



Market Procedure for the Determination of the Maximum Reserve Capacity Price (PC_2009_12)

Minutes

Location:	Cliftons Mezzanine Floor, Australia Place Cnr St Georges Tce & William Street Perth
Date:	Wednesday 2 December 2009
Time:	Commencing at 10:00am until 11:30am

Attendees	
Troy Forward	Independent Market Operator (IMO) (Acting Chair)
Allan Dawson	IMO
Jacinda Papps	IMO
Fiona Edmonds	IMO (Minutes)
Holly Cheung	Economic Regulation Authority (ERA)
Chris Brown	ERA
Robert Pullella	ERA
Duc Vo	ERA
Alinta Dykstra	Alinta
Brad Huppatz	Verve Energy
Wendy Ng	Verve Energy
Wana Yang	TransAlta
Dan Cannon	TransAlta
Steve Gould	Landfill Gas & Power
Wesley Medrana	Synergy
Stephen MacLean	Synergy
Alistair Butcher	System Management
Neil Gibbney (arrived at 10.30am)	Western Power
Jenni Conroy (arrived at 10.30am)	Future Effect
Jerome Fahrer	The Allen Consulting Group (via Teleconference)
Jun Wei Foo	The Allen Consulting Group (via Teleconference)
Apologies	
Brian Conrick	Gindalbie
Kevin Woodthorpe	Gindalbie
Michelle Bell	Gindalbie
Rob Rohrlach	Energy Response

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1.	<p>WELCOME</p> <p>The Acting Chair opened meeting at 10:00am and welcomed attendees to the public workshop for Procedure Change Proposal: Market Procedure for the Determination of the Maximum Reserve Capacity Price (MRCP) (PC_2009_12).</p> <p>The Acting Chair thanked Jacinda Papps as the Chair of the IMO Procedures Working Group (Working Group) for extending the attendance of this meeting to the wider industry.</p> <p>The Acting Chair also thanked Alinta for raising questions around the potential uncertainty caused by the publication of PC_2009_12. The chair noted that the questions raised by Alinta regarding the determination of the MRCP highlighted the need for review of the process, reinforcing the IMO's decision to undertake the five year review early next year.</p>	
2.	<p>INTRODUCTION and BACKGROUND</p> <p>The Acting Chair outlined the background of the IMO's annual review of the MRCP, including the associated methodology and the reasons for the Procedure Change Proposal.</p> <p>In particular the Chair noted that the IMO undertook its first review of the MRCP in 2007. As part of this process the basis on which the MRCP should be formulated was also reviewed. A number of suggestions were made at the time including forward pricing, smoothing and the basis of the Weighted Average Cost of Capital (WACC) which is applied. It was noted that the current approach adopted for calculating the MRCP assumes that a Reserve Capacity Auction takes place and that a long term agreement is provided to the successful marginal plant required for system reliability. The Chair acknowledged that in reality this is not the case and that it is more likely that merchant plant is the margin unit on the system for Reserve Capacity purposes.</p> <p>The Chair noted that following the experience of the last year, questions were raised regarding the appropriateness of the WACC in the post Global Financial Crisis (GFC) environment. In response the IMO commissioned the Allen Consulting Group (ACG) to review the Major and Minor components included in the calculations. During the review the ACG identified a significant difference in the Major components following the GFC. This has raised the question of whether it is appropriate to use the previous values specified in the Market Procedure or to use a revised value which reflects the changed environment and therefore, in the IMO's opinion correctly values Capacity Credits in the market.</p> <p>The Chair identified the following points for further discussion by the Working Group:</p>	

