Perth Energy Pty Ltd
Submission to the ERA Annual Market Review

Perth Energy appreciates the opportunity to provide input to the Annual Wholesale Electricity Market Report being provided by the Economic Regulation Authority to the Minister for Energy. Overall, Perth Energy considers that the WEM is working well:

- Medium to large retail customers have genuine choice of supplier;
- Electricity prices are sending clear investment signals;
- Generation capacity is being provided in advance of forecast demand;
- Competition is emerging for the provision of ancillary services; and
- The dominance of the incumbent generator and retailer is diminishing.

Perth Energy does not see any need for wholesale change though there are areas where the market can be improved. Of particular concern are the procedures and processes of Western Power which have the potential to restrict investment in new generation. In view of the need to install new plant to meet forecast demand, to replace aging plant and to fulfill Federal and State renewable energy targets, changes within Western Power are vital.

Perth Energy's comments come from a background of strong participation in the development and operation of the market. The company has now been operating for over 10 years and is an active provider of both energy and capacity. We have commented on a range of topics raised by the Authority and would be happy to discuss these in more detail should that be desired.

Discussion Point 2 – The Authority invites comment on the extent to which the risk that a network connection application will not be offered on time impacts on investment incentives, including incentives to invest in new facilities in particular geographic locations of the network.

This is a particularly significant issue and is related to discussion point 3 below. The Reserve Capacity Mechanism places an absolute requirement on a developer to have a network access proposal before Certification can be granted because:

- A proposal may not be made because of technical constraints,
- The cost of network access, which cannot be determined in advance, may prove to be uneconomic, or
- Connection may require system upgrades that take longer than the available project lead time.

This is quite different to the environmental requirement for certification where a developer needs only to show that there is a reasonable expectation that the required approvals will be granted.

Perth Energy only received an offer for access for the Kwinana Swift power station after Western Power had undertaken extensive studies that ran for a considerable time, and also cost a significant sum of money. One of the frustrating features of the process was that Western Power could not provide a timetable as to when the analysis would be completed and an offer made.

The timeframe required for technical and commercial analysis is excessive when compared to the time required to secure other approvals (environmental, local government, etc) and

the time to actually build new generation. It should also be a requirement that Western Power provide a timetable for the processes that it needs to undertake.

Part of the reason for the lengthy process was due to Perth Energy introducing a gas turbine that had not been used previously in the SWIS. However, the gas turbine is a well known, highly regarded and well used machine worldwide, including in New Zealand and Tasmania. It should have been incumbent on Western Power to have in its database performance and other specification information for this machine and other popular machines used in other major jurisdictions.

Also, when an access proposal was made to Perth Energy, this was not unconditional but was subject to the Western Power Board granting approval to the final commercial terms. This in itself proved very difficult and delays in getting Western Power Board sign-off came very close to causing Perth Energy to miss a key financial close deadline. If Western Power makes an access offer according to Regulations, and that offer is accepted by a developer, there should not be an option for the Western Power Board to then renege on the offer.

If Board approval is absolutely required, Western Power should rework its access offer process so that Board approval is obtained prior to an offer, provided that such revised process does not impinge even worse on the timing of access offers.

The Authority's Discussion Paper refers to comments about a lack of resources within Western Power. It appears to Perth Energy that Western Power is still struggling to adapt to the significant changes associated with the competitive market, even though the deregulation process has been in train for several years.

This has been highlighted in the Kwinana Swift project in respect to ensuring that the power station complies with the Technical Rules. There is no documentation or guidance as to how this critical approval process is to be undertaken nor is there any mechanism to resolve a technical dispute should this arise. Perth Energy acknowledges that the process is still being finalized but, as soon as possible, Western Power should establish a written procedure that can be published on its website.

Perth Energy cannot fault the dedication of and support from individual staff members at Western Power who have gone out of their way to progress with applications for network connection or in fact other services. It is the formal process and structure that needs urgent review, such that better resourcing and prioritizing and streamlining of work could be brought to bear on Western Power's core business of facilitating access for network users.

Discussion Point 3 – The Authority invites comment on network connection application. In particular:

- **To what extent would it be appropriate for Western Power to require that a sizable bond be lodged with an application for network access;**
- **To what extent would it be appropriate for Western Power to discriminate between network applications (other than based on their places in the sequence of the relevant queue); and**
- **If other means of discrimination between connection applicants are appropriate, taking into consideration Western Power's queuing guide, what should be the basis for such discrimination.**

Perth Energy considers that developers should be required to make a deposit to hold their place in the network connection queue. This needs to be high enough to make sure that the developer is serious but not so high as to be a significant burden. Most projects will have a

substantial development budget as a matter of course and be able to put aside around $100,000 to hold a place in the queue. This is drawing from Perth Energy's experience as a new entrant working on a Greenfield project.

It would be very hard to establish any other mechanism to discriminating between serious and less serious projects. Most developers would claim that their project has a real chance to proceed and experience has shown that opinions expressed by analysts or other professional commentators can be wrong. There are projects being built today that few people thought would fly whereas other "certainties" are still not proceeding.

