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## Wholesale Electricity Market Submission to Procedure Change

### PC\_2009\_12      Market Procedure for the Determination of Maximum Reserve Capacity Price

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#### Submitted by

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<b>Date submitted:</b>	18 December 2009

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#### Submission

Clause 2.10.7 of the Wholesale Electricity Market Amending Rules provides that any person may make a submission for a Procedure Change Proposal by filling in this Procedure Change Submission form.

Submissions for Procedure Changes that relate to the Power System Operation Procedures should be submitted to:

##### **Western Power Networks - System Management Division**

Attn: Alistair Butcher, Market Strategic Development Manager  
GPO Box L921  
Perth WA 6842  
Fax: (08) 9427 4228  
Email: market.development@westernpower.com.au

Submissions for Procedure Changes that relate to IMO Market Procedures should be submitted to:

##### **Independent Market Operator**

Attn: Manager Market Development & System Capacity  
PO Box 7096  
Cloisters Square, Perth, WA 6850  
Fax: (08) 9254 4399  
Email: market.development@imowa.com.au

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## **1. Please provide your views on the Procedure Change Proposal, including any objections or suggested revisions.**

### **Background**

Market Rule 4.16.6 requires that the Independent Market Operator (IMO):

- develop a Market Procedure documenting the methodology it uses and the process it follows in determining the Maximum Reserve Capacity Price (MRCP); and
- follow the documented Market Procedure to annually review the value of the MRCP.

The Market Procedure for Determination of the Maximum Reserve Capacity Price (the Market Procedure) was made on 13 October 2008 and then amended on 4 December 2008.

Clause 1.13.3 of the Market Procedure states that the methodology adopted by the IMO to determine the Weighted Average Cost of Capital (WACC) may involve components that will normally be reviewed annually ("Minor components") and those 'structural' components that require review less frequently ("Major components"). Clause 1.13.9 of the Market Procedure specifies values for the "Major components" that are to be used in the Capital Asset Pricing Model (CAPM) and in calculating the WACC.

The Market Procedure does not appear to explicitly specify how frequently the specified values for the Major components are to be reviewed, or how the values in clause 1.13.9 may be amended. Nevertheless, it appears reasonable to presume that it was intended that the value of these parameters be reviewed at least once every five years, consistent with the Major review provided for under clause 1.15.1 of the Market Procedure.

### **Issue**

Due to the Global Financial Crisis (GFC), the IMO requested that the Allen Consulting Group (ACG) review the values of both the Minor and the Major components of the CAPM and WACC in the Market Procedure.

The ACG recommended that the IMO adopt revised values for two of the Major components, being the asset beta, which measures the riskiness of an asset relative to that of the market as a whole, and 'gamma', which reflects the value of imputation tax credits attached to distributions to shareholders.

As noted above, it appears that the Market Procedure would not permit the IMO to adopt the alternative values for the asset beta and gamma that were recommended by the ACG.

## Procedure Change Proposal

By PC\_2009\_12, the IMO proposes to amend clause 1.13.3 of the Market Procedure to provide for prior year values to be used for Major components of the CAPM and WACC unless the IMO determined that the Major components require review. The Procedure Change Proposal would also delete the specified values of the Major components in clause 1.13.9.

### Alinta's views

Alinta Sales Pty Ltd (Alinta) does not support PC\_2009\_12. Alinta considers that the amendments proposed by PC\_2009\_12 are not 'procedural' as claimed, and would allow for a methodological change.

Firstly, Alinta considers that the amendments to the Market Procedure contemplated by PC\_2009-12 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.

Secondly, the effect of this increase in uncertainty is likely to be a material increase in the administrative complexity and cost of the annual determination of the MRCP. This is because the lack of certainty and clarity on the circumstances in which the IMO might review the Major components creates an opportunity and incentive for Market Participants to present the IMO with evidence from the academic literature to support changes to Major components where such changes are in their commercial interests. It is important to note that there exists a divergence of views in the academic literature on the appropriate methodology for determining the value of some of the Major components, as well as to 'correct' value of these components.

As advised by the ACG in its November 2007 (corrected September 2008) report to the IMO, fixing the values of the Major components of the CAPM and WACC reflects that these parameters "...are likely to remain stable over longer periods of time, and fixing the values of these parameters would minimise the administrative complexity, burden and cost...", and that "[t]his approach is also consistent with that taken in establishing the WACC for electricity transmission networks covered by the National Electricity Rules."