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	<ul style="list-style-type: none"> • Currently there is no provision in the major review of the Market Procedure to look at the WACC. The IMO considers that this is a failing in the current procedure; • Do the changes represent a real change or is it a sampling variance? • Should all components (minor and major) be assessed each year and should there be a limit applied to any variance, below which the old values are maintained? <p>The Chair noted that Alinta had requested that the Market Advisory Committee (MAC) consider the proposal at the MAC meeting and requested a seconder. The IMO considered that Alinta raised valid concerns and determined to call a meeting of the Working Group (constituted under the auspices of the MAC) and extend attendance to the wider industry.</p> <p>Corey Dykstra from Alinta disclosed to attendees that he had worked at the ACG in 2007 and had been involved in providing the initial advice to the IMO on the WACC and related parameters. At that time the ACG had suggested that the IMO adopt a process similar to Australian Energy Regulator (AER) for transmission pricing with regards to the CAPM calculation. The model that the AER adopted was that more stable parameters are fixed for five years and those which are generally variable in the market will be recalculated each year. Alinta noted that the philosophical issues associated with PC_2009_12 are whether to:</p> <ul style="list-style-type: none"> • fix some aspects of the parameters used in the calculation of the WACC; • more frequently review the parameters; and/or • include a clause in the Procedure Change Proposal to allow the IMO to the parameters within five years if a set criteria is meet. <p>Alinta also queried whether the GFC had resulted in these changes despite there having been no movement in the market risk premium. Alinta also noted it is unclear whether movements in the equity beta are due to sampling or variations in the market data.</p> <p>In response the ACG noted that the recommended change in gamma is due to recent academic work and has also been accepted by the AER. Alinta queried how confident attendees were that the process which has been set up will result in a value that is predominantly correct. Further Alinta noted that he disagrees with the assessment of the IMO that this is simply a procedural change.</p> <p>The IMO noted that there will be winners and losers associated with any change to the WACC and that its role is to try minimise the</p>	

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	<p>anticipated impacts of the process. The IMO noted that it will be held to account for any decisions it makes and considered that consultation with wider industry will improve the integrity of any associated decisions.</p> <p>The IMO noted that the IMO Board has delegated the responsibility of approving procedure changes to the IMO CEO. It was also noted that once the IMO CEO became aware of the report he commissioned legal advice regarding the IMO's decision to go ahead with calculating the value of MRCP based on proposed changes to the Market Procedure.</p> <p>The IMO queried ACG as to why the Major components are different from before, what has changed in the market externally and the resultant impact. In response, ACG noted that GFC has had a big impact on returns to businesses all around the world and has changed the correlation between the return of energy companies and the market as a whole. During the GFC there was a fall in stock market values all around the world but not such a large effect experience by energy related companies. As a result the correlation between the energy market and the rest of the market has reduced.</p> <p>ACG noted that the methodology applied for the 2010 WACC calculation is essentially the same as that applied the previous year. ACG did however judge that the relevant risk in Western Australia is riskier than for the transmission or distribution companies in both Western Australia and the eastern states but not as risky as for companies in the National Electricity Market.</p> <p>Alinta questioned how many of the companies in table 1.2 are the same as were in the previous advice. ACG advised that 7 of the 12 companies had changed. ACG also noted that the methodology for choosing companies was based on a set criterion. Further details of the methodology used are available in ACG's report which is available on the IMO's webpage: http://imowa.com.au/mrcp</p> <p>The Working Group requested that ACG re-run the numbers for the same set of companies selected in 2007.</p> <ul style="list-style-type: none"> • <i>Action Point:</i> ACG to determine the time requirement for re-running this and advise the IMO. • <i>Action Point:</i> ACG to re-run the calculations using the same set of companies from 2007 and provide the results to the IMO for distribution to all attendees. <p>ACG noted that the current literature considers that small companies should be excluded from calculations of the WACC. ACG was uncertain whether this premise was applied in the 2007 assessment. The Working Group agreed that this was not a pivotal point.</p>	<p style="text-align: center;">ACG</p> <p style="text-align: center;">ACG/IMO</p>

