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Dear Dr Shahnazari

RESPONSE TO ISSUES PAPER – MARGIN VALUES FOR THE 2018/19 FINANCIAL YEAR

Bluewaters welcomes the opportunity to provide comments on the paper entitled "Issues Paper – Spinning reserve ancillary service: margin values for the 2018-19 financial year" (Issues Paper). This paper was published by the Economic Regulation Authority (Authority) on 3 January 2018.

Bluewaters notes that the Authority is, through this Issues Paper, conducting a consultation under MR 3.13.3A(b). Bluewaters also notes this consultation is based on a proposal of Spinning Reserve Margin Values submitted by AEMO under MR 3.13.3A(a). Bluewaters further notes that AEMO has engaged Jacobs Group Pty Ltd (Jacobs) to provide an independent assessment of the Margin Values for the 2018/19 financial year.

Bluewaters also notes that MR 3.13.3A requires the Authority to determine the Margin Values taking into account the Wholesale Market Objectives.

Bluewaters notes that the proposed Spinning Reserve Margin Values (resubmitted on 31 January 2018) were a revision from the original proposal which was submitted on 3 January 2018. The revised Margin Values proposed were significantly lower compared to the original values[1]. Further information is available in the AEMO's letter to the Authority dated 31 January 2018.

Bluewaters notes that this revision significantly reduces the potential over-payment of Spinning Reserve by Market Generators (by at least $6.8M or 67%). This removes economic inefficiency in the Wholesale Electricity Market (WEM) and in turn substantially promotes the Wholesale Market Objectives.

Summary of recommendations

In summary, Bluewaters' recommendations are as follows:

- adopting the Authority's Available Cost model as set out in the Issues Paper;
- evaluation of the Spinning Reserve Margin Value to take into account energy supplied by Synergy[2] for replacing the Synergy's capacity withdrawn[3] (to the extent that this has not already been accounted for by Jacobs);
- evaluation of the Spinning Reserve Margin Value to take into account the Independent Power Producer (IPP) Spinning Reserve capacity from the FY 2018-19 tender;
- enabling the draft Spinning Reserve Margin Values to be used as price signals for the FY 2019/20 determination at the latest; and
- continual improvement of the Spinning Reserve Margin Values consultation process – for delivering maximum possible transparency and efficient economic outcomes.

The above recommendations are discussed in further details below.

[1] To account for some anomalies in modelling.
[2] As opposed to energy supplied by an IPP.
[3] Note: capacity withdrawn for Spinning Reserve provision.

The Authority's Availability Cost model

Bluewaters notes that the Authority is proposing an Availability Cost model that is different from that proposed by Jacobs. Bluewaters is of the view that the Authority's model better supports principles for promoting economic efficiency (and in turn promoting the Wholesale Market Objectives). This is the case despite the reasoning provided by the Independent Market Operator (IMO) [4] in 2011.

Bluewaters notes that both the Authority's and Jacobs' Availability Cost models calculate the Availability Cost by determining the incremental Synergy's cost difference between a "counterfactual scenario"[5] and a "Synergy providing Spinning Reserve scenario" [6]. This cost includes the: (a) opportunity cost of Synergy's lost revenue and (b) loss in efficiency of Synergy's facilities (in accordance with MR 3.13.3A).

The Authority's model takes into account the difference in balancing price outcomes between the two scenarios. The Jacobs' model, on the other hand, does not take balancing price outcomes difference into account and assumes that the balancing price outcomes of both scenarios are as per the "Synergy providing Spinning Reserve scenario".

Bluewaters notes that the Authority is seeking stakeholders' views as to whether such balancing price difference should be taken into account in evaluating the Availability Cost.

By not taking the balancing price outcomes difference into account[7], the Availability Cost would have ignored the fact that the balancing price would have been lower under the "counterfactual scenario" compared to the "Synergy providing Spinning Reserve scenario".[8]

Ignoring the impact of this price increase[9] would have overstated the Availability Cost (and therefore the Spinning Reserve Margin Values). This is because:

- The remaining Synergy's portfolio[10] would have benefited from this higher balancing price and such benefit should be offset against Synergy's costs (including opportunity costs) for providing Spinning Reserve. Bluewaters notes that such benefit has been taken into account in the Authority's model, but not in the Jacobs' model.
- As proposed in the Authority's model, the revenue foregone by Synergy for providing Spinning Reserve should have been valued at the balancing price of the "counterfactual scenario", rather than the "Synergy providing Spinning Reserve scenario" as suggested by Jacobs' model.

Bluewaters notes that in 2011 the IMO has argued in favour of assuming that the balancing price outcomes of both scenarios are as per the "Synergy providing Spinning Reserve scenario". The IMO's arguments and Bluewaters' response are discussed below.