The best test is an objective cash or cash equivalent deposit, with Western Power having the right to call for top-up as network studies are progressed. Any market participant ought to be able to set aside this upfront $100,000 to secure network studies from Western Power. Such a deposit would place the obligation on Western Power to resource up its capacity to deliver study outcomes and access offers to applicants expeditiously, moving the queue to more commercial time frames for the equitable benefit of all parties.
As Western Power proceeds with network studies, it should have the right to require top-up from applicants to maintain the deposit level, with top-ups being able to be called if more than $30,000 worth of work has been carried out. This amount is roughly the value of a first steady state study.
In return, Western Power should be required to nominate specific deadlines for milestones for access offers. Clear deadlines are required to prevent "hoarding" of queue positions by participants with uncertain intention to progress with their projects. Western Power should observe strictly a progress timetable with each participant, and at each milestone if the participant fails to progress then Western Power will have the right to increase the deposit by a certain amount – say, $30,000 for each key milestone missed by the participant.
The setting of key milestones should be undertaken by Western Power, with approval from the Authority, as transparently as possible and in fair dealing with market participants. There should not be an automatic cancellation of a participant's queue position on a key milestone breach, but only an increase in the deposit amount until the participant voluntarily relinquishes its position on its own commercial grounds. However, Perth Energy would not be averse to the idea of absolute deadlines in some circumstances where:

- network capacity is at an absolute premium against the large number of applicants
- the participant has been on the queue for an excessive length of time
- the participant, in Western Power's view, has no prospect of executing an interconnection works contract and being offered or accepting an access offer within x months; and
- there is another applicant behind in the queue with a prospect of achieving those contracts at better than x months.

There would be fewer concerns by participants about losing a position in the queue if the queue clearing process is efficient and timely. It is the fear of not being to get another look in to being considered for lengthy periods of time that has caused hoarding. Applicants would accept losing their place in the queue for someone behind if they knew that if and when they are in a position to progress with their project they would be accorded prompt and efficient service from Western Power, including moving up the queue within a reasonable time – ie within weeks and not years.

Discussion point 4 – The Authority invites comment on the application of deep connection charges set by Western Power.

The current "user pays" principle, while generically acceptable, can be highly impractical and unjustifiable in the case of network connection for projects designed to satisfy general

demand growth in the SWIS. Perth Energy has no problems with "user pays" when an application for connection to supply a specific discrete load is concerned. However, it is unreasonable that a developer of new generation capacity must pay deep connection costs when it is installing capacity to meet the system load increase from higher customer demand generally. If the increasing system demand causes fault levels to rise so that upgrades are required virtually irrespective of where new generation capacity is located on the system, Perth Energy suggests that the costs of upgrades should be rolled into Western Power's general system charges and allocated to all users.

It is our view that the cost of maintaining fault levels on existing infrastructure falls properly into the regulated asset base of Western Power, which should be incentivised to spend money to maintain the good workings of the system in anticipation of system demand growth, rather than wait for the next generator to be added to the system and charging that system user for the entire cost of rectifying underlying fault levels.

Where a network connection for a particular new discrete load is concerned, it would be relatively simple for Western Power to determine the size of that discrete load against the level of additional DSOC that a generator is applying for. The surplus DSOC should be treated as for system demand growth. Western Power has advance knowledge of new discrete loads' network access and supplier counterparty so should have no problems applying this proportional costing approach to a generator's connection applications.

A new discrete load in this context could be defined as one that:

- did not exist at the time of a generator's acceptance of an interconnection works contract (IWC) and an access offer by Western Power for new generation capacity,
- but does exist at the time the generator's new capacity is delivered to market (ie when the generator confirms with IMO its capacity credit obligation associated with the new capacity)
- is an end use customer/site
- is from a new load site or an existing load site (ie an increase in existing demand)
- is of at least 50MW or >1% of total system load in size
- is bilaterally contracted to the generator (the load does not have to be nominated bilaterally to the generator's new capacity, just the generator)
- makes up more than 25% of the generator's new capacity (increase in total generator DSOC)

This proposed proportional charging approach would also address a significant inequity issue between existing and new generators. Perth Energy understands, for example, that Verve Energy is being allowed to transfer its network access rights from the retired Kwinana B power station to the planned new gas turbine plant without making a contribution for deep upgrades. But for someone else to expand its generation capacity in Kwinana, they would face a large contribution to deep connection charges.

Perth Energy is not arguing that Verve Energy should not be allowed to replace its generation capacity. It should be but only under our proposed approach, so that network upgrade costs, where they relate to satisfying general system demand growth, are absorbed in Western Power's general system charges for all users.

Funding for general Network enhancement and/or augmentation should be the responsibility of the Government of the day. There are few more critical public goods for Government to spend money on than expansion of the power transmission and distribution network for State development purposes. This is far more important than Government spending on generation capacity where the Wholesale Electricity Market has more than adequately provided.

Discussion Point 8 – The Authority invites comment on what factors may inhibit a generator from participating in the competitive procurement of ancillary services

Perth Energy has recently tendered for the provision of System Restart Services. There were, in our opinion, minor process issues and these were resolved promptly through discussion with Western Power. We are confident that Western Power and market participants will be able to work through the processes needed to allow other ancillary services to be successfully procured by Western Power through a tendering process.

Discussion point 15 – The Authority invites comment on options for promoting efficiency in network planning and investment that are consistent with the Reserve Capacity Mechanism requirements.

There are two shortcomings in the incorporation of network planning and investment and Network connection costs in the RCM process.

First, the cost of Network access, provided by Western Power as an input into the Reserve Capacity Mechanism, does not take into account fully the additional costs that Greenfield sites have in accessing the Network, in particular consequential costs such as regional or general fault level protection. Hence the Reserve Capacity Mechanism does not adequately compensate developers for the true cost of Network access. This difference can run to millions of dollars.
This issue would be resolved to a large extent by our proposed proportional access charge approach above if adopted.

