

Our ref: RCM/0485-02
Enquiries: Jason Banks

To Market Participants by e-mail (hard copy to follow)

Dear Market Participant

AMENDMENT OF CLAUSE 4.29.1 OF THE WHOLESALE ELECTRICITY MARKET RULES

This letter is to inform you that the Office of Energy (“OOE”) has recommended to the Minister for Energy that he amend clause 4.29.1 of the Wholesale Electricity Market Rules (the “Rules”). The Minister has been briefed on this proposed Rule change. The recommended amendment is as follows:

- Delete the existing clause 4.29.1(b), and replace it with the following:
 - (b) a. Prior to 1 October 2008, if no Reserve Capacity Auction was run for the Reserve Capacity Cycle, 85% of the Maximum Reserve Capacity Price for the Reserve Capacity Cycle divided by 12;
 - b. From 1 October 2008, if no Reserve Capacity Auction was run for the Reserve Capacity Cycle, 85% of the Maximum Reserve Capacity Price for the Reserve Capacity Cycle multiplied by the Excess Capacity Adjustment and divided by 12;
- Insert a new clause 4.29.1(c), as follows:
 - (c) where the Excess Capacity Adjustment is equal to the minimum of:
 - a. one, and
 - b. the Reserve Capacity Requirement for the Reserve Capacity Cycle divided by the total number of Capacity Credits certified by the IMO for the Reserve Capacity Cycle.

The effect of this amendment would be to adjust the administered price for Capacity Credits purchased by the IMO, as from 1 October 2008, if excess Capacity Credits are assigned and there is no auction. If there is excess capacity, the administered price will be adjusted according to the proportion of the Reserve Capacity Requirement relative to the quantum Capacity Credits allocated in the Capacity Cycle. Effectively, this caps the total cost for Capacity Credits traded through the IMO.

Generators that have bilaterally traded all of their Capacity Credits should not be affected by this Rule change, as they have negotiated contracts, and do not rely on the administered price for Capacity Credits traded through the IMO.

I note that, in recommending this amendment to the Rules to the Minister, the OOE is departing from its recommendation regarding the IMO's previous proposal to amend Rule 4.29.1(b), as indicated in the Rule Change Report published on the OOE's website on 16 June 2006.

The OOE's Rule Change Report indicated that it is concerned with the current operation of the Reserve Capacity Mechanism, and with Rule 4.29.1(b) and Appendix 3 in particular. The OOE supported market-based mechanisms to allocate and set the price for Capacity Credits, rather than relying on predetermined arbitrary processes administered by the IMO.

However, the OOE did not support immediately moving to market-based mechanisms to allocate and set the price of Capacity Credits because it was (and still is) concerned with the level of competition in the market. With the current level of competition in the market, there is a potential for abuse of market power under any market-based mechanism to allocate and set the price of Capacity Credits.

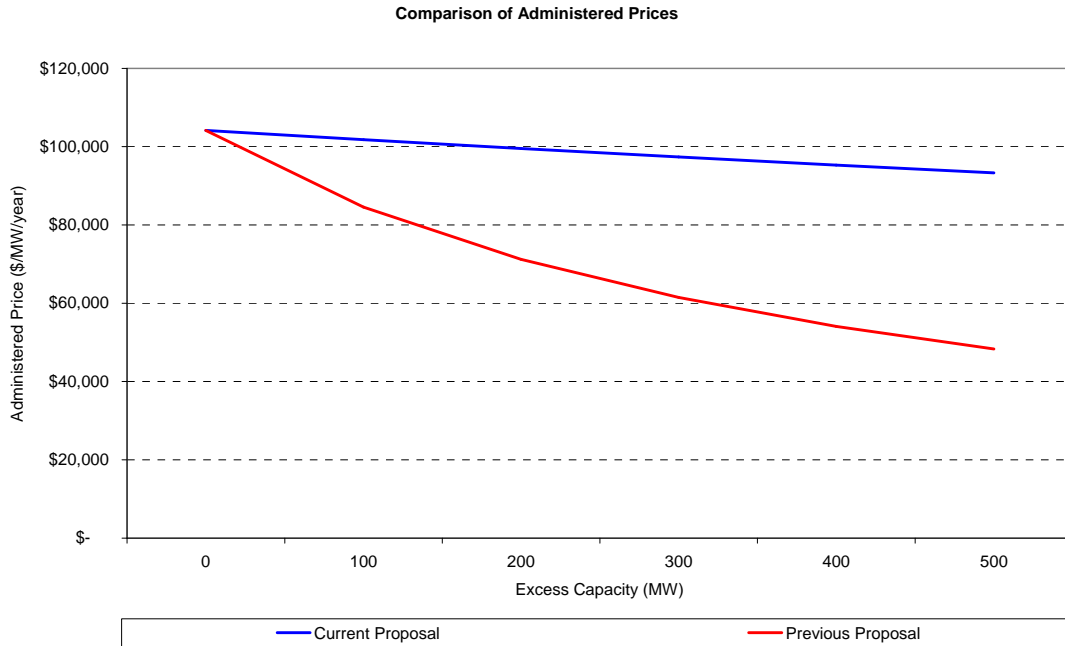
The OOE also noted that it received submissions from six parties, including Alinta, the Chamber of Commerce and Industry of Western Australia, Landfill Gas and Power Pty Ltd, Perth Energy, Synergy, and Verve Energy. While all of these parties generally agreed with the principles and objectives behind the IMO's proposed Rule change, most of them did not support the specifics of the proposal.