<u>IMO's argument 1: the network would not be operated without a reserve</u>

The IMO argued that "Because the network would not be operated without a reserve, the counterfactual price (set by the cost of the marginal generator) is not valid." The IMO further stated that "while the [counterfactual] scenario provides a useful estimation of Verve Energy's[11] costs, its SMP [system marginal price] results are based on unrealistic assumptions and so are unlikely to be reflective of real market prices".

Bluewaters considers this IMO's argument can only practically mean that, if Synergy does not provide Spinning Reserve, the IPPs would have needed to provide the Spinning Reserve and the balancing price outcome would have been the same in both scenarios.

Bluewaters disagrees with this argument. This is because the IMO's argument implies comparing the "IPP providing Spinning Reserve scenario"[12] with the "Synergy providing Spinning Reserve scenario" for evaluating the Availability Cost. This is not the intent of the Market Rules.

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[4] IMO is the predecessor of AEMO.

[5] This is the scenario where no one in the WEM provides Spinning Reserve, including Synergy.

[6] This is the scenario where Synergy is the sole provider of Spinning Reserve.

[7] As in the case for the Jacobs' model.

[8] This is because the former scenario does not include withdrawal of Synergy's capacity for providing Spinning Reserve. This means higher supply compared to the latter scenario, hence lower balancing price outcome.

[9] By moving from the "counterfactual scenario" to the "Synergy providing Spinning Reserve scenario".

[10] That is, those Synergy facilities not providing Spinning Reserve at that time.

[11] Note: Verve Energy is the predecessor of the generation part of Synergy.

[12] This is a hypothetical scenario where all Spinning Reserve in the WEM is provided by the IPP rather than by Synergy.

Rather, the intent of the Market Rules is more suitably interpreted as comparing the "counterfactual scenario" against the "Synergy providing Spinning Reserve scenario" because this more closely follows the sequence of System Management's Spinning Reserve procurement process as intended in the Market Rules.

The Spinning Reserve procurement sequence is as follows: (a) MR 3.11.7A and 3.11.8 strongly implies that Synergy is the default Spinning Reserve provider; and (b) under MR 3.11.8, IPP can provide Spinning Reserve [13] where Synergy cannot provide it, or where the IPP can provide it cheaper than Synergy. Comparing the two scenarios gives an Availability Cost of the default Spinning Reserve provider (to the extent it can be provided by the default provider). This Availability Cost is then compared against the cheaper option of IPP offered Spinning Reserve. The IPPs may provide Spinning Reserve to that extent that it is cheaper to do so. The IPPs may also provide Spinning Reserve to the extent that it cannot be provided by Synergy.

Bluewaters considers the alternative interpretation (reflecting IMO's argument) is not workable in the context of the above Spinning Reserve procurement sequence.

Note that the proper interpretation is also consistent with the fundamental principle of the Jacobs' Availability Cost model. This principle works on the premise of comparing the "counterfactual scenario" against the "Synergy providing Spinning Reserve scenario". Bluewaters considers the IMO's argument which selectively ignored the balancing price outcomes difference is contradictory to this fundamental principle.

In addition, the fact that Synergy is the default Spinning Reserve provider means it is the first port of call for Spinning Reserve provision in a WEM. This strongly implies that Synergy is obliged to provide Spinning Reserve in a WEM that has no Spinning Reserve provision, and be compensated for it. This in turn strongly implies that the Availability Cost[14] should account for the difference between the "counterfactual scenario" and the "Synergy providing Spinning Reserve scenario" – including the difference in the balancing price outcomes. This refutes the IMO's argument that the counterfactual price is "not valid" or "based on unrealistic assumption".

Bluewaters also considers the proper interpretation also reflects a competitive Spinning Reserve market arrangement. Under a competitive market structure, a prospective Spinning Reserve provider would have made a trade-off decision between selling energy and foregoing energy sales for Spinning Reserve provision. A prudent Spinning Reserve provider would have taken the impact on balancing price outcome into account in making the Spinning Reserve offering decision.

<u>IMO's argument 2: most of Synergy's output is traded through bilateral contracts</u>
The IMO have also argued that the difference in balancing price outcomes between the two scenarios[15] should not be taken into account because "Verve Energy traded most of its output through bilateral contracts" and "changes in the SMP [system marginal price] would only be expected to have an impact over the comparatively small quantities generated above or below Verve Energy's Net Contract Position".

Bluewaters also disagree with this argument.

Bluewaters considers this argument assumes that both of these scenarios are expected to give identical bilateral contract price outcomes. In fact, the bilateral contract price outcomes are likely to be different under each of these scenarios. It is expected that, under the "counterfactual scenario", Synergy would have contracted at a lower price to reflect the expected lower balancing price outcome under this scenario (compared to the "Synergy providing Spinning Reserve scenario").

Hence, Bluewaters considers the difference in contractual price outcomes should be taken into account in the evaluation of the Availability Cost.

As it may be difficult to determine what the contracted price outcome would have been under the "counterfactual scenario", Bluewaters recommends using the balancing price difference as the proxy.