The second issue is the significant delay in the provision of IWC and network access offers to projects. The system appears to be "full" in many locations and even requests for relatively small connections trigger requests to fund major upgrades. Steps need to be taken to alleviate this situation and ensure that Network access can be granted in a reasonable timeframe and at reasonable cost.

To provide a good service in the competitive market, where there are numerous businesses considering power station developments, Western Power needs to have a planning team large enough to respond rapidly to connection requests. It should not be necessary to wait 6-12 months for analysis to be undertaken.

There are in our view two ways that Western Power could address this delay. First, if Western Power does not want to carry a high level of permanent staffing then it should have a pool of approved consultants from where developers are allowed to draw to contract for work to assist Western Power. These consultants can present a formal case to Western Power for review on behalf of developers. Western Power will need to have clear guidelines on the issues that need to be considered in presenting these cases and also the experienced staff to enable a speedy consideration and resolution of the cases. The cost of additional planning staff could be accommodated from a system of callable queuing deposits proposed above.

This approach would maintain impartiality of consultants and confidence in the market that the consultants, who could be subject to an annual review by Western Power to be retained in the approved register, will act in the mutual interest of Western Power and developers.

Second, Western Power should resource up its planning team anyway, in addition to having the pool of approved consultants, to undertake rolling studies to assess the impact on the power system of adding sufficient capacity to meet the IMO's forecast requirements for future years. It will not be possible to determine precisely where the new generation

capacity will be added but it is possible to make an educated guess as to likely options based on published material and Network access applications that have been made. Western Power could consider a number of scenarios and then undertake the upgrades which have a high probability of being required for general system demand growth.

A pro-active approach to planning and steering development projects to areas of least cost to the public would be consistent with Western Power's role of expert Network business with a monopoly mandate. It is in the same vein as taking a leadership role in studying the suitability of best gas turbines and maintaining an updated database on most efficient and suitable machines for the SWIS that are being used worldwide.

The cost of a pro-active approach would again be accommodated by the callable queuing deposit arrangement where applicants would, in our view, be happy to oblige if they could obtain expedient expert services from Western Power. We believe Western Power would be justified even in applying a higher charge for certain services as long as they would go towards shortening the application and granting process. There is a far greater cost of projects being delayed than the cash carrying cost of relatively moderate deposits or some higher charges for identifiable value-added services.

Government, through Western Power and/or LandCorp or a development agency, could be proactive in helping establish "generation parks" specifically for power stations. Locations could be identified and developed in the same manner that heavy industrial zones are. Arrangements could be put in place to ensure that Network access can be provided readily to these sites at a known price.

This does not mean that only such locations would be afforded competitively costed network connection. This pro-active planning should not be confused with dictatorial planning. Western Power would still service developers according to their needs, by using proportional user pay costing as proposed above for locations that are not Western Power's recommended generation parks.

If specifically located new generation is required to supply specifically located discrete loads, then the proportional connection and access cost charging approach would go a long way to satisfying the different needs of various parties equitably.

Discussion point 19 – The Authority invites comment on the 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 Wholesale Electricity Market (for capacity and energy) are encouraging an inappropriate mix of plant; and**
- **Are there alternative mechanisms, or changes to the Reserve Capacity Mechanism, that could better achieve the Market Objective of promoting the economically efficient, safe and reliable production and supply of electricity and electricity services in the SWIS.**

It has been suggested that the SWIS has a surfeit of base load plant when considering the amount of coal fired generation and cogeneration plant either in place or under development. It has also been suggested that there is a shortage of mid-merit plant – though adequate peaking capacity – on the system. Some commentators are suggesting that the Wholesale Electricity Market should be changed to rebalance the plant mix.

Perth Energy disagrees with this strongly. Developers will build the types of plant that they consider will enable them to participate profitably in the market. Their investment decisions will be partially influenced by the Reserve Capacity Mechanism but the key drivers will be

- The expected price of fuel;
- The relative capital costs of plant; and
- The requirements of retailers who will purchase the output.

In short, according to market forces. Over the past few years, several of these key drivers have changed substantially. These include:

- The increase in demand for base load power to meet the requirements of new mining developments, in particular for gold and the magnetite iron ore industry;
- The requirement to monetize coal deposits;
- The substantial change in the relative prices of coal and gas;
- Technology changes for both coal and gas fired plant;
- To a lesser extent the entry of larger wind farms with some unexpected off-peak intense generation profile.

This is not unusual; the relative prices of different fuels has changed radically in Western Australia over the past 40 years as has the availability of various power generation technologies. Wind farms are expected to generate more during the peak but haven't, and the increased target for renewable energy entry will have an impact on the distribution of power generation in the SWIS. As a consequence, it is hard to determine just what the ideal plant mix should actually be. Right now, the SWIS appears to have a good balance of plant types.

The proportion of plant that can operate only on gas has left the state exposed during gas supply shortages. This risk has diminished from being exposed to interruption in both commodity and transport along the Dampier to Bunbury Pipeline to being exposed to commodity and less to transport, given the substantial looping along the DBP that has occurred over recent years. Over time, we can see a rise in the use of dual fuel machines, run on gas or liquids. This would help reduce the system's exposure to gas commodity disruption.

