



MORRISON & CO

13 August 2009

Discussion Paper: Annual WEM Report to the Minister for Energy
Economic Regulation Authority of Western Australia
PO Box 8469
Perth Business Centre
PERTH WA 6849

SUBMISSION TO THE ERA'S ANNUAL REVIEW OF THE WEM

Dear Sir,

Infratil Limited is the majority shareholder in Perth Energy Pty Ltd a growing integrated energy business that is currently constructing an open cycle dual fuel gas turbine power station at Kwinana¹.

As Infratil's manager, Morrison & Co would like to take this opportunity to share with the Economic Regulation Authority (ERA) our experience to date with the West Australian market by responding to the following points raised by the ERA in the 15 July 2009 discussion paper.

DISCUSSION POINT 1

Are the Wholesale Electricity Market (WEM) objectives appropriate? How effective is the WEM in meeting these objectives?

Infratil believes that the current Market Objectives are appropriate and to the extent practicable, the WEM seems to be meeting these objectives considering its relatively short life.

For Infratil a primary attraction of the WEM was that the government had gone to considerable effort to design a competitive and efficient market that separately priced capacity in contrast to the National Electricity Market in the eastern states. As intended, this capacity market has appealed to investors by providing a suitably-priced and stable revenue stream that helps underpin generation projects that in turn are capable of supporting the growth of retail businesses.

¹ For further details on Infratil and its long-term involvement in the Australian and New Zealand electricity markets, please refer to www.infratil.com.

DISCUSSION POINT 3

Comments on Network Connection Applications, in particular:

- *...would it be appropriate for Western Power to require a sizeable bond to be lodged with an application for network access;*
- *.....would it be appropriate for Western Power to discriminate between connection applicants...*

Whilst Infratil can appreciate the frustration of market participants with the length of time it takes to process a network access application, it does understand the complexity and time consuming nature of the task that Western Power needs to undertake.

Based on experience in developing power stations in three other Australian jurisdictions, Infratil is generally comfortable with the current process but would be supportive of any additional measures that reduced the time to assess an application, specifically Infratil would:

- encourage the ERA to allow Western Power additional costs in this area when setting its regulatory cost base;
- support a bond being lodged with the application, however any such bond should not be material in size. We suggest an amount of between \$50,000 to \$100,000;
 - ◊ Western Power would need to develop a policy around how this bond would be released or drawn down to cover their costs
- find it difficult to support an “eligibility test” in the form of a high level feasibility study to be carried out on a application;
 - ◊ Difficult to understand how this would not just turn into a box ticking exercise which could end up precluding some worthy projects
- not support queue jumping but would support a limited period in which an applicant would have to accept a network offer;
- give qualified support to Western Power’s proposed mechanism for prioritising applications based on the “applicant’s readiness to enter into a connection agreement”, subject to understanding how Western Power would implement such a proposal

DISCUSSION POINT 11

...ahead of the introduction of competitive balancing, to what extent is it appropriate to:

- *require the equivalent of a Resources Plan from Verve Energy*
- *enhance reporting in respect of outages by unit & fuel usage changes from plan...*

Infratil strongly advocates the introduction of a competitive balancing market and fully supports Verve Energy being required to provide to the IMO a day ahead Resource Plan.

DISCUSSION POINT 12

...comment on the Rule change process. In particular, given the potential for the more active Market Participants to be better placed to argue their position on Rule change proposals, the Authority invites comment on:

- *...is there sufficient balance in the Market Participant classes represented on the MAC;*
- *whether a better resourced IMO could address concerns relating to the self-interested positions taken by Market Participants*

Infratil believes that MAC membership is sufficiently balanced at present, however this may change as the WEM develops over time.

A well resourced IMO is critical for the health of the WEM and as such Infratil is very supportive of the IMO maintaining and developing the ability to efficiently evaluate and formulate rule proposals in light of the market objectives.

DISCUSSION POINT 14

...comment of the effectiveness of the IMO, System management and the ERA.

The current healthy state of the WEM is testament to the effectiveness of the IMO, System Management and the ERA.

From an investor's perspective our interactions with the IMO and ERA have been positive and constructive.

DISCUSSION POINT 19

...appropriateness of the Reserve Capacity Mechanism for determining the Reserve Capacity Price. In particular:

- *is there any evidence demonstrating that overall pricing signals provided in the WEM (for capacity & energy) are encouraging an inappropriate mix of plant;*
- *are there alternative mechanisms, or changes to the Reserve Capacity Mechanism that could better achieve the Market Objective...*

At the crux of the WEM is the Reserve Capacity Mechanism (RCM) which was understood to be a primary focus of the market designers.

