LGP

Landfill Gas and Power

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Economic Regulation Authority
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Dear Sir/Madam

SUBMISSION ON THE ANNUAL WHOLESALE ELECTRICITY MARKET REPORT DISCUSSION PAPER

Thank you for the opportunity to make a submission in respect of the ERA's annual review of the Wholesale Electricity Market (WEM).

Landfill Gas and Power Pty Ltd (LGP) has been a producer of renewable electricity since 1993 and a boutique electricity retailer since the commencement of the deregulated market. LGP currently produce some 8MW of landfill gas fuelled intermittent generation and supplies some 90 customers operating 370 loads and drawing 45MW. We also operate a 1.3MW diesel-fired Scheduled Generator.

LGP considers that the new market has been extremely successful. In particular, it has delivered some $2 Billion of private generation capacity (2,000MW), thereby permitting the state to deploy its development capital in other areas while retaining its AAA credit rating. The market has also seen the development of effective retail competition via seven active retailers, the most recent having established in the past year. Retail competition has been given further impetus now that regulated tariffs have made significant progress towards cost reflectivity. That said, LGP notes that the customer churn rate is only around 4% of the eligible market per year. While there is still considerable scope for development, the indications are that contestable retail prices will ultimately be capped by competition rather than set by government.

LGP comments in detail on the matters raised in the Discussion Paper as follows, using the paper's format.

What is the likely impact of a possible re-merger of Verve Energy and Synergy on the Wholesale Electricity Market?

LGP considers that such a merger would have a very negative impact on the Wholesale Electricity Market as it would diminish competition in retail and generation in opposition to the Market Objectives. It would represent a high level of Political Risk by destabilising the investment and commercial environments. In particular, major private investment in generation has taken place since market start in the expectation that the market power of the

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State owned enterprises Verve and Synergy would be constrained. This has been achieved through the Vesting Contracts between Verve and Synergy, constraining Verve and Synergy to their core functions, and through express Market Rules overseen by the ERA. These market institutions have taken a decade to develop and implement, and vigorous processes are in place to further refine and optimise them as the market evolves. LGP considers the re-merger of Verve and Synergy would seriously undermine them in an undeclared reversal of Government policy.

Notwithstanding these objections to a re-merger, LGP also perceives that the proposal lacks a credible intellectual foundation and has the appearance of being founded on only arbitrary political expediency. More generally, we regret to observe that the standard of political debate of the electricity market has been of a low standard focussing on avoiding accountability to a financially distressed and uninformed electorate, rather than establishing the facts and determining the optimal strategy for the future. In particular, we perceive that the re-merger proposal is offered as a means of remedying losses incurred by the State-owned enterprises, without recognition that those losses are primarily due to under-recovery by the gazetted tariffs of the costs of supply. In particular, the gazetted tariffs were held relatively fixed for nearly 20 years amid a commodities and resource boom. The State Government properly instituted the Oates Review to evaluate the causes of Verve's losses and assess potential remedies and the recommendations of that review are being vigorously progressed by the IMO. More importantly, that review advised against the re-merger of Verve and Synergy, a fact that is now forgotten and ignored in the political debate.

Another important issue is the fact that Verve Energy is a key supplier of energy to several retailers, including LGP. In LGP's experience, Verve has conducted itself professionally and responsibly in respect of supplying private retailers. A merger with Synergy would not only constrain that facility in the future, but would also compromise the integrity of the existing arrangements, some of which are known to be long term.

Does the design of the Wholesale Electricity Market provide the most efficient outcomes with meeting climate change policies?

LGP considers that the WEM provides very efficient outcomes with respect to meeting climate change policies because it provides for efficient production of electricity without regard to source. Furthermore, it expressly seeks to avoid discrimination amongst technologies and the implementation of subsidies. In particular, we perceive the WEM to have readily facilitated without modification the state Feed-In-Tariff and the federal Mandatory Renewable Energy Target. We further perceive that it will similarly facilitate the intended flow-on effects of the introduction of a "cost of carbon" to the cost structure of electricity generators via the federal Clean Energy Bill 2011.

