

Our Ref: DM # 3455552
Enquiries: Jacinda Papps
Telephone: (08) 9424 1917
Facsimile: (08) 9424 1922



2 May 2012

Economic Regulation Authority
PO Box 8469
Perth Business Centre
PERTH WA 6849

Attention: *Helen Ensikat - Manager Projects, Economics*

Email: publicsubmissions@erawa.com.au

Dear Helen

INVITATION FOR SUBMISSIONS ON THE DRAFT REPORT ON THE INQUIRY INTO THE EFFICIENCY OF SYNERGY'S COSTS AND ELECTRICITY TARIFFS

Thank you for the opportunity to comment on the draft report on the Inquiry into the Efficiency of Synergy's Costs and Electricity Tariffs. Verve Energy's review and submission has been based on section three of the draft report (Wholesale Electricity Cost).

Verve Energy's specific comments are outlined below.

Replacement Vesting Contract

In its draft report the Authority expresses a number of concerns with the Replacement Vesting Contract which Verve Energy wishes to respond to.

The Authority notes that:

- The process undertaken in the establishment of the Replacement Vesting Contract was not open and competitive;
- The Replacement Vesting Contract was "imposed upon Synergy" and "assigned to Synergy by the State Government¹";
- The Replacement Vesting Contract lacks the pro-competition features included in the Original Vesting Contract, in particular the displacement mechanism and the associated information provision by Synergy to the market, i.e. the displacement statement of opportunities;
- The lack of pro competitive features will have an adverse impact on investment in the future; and

¹ Draft Report, pg 29

² Draft Report, pg 19

- The Replacement Vesting Contract is the “most expensive of Synergy’s traditional energy source contracts³” and that “this high cost...casts doubt over whether this is an efficient contract for Synergy to hold”.

Verve Energy considers that some of the assertions made by the Authority are outside of the scope of the inquiry, nevertheless our response is as follows.

The Replacement Vesting Contract was a negotiated outcome between Verve Energy and Synergy. The outcome was a more cost reflective bilateral contract which allocates risk to the appropriate parties and allows for the supply of energy and capacity at commercially agreed prices. During the contract negotiation process the Department of Treasury and Finance reviewed the financial outcomes to ensure that they were appropriate. In addition to this the contract was independently reviewed, both for fairness and reasonableness of the risk allocation methodology. Specifically the independent reviewer was tasked with providing “an independent opinion on whether the terms of the agreement are consistent with a typical commercial agreement between a generator and a retailer operating within a competitive market of the nature of the Wholesale Electricity Market (WEM)”. Verve Energy notes that the decision of the Minister for Energy to prescribe the contract, under Section 82 of the Electricity Corporations Act 2005 (WA), was made after the contract was largely negotiated. Therefore, Verve Energy considers that, despite the decision to prescribe the contract, it was not imposed on either party.

Although the Replacement Vesting Contract does not have any explicit and rigid displacement mechanism, Verve Energy notes that its contract quantities decrease significantly every year. This gives Synergy scope for securing new supplies in an open and competitive manner. Additionally, the contract is not an enduring assignment of any rights. There is no requirement in these arrangements for Synergy to recontract with Verve Energy after the end of the contract, or for Verve Energy to continue to supply Synergy.

The Authority has stated that the Replacement Vesting Contract is the most expensive of Synergy’s traditional energy source contracts. This may possibly be the case if various contracts were compared on the numerical value of the prices only (although it should be noted that the Authority has not quantified how it arrived at this conclusion). Verve Energy notes that when comparing electricity supply contracts, provisions other than the price can have significant value and need to be taken into account. Contractual parameters such as take or pay provisions, risk structure, load factors or nominations flexibility can have enormous affect on the final unit cost to the retailer and cannot be overlooked when contracts are evaluated.

Approach to Long Run Marginal Cost (LRMC) Estimation

In commenting on the LRMC estimation, Verve Energy makes reference to both the Draft Report and Frontier Economics’ (Frontier’s) report “LRMC of Regulated Tariffs – Final report – March 2012”.

Verve Energy considers that there are a number of deficiencies in the LRMC methodology and calculations, which lead to a material underestimation of the LRMC forecasts and an underestimation of average Carbon intensity.

³ Draft Report, pg 23

Overview of modelling approach

In the description of modelling methodology, Frontier mentions that the regulatory obligations are taken into account in the LRMC calculations. In the reported results, there is evidence that reserve capacity obligations and carbon costs were taken into consideration but there appears to be no consideration of renewable energy targets. There is no wind or other renewable plant capacity and no consideration of wind impact on efficient dispatch of scheduled generation plant or costs of Ancillary Services associated with load following.

Greenfields portfolio

Frontier has utilised the 'Greenfield approach' to determining LRMC. Using this new entrant plant methodology typically requires use of market price assumptions and parameters. For example fuel price assumptions should reflect the market price for fuel for each type of generation technology. Currently in the Western Australian context, there is a significant difference between market coal and gas prices as indicated by Frontier's LRMC fuel price assumptions. Given the assumed Carbon prices utilised, it would be reasonable to expect that some degree of coal generation would be evident in the 'Greenfields' portfolio.