The one plant type that the Reserve Capacity Mechanism strongly influences is peaking plant. Base load and mid-merit plant are primarily funded by energy sales but peaking plant relies heavily on income from capacity credits. SWIS is a summer peaking system and has a relatively low system load factor, with short sharp demand spikes. Reliability of supply requires sufficient entry of peaking capacity.

Perth Energy considers that the general level of maximum reserve capacity prices (MRCP) is adequate to finance new projects but that the discounted reserve capacity price (RCP) actually paid to investors confuses the market while the MRCP/RCP volatility concerns investors. A change to price setting such that it reflects the underlying costs of development but has smoothed year-on-year changes would reduce investor risk and, hence, reduce long term prices by minimizing any risk premium required by investors/lenders.

To prevent confusion and potentially higher risk pricing in generation project financing, Perth Energy proposes that there be only one capacity price being the RCP and no MRCP, ie no discounting involved, and there be limits placed around how much the RCP can vary year on year.

If the process of compiling the current MRCP each year is credible, it should be sufficient to produce a RCP without discounting. The market, especially lenders, views the current RCP as "the" market price for capacity anyway, so having the MRCP serves no purpose. It would be sufficient to take the most probable capacity price level presented by consultants as RCP.

In addition, given a key objective of the capacity market is to provide less volatile power pricing in general, through reduction of risk of capacity shortages in the medium to long term, the RCP itself should not be allowed to become volatile. The fundamental components of costing of the current MRCP, such as the WACC, are not variables that can change vastly year on year when bundled together as a group of diverse items.

An example is, when the financial crisis hit the financial markets late last year, it caused lending margins to soar before it hit the real economy many months later. WACC calculation in our view failed to incorporate the full extent of the lending margin hikes and paid heed mainly to the falls in the official cash rate in response to recession fears. Concerns over the economic downturn also led to perception of steep falls in the cost of labour, plant and machinery for generation projects, but in reality these capital industries based costs usually take 12-18 months to flow through the sytem / market. In net terms, it would be difficult to say that generation costs have declined considering the scarcity of funds. It would be hard to ascertain that generation costs could change more than 5-10% in any 12-month period.

If there were to be some adjustment to an initial RCP as compiled by consultants, it should be only in moderating any variation in the price so that investor confidence in the price setting process is maintained. A limit of 10% per year should be set in RCP variation. As investment in generation capacity is a very long term undertaking, such limit would be reasonable and productive and would not interfere with true reflection of market circumstances. To continue with the example, if the real economy downturn persists worldwide, leading to real and material falls in costs, then these falls would continue to feed through the system in the subsequent Capacity Year(s). Market signals would still flow through and investor response would still be efficient though less volatile.

Other than the double-capacity price and volatility issues, Perth Energy views the existing Reserve Capacity Mechanism as effective and market reflective. It provides a solid and objective market based informative process for investors to make long term, capital investment decisions efficiently.

Discussion Point 20 – The Authority invites comment on the merits of moving the Reserve Capacity Mechanism to more than two years in advance of the relevant Capacity Year, and the extent to which such a change could assist in resolving network access application problems.

Perth Energy disagrees strongly with uniform extension of all Certification to more than two years in advance of the relevant Capacity Year. This would have immediate and negative impact on new projects. Perth Energy would strongly recommend that a wider range of lead times be accorded to projects as proponents see fit to apply for.

At present, the IMO certifies capacity and assigns capacity credits two years in advance. There is also the provision for generators to seek Conditional Certification for facilities that have a lead time that is longer than two years. It would be helpful to allow Conditional to be converted to "full" Certification in advance of two years lead time if proponents wish to do so.

Perth Energy understands that Conditional Certification helps but cannot be used to confirm project financing as there is the belief that the IMO has discretion in converting this to "full"

Certification at a later date. For this reason, there is a benefit to allowing generators to seek "full" Certification earlier than two years ahead. This is now being considered.

Some projects, such as small sized facilities or plant enhancements, can be implemented in a much shorter timeframe and extending the timeframe for all new facilities out to three years would hamper these developments and prevent efficient entry of new capacity. It is quite likely that these small developments would face difficulty in securing finance because financiers would be required to set aside funds well before the project needs to draw down these.

Allowing full Certification earlier than two years is also required for projects in a bilateral contracts regime like the SWIS. To finance projects, proponents require customer off-take and this is usually difficult to acquire with too long a lead time. Customers do not have the ability or willingness to wait up to three years as currently the case (ie. the earliest a project could be delivered for capacity credits is two years from Certification, which is given only once a year in August). Project proponents therefore must move faster if they want to acquire (and maintain) customer interest. It is imperative that a shorter lead time for Cerification be implemented.

For the same reasons, there is a strong need for more than once-a-year Certification. The inability to obtain customer interest with the current long lead time applies particularly to retail customers. For new large discrete loads, there may be a willingness to wait for a new project, but developers will usually not be able to oversize projects too far away from the size of the discrete loads in order to supply retail loads, making it difficult for projects to be used for retail competition. Even if a proponent is willing to take stranded asset risk, lenders will not.

To assist retail customers take advantage of the Reserve Capacity Mechanism, developers should be able to apply for and obtain full Certification any time in the year. There is really no rational reason, or market efficiency reason, why this should not be able to be done. In the National Electricity Market, a developer can bring on stream a project at any time of the year.