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	<p>TransAlta queried why no Australian companies have been included in the beta calculation. AGC advised that Australian companies are all on the eastern seaboard and are involved in integrated activities and so will not show up in the Bloomberg field. TransAlta also queried why different company mixes are applied to the equity beta and the asset beta (with reference to table 1.4 and 1.2). AGC advised that a raw beta is an equity beta.</p> <p>AGC advised that gamma has recently been updated due to more sophisticated thinking by the AER on the advice of Professor Handley which suggests it is best to assume a 100% payout. AGC noted that this interpretation changes the estimates of the gamma and that further details are available in the report it commissioned for the IMO (available on the IMO's webpage).</p> <p>Alinta noted that the treatment of gamma is not a GFC issue but rather a philosophical change in views on how this parameter should be calculated. The IMO questioned what the sensitivity of this is on the outcomes. AGC noted that the 6.89% Pre Tax Officer WACC (real) would become 7.6% if gamma changes from 0.66 to 0.5.</p> <ul style="list-style-type: none"> • <i>Action Point:</i> The IMO to distribute the impact of changes to the value adopted for gamma on the results to all attendees. <p>AGC noted that there was no scientific reasoning for the adoption of a value of gamma of 0.5 in the past. The IMO noted that this might be a matter of consideration for the MRCP process.</p>	IMO
3.	<p>ATTENDEES INVITED TO OUTLINE VIEWS</p> <p>The Chair noted that the conceptual issue is whether the IMO should proceed forward with the changes as currently proposed under PC_2009_12 and that the Working Group should consider the regulatory requirements. The Chair requested discussion of the issue in light of upholding the market objectives.</p> <p>LGP noted that the Procedure Change Proposal must run its course and that the change should proceed, as it is consistent with Market Objective (d) which is to minimise the long term cost of electricity supplied. However, LGP noted that the IMO should do everything possible to get the correct answer. LGP questioned what the financial impacts would have been in previous years. The IMO noted that the \$90m is a real change and assuming that everything is at that price.</p> <p>Alinta noted that now a value of \$90m associated with not revising the values of the Major components has been made publically available there will be a perception that the market is paying too much. Alinta noted that the focus should be on the process and not on the monetary value to the market. The IMO noted that the concept of whether the value determined is "fit for purpose" is the fundamental question which needs to be addressed. The IMO also noted that</p>	

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	<p>detailed discussions of the WACC are common across many electricity markets.</p> <p>TransAlta questioned whether the ERA would be better placed to determine the WACC and if they have more experience and expertise than the IMO in this area. The ERA noted that it is currently building up the capacity to undertake its own analysis rather than outsourcing this. Alinta noted that parameters are process driven and largely driven by regulatory precedence and academic studies.</p> <ul style="list-style-type: none"> • <i>Action Point:</i> Consideration of whether the ERA should determine the WACC to be used in the calculation of MRCP to be included by the IMO on the list of issues to be considered as a part of the wider review of the MRCP. <p>The IMO requested that information of the various WACC processes undertaken by the ERA be made available during the wider review.</p> <ul style="list-style-type: none"> • <i>Action Point:</i> IMO to ensure that the ERA are involved on any working groups constituted to undertake the wider review of the MRCP. <p>The Chair noted that under clause 2.10.13(d) of the Market Rules the views of the Working Group will be provided in the Procedure Change Report and will constitute one the elements for consideration by the IMO CEO in determining whether to approve the Procedure Change Proposal.</p> <p>Alinta noted that conceptually there has been a framework put in place and that this should not arbitrarily change. Alinta noted that no evidence to support a change has been provided at this stage and that any changes should be considered as part of the wider review. Additionally, Alinta noted that the appropriate place to consider whether more flexibility in determining the Major components is warranted would be the broader review. This was supported by TransAlta and System Management.</p> <p>LGP noted that the problem should aim to be fixed before the next Reserve Capacity Cycle.</p> <p>Alinta requested that the IMO's legal advice on proceeding with this procedure change be distributed to the wider group for consideration.</p> <ul style="list-style-type: none"> • <i>Action Point:</i> The IMO to distribute its legal opinion on the Procedure Change Proposal <p>The IMO noted that it will need to make a decision on the advice it receives on the values of the parameters and queried whether the Working Group should meet again to discuss these matters once the further analysis requested from the AGC is made available. The Chair requested that attendees make any views on the parameters known during the MRCP process.</p>	<p>IMO</p> <p>IMO</p> <p>IMO</p>

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4.	WORKSHOP WRAP UP AND PROCESS FROM HERE The extended Working Group will reconvene to discuss the parameters adopted if requested by two attendees following the distribution of the updated calculations and the IMO's legal position.	Chair