should be a precondition of other market reforms. This is clearly not on the agenda for the EMR Steering Committee, which is a pity, but it is all the more reason to proceed slowly to an auction process – or an alternate market mechanism – until Synergy's market dominance is addressed.

The other major contextual omission from the Position Paper is that is seems to be completely unaware of the Renewable Energy Target (RET). The bipartisan support for the RET, and the general world-wide move towards renewables and decentralised generation, should at least have formed part of the discussion in the Position Paper. Renewable generation will benefit from the move to a constrained access model and being linked to the market operation – again this was not part of the discussion in this Position Paper.

SPECIFIC COMMENTS ON THE POSITION PAPER

Section 3. Reform Objectives and Principles

The objectives and principles listed for the proposed reforms to the RCM are supported.

However, two other important principles are:

- minimising future changes, and
- separating rule making from ownership.

Government is in the unique position as both owner and rule/policy maker. This is clearly a conflict which does not sit well with the imperative of attracting private sector investment and giving confidence that the rules will not be skewed to protect the State's own business.

While some changes to the RCM are required, as we stated in the introduction, there is no mandate for radical changes unless and until the structure of the industry is addressed.

Section 4. Proposed reforms to the Reserve Capacity Mechanism

The decision to move to an auction mechanism seems to have already been decided.

As stated previously, there was no mandate for this policy option coming out of the consultative first phase of the EMR process. Nevertheless, the WAIPA has always supported gradually moving towards a market based mechanism for capacity over time.

The WAIPA was clear in its submission to the EMR that the first step needed was to steepen the price curve and implement those other reforms - such as harmonisation of demand side management and improving capacity availability - that were on track to be implemented before the EMR was announced.

But our view was, and remains, that those reforms should be given time to work to reduce excess capacity and we could then use that period to develop a market based mechanism that has broad support from market participants. Most probably that would be an auction mechanism, but only if it is broadly supported and only if it is done so as not to jeopardise investments made in good faith by the private sector based on the current capacity mechanisms and policy settings.

The other major condition that the WAIPA believes needs to be met before moving to an auction or another capacity market mechanism is to reform the industry structure – specifically to split Synergy into two or more "gentailers". This is the only real way of getting competition into both the retail and wholesale markets. As we stated in September 2014:

"The WA IPA recommends the splitting of Synergy into two separate gentailers, each with a suite of generation assets and/or contracts suitable for its load. Excess generation should be retired or sold."

At the very least, in the absence of any sign that the government will split Synergy, there should be a commitment to reduce the dominance of Synergy's generation fleet.

It is disappointing that the Position Paper did not make any commitment to reduce Synergy's dominance in generation as a condition of moving to an auction process by mandating the retirement or selling of its own excess generation.

The proposal to remove demand side management completely from the RCM in the "transitional arrangements" and then let it re-enter at the auction process seems contrived and more to do with reducing costs to Synergy or improving the profitability of its generation fleet.

No rational justification is made for treating demand side management differently to peaking plant which provide a similar service, and the argument that one form of capacity costs less in capital than another is actually a good reason to keep demand side management in if the objective is to reduce the overall cost of capacity.

The arguments made against demand side management about being seldom dispatched apply equally to liquid peakers; similarly regarding their contribution to the energy market: if the liquid peakers had to be regularly dispatched they would probably lose money.

The problem of excess capacity is more about poor forecasting, the impact of rooftop solar PV and the capacity price being set too high. As pointed out previously in this submission, the NEM has a similar problem with excess generation – it is not unique to the WEM's capacity market.

The proposed transition arrangements do not actually send a signal to retire old or inefficient plant; taking out demand side management from the RCM could actually tend to benefit existing generators and postpone decisions on retirement.

Having said that, the WAIPA does support a transitional phase which includes those reforms previously developed by the Independent Market Operator.

This transition plan should see a gradual lowering of capacity prices over time, rather than the proposed transition plan which will lead to two large price shocks for WAIPA members who have invested in the market in good faith.

These reforms should be given time to work and allow market participants to adjust to the changes. The transition period should then be used to refine the auction mechanism, again with the principle of avoiding any price shocks.

Part of the "transitional arrangements" should also include a clear program for Synergy to divest a major part of its generation fleet, as well as being obliged to bid on a facility basis rather than the current portfolio bidding.

Section 5. The capacity auction

The WAIPA does not have any specific comments on the proposed structure of the capacity auction, except that the "all-in" approach would best achieve the stated principles of the reform.

Again, our view is that the detailed structure of the proposed auction or other similar capacity market mechanism should be considered carefully over the "transitional arrangements" period.

In our 2014 submission we said:

"The IPA believes that it would be imprudent to rush into a new mechanism for providing capacity without clearly understanding the implications for existing market participants, as well as the implications for future investment…. It is important that any reforms to the capacity mechanism are done carefully and with the involvement of industry."

One comment that can be made, however, is that any market power mitigation measure will only ever be imperfect and is second best to the structural separation of Synergy. It is bad policy to design a market mechanism to try to minimise market power behaviour when the obvious policy decision needed is to address the market power directly through changing the industry structure. Measures put in place to supposedly mitigate Synergy's retail and wholesale dominance, especially after the merger with Verve, have not worked well. As we stated in 2014:

"Regulation to mitigate market power is always an inferior option to competition itself. Human nature is not something that responds well to regulation. If you were able to control, through rules and regulations, the impulses of an individual (or a group of individuals) to not be as successful as they might be if they were to benefit from (if not outright abuse) their monopoly power – then those individuals are probably ill equipped to run a successful business. Nothing drives innovation on price and service like an even, competitive playing field."

Section 6. Complementary reforms

The WAIPA supports the complementary reforms to be introduced in the transitional arrangements, specifically:

- harmonisation of demand side management
- reforms to capacity availability, including dynamic refunds, refunds recycling and generator availability

The WAIPA notes that the transition to a constrained access model represents an opportunity to remove the advantage of incumbency which largely benefits Synergy as well as removing the impediment to retiring inefficient plant. Though not discussed in this Position Paper, it is very important.

It is not enough however, to say that this may lead to sending better signals to retire plant, and that it will mean Synergy will then have to bid on a facility basis. This could be some way off, given the complexities of transitioning existing network agreements to a constrained model.

Part of the transition arrangements for the RCM should also include insisting that Synergy bids on a facility basis and that there is a program or process for retirement or selling of old and inefficient plant.

This is critical not just for addressing the market power of Synergy, but it should be part of the package of reforms to address excess capacity. As we stated in our 2014 submission:

"Given the newer private generators are likely to be more cost effective than aging Synergy plant, it would appear to be sensible to retire inefficient plant to reduce the supply-demand imbalance."

Section 7. The transition period

The reforms to increase the slope of the price curve to negative 5 and to increase the capacity price cap to 110 per cent of the Maximum Reserve Capacity Price in the transition period are supported.

But to be clear, as we have stated previously, the "transition period" does not mean automatic progression to an auction, whether or not excess capacity has been removed: the other, more important criteria to move to an auction or some similar market mechanism, is to have structural change leading to competitive wholesale and retail markets.