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ERA Review of the BRCP Market Procedure

1. Background

Merredin Energy Pty Ltd (MEPL) welcomes the opportunity to provide feedback on the ERA's review of the Benchmark Reserve Capacity Market Procedure (BRCP). MEPL owns and operates the 82 MW open cycle gas turbine power station located near Merredin, Western Australia. The financial performance of the plant is dependent on the revenue earned by providing Capacity Credits under the Reserve Capacity Mechanism (RCM). The BRCP has the potential to impact the revenue received by MEPL in future years, and could also impact the incentives for new plant entry in the South West Interconnected System (SWIS).

Merredin Energy has had ongoing concerns over a number of years that the methodology for calculating the BRCP is not reflective of the cost of financing new power stations.¹ Merredin Energy was supportive of a comprehensive review of the BRCP methodology, but understands that the Economic Regulation Authority (ERA) has postponed the (comprehensive) review of the method for setting the BRCP and that the most recent report² released by the ERA provides a review and recommendations on the market procedure relating to the calculation of the cost of capital of the benchmark generator.

2. Feedback on the ERA Market Procedure Proposals

Nominal versus Real WACC

The ERA has rightly indicated that the annuity process for calculating the annual capital cost should be based on a nominal Weighted Average Cost of Capital (WACC), not a real WACC that is used in the current process, as this reflects the funding costs for a power station.

¹ For example, Merredin Energy submission to AEMO on the Draft Report, 2019 Benchmark Reserve Capacity Price for the 2021-22 Capacity Year. Submission dated 24 October 2018.

² ERA, Procedure change proposal: Calculation of benchmark reserve capacity price (EEPC_2020_02), September 2020

An owner wanting to refinance their power station, or a new generator investor, would obtain a loan and be required to make nominal interest payments (which includes a component for expected inflation). Similarly, an investor in an existing or new power station would seek to be compensated for expected inflation in the rate of return that they receive.

Merredin Energy endorses the proposed amendment to the market procedure to state that a nominal WACC should be used to calculate the annualised capital cost of peaking plant for use in the calculation of the BRCP.

Nominal Cost of Debt

Merredin Energy has been consistent in its criticism of the setting of the nominal cost of debt. As outlined in our submission to AEMO in 2018:³

“In our view, while the nominal return on debt of around 4.8 to 5 per cent is a reasonable point estimate, it does not reflect likely funding costs over a 10-year period (power stations will typically have to be continually re-financed over their assets lives). In our view, nominal return on debt should reflect current market rates (above) plus longer-term rates that are likely to eventuate. This is the methodology employed by the Independent Pricing and Regulatory Tribunal (IPART) in New South Wales¹. Using their methodology whereby current market rates and likely future rates are weighted 50 per cent each result in a nominal return on debt of 5.8 per cent.”

AEMO had previously acknowledged⁴ that the current method of using low estimates of the real risk-free rate and subsequently the WACC, are not likely to reflect market rates that new entrant generators are likely to pay. In addition, existing generators are unlikely to obtain new debt financing annually, that is, the current estimate of market rates are unlikely to reflect the actual cost of debt paid by existing generators as they may have obtained debt financing at a different time period to when the cost of debt is determined for the purpose of setting the WACC.

The nominal cost of debt used in the setting of the 2020 BRCP by AEMO was 3.34 per cent reflecting the low interest rate environment that we are operating under due to the COVID-19 induced recession in Australia. Once again, we would argue that the relevant nominal return on debt should be based on an average of current (historically low rates) and historical interest rates. IPART is currently using an average nominal cost of debt 4.7 per cent⁵, which is made up of 50 per cent of current nominal cost of debt of 4.0 per cent, and 50 per cent of the long term average of the nominal cost of debt which is 5.4 per cent. The average nominal cost of debt of 4.7 per cent is substantially higher than the rate used by AEMO.

This issue has not been addressed in the review of the BRCP Market Procedure by the ERA.