LGP also supports the IMO processes for upgrading the Market Rules to properly accommodate the uptake of intermittent generation technologies and to require participation of all generators in the Balancing Market to be introduced on April 2012. This latter evolution will facilitate the implementation of a carbon price into the fuel components of generator bids, and the pass-through of those costs to Market Customers.

Intermittent Generation, and in particular wind, is likely to provide the largest component of renewable generation in the near term, which creates considerable system management issues. In response to these, the IMO is instituting new rules to properly value its contribution to system capacity and the burden it places on Balancing Services and Ancillary Services. It is also creating separate Ancillary Services and Balancing markets in order to improve their efficiency and facilitate price-based turn-down of facilities during the overnight load minimum.

What impact does Demand Side Management have on the achievement of the efficiency, reliability and security objectives of the Wholesale Electricity Market?

LGP supports the Authority's assessment of the Demand Side Management (DSM) issue, and considers that the proper forum for resolving it is the IMO's prospective Reserve Capacity Mechanism Working Group based on the review by the Lantau Group.

We would reiterate the Lantau Group's comments on the need to harmonise the treatment of DSM and supply-side resources. In particular, the quantity of DSM will be in the region of 500MW in the 2013/14 Capacity Year, and this will be available for only 24 hours cumulative per year. There are also restrictions on the number of consecutive days it may be dispatched and also the number of hours per day. System Management is also obligated to not dispatch DSM if it reasonably considers that to do so would render it unavailable during the peak season.

LGP supports the development of DSM and welcomes the entry into the market of specialist providers. However, we share System Management's concern that the quantity of DSM is a security issue, and we consider that the market isn't receiving value-for-money. We further suggest that the application of Market Objective c) (avoidance of discrimination) needs to be reviewed in respect of DSM.

What impact does the outage planning process have on the achievement of the efficiency, reliability and security objectives of the Wholesale Electricity Market?

LGP supports the ERA's assessment of the outage planning process and in particular that the transparency and dissemination of outages is important for achieving the Market objectives. We also support recommendation of PA Consulting that the IMO should develop changes to the Market Rules to establish System Management's obligations with respect to the disclosure of information on Planned Outages, and that System Management should develop protocols that set out how these obligations would be discharged.

We welcome the ERA's comments that price spikes have coincided with Planned Outages and its concern about the number of outage hours granted to certain generation facilities during high demand periods. In this regard, we note that in the first week of July, 1200MW of plant was on outage, of which 888MW was coal-fired, which included 185MW unplanned. Furthermore, some of the generators concerned were off line for a considerable time. These outages, combined with a gas-fuel shortage, caused prices to spike to the non-liquid price cap. This was a similar price outcome to the summer-time one week outage of the Varanus Island Gas Processing Plant (due to a cyclone) which occurred during peak temperatures. While we accept that the February incident was the outworking of a healthy market, LGP questions the appropriateness of having such a large amount of coal plant off line for so long during the winter. While we accept that there was abundant liquid-fuelled plant available to meet the current reliability criteria, we suggest that outage planning should have regard to fuel diversity to better guarantee reliability and the avoidance of energy price blow-outs, in support of Market Objective (d).

How effective is the Rule Change process, and its governance structure, in promoting the efficiency, reliability and security objectives of the Wholesale Electricity Market?

LGP is a member of the Market Advisory Committee and its various working groups, and is a committed participant in the Rule Change process. We support the ERA's comments to the effect that the Rule Change process has to date worked as intended and that due to the small size of the market it has been appropriate for the IMO to possess a dual role.

In assessing the IMO's performance in these roles over the last year, it is important to recognise that the development process has been extensive, complex and fully consultative within an urgent political context; specifically the government's contemplation of re-merging Synergy and Verve as an alternative to evolution of the WEM.

In accordance with advice from industry, the IMO decided to implement new Balancing and Ancillary Services markets within the existing market structure, representing the optimal combination of rapid implementation and effectiveness. LGP considers that, while the process has not yet concluded, the IMO has performed extremely well in developing and implementing these markets and we are optimistic that they will significantly improve the efficiency and effectiveness of the WEM. While the issues are complex and subjective, we strongly consider that imposition of a third party approval body would have delayed implementation by at least several months and, given the seasonality of market security issues, probably by a year. On this basis, we fully support the process that has been undertaken. We further consider that there is within the industry a leadership void, and congratulate the IMO for performing this role and espousing the values of "leadership" and "courage" in the wider interests of the industry.

