



Independent Market Operator

Procedure Change Report

**Title: Amendments to the Market
Procedure for
Determination of Maximum
Reserve Capacity Price**

Ref: PC_2009_12

Date: 30 March 2010

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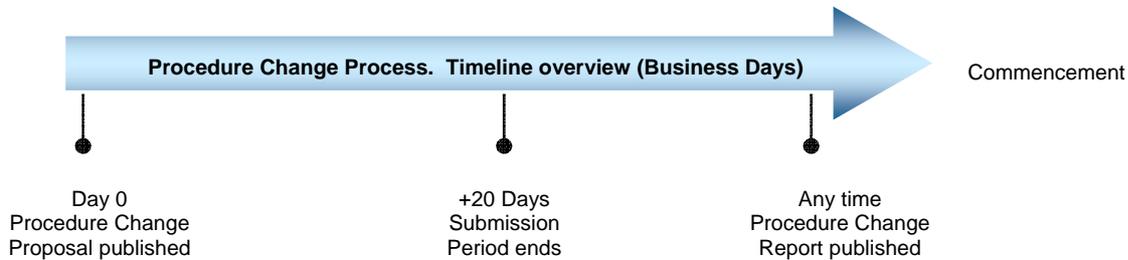
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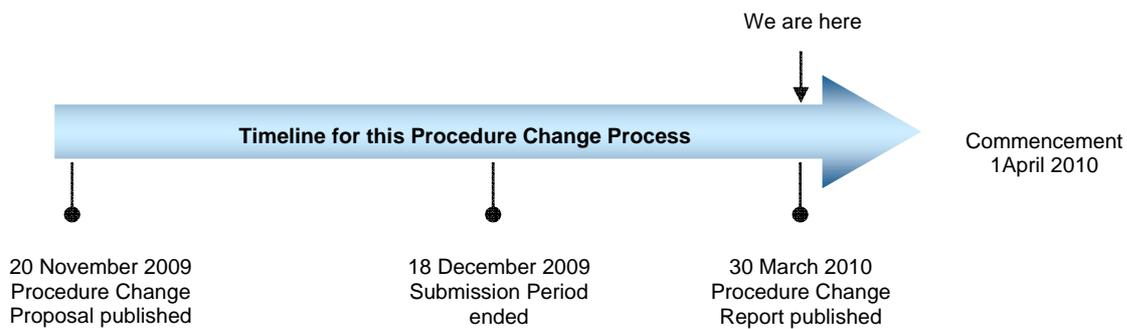


1. INTRODUCTION

On 20 November 2009, the Independent Market Operator (IMO) published a Procedure Change Proposal on the Market Procedure for Determination of Maximum Reserve Capacity Price (Market Procedure). The proposal has been processed according to the Procedure Change Process under clause 2.10 of the Wholesale Electricity Market Rules (Market Rules). This process adheres to the following timelines:



The key dates in processing this Procedure Change Proposal are:



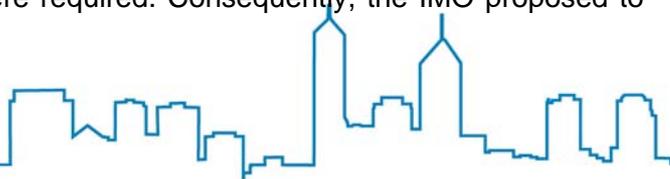
This Procedure Change Report is published by the IMO in accordance with clause 2.10.12 of the Market Rules.

2. THE PROCEDURE CHANGE PROPOSAL

2.1 Summary Details of the Proposal

The IMO is required to conduct an annual review of the Maximum Reserve Capacity Price (MRCP). For the 2010 Reserve Capacity Cycle the IMO requested The Allen Consulting Group (ACG) to review the major components of the Weighted Average Cost of Capital (WACC) used in calculating the MRCP. As an outcome of this review a number of changes to the major components were suggested. A copy of the AGC's report is available on the IMO's webpage: <http://www.imowa.com.au/mrcp>.

