vinalco energy

Ref: LE-725-140724

24 July 2014

Allan Dawson
Chief Executive Officer
IMO
Level 17
197 St Georges Terrace
Perth WA 6000

[redacted]

Dear Mr Dawson

VINALCO ENERGY PTY LTD – BALANCING SUBMISSIONS
REQUEST FOR EXPLANATION UNDER CLAUSE 2.16.9B(c) OF MARKET RULES

We are writing to provide the Independent Market Operator (**IMO**) an explanation under clause 2.16.9B(c) of the Wholesale Electricity Market Rules (the **Market Rules**), as requested by you by letter dated 22 July 2014.

Vinalco Energy Pty Ltd (**Vinalco**) remains disappointed that the IMO continues to focus on Vinalco's conduct, in circumstances where:

1. System Management has directed Vinalco to provide ongoing system support to resolve or avoid network issues resulting from the failure of Transformers BTT1 & BTT2, and the subsequent planned outage of SWCJV_WORSLEY_COGEN_COG1 Facility—which, as Vinalco has raised with the IMO a number of times, may be neither permitted under the Market Rules nor appropriate;

2. System Management's directions mean that Vinalco is running the Muja AB Facilities in circumstances where it would otherwise **not run**; and

3. Vinalco's pricing behaviour is, as it has previously advised the IMO, aimed to ensure that Vinalco avoids incurring losses . On this point, the IMO's position appears to be that Vinalco should provide ongoing system support at a loss.

Despite this, Vinalco understands that the IMO:

1. has concluded that certain prices (described as **Pricing Behaviour 1** and **Pricing Behaviour 2**) offered by Vinalco between 9 June 2014 and 30 June 2014 (the **Investigation Period**) in its Balancing Submissions **may have exceeded** Vinalco's reasonable expectation of the short run marginal cost of generating the relevant electricity; and

2. considers that the behaviour related to market power.

Vinalco's explanation, and response to the specific questions in the IMO's letter are as follows.

Vinalco does not have market power and its pricing behaviour does not relate to market power

Vinalco does not accept that it has market power, nor that its pricing behaviour "relates to market power".

The IMO's letter suggests that Vinalco has market power because System Management has taken a regulatory decision to dispatch Vinalco Out of Merit, resulting in a situation where Vinalco will be dispatched at its offer price, regardless of any competing offer. In expressing this view, the IMO has not commented on the relevant market, and has instead focused on the fact that, if System Management elects to dispatch Vinalco Out of Merit, then Vinalco's offer price is accepted whether or not it would be cleared in the Balancing Market.

Vinalco's view is that this is not evidence of market power in any relevant sense. The fact that Vinalco would be dispatched Out of Merit, and therefore dispatched at its offer price, is solely a product of System Management's regulatory intervention. It has nothing to do with market power, and there is no evidence that Vinalco has market power.

Short Run Marginal Cost model

Vinalco understands that the IMO's view that the short run marginal cost (**SRMC**) model, which Vinalco voluntarily provided to the IMO, should not include cost categories allowing for Capacity Cost Refunds based on a 4% forced outage factor or a reasonable profit margin.

The SRMC model is an internal tool to assist Vinalco in estimating the approximate level of each Facility's SRMC. As previously explained to the IMO, one of the issues faced by Vinalco is that the SRMC model did not predict that Vinalco would incur significant losses (which Vinalco did in March and April), which suggests that the SRMC model underestimates cost, irrespective of whether particular cost categories should, as a matter of economic theory, be included in a theoretical model of SRMC.

There might, for example, be other cost categories that could be included in the SRMC model that are not. Vinalco also observes that the SRMC model fails to take into account significant costs, such as starting and shutting down the Muja AB Facilities (which, in the absence of System Management's direction, would not have been run).

If those cost categories about which the IMO complains were excluded from the SRMC model, then Vinalco would have faced even more significant losses. That would clearly be an untenable position.