Notwithstanding our support of the IMO, we recognise that the Market Evolution Programme has been of exceptional importance, scope and urgency, and that there is considerable merit in instituting "separation of powers" over the longer term. In particular, we note that submissions in the Market Rules Change consultative process are increasingly citing objections based on Regulatory Risk. Examples include the changes to the Maximum Reserve Capacity Price and the capacity valuation of Intermittent Generation. It also likely that this issue will arise with respect to DSM via the review of the Reserve Capacity Mechanism.

LGP considers that appointment of a separate body to oversee the Rule Change process would be beneficial in mitigating Regulatory Risk. We suggest that such a body would ideally be empowered to review the merits of 'grandfathering' existing arrangement in the face of significant regulatory changes.

Does the recent increase in capacity traded through the Independent Market Operator have implications for the effectiveness of the Wholesale Electricity Market? In particular, does the recent increase in capacity traded through the Independent Market Operator imply that the level of the Reserve Capacity Price is too high?

LGP notes that this issue is at a very early stage of public consultation and considers that the proper forum for resolving it is the IMO's prospective Reserve Capacity Mechanism Working Group based on the review by the Lantau Group.

LGP considers that one significant contribution to the increase in capacity traded through the IMO is a consequence of the logistics of capital-raising for generation projects. In particular, the cost of debt (interest rate) is based in part on the ability of an income stream to service in a reliable manner the debt of the asset providing the stream. On this basis, a specific and stable income stream from a party of sound credit status is less risky, and merits lower rates. In practice, large state-backed corporations with monopoly or pseudo-monopoly revenues best fit this criteria. Examples include the State Government, Synergy, Verve and Water Corporation. Private companies include the Boddington Gold Mine. These entities have directly or indirectly underwritten the bulk of the recent generation projects, including the NewGen and Bluewaters plants, Verve's HEGT, Emu Downs Windfarm, Mumbida Windfarm and the Greenough Solar facility. However, such highly credit-worthy entities are approaching saturation, and developers are turning to the WEM as an alternative off-taker.

While the WEM suffers the disadvantage of providing a fluctuating price (in the absence of an auction), it offers a de-facto sound credit rating via its requirement for prudential support and its requirement to pass through to all market customers any default in paying for capacity. While this is not ideal for a debt provider, those willing to understand the market and rely on a forecast of the evolution of the capacity price can optimise other levers in the mix, such as Gearing Ratio, to satisfy their risk-return needs at rates that do not undermine the economic viability of the project.

While LGP considers that this phenomenon is a significant driver of the increase in capacity transactions via the IMO, we note that discussion of this issue is at an early stage and has not yet been assessed by the planned working group. In particular, LGP notes that the stated discontinuity date of 1 October 2010 is also the date of commencement of the Replacement Vesting Contract and we would like to enquire as to the impact of that arrangement on the present matter. We would also request confirmation of what actually constitutes an IMO purchase/sale as we understand that in certain circumstances "internal transfers" by a Market participant might be flagged as arms-length transactions.

Do the existing arrangements regarding Bilateral Contracts provide sufficient transparency to achieve efficient market outcomes?

As a general rule, efficient markets depend on the timely dissemination of price and other information, and are facilitated by increased transparency.

Virtually all end-users of electricity are supplied via bilateral contracts, with the WEM functioning as a mechanism for providing ancillary services and transacting wholesale "overs and unders" in both capacity and energy. These bilateral contracts are generally kept confidential between the parties, with the notable exception of the published gazetted tariffs offered by Synergy to franchise and selected other customers. These tariffs are from time to time analysed and 'unbundled' by consultants to the Office of Energy. The conclusions of this analysis are often published in summary form, and occasionally in detail. Informed participants may also perform this analysis for themselves.

The most significant bilateral contract is the Replacement Vesting Contract between Verve and Synergy, which has been published in general form without the commercial detail. All retailers offer end-users contract pricing and terms unique to themselves, which complicates the comparison of a contract "price". For example, gazetted tariffs are usually subject to anytime termination and flexible consumption profile, whereas a contract price will be subject to a minimum term and might require specific consumption criteria, such as a minimum quantity.