To implement the recommended changes into the calculation of the MRCP, the IMO considered that amendments to the Market Procedure were required. Consequently, the IMO proposed to



remove the current prescribed values of the major components of the WACC from the Market Procedure. This allows for revised values for the major components to be included in the determination of the WACC in subsequent years when necessary. Full details of this Procedure Change Proposal are contained within Appendix 1 of this report.

3. PUBLIC CONSULTATION PERIOD

3.1 Submissions received

The public submission period was between 23 November 2009 and 18 December 2009. The IMO received submission from Alinta and Landfill Gas & Power (LGP) during this period.

The details of the submissions received during the public submission period are summarised below. The full text of the submissions is available on the IMO website.

3.1.1 Submission from Alinta

Alinta does not support the Procedure Change Proposal. Alinta considers:

- That the amendment is not a procedural change, rather it is a methodological change;
- The Procedure Change Proposal will create significant uncertainty for existing and potential future Market Participants. This is because the amended Market Procedure would not explicitly identify the basis on which the IMO might conclude that one, or more, of the major components require review;
- That the effect of the increase in uncertainty is likely to be a material increase in administrative complexity and cost of the annual determination. This is because the lack of certainty and clarity on circumstances the IMO would review the major component creates opportunity for Market Participants to provide academic evidence to support changes that suit their commercial interests; and
- That academic literature is widely divergent on appropriate methodology for determining values of some of the major components.

Alinta acknowledges that fixing the values of the major components for a period of time creates a risk that, at any point in time, the values of a single major component may not be consistent with prevailing capital market evidence. However this risk, on the effect on the WACC and the ability to attract investment in generation capacity in the Wholesale Electricity Market (WEM), needs to be balanced against the potential additional cost and complexity that establishing a mechanism to review the major components more frequently might create.

Alinta submits that it is for this reason if the Market Procedure were to be amended to allow the IMO to change the values of major components outside of the specified review periods (currently every five years), the Market Procedure should explicitly specify the type of circumstances that would need to exist, or criteria that would need to be satisfied, for the major parameters to be reviewed.



Alinta considers that these matters however would be most appropriately considered as part of the IMO's review of the methodology used to calculate the MRCP.

Alinta also notes the information provided by AGC indicates that the proposed changes to the values of the asset beta and gamma are respectively due to a change in the set of comparator companies and developments in the academic literature and not due to the GFC or changes in market fundamentals themselves as noted by the IMO in proposal. Alinta supports this statement in its submission, available in full on the IMO Website: www.imowa.com.au/PC_2009_12.

Wholesale Market Objectives

Alinta considers that PC_2009_12 is likely to be inconsistent with Wholesale Market Objectives (a) and (d).

3.1.2 Submission from Landfill Gas & Power

LGP supports PC_2009_12 on the grounds that it will facilitate the determination of a MRCP that reflects the true cost of bringing capacity into the WEM through revision of the major components to be included in the determination of the WACC. LGP considers that the proposed changes are a proper response to the impact of the GFC, which has demonstrated the volatility of financial parameters.

While LGP supports the principle of minimal intervention to implement the change, it considers that clauses 1.3.5 and 1.3.6 should also apply to both the major and minor components.

LGP notes that perhaps the opportunity should be taken to relocate the word "and" in clause 1.12.1 (a) of the Market Procedure.

Wholesale Market Objectives

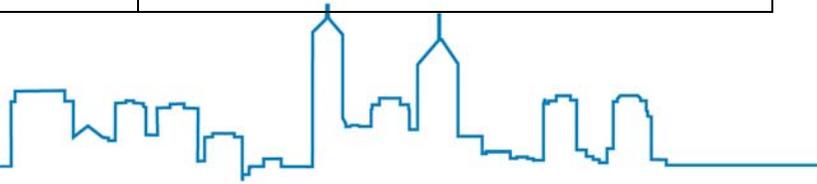
LGP considers that the proposed changes support Wholesale Market Objectives (a), (b) and (d).

