Government of **Western Australia**
Department of **Finance**

Our Ref: 2012/01395 (00104811)

Inquiry into the Efficiency of Synergy's Costs and Electricity Tariffs
Economic Regulation Authority
PO Box 8469
Perth Business Centre
PERTH WA 6849

Attention: Ms Helen Ensikat

Dear Ms Ensikat

SUBMISSION ON THE DRAFT REPORT ON THE INQUIRY INTO THE EFFICIENCY OF SYNERGY'S COSTS AND ELECTRICITY TARIFFS

The Department of Finance's Public Utilities Office (PUO) is pleased to submit the following comments in response to the Economic Regulation Authority's (the Authority) Draft Report of 4 April 2012.

We commend the Authority for its comprehensive examination of Synergy's costs of service provision and its cost stack analysis of regulated tariffs.

The Draft Report has highlighted a number of areas on which the PUO wishes to comment. This includes:

- The conversion of the Tariff Equalisation Contribution to a Community Service Obligation.
- An analysis of Synergy's financial sustainability.
- The Authority's Long Run Marginal Cost (LRMC) assumptions, where there may be a need to reassess their appropriateness to better recognise:
  - existing generation plant in the system;
  - legacy contractual arrangements; and
  - constraints around gas (availability and pipeline capacity).
- Differentiation of tariff customer costs, including wholesale, cost to service and retail margin. The PUO hopes that the Authority's Final Report provides more transparency and differentiates between varying costs of providing electricity to different tariff classes.
  - The PUO views that it is necessary to gain transparency of individual tariff class costs to ensure that regulated tariffs can be set appropriately; that

cross-subsidisation between customer classes is minimised; and appropriate price signals can be sent.

- The regular review and pass through of non-controllable costs.

The PUO views that a robust tariff setting methodology can be setup as part of this process and encourages the Authority to ensure that its Final Report presents as robust methodology as possible.

Please refer to Attachment A for more detail around the PUO's comments. If you have any queries in relation to our comments, please do not hesitate to contact Jason Dignard on 6551 4643.

Yours sincerely

[redacted]

Michael Kerr
A/ DEPUTY DIRECTOR GENERAL

2 May 2012

PUBLIC UTILITIES OFFICE'S SUBMISSION ON THE DRAFT REPORT OF THE ECONOMIC REGULATION AUTHORITY'S *INQUIRY INTO THE EFFICIENCY OF SYNERGY'S COSTS AND ELECTRICITY TARIFFS*

The Public Utilities Office (PUO) supports an appropriate and well considered tariff methodology, that recognises the dynamic nature of the underlying costs to provide electricity and provide transparency of each respective tariff class.

With respect to this, the PUO would like the Authority to consider the following when evaluating whether its proposed methodology is appropriate:

1. Tariff Equalisation Contribution (TEC)

The Government's uniform tariff policy keeps tariffs the same for each customer category throughout Western Australia. This means regional customers pay the same tariff as those in the South West of Western Australia, even though it costs more to service them. This uniform tariff policy is paid through the TEC that is funded through South West customers distribution network charges.

The Authority recommends that the TEC no longer be met by electricity consumers in the South West and should not be part of the cost for electricity tariff.

The PUO notes that the method to fund the TEC is a decision for Government. The Authority's proposed change would have a significant budget impact on Government and in light of this the PUO requests inclusion of information in the report based on current Government policy.

2. Synergy's financial sustainability

The PUO recognises that as a retail business Synergy operates on small margins off a large cost base of well over $2 billion per annum. This creates a situation where a small change to a large cost contributor can have a significant impact on Synergy's profitability and cashflows.

For example, a tariff methodology that locks forecast costs in for three or four years in advance may see costs (actual or market) diverge by increasing amounts over this period. At the end of the forecast period tariffs may diverge significantly from cost resulting in significant profit or cashflow impacts on the retailer.

The Authority's Draft Decision has not sufficiently detailed its implications on Synergy's financial sustainability. The PUO notes that this is confidential information and is not necessarily appropriate to disclose publicly.

To ensure the robustness of the tariff methodology, the PUO requests that the Authority analyse Synergy's financial sustainability, including of select scenarios on Synergy's profitability and cashflow position. This analysis should be provided to Government.

3. Long Run Marginal Cost (LRMC) Assumptions

The PUO notes that the Authority has accepted Synergy's wholesale electricity costs for the 2012/13 and 2013/14 financial years but has set market efficient rates for the following two financial years. This is based on the premise that Synergy is able to transition to 'stand-alone' LRMC rates after two years.

Two years does not appear sufficient time to achieve a LRMC based mainly on a Combined (or Closed) Cycle Gas Turbine (CCGT) new entry plant (with associated costs based on the most efficient new entry plant each year).