Infratil supports the concept of the RCM and in the most part its implementation, however we believe that some aspects of the mechanism are not functioning as originally intended. In particular we believe that the prospect of a Reserve Capacity

Auction occurring for any material quantum of capacity is, at best, remote. In support of this conclusion, we would like to share with the ERA the following observations:

- A greenfield project (open cycle gas turbines included) cannot base its investment on participating in the Reserve Capacity Auction
 - ◇ The development timeframe for an open cycle gas turbine project is such that material funds are spent prior to the project's first certification and capacity credit allocation.
 - ◇ Material costs are incurred by the project just to be certified. Infratil notes that commitments to equipment, fuel and service providers are required by the IMO for Reserve Capacity Cycle certification.
 - ◇ Even if there were only a remote possibility that an auction would not be held this would be too high a risk to accept for a project. Failure to secure a capacity credit allocation would have very material financial consequences and in many cases would lead to project abandonment and write off of significant development costs.
- Project certification and capacity credit allocation are an absolute requirement for funding providers
 - ◇ These are essential before any project will receive unconditional debt and equity funding.
- Merchant greenfield projects therefore have no choice but to enter into bilateral contracts struck at or near the prevailing market prices for capacity credits
- The IMO administrated price (set at or less than 85% of the MRCP) has become the market price for capacity credits in the medium to long term
 - ◇ Whether or not this was intended by the market designers is a mute point, the reality is that in an illiquid contract market the IMO administered price is the only price visible to all those that are not direct market participants such as new entrants, banks etc.
- Capacity augmentations to existing plant are the only likely credible participants in an auction and hence recipients of a Long Term Special Price Arrangement
 - ◇ Capacity augmentations would require a very low level of financial commitment at the time of certification and capacity credit allocation together with a relatively short timeframe to implement

As currently structured the best that a low fixed cost new entrant peaking plant could expect to earn from the market for its capacity is 85% of a variable Maximum Reserve Capacity Price (MRCP). Infratil believes, as, it appears, does The Allen Consulting Group (ACG), that this price is insufficient for any investor, particularly in the current financial climate, and was not the intent of the market designers.

*"WACC -This could lead to the administered price not being sufficiently high to attract commercial entry (and hence greater reliance on the use of a Reserve Capacity Auction)."*²

² "Review of the Weighted Average Cost of Capital for the Purposes of Determining the Maximum Reserve Capacity Price", The Allen Consulting Group, September 2008 pg ix.

Further, notwithstanding the best intentions of the market designers, in practise it is extremely unlikely that an auction will be held. Hence, it is extremely unlikely that a Long Term Special Price Arrangement will be available to any greenfield project. This, however, is an underlying assumption in the derivation of the WACC used in the MRCP determination.

Infratil has already shared the above concerns with the IMO and it is our understanding that they will be considered as part of a forthcoming RCM review.

However, notwithstanding the above points, Infratil believes that:

- **adequate pricing signals do exist in the market to bring on new generating capacity** so long as the IMO derives a credible MRCP given that the Reserve Capacity Price will for most reserve capacity cycles be equal to 85% of the MRCP scaled back for oversupply ; and
 - **that past STEM and Balancing market prices together with the future balance of supply and demand** is sufficient, (with some analysis), to **influence the choice of generating plant type**, (baseload, mid-merit or peaking), made by a proponent. This information is available already in the most part from the IMO.
 - ◊ eg. When historical and future estimates of STEM and bilateral contract energy prices are great enough such that when combined with forecast Reserve Capacity Prices the outcome is greater than the rolled up capacity and energy price required by the baseload power station to be economically feasible, a proponent will if a choice exists, choose to build such a plant.
- Alternatively if capacity is clearly required and energy prices are not high enough the proponent will choose to build a peaking plant.
- ◊ Most of the information required by a proponent to make such a judgement call is available from the IMO, although some additional information relating to generating plant fuel type and age would be helpful to be included in future Statements of Opportunities.

DISCUSSION POINT 22

...the Reserve Capacity refund mechanism should be included for consideration as part of the road map proposed review of the market

Infratil is very supportive of the Reserve Capacity refund mechanism being included in any proposed review of the market.

When this mechanism is reviewed by the ERA it should consider the inclusion of certain force majeure events which are clearly beyond the control of the Participant and cannot be mitigated through any means. Such events should include, (but not be limited to), terrorist attacks, war, invasion, acts of foreign enemies or catastrophic acts of God.

DISCUSSION POINT 24

...comment in respect of the impact of structural issues on the effectiveness of the market and achievement of the Market Objectives (merger of Verve & Synergy)

Infratil has invested heavily in the WEM through Perth Energy on the premise that the WA government supported the development of a competitive and efficient electricity market striving to achieve its Market Objectives.

The merger of Verve Energy and Synergy will materially reduce competition through the raising of barriers to entry because investment in capital intensive generation assets will become the only manner in which a new retailer can gain entry. Such a merger will have a detrimental effect on emerging energy businesses such as Perth Energy and will very likely see the re-introduction of the inefficiencies and the higher costs of the past.

Infratil believes that the interests of all West Australians are best served by:

- re-pricing the vesting contracts between Verve and Synergy on commercial terms to fully reflect the cost of production;
- **not** proceeding with any merger; and
- introducing full retail contestability as soon as is practicable, which will in the longer term yield the lowest sustainable electricity prices.

Infratil strongly believes that any merger of Verve and Synergy will have a very negative impact on the health and future of the WEM and that should such a merger take place Infratil's enthusiasm for further investment in the WEM will be materially reduced.

I trust you find the above comments constructive and would be pleased to discuss with you further any of the issues raised in this letter. Please feel free to contact me on (07) 3220-0949 or by email: roger.crawford@hrlmorrison.com.au

Yours faithfully

for and on behalf of
HRL Morrison & Co (Australia) Pty Ltd

Roger Crawford