3.2 The IMO's assessment of Public Consultation period responses

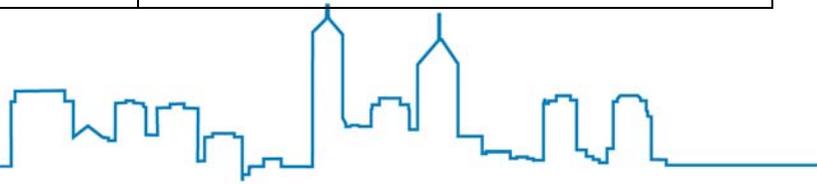
During the consultation period a number of points were raised regarding the proposed amendments to the Market Procedure. The IMO's response to each of the issues is presented in the table over the page.



Section of Procedure	Submitter	Comment/Change Requested	IMO's response
All	Alinta	The proposed amendments are not "procedural" and would allow for a methodological change.	<p>The IMO does not consider that the proposed amendments would allow for a methodological change. Clause 1.13.3 of the Market Procedure states that the major components of the WACC require review <i>less frequently</i> than the minor components. The proposed amendments do not change the current methodology by prescribing a more frequent review; they simply remove the values being specified in the Market Procedure.</p> <p>The IMO considers that major components should continue to require less frequent review than the minor components due to the nature of the variables.</p> <p>Further the IMO has included details of the circumstances under which the major components may be reviewed into the Market Procedure in section 1.13.5 and 1.13.6 and included requirements for public consultation on any such changes. This is similar to the process adopted for any changes to the minor components. This will ensure that the integrity of the review process is maintained.</p>
All	Alinta	The amendments would create significant uncertainty for existing, and potential future, Market Participants.	The IMO has included a new section 1.15.2 to the proposed Market Procedure to state that the <i>methodology</i> adopted for determining the major components in the five yearly reviews must be used in subsequent reviews.



Section of Procedure	Submitter	Comment/Change Requested	IMO's response
			<p>The IMO considers that this will remove any uncertainty regarding the approach to be adopted in setting the MRCP while ensuring that any necessary changes can be made to the methodology through the review at least once every five years.</p> <p>It is noted that the only situation where the methodology could be amended outside this five yearly review, would be if one of the circumstances specified in the Market Procedure arose and would require public consultation on the specific change.</p>
All	Alinta	The effect of the increase in uncertainty is likely to be a material increase in the administrative complexity and cost of the annual determination of the MRCP.	The IMO considers that by removing the prescribed values for the major components the resultant MRCP will better reflect the cost of capital to the market. This will increase the level of certainty of prices for Market Participants making investment decisions. Further, the IMO does not consider that there will be significant increases in administrative complexity or the cost of annually determining the value for the MRCP. This is because the IMO will not be changing the methodology used in calculating WACC unless determined during the 5 yearly reviews.
All	Alinta	If the Market Procedure were to be amended as proposed it should explicitly specify the types of circumstances that would be to exist, or criteria that would need to be satisfied, for the Major parameters to be reviewed.	The IMO agrees with Alinta's suggestion. This has been incorporated into the Market Procedure in section 1.13.5.



Section of Procedure	Submitter	Comment/Change Requested	IMO's response
All	Alinta	The circumstances surrounding a decision to amend the major components would be most appropriately considered as part of the IMO's review of the methodology.	The IMO does not agree. The IMO notes that the proposed amendments do not change the methodology but simply remove the values specified in the Market Procedure. Additionally, any changes to the major components would require public consultation.
Asset beta	Alinta	The available market evidence is not consistent with a recommendation for a reduction in the value of the asset beta, and by derivation a reduction in the value of the equity beta.	The IMO notes that Alinta's concern with the values adopted for the asset beta was responded to during the 2010 MRCP process. For further details please refer to the IMO's Final Report: http://www.imowa.com.au/mrcp
Gamma	Alinta	The available market evidence is not consistent with a recommendation to increase the value of gamma to 0.66.	The IMO notes Alinta's concern with the values adopted for gamma however a response to this issue was provided during the 2010 MRCP process. For further details please refer to the IMO's Final Report: http://www.imowa.com.au/mrcp
Set of comparator companies	Alinta	If, in calculating the asset beta of a set of comparator companies, the same set of companies should be used, it is necessary to consider whether the set of comparator companies used by the ACG to guide the derivation of an asset beta best reflects the risk faced by a supplier of capacity to the WEM.	The IMO agrees it is desirable to use the same set of companies when calculating the asset beta and notes that following from the public workshop ACG re-ran the results using the same set of comparator companies as used in 2007. The results from this simulation showed that when the asset beta increased from 0.44 to 0.62, the WACC increased from 6.89% to 7.78%. The findings of ACG's further assessment were distributed to workshop attendees on 16 December 2009. Given the different outcome, the IMO considers that the same methodology employed in the most

