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## Concept Paper: Annual Approval of Facility Costs to Streamline Ancillary Service Procurement

### 1. BACKGROUND

The recent transformer failure at Muja has created the need for System Management to consider procuring Dispatch Support Services<sup>1</sup> under an Ancillary Service Contract to support Power System Security and Reliability in the South West and Great Southern regions. The procurement process for Ancillary Service Contracts can be lengthy. Where the process is protracted, inefficient dispatch options and distortions in the market may result.

Currently, under clauses 3.11.8 and 3.11.8A of the Wholesale Electricity Market Rules (Market Rules), System Management may enter into Ancillary Service Contracts with Rule Participants for the purpose of providing Spinning Reserve Services (where the requirement cannot be met with Synergy's Facilities), Load Rejection Reserve Services, System Restart Service or Dispatch Support Service<sup>2</sup>.

Clause 3.11 of the Market Rules outlines the process required to procure a Dispatch Support Service Contract as follows:

1. System Management must update the Ancillary Service Requirement (which includes Dispatch Support Services) at any time if it considers that a considerable shortfall of that service relative to the applicable Ancillary Service Standard is occurring, or is likely to occur before the next annual update. System Management must submit this to the IMO for approval.
2. The IMO must audit System Management's updated Ancillary Service Requirement.
3. Where System Management intends to enter into an Ancillary Service Contract, it must:
  - seek to minimise the cost of meeting its obligations to schedule and dispatch facilities to meet the Ancillary Service Requirements in each Trading Interval in accordance with Chapter 7 (Dispatch) of the Market Rules; and
  - give consideration to using a competitive tender process, unless it considers that this would not meet the requirements to minimise the costs.
4. Before entering into an Ancillary Service Contract, System Management must obtain the approval of the contract from the ERA. In its approval, the ERA "must only review whether an Ancillary Service Contract... would achieve the lowest practicably sustainable cost of delivering the services" and may undertake a public consultation process.

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<sup>1</sup> Under clause 3.9.9 of the Market Rules, a Dispatch Support Service is an Ancillary Service that is needed to maintain the Power System Security and Power System Reliability that are not covered by the other Ancillary Service categories, including the service of controlling voltage levels, where that service is not already provided under any Arrangement for Access or Network Control Service Contract.

<sup>2</sup> It should be noted that under clauses 5.1.1 and 5.1.2 of the Market Rules, Network Control Services are to be procured by the Network Operator to cover services that are provided as a substitute for transmission or distribution network upgrades. These are no longer considered by the Market Rules as they are designed to provide non-market related support to the network.

Despite the ERA's ability to circumvent the consultation process under clause 3.11.8D of the Market Rules, the IMO considers that there are further opportunities to expedite and streamline the procurement process which could result in more efficient market outcomes.

## 2. ISSUES WITH THE ANCILLARY SERVICE PROCUREMENT PROCESS

Where System Management considers that a Dispatch Support Service needs to be procured, it currently publishes an Expression of Interest on its website. Rule Participants are required to submit the technical specifications, quantity of energy available to be used for dispatch support and cost of providing the required service. System Management then evaluates all aspects of the tender submissions to determine the most efficient procurement of the required Dispatch Support Service.

This requires System Management to make an effective assessment of the least cost solution. However, System Management does not have sufficient information on the expected/benchmark Short Run Marginal Cost (SRMC) of different Facilities to assess the costs submitted in the tenders and therefore inform its decision with regard to the contract. Consequently, the process for procuring Ancillary Services may take longer than required where the ERA does not agree with the System Management's contract arrangements, which would then require the process to be restarted.

By contrast, the ERA (and the IMO) undertakes a range of functions in the market, where it is required to assess economic efficiency (costs and prices) and is best placed to do so. Further, the ERA has access to the information necessary to make a fully informed decision with respect to the efficient cost of the provision of Ancillary Services. While the ERA making the determination is consistent with the current process, under the current arrangements the ERA is only required to make this determination at the end of the process.

In the period between System Management identifying a considerable shortfall of Ancillary Services relative to the applicable standard and the completion of the procurement process, the market bears the associated costs (for example, constraint payments for Out of Merit generation). Where this is a protracted process, the resulting market outcomes are likely to be inefficient and the effect on the market is likely to be significant.

The IMO notes that possible inefficient outcomes include the following:

1. Out of Merit dispatch is likely to be required, which does not ensure that the lowest cost energy is dispatched. This mechanism is only designed to retard brief disruptions to normal dispatch.
2. Constraint payments to Market Participants for the Out of Merit generation of a Facility may not recover the SRMC of that Facility providing energy in that Trading Interval. In particular, this is a problem where the constraint requires a Facility that has market power, and is therefore required to bid at SRMC to run, where the Facility has a low Ramp Rate Limit, where the Facility would otherwise not be running and where the Facility is required to run across multiple Trading Intervals.
3. In most cases, System Management must dispatch Facilities in the order required under clause 7.6.1D of the Market Rules (i.e. each Facility in order of the Balancing Merit Order (BMO), any Facility in the BMO and a Non-Balancing Facility). This means that System Management is unable to dispatch other (potentially cheaper) Facilities, potentially

resulting in a less efficient outcome than would be achieved under an Ancillary Service Contract.

4. Market Customers cannot easily predict the costs associated with the constraint payments to Market Participants for the Out of Merit generation required to pay for the Ancillary Services.
5. Market Participants that have Facilities operating near the margin cannot easily determine the reason that the Facility has been dispatched in a certain manner by System Management in a Trading Interval.

### 3. PROPOSED SOLUTION

The IMO considers that the process of procuring Ancillary Services can be expedited by instituting a requirement for all Facilities wanting to enter into an Ancillary Service Contract to provide a price to the ERA to approve, prior to the start of each Capacity Year.

The IMO proposes that this price is the SRMC of the Facility, less the Balancing Price, plus a profit margin. The SRMC of the Facility will provide the Market Participant's expectation of the cost of providing energy for each Facility and should factor in start-up costs and other operating costs<sup>3</sup>. The IMO considers that the combination of the capacity payment, energy payment (Balancing Price), and Ancillary Service payment will ensure that a Facility does not run at a loss. The profit margin, on top of this, should provide an appropriate return for the service. The IMO considers that the profit margin should be based on the 10-year Government Bond Yield rate.

The IMO proposes that each year the ERA would then provide the list of approved prices to System Management with the lowest prices ranked first, and where Ancillary Services are required, System Management follows that order (where the Facility meets the requirements) for the quantity in the IMO-approved requirement.

This pre-approval process, where Ancillary Services are required, would allow for System Management to request only for the quantity of energy and technical specifications from Rule Participants, and access Dispatch Support Services more quickly when required.

The IMO notes that a requirement could also be introduced for System Management to procure a Dispatch Support Service under an Ancillary Service Contract in accordance with the above proposed process where the shortfall has persisted for more than five Business Days or was expected to last for an extended period.

### 4. ACTION POINTS

The IMO recommends that MAC members:

- **consider and discuss** the proposed solution; and
- **recommend** to the IMO whether to progress a Rule Change Proposal.

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<sup>3</sup> It should be noted that the SRMC does not include fixed costs which do not vary in the short run. These fixed costs are recovered through Capacity Credit payments under the Reserve Capacity Mechanism.