At the very least, SWIS should be able to accommodate quarterly Certification. Besides helping projects progress as soon as developers have managed to get hold of potential customers, a quarterly schedule would spread the workload for Western Power and other permitting authorities by spreading application activity across the year instead of funneling participants into a June quarter bottleneck each year with all participants rushing to finalise projects at the same time.

Quarterly Certification would assist the system obtain new generation capacity evenly across the year, reducing the risk of summer shortages if the once-a-year delivery deadline near end of calendar year is missed. It would consequently spread the entry of new energy supplies more evenly, leading to less volatility in spot energy prices in STEM and MCAP. Currently, while new loads enter the market at any time of year, new energy supplies could only enter at the start of a Capacity Year as generators time delivery of new capacity in relation to the start of receipt of capacity credit payment. This has tended to cause energy shortages prior to Capacity Year start and energy surplus after. Ironically, the spot market would escape this predictable cycle only if there were significant unplanned delays in capacity delivery schedules.

Extending uniformly the Certification timeframe will not ease the current issues with Network access. If the timeframe for Certification is extended this would also push out the required timeframe to secure Network access and it would be predictable that Western Power would

respond accordingly. Extending the Certification timeline would actually increase the risk of new generation not being able to get Network access in time due to potential complacency.

Only spreading the workload for Western Power by having more frequent Certification rounds in a year, together with the imposition of queuing deposits and allowance for higher charges for value-added services, would assist parties in having a smoother process and allow Western Power the time management and resources to work on providing network access to applicants in a timely fashion.

There is currently a mechanism, market rule 4.28B, whereby very small generators can secure Certification after entering service. This is a very useful arrangement but is currently restricted to facilities with a nameplate rating of under 1 MW. Extending this to facilities with a maximum size of, say, 10 MW would greatly enhance the opportunity for very small facilities to be brought on stream. The 10 MW size is proposed because it is the size below which Western Power does not apply a spinning reserve charge – ie it is of little consequence to system management.

In summary, Perth Energy

- supports the arrangement whereby generators will have the option to secure Certification earlier than two years ahead of the in-service date
- proposes more frequent Certification rounds in a year, at least quarterly
- strongly opposes the setting of a three year time frame for all generators
- supports Western Power requiring a queuing deposit of at least $100K, callable for top-up once work has been done to the value of >$30K, and increased in step changes of $20-30K per key milestone missed by the applicant
- considers that the size limit for “Small Generators” be increased to 10 MW

Discussion Point 24 – The Authority invites comment in respect of structural issues on the effectiveness of the market and achievement of Market Objectives.

Perth Energy considers that the market structure is developing well. The WEM has some practical shortcomings as discussed above, shortcomings that we see as being able to be resolved effectively within the current Market Rules change process and legislated requirement for review by the Economic Regulation Authority and reporting to the Minister and Parliament.

There are potential policy developments that could cause significant damage to the market, however. These surround the issue of how to deal with Verve Energy’s losses and the proposal to re-merge Verve and Synergy. Such development would radically alter the market structure and create enormous sovereign risk that would potentially shut down the wholesale market and drive away private sector investors.

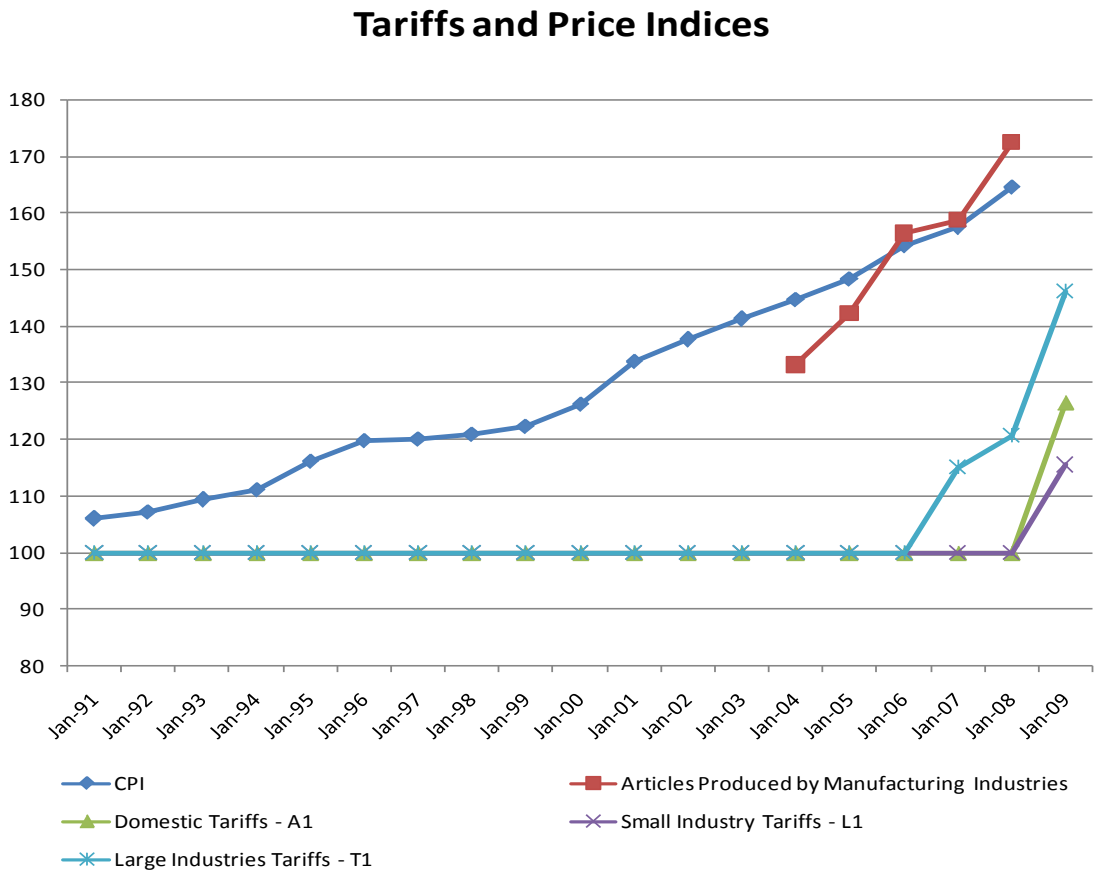
Perth Energy attaches a paper – Facts About the WA Electricity Market – that discusses these issues in more details.