Section of Procedure	Submitter	Comment/Change Requested	IMO's response
			recent Major Review should be used. Where the IMO considers that any of the comparator companies are no longer available or that its characteristics have changed the IMO considers it may be necessary to select a different set of companies using a set of predetermined criteria. These amendments have been incorporated into the Market Procedure in section 1.15.2.
Wholesale Market Objectives	Alinta	The proposed amendments are likely to be inconsistent with market objectives (a) and (d).	Please refer to the IMO's assessment of proposed amendments against the Wholesale Market Objectives provided in section 4.1 of this report.
Clauses 1.13.5 and 1.13.6	LGP	Should also apply to both the Major and Minor components	The IMO agrees with LGP's suggestion to apply both major and minor components to clauses 1.13.5 and 1.13.6 and has accordingly amended the originally proposed Market Procedure to incorporate this decision.
Clause 1.12.1 (a)	LGP	The word "and" should be relocated in the sentence.	The IMO agrees with LGP in that clause 1.12.1(a) should be restated as "legal costs associated with the design <u>and</u> construction and of the power station". This change has been included in the amended Market Procedure.



3.3 Public Workshop

Following the IMO's publication of PC_2009_12 and the notification received from a Market Participant suggesting the proposal would benefit from discussion by the MAC, the IMO determined to hold a public workshop on 2 December 2009 to allow for discussion of the proposed amendments by the wider stakeholder group.

The workshop was attended by a range of Market Participants:

- Economic Regulation Authority (ERA);
- Verve Energy
- TransAlta;
- LGP;
- Synergy;
- System Management;
- Western Power;
- Alinta

The workshop demonstrated a high level of engagement from industry and in particular provided a forum for:

- The IMO to present the proposed amendments to the Market Procedure;
- Alinta to put forward its philosophical issues around the proposed amendments; and
- Market Participants views to be heard and queries to be addressed.

A copy of the full workshop minutes is available on the IMO website, http://www.imowa.com.au/PC_2009_12.

4. THE IMO'S ASSESSMENT

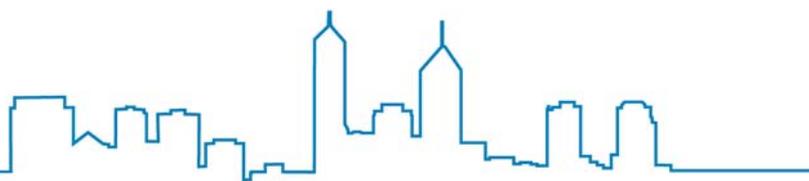
In determining whether to accept the Procedure Change Proposal, the IMO has assessed the Procedure Change Proposal in light of clauses 2.9.3 (a) of the Market Rules.

Market Rules 2.9.3 (a) outlines that Market Procedures must be:

- developed, amended or replaced in accordance with the process in the Market Rules;
- consistent with the Wholesale Market Objectives; and
- consistent with the Market Rules, the Electricity Industry Act and Regulations.

Additionally, clause 2.10.13 states that the Procedure Change Report prepared by the IMO must contain the following:

- the wording of the proposed Market Procedure or amendment to or replacement for the Market Procedure;



- the reason for the proposed Market Procedure or amendment to or replacement for the Market Procedure;
- all submissions received before the due date, a summary of those submissions and the response of the IMO or System Management, as applicable, to any issues raised;
- a summary of the views of the Market Advisory Committee (MAC); and
- a proposed date and time for the Market Procedure or amendment to or replacement to commence, which must allow sufficient time, in the IMO's opinion, after the date of publication for Rule Participants to implement changes required by it.

The IMO's assessment is outlined in the following sections.