On 5 August 2006, the IMO certified Reserve Capacity for the 2008/09 capacity year. As a result, the OOE is now concerned that the IMO may end up acquiring a significant amount of excess capacity, which could impose substantial increased costs to Retailers and end users.

Therefore, the OOE requested that the IMO develop another, simpler amendment to Rule 4.29.1(b) to use until the Market Advisory Committee develops more permanent changes to Rule 4.29.1(b) and Appendix 3. The IMO developed the Rule change indicated above in response to the OOE's request.

I am writing to you to advise you of this proposed amendment so that you have as much advance notice of the amendment as possible, and so that Generators can take account of this information when making your Bilateral Trade Declaration on Friday 10 August 2006.

To assess the impact of this proposed Rule change, consider the chart below, which shows a comparison between the current proposed Rule change, and the IMO's previous proposal. This chart shows that the administered price is sensitive to excess capacity under both of the proposed Rule changes, but is more sensitive to excess capacity under the IMO's previous proposal. The current proposed Rule change will protect Retailers and end-use customers from potentially onerous costs from excess capacity, but also minimises the impact of this protection on Generators.



I note that Generators can mitigate the price risk that this Rule change may impose by:

- going to an auction and securing a long-term price guarantee for their Capacity Credits; or
- entering into bilateral contracts for their Capacity Credits.

I also note that this Rule change will not affect the first Reserve Capacity Cycle (2007/08), as it will only affect the administered price for Capacity Credits from 1 October 2008.

The OOE continues to recommend that, after market start, the Market Advisory Committee expeditiously consider amendments to Appendix 3 and Rule 4.29.1(b), giving specific consideration to the issues listed in the Rule Change Report published on the OOE website on 16 July 2006.

I trust that you find this information useful, and wish you the best of luck with procuring Capacity Credits for the second Reserve Capacity Cycle. Please contact me on (08) 9420 5601 if you would like to discuss this matter further.

Yours sincerely

JASON BANKS
A/COORDINATOR OF ENERGY

9 August 2006

Illustration of how the Proposed Rule Change will Work

Consider the following table as an illustration of how the proposed Rule change works, where the Reserve Capacity Requirement is 4,322 MW, and the Maximum Reserve Capacity Price is \$122,500/MW.

Capacity Credited by IMO (MW)	4,322	4,422	4,522	4,622	4,722	4,822
Excess Capacity (MW)	0	100	200	300	400	500
Under the Current Rules						
Administered price (\$/MW)	104,125	104,125	104,125	104,125	104,125	104,125
Total payment for capacity (\$ millions)	450.03	460.44	470.85	481.27	491.68	502.09
Payment for excess capacity (\$ millions)	0	10.41	20.83	31.24	41.65	52.06
Under the Proposed Rule Change						
Administered price (\$/MW)	104,125	101,770	99,520	97,367	95,305	93,328
Total payment for capacity (\$ millions)	450.03	450.03	450.03	450.03	450	450.03
Payment for excess capacity (\$ millions)	0	0	0	0	0	0
Effect of the Current Propose Rule Change						
Administered price reduction (\$/MW)	0	2,355	4,605	6,758	8,820	10,797
Administered price reduction (%)	0.0	2.3	4.4	6.5	8.5	10.4