Vinalco also observes that the "Portfolio Short Run Marginal Cost of Electricity Supply in Half Hour Trading Intervals" paper published by the Economic Regulation Authority indicates that it is appropriate to include operational and maintenance inputs (including estimates in relation to planned and unplanned outage costs, loss of net revenues as a result of plant unavailability, financial penalties imposed for unscheduled outage, startup costs and shutdown costs).[1]

It is also important to recognise that Vinalco's offer price in each Balancing Submission is partly dependent on a range of forecasts it must make, based on what network support generation it has been told by System Management is likely to be required, and what it anticipates will happen in the Balancing Market. Some of the critical assumptions that have applied in June include:

1. System Management advising Vinalco that it would be required to operate three units at up to 55 MW each (which did not in fact occur), which had a material impact on anticipated costs; and

2. forecasts about the Balancing Price (the Balancing Price that ultimately applied was lower than forecast).

In any event, Vinalco's position is that clause 7A.2.17 of the Market Rules does not apply to Vinalco, as it does not have market power, and its prices do not relate to market power. It would be open for Vinalco to price at the Price Cap, and Vinalco reserves its rights to do so in the future.

Effect of Vinalco's shortfall allowance on its overall yield position

The IMO has specifically asked Vinalco to address the following matters (even though these requests cover a period beginning well before the Investigation Period):

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1 Portfolio Short Run Marginal Cost of Electricity Supply in Half Hour Trading Intervals (11 January 2008) at 2.4 and 5.

1. comment on the IMO's comparative analysis of Vinalco's current SRMC and the estimated financial outcomes (identifying any specific areas of disagreement and stating how Vinalco's analysis produces a different result); and

2. quantify the extent to which it has under-recovered or over-recovered its estimated SRMC on a cumulative basis since March 2014, as a result of including the shortfall allowance in its SRMC model.

Comparative analysis of Vinalco's SRMC versus IMO's yield analysis

Vinalco is unclear about what the IMO would like Vinalco to comment on in respect of its "comparative analysis" of Vinalco's SRMC and the IMO's estimated financial outcomes.

As the IMO is aware, the SRMC model seeks to estimate, based on a number of assumptions including in relation to the Balancing Price and level of generation required from the Muja AB Facilities, Vinalco's SRMC. The SRMC model has been refined to take account of actual outcomes in the market, which have resulted in Vinalco being paid less compensation than its actual costs. [redacted] Vinalco began including the shortfall allowance in its calculation of offer prices from 17 June 2014. Information about the difference between Vinalco's balancing and Constrained on Compensation payments and its actual costs are set out below.

As for the IMO's estimated financial outcomes, Vinalco has not been provided with details of how the IMO has calculated the financial outcomes. However, in broad terms, if the IMO has used Vinalco's actual offer prices, the actual Balancing Price, and the actual quantities generated, then Vinalco would expect that the estimated "yield" (ie settlements for balancing and Constrained on Compensation payments) would be at the $/MWh rate suggested by the IMO. However, Vinalco notes that the calculation of Constrained on Compensation payments under the Market Rules is very complicated.

Of course, as the IMO would appreciate, the challenge for Vinalco is that it must set offer prices not less than two (2) hours before each Trading Interval. This means that Vinalco must forecast, among other things, the likely Balancing Price, quantity of electricity to be generated, and its likely costs. Vinalco's offer prices must take into account those forecasts. The estimated financial outcome based on those forecasts will be different if the actual Balancing Price, quantity of electricity generated and actual costs are different, which is inevitably the case.

Quantifying over or under-recovery as a result of including the shortfall allowance

Vinalco has sought to calculate its balancing and Constrained on Compensation payments and actual costs since March 2014. However, Vinalco's ability to do so is significantly limited by the fact that there is a significant "lag" between each Trading Interval, and when actual data becomes available.

For example, there are significant delays in receiving details of actual Capacity Cost Refunds and operating and maintenance costs.

Vinalco's best **estimate**, using available data, is summarised in the table below. Vinalco's estimate is based on comparing the amount Vinalco was actually paid (to the extent the data is available) and Vinalco's best estimate of its actual costs.

Month	**Estimate of under or over recovery (AUD)**
March	744,000 less than Vinalco's estimated actual costs
April	1,055,904 less than Vinalco's estimated actual costs
May	Not applicable as Facilities were not dispatched Out of Merit
[redacted]	[redacted]
Cumulative Estimated Position	[redacted]

[redacted]

Yours sincerely

Paul Gower
GENERAL MANAGER OPERATIONS
VINALCO ENERGY PTY LTD