4.1 Wholesale Market Objectives

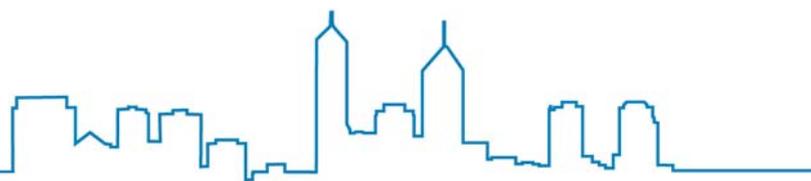
The IMO considers that the Market Procedure, as a whole, if amended will be consistent with the Wholesale Market Objectives.

Wholesale Market Objective	Consistent with objective
(a) to promote the economically efficient, safe and reliable production and supply of electricity and electricity related services in the South West interconnected system	Yes
(b) to encourage competition among generators and retailers in the South West interconnected system, including by facilitating efficient entry of new competitors	Yes
(c) to avoid discrimination in that market against particular energy options and technologies, including sustainable energy options and technologies such as those that make use of renewable resources or that reduce overall greenhouse gas emissions	Yes
(d) to minimise the long-term cost of electricity supplied to customers from the South West interconnected system	Yes
(e) to encourage the taking of measures to manage the amount of electricity used and when it is used	Yes

Further, the IMO considers that the steps of the Market Procedure, if amended, are drafted in such as way that the Market Procedure would better address Wholesale Market Objective (a) and (b):

Impact	Wholesale Market Objectives
Allow the Market Rules to better address objective	a, b
Consistent with objective	c, d, e
Inconsistent with objective	-

(a) *to promote the economically efficient, safe and reliable production and supply of electricity and electricity related services in the South West Interconnected System*



The proposed changes will encourage greater allocative efficiency by better reflecting the cost of capital to the market. Allowing revised values for the major components will ensure that the WACC is a true reflection of the current economic conditions. Therefore Market Participants, in making their investment decisions, will have greater certainty that the WACC value used in determining the MRCP will reflect the true cost of capital.

b) to encourage competition among generators and retailers in the South West interconnected system, including by facilitating efficient entry of new competitors

The proposed changes will facilitate the entry of new competitors into the market by encouraging greater competition. The IMO considers that certainty over the cost of capital may incentivise new entrants into the market.

4.2 Wholesale Market Rules, the Electricity Industry Act and Regulations

The IMO considers that the proposed amended Market Procedure is consistent as a whole, with the Market Rules, the Electricity Industry Act and Regulations.

The IMO also considers that the proposed amended Market Procedure is consistent with all other Market Procedures.

4.3 Views expressed in submissions

The IMO received two submissions from Alinta and LGP.

Alinta did not support the proposal on the grounds that the proposed amendments are not procedural in nature but rather represent a methodological change. The IMO has made a number of amendments to the Market Procedure in response to some of the concerns raised by Alinta.

LGP was supportive of the proposed changes as it would facilitate a MRCP that reflects the true cost of bringing capacity into the WEM.

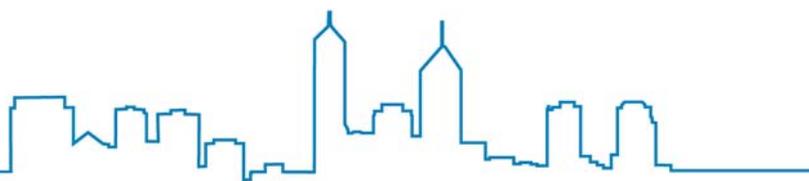
The IMO's responses to the issues raised during submissions are provided in section 3.2 of this report.

4.4 Implementation of the Market Procedure

The Market Procedure will not require Rule Participants or the IMO to implement any procedural or system amendments before it can commence. Consequently, the IMO considers that commencement at 8:00am on 1 April 2010 will allow Rule Participants sufficient time from the date of publication of this Procedure Change Report to ensure compliance with the amended Market Procedure.

4.5 Views of the Market Advisory Committee

The MAC did not meet to discuss the proposed Market Procedure. The proposed amendments were however discussed at the public workshop attended by all interested stakeholders on 2 December 2009.



Workshop attendees generally noted the need for further analysis. Specifically, that:

- the Allen Consulting Group re-run the numbers for WACC for the same set of companies selected in 2007; and
- the IMO distribute the impact of changes to the value adopted for gamma on the results.