Facts About WA Electricity Market

July 2009

Electricity Price

- Electricity price around the world has been rising due to (a) higher fuel costs, (b) higher material costs and (c) explicitly recognised environmental cost in power generation and consumption.
- In WA, electricity tariffs are increasing also because they have been kept unchanged from 1992 to 2007 (for business) and 2009 (for households, with the exception of a 4% rise in 1998).
- During this period, the costs of generation have risen significantly, even more so in the last 5 years.
- If we don't pay for true costs as consumers, we must pay for them as taxpayers through subsidies to Verve Energy, which has been forced to sell power to Synergy at below cost.



- The price of natural gas in WA, the key fuel for electricity generation, rose 4-fold between 2003 and 2008, even excluding the impact of Varanus Island.
- Nearly half of power generation in the South West Interconnected System is fuelled by natural gas.
- Verve Energy has incurred large cost increases but has had to sell all of its capacity and almost all of its output to Synergy at a loss under the Vesting Contract.

Vesting Contract

- The Vesting Contract was designed to guarantee Synergy sufficient capacity and energy to supply its entire customer base while Synergy contracts from the market for new generation supplies.

- **The Vesting Contract acts as integrator of Verve and Synergy already, so re-merging the 2 entities would make no difference to Verve's current losses.**

- At least at present Verve can sell spare energy to third parties at a profit.

- The Vesting Contract allows Synergy to gradually replace Verve's capacity with that from third party generators, such as Griffin Energy and Newgen, through competitive tender.

- Synergy has been reported to have testified to a Parliamentary Committee that Synergy had saved >$1.0 billion through market tendering for new generation capacity.

- The Vesting Contract allows Verve Energy to gradually withdraw capacity from Synergy to sell to the market, enabling Verve to make better margins and enhance retail competition.

- Verve could return to profitability this financial year if it could withdraw from the Vesting Contract as scheduled without delay and through electricity tariff increases recently if these increases would be allowed to flow through to Verve in full.

- **There is therefore no basis to interfere with the electricity market structure without wide ranging public consultation**. Current legislation provides for any shortcoming to be addressed via the Market Rules change process and annual reporting to Government by statutory authorities.

- If there is a need for policy revision, focus should be on the Vesting Contract, which imposes unsustainable losses on Verve. **The imperative here is in decoupling Verve from Synergy even more practically.**

- Synergy needs only half of Verve's total capacity to satisfy its franchise customer base. **At least 1500MW of Verve's capacity can be sold to third parties to flourish the retail market and return to Verve positive margins.**

- It is incorrect to compare Verve's current losses with the profitability of the previous integrated Western Power. The combined results of Verve, Synergy, Horizon Power and Western Power currently would be similar to previous results, adjusted for the impact of continued unchanged tariffs and increased capital expenditure on the networks to improve supply reliability since disaggregation.

- Measured power outages (including instantaneous trips) and duration of outages have improved significantly on 10-15 years ago.

Electricity Market Structure

- By law, the Economic Regulation Authority (ERA) must report to Government (and Parliament if so wished) on the state of the electricity market annually.

- The ERA has stated that the current market structure works in adequately providing for new generation capacity and engendering new retail competition.

- The Office of Energy (OoE) has expressed similar views, with a key shortcoming identified as being the capped electricity tariffs below costs. The OoE has recommended tariff increases by more than what has been announced by Government.

- The Federal Government report on Energy Security in 2008 views the WA electricity market structure as working well and providing adequate generation capacity.