The Base Case modelling outcome in which the LRMC is derived from a 'Greenfield' portfolio made up purely of Combined Cycle Gas Turbines (CCGTs) and Open Cycle Gas Turbines (OCGTs) occurs primarily due to:

- coal technology choice assumption, noting that Subcritical PC – Black Coal technology was not considered even for scenario modelling purposes despite the role this technology currently plays in the SWIS;
- capital cost assumptions for CCGTs and OCGTs; and
- delivered gas price assumptions utilised by Frontier are lower than the likely market price for long term gas supply contracts in the context of the Western Australian market.

Notwithstanding any possible concerns regarding new entrant input assumptions that lead to an outcome whereby the 'Greenfield' portfolio is made up purely of OCGTs and CCGT's, Verve Energy considers it unrealistic to derive LRMC from such a portfolio mix given that it is not currently achievable from a gas fuel supply point of view.

Capital Costs

Verve Energy considers that the capital costs for the technology types considered by Frontier appear to be grossly underestimated (in the Western Australian context). The costs used by Frontier were sourced from the Australian Energy Market Operator's 2011 National Transmission Network Development Plan (Scenario 3), without any adjustments, even though it is widely known that plant construction costs in Western Australia are higher than those in the National Electricity Market (NEM).

During the recent review of Maximum Reserve Capacity Price, the Independent Market Operator has determined the cost of construction of a 160 MW OCGT to be about \$192M, which is approximately \$1200/MW. This is significantly higher than Frontier's number of \$871/MW.

In Verve Energy's opinion Frontier's forecast capital costs for a CCGT are also grossly underestimated. Our view is that the capital cost for a CCGT is more in the region of \$1,800/kW rather than the \$1,251/kW assumed by Frontier.

Additionally, Verve Energy's experience with other technology types also points to costs significantly higher than those used by Frontier.

Differential treatment of various cost elements

Verve Energy notes that the Authority is not consistent in its approach when treating various cost elements that will form the final tariff:

- When the Authority considers the costs of procuring capacity in the WEM it acknowledges that there are higher capacity requirements than those under the LRMC model and subsequently it recommends an adjustment to LRMC model to accommodate this requirement. As such, the Authority deviates from the theoretical LRMC model for this purpose.
- In its recommendation of carbon pass through the Authority takes the pure theoretical LRMC model without any consideration of the existing portfolio, despite the fact that:
 - Some of the existing generation plant was constructed before any carbon scheme was envisaged; and
 - It would be impossible to replace existing plant with the lower LRMC gas plant within the required time frame because of substantial lead time necessary to plan and construct new capacity.

Verve Energy considers that if the LRMC is adjusted for capacity payments to IMO, an appropriate adjustment should be allowed for the existing high carbon intensity plant especially taking into account the fact that a complete gas portfolio is not achievable in the view of above arguments.

Costs of Carbon Pricing

The Authority notes that⁴:

- The full cost of carbon that is imposed on a generator is not necessarily passed on to consumers in an efficient market;
- A coal based generator cannot always pass through the full carbon cost because in a competitive environment it may be underpriced by a less carbon intensive generator;
- The carbon cost built into the LRMC calculation is consistent with a carbon cost that would be expected in a competitive market; and
- It may require two years for Synergy to renegotiate its contracts to ensure that only an efficient level of carbon cost is recovered in tariffs.

Verve Energy considers that the Authority's assertions regarding pass through of carbon costs may be applicable to a gross pool market, such as the NEM.

⁴ Draft report, pgs 28 – 29

However they cannot be applied to the WEM, which is based on bilateral contracts. Therefore the impact of carbon in the WEM will (at least initially) be subject to the terms and conditions of the current bilateral contracts.

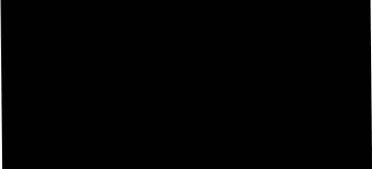
The majority of existing bilateral contracts were negotiated prior to the implementation of the Clean Energy Future policy, and although some thought was given to potential carbon costs there is no explicit mechanism for passing on these costs. All contracts contain a "change in law" provision which allow generators to pass through the costs incurred. Once the mechanism for the pass through is agreed, it will stay in force for the remainder of the contract term. Therefore, Verve Energy does not consider that Synergy will be able to "renegotiate its contracts to ensure that only an efficient level of carbon cost is recovered in tariffs" within two years.

Additionally, Verve Energy considers it flawed to suggest Synergy should renegotiate its contracts based on the notion of a "Greenfield" LRMC calculation with no recognition of existing generation plant on the SWIS.

Finally, the Authority notes that "Verve Energy has earned a significant return in the last financial year, and therefore any re-negotiation to reduce the carbon cost pass through should not impact on Verve Energy's financial viability⁵". Verve Energy does not see the relevance of its profitability on this discussion. Verve Energy considers that a generator's historical profitability has no relevance to the calculation of efficient wholesale costs. Additionally, regardless of whether Verve Energy made a 'significant' return last year, we do not consider that accepting a reduction in ongoing profit, by not passing through the full carbon cost, is acting commercially.

Thank you again for the opportunity to comment, should you require additional information on any of the above issues could you please contact Jacinda Papps on (08) 9424 1917.

Yours sincerely,


ANDREW EVERETT
MANAGER TRADING & REGULATION

⁵ Draft report, pg 29