Following the workshop, AGC was requested to re-run the calculation using the same set of comparator companies for the MAC Meeting on 9 December 2009.

The IMO also decided to reissue the draft report using the major components as prescribed in the Market Procedure. The notice of correction can be found at <http://www.imowa.com.au/mrcp>.

The impact of the changes to gamma on the results was discussed in the MAC Meeting 25 on 9 December 2009.

5. THE IMO'S DECISION

The IMO's decision is to approve the proposed amended Market Procedure as proposed in the Procedure Change Proposal and updated following the public consultation process.

The IMO has made its decision on the following basis. The amended Market Procedure:

- is consistent with the Wholesale Market Objectives;
- improves consistency with the Market Rules, Electricity Industry Act and Regulations; and
- requires no system changes prior to implementation.

Additional detail outlining the analysis behind the IMO's reasons is outlined in section 4 of this Procedure Change Report.

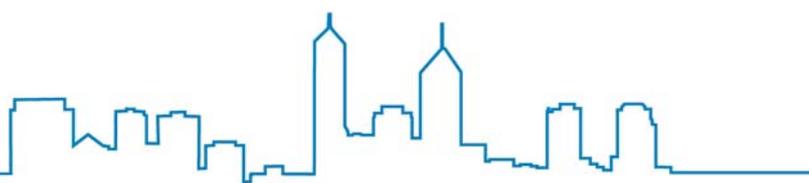
6. THE AMENDED MARKET PROCEDURE

6.1 Commencement

The amended Market Procedure for Determination of Maximum Reserve Capacity Price will commence at 08.00am on 1 April 2010.

6.2 The amended Market Procedure

The wording of the amended Market Procedure, as proposed by the IMO and updated following the public consultation period, is available on the IMO's website: http://www.imowa.com.au/PC_2009_12



APPENDIX 1: FULL DETAILS OF THE PROPOSAL

Each year the IMO is required to conduct a review of the MRCP. As part of this review the IMO determines the WACC to be applied to various costing components of the MRCP. The methodology adopted by the IMO to determine the WACC is outlined in section 1.13 of the Market Procedure for the Determination of the Maximum Reserve Capacity Price and involves a number of components that require review. These components are classed as those which require review annually (called minor components) and those structural components of the WACC which require review less frequently (called major components).

Currently the Market Procedure prescribes the values for the major components to be included in the WACC, for example a market risk premium of 6.00%. The values of the major components were developed before the volatility experienced in financial markets over the past 12 months. As such, the IMO considers that these values are out of date and do not reflect the current economic climate and therefore should be updated. In contrast the Market Procedure allows the values for the minor components to be left to be determined by the IMO as part of the annual review process.

In order to change the major components to be relevant for the year they apply to the IMO considered that it must initiate a Procedure Change Proposal each year that a change is required to reflect economic conditions. This current process poses a procedural issue as the IMO would not be aware that the major components would require change until the IMO receives external financial advice as part of the annual MRCP process. The result of this procedural issue is that any changes to the major components to be used in the calculation of the WACC would require a procedure change in parallel with the consultation for the MRCP draft report.

The IMO proposed to update the Market Procedure so that the major components of the WACC are not prescribed in the Market Procedure. This will allow for revised values for the major components to be included in the determination of the WACC. The IMO considered that the proposed changes will ensure that the IMO can determine a MRCP that reflects the true cost of bringing capacity into the WEM, while still giving Market Participants the ability to comment on the components used to determine the WACC.

The proposed changes will give greater visibility to the financial implications of changes to the WACC components as the outcomes of the changes on the MRCP can be calculated with the actual values that will be used in the final MRCP figure. In addition, the IMO considers that the proposed changes will allow the IMO to update the major components included in the calculation of the WACC inline with changes in operating conditions in the future.

The proposed amendments to the Market Procedure do not attempt to allow for a methodological change, but rather will allow for revisions to the values the determinant information. The IMO notes that it will conduct a review of the methodology used to calculate the MRCP, as specified in clause 4.16.9, before the start of next years MRCP process.