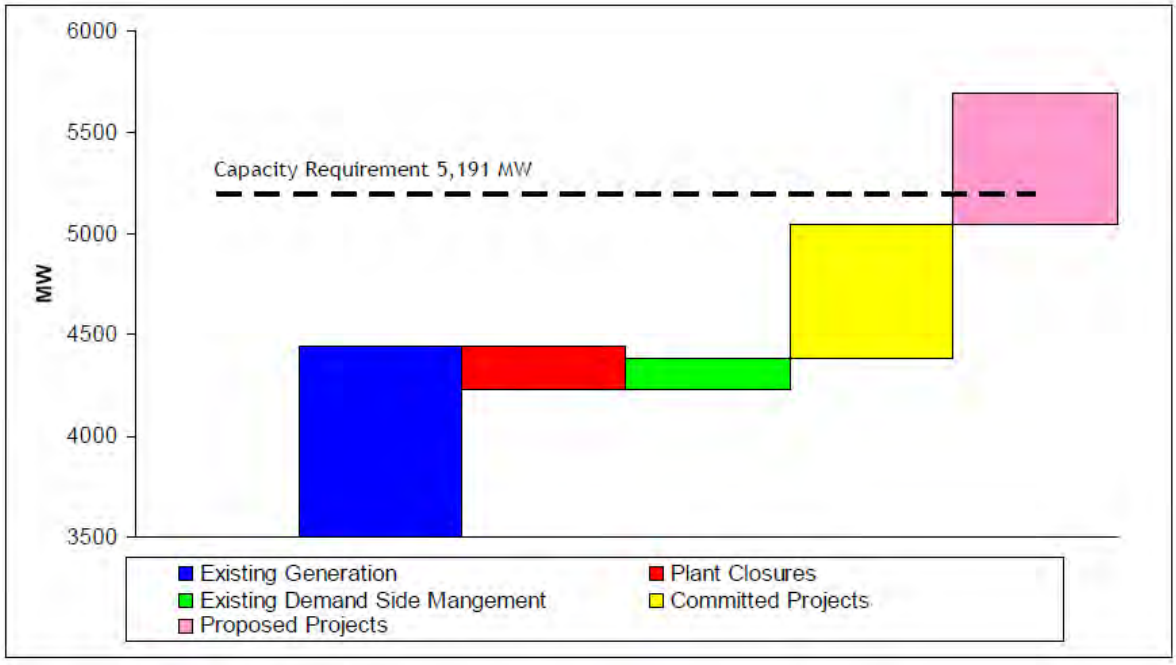
- Since the introduction of electricity industry reform legislation in 2004 – that led to the establishment of the Wholesale Electricity Market, Economic Regulation Authority and Independent Market Operator in 2005 and the associated break-up of the old vertically integrated Western Power in 2006 – there has been **>$2 billion of new private sector funded generation capacity installed or committed in the SWIS**.

- Total new capacity amounts to nearly 2000MW, or about 40% of total capacity in the SWIS, with an appropriate mixture of baseload, mid-merit and peaking power.

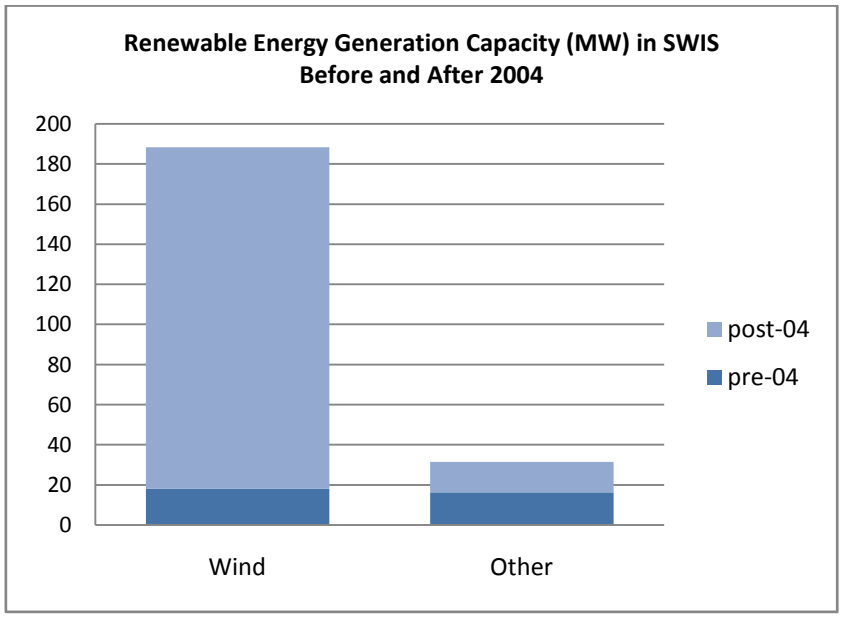
- This substantial private sector investment has been due to market confidence in the transparent policy, regulatory and market operation regime instituted by reform.

New Private Sector Funded Projects	New Capacity
Walkaway wind farm (Babcock)	89MW
Emu Downs wind farm (Stanwell/Griffin)	79MW
Newgen Kwinana combined cycle gas (Babcock/ERM)	320MW
Neerabup open cycle gas (Babcock/ERM)	330MW
Pinjarra cogeneration (Alinta)	258MW
Wagerup open cycle (Alinta)	351MW
Bluewaters 1 coal (Griffin)	204MW
Bluewaters 2 coal (Griffin)	204MW
Kwinana Swift (Perth Energy)	120MW
TOTAL	**1,955MW**

IMO Forecast Generation Capacity Status for 2011-12



- Since the introduction of reform legislation in 2004, there has been a **10-fold increase in renewable energy generation capacity installed in SWIS**.



- The Independent Market Operator's forecasts show more than adequate generation capacity being proposed or built in the SWIS for the next few years.

- **There is therefore no need for Government to spend money on building power stations.**

- Government could fund or support Verve to replace its most ageing plant within the current 3000 MW cap or install new renewable energy projects as currently provisioned for in the legislation. This task alone would be sufficient to test the Government's budget capacity over the coming decade.

Risks of Changing Market Structure Without Thorough Public Consultation

- No one in the market sees a need for the Government to change the electricity market structure.

- Synergy is against it, Verve is against it, the ERA is against it, the IMO is against it, the Office of Energy is against it, the CCI is against it, the CME is against it, private sector participants such as Perth Energy are against it, the WA Sustainable Energy Association is against it, consumer groups are against it, the State Opposition is against it, Federal Government bodies and regulators who have reviewed the WA market see no need for it.