Market Risk Premium

AEMO has adopted a Market Risk Premium of 6.0 per cent for use in the calculation of the BRCP for several years (includes the 2019 and 2020 BRCPs). This is then added to the current inflation rate to determine the return to equity holders. While 6 percentage points reflects the long run risk premium associated with power station finance, it may not reflect the risks associated with financing a power station today. As shown below, IPART has calculated that the MRP exceeds 8.0 per cent in recent years (was 8.6 per cent in July 2020).

IPART’s approach is to calculate WACCs based on both the long term MRP (6.0 per cent) and the current MRP (8.6 per cent)⁶, and then use the mid-point of short term and long term WACC estimates in the assessment of regulatory pricing.

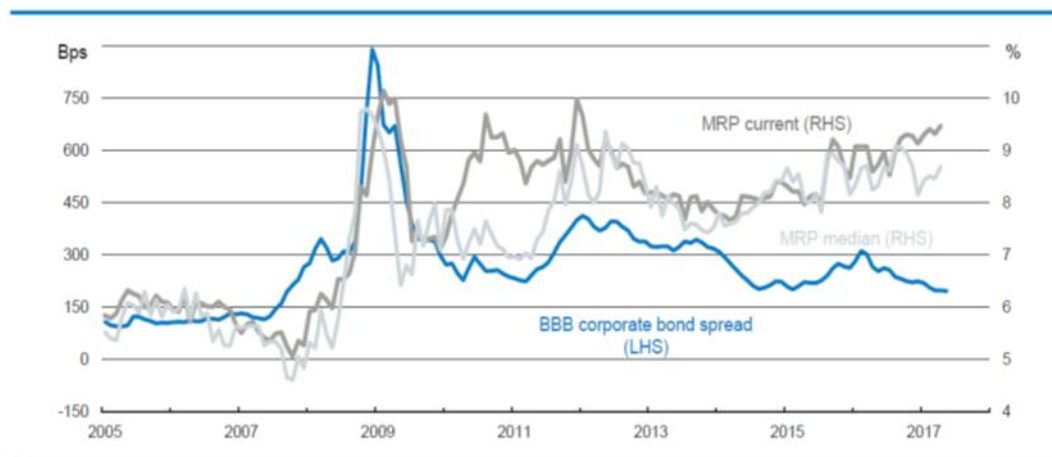
³ Merredin Energy, Response to Draft Report: 2019 Benchmark Reserve Capacity Price for the 2021-22 Capacity Year, prepared by AEMO, Submission sent 24 October 2018.

⁴ Chapter 4 of AEMO, 2019 Benchmark Reserve Capacity Price for the 2021-22 Capacity Year, October 2018.

⁵ IPART, Spreadsheet WACC Model August 2020.

⁶ IPART calculated an MRP of 8.6% for July 2020.

Figure 1: Market Risk Premiums and BBB corporate bond spread



Source: IPART, Review of our WACC method, Final Report Research, February 2018

Given that the current market risk premium currently exceeds 8.0 per cent (mainly due to the lower risk-free rate of debt), we suggest that the MRP used by AEMO in the calculation of the BRCP should be increased to 7.3 per cent.

Merredin Energy does not endorse the ERA's recommendation to set the parameter at 5.9 per cent.

3. Conclusion on WACC calculations and BRCP Market Procedure

While we endorse the ERA's recommendation that a nominal WACC should be used to calculate the annualised capital cost of peaking plant for use in the calculation of the BRCP, we argue that further amendments to the BRCP Market Procedures should be considered to take into account both the current and long-term estimates in cost of debt and market risk premium to more accurately reflect the true cost of capital generators would have.

These would result in the following WACC parameter changes for 2022-23:

- MRP increased from 6.0 to 7.3 per cent
- Nominal return on debt should be increased from 3.34 to 4.7 per cent.

If these parameters were used, then the nominal WACC used in the calculation of the BRCP for 2022-23 would be 7.33 per cent (pre-tax nominal), rather than the nominal WACC of 5.95 per cent applied by AEMO. An increase in the nominal WACC of 1.38 per cent, would increase the BRCP by \$11,990 per MW per annum for 2022-23.

MEPL would welcome an opportunity to further discuss with you the points raised in this letter.

Yours sincerely,



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General Manager
Merredin Energy