Market Objective d) seeks to minimise the long-term cost of electricity supply to customers. While all Rule Change Proposals are assessed against this objective, the assessment is performed mostly intuitively based on the assumption that reduced costs and risks will eventually manifest as lower contract prices to customers. This intuition presumes that effective competition exists and that it will ensure that cost reductions will be passed through to customers rather than retained as higher profit by Market Participants.

While LGP welcomes increased transparency in principle, we perceive that under the present market structure this could only be achieved by mandating (anonymous) disclosure of contract pricing and then standardising this in some manner. LGP is unconvinced as to the merit of this. However, that said, we would welcome further elaboration of the meaning of Market Objective d) and would welcome other suggestions as to how to improve the situation.

Are there any other strategic, policy or high-level issues, including those raised in this Discussion Paper, that are impacting on the effectiveness of the Wholesale Electricity Market in meeting the Wholesale Market Objectives?

Cost reflective gazetted tariffs: We note that Synergy is in receipt of a significant government subsidy to compensate it for the fact that the gazetted tariffs under-recover the costs of supply. We also note that the government has mooted a 12% increase in the gazetted tariffs from 1 July 2012, of which 7% is to accommodate the impact of the Clean Energy Bill 2011. The balance is likely to be fully absorbed by the prospective increase in Western Power's network charges, with no provision for increases in the other two-thirds of the cost structure. In this respect, we also note the 'wild card' of the Small-scale Technology Percentage, which has blown out in years 2011 and 2012, imposing significant costs.

Given community objection to recent price increases and the proximity of the next State election, there is no certainty as to the level of the increase of gazetted tariffs or the appropriateness of their assessment. LGP suggests that this assessment should be managed and implemented by the ERA, so that decisions are taken independently in the best interests of industry and the community. Insofar as politicians wish to subsidise electricity prices, they would then have to do so expressly within the context of a healthy competitive industry delivering optimal price outcomes. Any such subsidy could then be offered equally to all retailers.

LGP supports full cost reflectivity of the gazetted tariffs without phase-in. We consider that cost reflectivity would remove the need for Synergy to receive a subsidy, promote energy efficiency, reduce carbon pollution and encourage retail competition. In particular, retail competition would be encouraged through the removal of direct support for the State-owned retailer.

Fuel: Fuel prices impact the WEM via STEM and Balancing prices offered by generators with uncontracted energy. In particular, Verve's fuel arrangements are very important in setting market prices.

LGP notes that Verve's legacy gas contract expires around 2015 and that Verve has flagged a potential gas shortage for a few years prior to commencement of its principal replacement contract. More generally, Market Participants are reporting difficulty in contracting for gas fuel and delivery. In parallel with this, both the major coal producers have been sold to foreign interests which are seeking higher prices and to export their production. In addition to increasing un-contracted energy prices, this potentially threatens system security via the continuing uncertain future of Griffin Energy, which operates 430MW of coal plant.

LGP encourages review of long term fuel arrangements and in particular strategies for ensuring the availability of domestic gas.

Network Prices: LGP notes that Western Power has proposed that network access costs be increased by around 70% over the next 5 years. While we will lodge a submission to the appropriate venue, we wish to record in this forum our opposition to this proposal and our support for the alternative of innovating Western Power's practices and allowing only fit-for-purpose increases. In particular, we support the development of a constrained network access regime in order to optimise the value for money of the existing assets.

Strategic Energy Initiative 2030: We note the delay in the issue of this document and look forward to its conclusion. We consider that this is the proper forum for a resolving the issues of fuel availability. Any proposal to re-merge Synergy and Verve should also be referenced in this document.

The Authority invites comment on the effectiveness of the Independent Market Operator, System Management and the Economic Regulation Authority.

LGP is satisfied with the effectiveness of the IMO, System Management and ERA. We note that the WEM is subject to an extraordinary level of development and we especially welcome the commitment of the IMO and System Management.

If you require any further information, please contact Steve Gould, General Manager - Retail on 041 250 8291.

Yours faithfully

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