[13] By contracting with System Management.
[14] Which is a measure for Synergy's compensation for providing Spinning Reserve.
[15] That is, the "counterfactual scenario" and the "Synergy providing Spinning Reserve scenario".

Availability Cost model – withdrawn energy replaced by energy from Synergy's facilities
Figure 1 of the Jacobs report[16] assumes that the capacity withdrawn by Synergy for providing Spinning Reserve is replaced by an IPP generation. This would have resulted in loss of revenue by Synergy which forms part of the Availability Cost.

Bluewaters notes that the energy replacing the Spinning Reserve capacity does not necessarily always come from an IPP. In fact, given that the Synergy's Balancing Portfolio has the largest share of the WEM generation market, it is more likely that the withdrawn capacity will be replaced by energy from another generator within the Synergy Balancing Portfolio. Under this circumstance, the Synergy will not incur a revenue loss and does not need to be compensated. In fact, this portion of Synergy's generation is likely to benefit from the higher balancing price outcome under the "Synergy providing Spinning Reserve scenario".

Bluewaters recommends that the Authority ensures that such circumstance be taken into account in the Availability Cost evaluation in the final Margin Values determination (to the extent that Jacobs has not already done so).

Bluewaters notes that the Issues Papers is already considering this aspect of the Availability Cost evaluation.[17]

IPP Spinning Reserve capacity from the FY 2018-19 tender
On 28 September 2017, the AEMO sought Express of Interest (EOI) from prospective IPP Spinning Reserve providers for FY 2018/19 and beyond. This EOI was sought as part of the IPP Spinning Reserve procurement process under MR 3.11.8. It is anticipated that System Management will enter into Ancillary Services Contracts for provision of Spinning Reserve by IPPs if they are a less expensive alternative compared to what Synergy can provide.

Bluewaters notes statement in Jacobs' report that "As AEMO has not finalised all the Spinning Reserve contracts for FY 2018-19, the previous Spinning Reserve contracts for FY2017-18 will be used for modelling the Spinning Reserve contracts for the current review period." This means the potential outcome of the IPP Spinning Reserve procurement process has not been factored into the draft Margin Values recommendations.

Bluewaters recommends that the outcome of the IPP Spinning Reserve procurement process be taken into account in the Spinning Reserve Margin Values determination. This is expected to allow Margin Values to be determined based on more accurate information hence promoting economic efficiency (which in turn promotes the Wholesale Market Objectives).

If the process procurement cannot be completed before the final determination of the Spinning Reserve Margin Values, Bluewaters recommends that they be adjusted by the Authority following the completion of the procurement process.

Draft Spinning Reserve Margin Values as a price signal
The Market Advisory Committee (MAC) is considering recommending an arrangement that allows IPP Market Generators to vary their Spinning Reserve offers in response to the draft Spinning Reserve Margin Values determination. This will allow the draft determination to be used as a price signal for the IPPs to offer Spinning Reserve capacity at more economically efficient quantity and price.

Bluewaters considers the sensitivity analysis[18] is an important piece of information for the IPP to make the revised Spinning Reserve offer.

During a MAC meeting, AEMO has advised that a Rule change may not be necessary for implementing this arrangement.

Further information is available in the minutes for MAC Meeting No. 8.[19]

[16] This is an attachment to the Authority's Issues Paper.
[17] See Figure 3 of the Issues Paper and related discussions.
[18] The sensitivity analysis should inform what the Spinning Reserve Margin Values would have been at various quantities of IPP contracted Spinning Reserve.
[19] At the time of writing of this submission, only the draft minutes was available. The minutes was not published but was circulated to MAC members and observers. See Agenda 9, Issue 18. It is expected that the minutes will be published here when it is finalised.

Bluewaters recommends that this arrangement be implemented for Spinning Reserve Margin Values determination, for the FY 2019/20 determination at the latest.

Spinning Reserve Margin Values consultation process

Bluewaters considers performing the sensitivity analysis is a positive step for improving transparency of the Margin Values determination process. In addition, AEMO's performance of backcasting is also a positive step for improving transparency.

Bluewaters encourages the Authority and AEMO to continually improve the transparency of this process.

Bluewaters notes that the Spinning Reserve procurement process (and hence the Margin Values determination process) is expected to be superseded by the co-optimised energy and ancillary service dispatch arrangement in the longer term. This, however, depends on the outcome of the market reform. The scope and timing for implementation are also yet to be ascertained.[20]

Bluewaters considers, while the current process is in place, it should be enhanced to the maximum extent feasible for improving transparency and/or delivering a more economically efficient outcome. This should especially be the case for any improvements that can be achieved within the current Market Rules.

Should you have any questions regarding this submission please contact Ignatius Chin on 08 9261 2890 or ignatius.chin@bluewatersps.com.au.

Yours sincerely

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[20] The Public Utilities Office (PUO) has published a roadmap which provides some guidance – see here.