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, and the effect on the WACC and the ability to attract investment in generation capacity in the 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.

For this reason, Alinta considers that 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.

However, Alinta considers that these are matters that would be most appropriately considered as part of the IMO's review of the methodology used to calculate the MRCP, which it has indicated it intends to undertake before the start of next years MRCP process.

Finally, the IMO comments in PC\_2009\_12 that the values of the Major components were established before the volatility in financial markets over the past 12 months and therefore need to be updated to reflect the current economic climate.

However, as discussed below, the information provided by the ACG indicates that the proposed change in 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, not due to the GFC or changes in market fundamentals themselves.

#### *Asset beta*

The ACG's November 2007 (corrected September 2008) report used a value for the asset beta of 0.5, whereas its October 2009 report recommended that a value of 0.42 be adopted.

It is understood that only 5 companies from the ACG's November 2007 (corrected September 2008) report are included in the set of twelve comparator companies used in its October 2009 report. Subsequent analysis conducted by the ACG reveals that had the same set of comparator companies been retained in its October 2009 report, the value of the asset beta would actually have increased from 0.50 to 0.62.

Similarly, using the set of comparator companies from its October 2009 report, the calculated asset beta would have been 0.41 in the November 2007 (corrected September 2008) report, whereas a value of 0.44 was calculated in its November 2009 report. Therefore, the value of the asset beta would also have increased (from 0.41 to 0.44).

Therefore, 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.

#### *Gamma*

The ACG's November 2007 (corrected September 2008) report used a value for gamma of 0.5, whereas its October 2009 report recommended that a value of 0.66 be used.

The ACG's report details the recent precedent established by the Australian Energy Regulator's (AER) decision to accept that all (i.e. 100 per cent) imputation credits are paid out, which effectively reduces the value of imputation credits to the same value as the utilisation rate. Nevertheless, the ACG's report also refers to evidence that the market average pay out ratio is 0.71.

Had the average market pay out ratio of 0.71 been used to calculate gamma, its value would have been 0.47 (based on a 'utilisation rate' of 0.66 as per the ACG's report), a reduction from that used in the ACG's November 2007 (corrected September 2008) report.

Again, the available market evidence is not consistent with a recommendation to increase the value of gamma to 0.66.

#### *Set of comparator companies*

Finally, it remains relevant to consider whether, in calculating the asset beta of a set of comparator companies, the same methodology should be applied each year (as the ACG has done, which potentially results in changes to the set of comparator companies) or alternatively, whether the same set of companies should be used.

If the second approach were adopted, it would be necessary to consider whether the set of comparator companies used by the ACG to guide the derivation of an asset beta for estimating the cost of equity capital in its November 2009 report best reflect the risk faced by a supplier of capacity to the Wholesale Electricity Market (WEM).

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## **2. Please provide an assessment whether the Procedure Change Proposal is consistent with the Market Objectives and the Wholesale Electricity Market Amending Rules.**

Market Rule 2.4.2 states that the IMO must not make Amending Rules unless it is satisfied that the Market Rules, as proposed to be amended or replaced, are consistent with the Wholesale Market Objectives. The Wholesale Market Objectives are as follows.

- (a) To promote the economically efficient, safe and reliable production and supply of electricity and electricity related services in the South West interconnected system.
- (b) To encourage competition among generators and retailers in the South West interconnected system, including by facilitating efficient entry of new competitors.
- (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.
- (d) To minimise the long-term cost of electricity supplied to customers from the South West interconnected system.

- (e) To encourage the taking of measures to manage the amount of electricity used and when it is used.

Alinta considers that the IMO cannot be satisfied that PC\_2009\_12 is consistent with the Wholesale Market Objectives, and that in any event it is likely to be inconsistent with the Wholesale Market Objectives (a) and (d).

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**3. Please indicate if the Procedure Change Proposal will have any implications for your organisation (for example changes to your IT or business systems) and any costs involved in implementing these changes.**

The changes to the Market Procedure contemplated by PC\_2009\_12 would not of itself have implications for Alinta by requiring a change in its IT or business systems, and hence there are no IT or business costs associated with the rule change proposal.

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**4. Please indicate the time required for your organisation to implement the changes, should they be accepted as proposed.**

The changes to the Market Procedure contemplated by PC\_2009\_12 would not require Alinta to change its IT or business systems, and hence there is no specific period of time that would be required to implement the changes arising from the procedure change proposal.

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