- Current legislation requires the ERA to report annually on the state of the market to Government and recommend any change. There is no reason for the Government to pre-empt this work and start interfering radically simply because a state owned entity is making losses.

- **Interference in a transparent market with legislated processes in place would create significant sovereign risk that would drive away much needed private sector investment.**

- Any public policy that has the potential to take away consumer choice would cause significant damage to the efficiency of the market.

- Whether re-merged or not, Verve and Synergy both have overwhelming market power. **Any change to market structure or current framework to release Verve or Synergy from constraints in the use of market power would damage retail competition in the market.**

- While Verve's capacity makes up just under 80% of total SWIS capacity – with the likelihood of this share falling to 60% in the next 5 years once currently committed new capacity by the private sector is built – its "true" market share is closer to 90% based on non-affiliated generation capacity, ie. capacity that is not tied to individual mining or resource loads and that can be made available to retail consumers in general.

- Synergy holds >90% of the non-affiliated customer base in the SWIS.

- Current legislation does not allow Verve to retail until the ERA reports to Parliament that it otherwise should be, given Verve's market power. **This constraint must remain**.

- Synergy is not allowed to own generation for the same reason, but by awarding long term take-or-pay purchase agreements to independent generators that bid to supply it, Synergy is effectively holding generation capacity as a vertically integrated entity.

- To partly counter Synergy's market power, Verve has been allowed to sell excess energy – ie energy not locked in under Vesting Contract – to third party retailers to assist retail competition. **Verve must be able to retain and expand on the ability to sell to third parties.**

- Without a captive market like Synergy's small business and residential segments, and without a starting monopoly position, independent retailers cannot build generation fast enough to compete with Synergy. **Third party retailers' ability to buy large volume of energy and capacity from Verve is critical to benefit retail consumers.**

- Private investors would see any move to damage retail competition as significant sovereign risk to private sector generation capacity building.

- Without a transparent and wide-ranging public consultation process, any radical change to the electricity industry could be seen as formulated by star chambers – market reform has been developed and implemented over 15 years, and the previous Government set up 2 reform committees to implement it, **with bipartisan support**.

- A Verve-Synergy re-merger would do substantial damage to the reputation of WA. The State could be seen to be subject to misleading and deceptive conduct in public policy, with the market being offered reform to entice private sector investment and then re-monopolised as Government saw fit.

- **Re-strangulation of the market would see electricity price for business rise even more as consumers would have to pay a monopoly premium over and above true costs**. The more Government tried to protect residential users artificially the larger the business tariff increases would be.

- All business users who have taken out electricity supply contracts with Synergy or independent retailers over the past few years cannot return to gazetted tariffs – they would have to go cap in hand back to Synergy as the monopoly supplier for a new contract.

- The Government would have to commit $2-3 billion in the next 5-6 years to refurbish Verve's ageing power station fleet and build new capacity to keep up with demand growth.

- Re-creation of an integrated State owned monopoly would take away liquidity in the Electricity Wholesale Market and could shut it down, exacerbating a wholesale withdrawal of private participants.

- Even if Verve's total capacity remained capped and Synergy were allowed to continue to source capacity from the market under a merged structure, there would be no private sector bids to supply Synergy due to distrust of what could happen next.

- In 1998 Western Power failed to draw in a single bid when it tried to sell the Bunbury Power Station – **the private sector had no confidence in the integrity of a vertically integrated utility structure and would not participate.**

- If private sector involvement could be enticed, it would be done with full take-or-pay guarantee from the merged entity, making such involvement simply off-balance sheet capital expenditures by the merged entity.

- Renewable energy entry would dry up since there would be no pressure or incentives for an integrated monopoly to engage in such effort – it would be much simpler for a merged Verve-Synergy to simply use whatever fossil fuels it had at its disposal.

- Without private sector participation, public funds would have to be used for power station building, potentially sending the State Budget into deficit and risking the State's AAA rating.

- Funds at risk for WA would include approx $60m of National Competition Council payment being cancelled.

- Power station building, mainly along the north-south coastal corridor of the main grid, would suck away regional spending in all other parts of the State.

- Funds committed to power station building in the SWIS would suck away funds that would have been reserved for other more urgent regional development initiatives in other areas.

- Funds committed to power station building would prevent Government from pursuing real State development activities such as building new transmission capacity in the SWIS to enhance security and reliability of supply and facilitate new private sector investment in new generation capacity.

Summary

- There is no support whatsoever for Government to re-merge Verve and Synergy.

- There is no support whatsoever for Government to allow Verve or Synergy to exert their significant market power on consumers – Verve ought not to be able to retail on its own until the ERA reports to Parliament that such activity would not impact negatively on market competition.

- Verve will be able to address its current losses quickly if it could withdraw from the Vesting Contract on an accelerated schedule and sell all its withdrawn capacity to third parties in the market at a profit.

- Electricity tariffs need to rise to adequately cover Verve's generation costs under the Vesting Contract and to encourage demand conservation – retail competition will ensure that tariff rises would not be unjustifiable.

- Government should focus on building transmission capacity to enhance security and quality of supply, provide opportunities for regional development and facilitate entry of new privately funded generation capacity, in particular renewable energy generation.

- Government should pursue further reform as envisaged under current Legislation, with regard progressing to Full Retail Contestability as soon as possible to maximise consumer choice.