The reality of the Wholesale Electricity Market means there are a number of barriers in the existing generation market preventing the Authority's assumptions from becoming a reality within the next two years.

Accepting the LRMC as an efficiency driver, the calculation of the LRMC nonetheless needs to recognise the Western Australian market environment for it to be adopted. The PUO requests that the Authority examine what a reasonable period to LRMC would be considering the current market barriers.

3.1. Existing generation plant in the system

In 2010, gas accounted for around 46 per cent of electricity in the SWIS from thermal generation. The SWIS accounts for all of Western Australia's coal fired power generation. [1]

Despite the carbon tax, coal-fired power generation will likely still continue to be a key contributor to the SWIS. Gas availability, pricing and risks associated with security of supply increases the likelihood that coal-fired power generation will continue to be considered cheaper for base-load capacity.

Furthermore, a large percentage of gas-fired generation facilities commissioned since 2000 consist of Open Cycle Gas Turbines (OCGT). This is because demand requirements, the cost of a CCGT and the availability of fuel are barriers for new entrants into a very competitive generation market.

The PUO requests that the Authority's LRMC calculation appropriately recognises the importance of coal fired plant in the SWIS context. The PUO would also request that the Authority consider what a reasonable glide path to LRMC would be.

3.2. Carbon costs

Electricity supply contracts typically contain clauses that allow for the contracts to be amended if a change in law occurs, allowing for a one time amendment to the contract with each change in law.

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[1] Independent Market Operator, 2011 Statement of Opportunities, page 54.

Generators are expected use this clause to pass through their increased costs relating to Carbon Price. The PUO understands that there may be little incentive for current contracted generators to re-negotiate their respective contracts. For Synergy to renegotiate its contracts within two years to decrease carbon costs seems ambitious.

The PUO understands that the Authority has chosen to set LRMC carbon intensity independent of existing contracts to be an efficiency benchmark.

Since LRMC is traditionally used to calculate costs for new investments, the PUO requests that the Authority also consider alternative options and pathways that can be used to transition to efficient carbon costs.

3.3. Constraints around gas

Other barriers to LRMC being achievable are the constraints around gas (availability and pipeline capacity). The constraints around the domestic gas supply may make it difficult for new entrants to obtain sufficient gas to compete in the generation market or to do so in an optimal manner.

Some gas users consider there to be a serious risk of domestic gas supply shortage by 2015[2] as legacy contracts expire.

Demand and competition for gas will add extra upward pressure on gas prices and pipeline capacity, widening the gap between the Authority's LRMC assumptions and what is practically possible in the Western Australian generation market.

The PUO requests that the Authority revisit some of its underlying LRMC assumptions, including the heavy reliance on gas plant and assumptions on future gas prices.

4. Transparency of differing tariff customer costs

It appears that the Authority does not differentiate between tariff classes regarding the underlying 'cost stack'. However, the cost of providing electricity to different tariff customer groups can be materially different.

The Authority allocates energy and capacity costs by looking at Synergy's total load and summarising each customer groups' consumption pattern into preset categories. This approach can average customer groups' load profiles and could disguise the true impact one customer group has on the system over another.

[2] Energy Supply Association of Australia, *Western Australian Energy Market Study: 2 Year Update*, November 2011

For example some large business customers may have relatively flat load profiles and applying an average load profile to them would in effect cross-subsidise peakier customer classes.

The PUO views that in bidding for different customer groups the market will recognise, and price, the differing underlying costs for each tariff class.

In its Draft Report the Authority highlights that retail operating costs will vary between contestable and non-contestable customers as there may be additional costs associated with customer service, or transferring customers to alternative tariffs. It further recommends that any additional costs associated with the contestable market should be recovered through Synergy's retail margin.

However, the Authority also assumes a differing view that contestable and franchise customers should carry the same retail margin.

It is of the upmost importance that a tariff methodology observes the differences in customer groups when setting wholesale costs, retail margins and operating costs for each tariff class. To do otherwise may lead to cross-subsidisation, risks sending incorrect price signals and may adversely impact the ability to compete for particular tariff customers.

Consistent with the Inquiry's Terms of Reference, the PUO requests that the Authority's tariff methodology recognise the differing underlying costs of each tariff class.

5. Non-controllable costs

The PUO notes that the Authority considers it appropriate to pass through non-controllable costs and recognises that these costs can and do regularly change over time.

It is the PUO's view that the Authority has not considered all non-controllable costs, including balancing costs.

The PUO requests that the Authority considers all potential non-controllable costs and proposes a methodology of how tariffs would appropriately reflect changes in non controllable costs.