



Our Ref: DMS #3094790 V4
Enquiries: Jenni Conroy
Telephone: (08) 6212 1661

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Lyndon Rowe
Economic Regulation Authority
Level 6 Governor Stirling Tower
197 St Georges Terrace
PERTH WA 6000

Dear Lyndon

ANNUAL WHOLESALE ELECTRICITY MARKET REPORT

Thank you for the opportunity to comment on the Authority's discussion paper: "Annual Wholesale Electricity Market Report to the Minister".

Synergy has developed a substantial body of knowledge by virtue of our activities in the WEM's Short Term Energy Market (STEM), balancing and capacity markets. Further, Synergy has been active in the wholesale market attempting to put in place new supply agreements via the vesting displacement mechanism and other bilateral arrangements. The timing of the 'Market Report' is unfortunate, given that the results of our procurement activity are not yet able to be announced, and would shed more light on the relative success of the wholesale market.

It is clear that, as a market, the WEM is in its infant stages and hence its effectiveness is still to be evidenced. However, despite its infancy, Synergy can identify some key issues, which if they remain unaddressed, may impinge on the potential effectiveness of the WEM in the medium to longer term. Synergy welcomes the opportunity to outline our concerns in this regard.

Yours faithfully

TONY PERRIN
HEAD OF WHOLESALE

Introduction

Synergy is Western Australia's largest energy retailer with approximately 890,000 industrial, commercial and residential customers, generating total revenue of more than \$1.5 billion annually and is responsible for purchasing and retailing electricity and gas to customers in the South West Interconnected System (SWIS). Synergy is a statutory State owned Corporation, with more than 350 staff. It was established on 1 April 2006, as part of the restructure of the Government owned vertically integrated monopoly, Western Power Corporation and the creation of four new stand-alone corporations.

Synergy has developed a substantial body of knowledge by virtue of its activities in the WEM's Short Term Energy Market (STEM), balancing and capacity markets. Further, Synergy has significant recent bilateral contracting experience as evidenced in our activities to bring new capacity into the market. These activities include:

- Supply of 400 MW of Capacity Credits and associated electricity commencing from 1 October 2010; and
- supply 50 MW of Capacity Credits and associated renewable electricity commencing from 1 October 2009.

It is clear that, as a market, the WEM is in its infant stages and hence its effectiveness is still to be evidenced. However, despite its infancy, Synergy can identify some key issues, which if they remain unaddressed, may impinge on the potential effectiveness of the WEM in the medium to longer term. This submission provides an overview of Synergy's perspectives of the performance of the WEM when measured against the key legislated objectives for the WEM. Synergy notes the objectives for the WEM, as established in the Electricity Industry Act are:

- to promote the economically efficient, safe and reliable production and supply of electricity and electricity related services in the South West interconnected system (SWIS); (Objective 1).
- to encourage competition among generators and retailers in the SWIS, including by facilitating efficient entry of new competitors; (Objective 2).
- to avoid discrimination in that market against particular energy options and technologies, including sustainable energy options and technologies such as those that make use of renewable resources or that reduce overall greenhouse gas emissions; (Objective 3).
- to minimise the long-term cost of electricity supplied to customers from the SWIS; and (Objective 4).
- to encourage the taking of measures to manage the amount of electricity used and when it is used. (Objective 5).

These objectives are critical to any assessment of the outcomes achieved through the WEM.

Synergy believes for there to be an efficient and effective wholesale market, there must be evidence of the following:

1. Many wholesale sellers and buyers.
2. Third party access to monopoly controlled infrastructure.
3. Creation of a market operator to administer the market, enforce market rules and to ensure that there is sufficient capacity (wholesale supply) to meet a prescribed reliability criteria (1 in 10 year critical peaks etc).

4. Visible short run price signals to enable the market to be in balance.
5. Visible long run price signals that enable market participants to make appropriate investment signals.
6. Development of financial instruments (for example contracts for differences) that enable parties to manage risk effectively.

The WEM probably has some evidence of three of these six features (2, 3 and 4) although it could also be argued that it provides long term signals via the Reserve Capacity Mechanism for peaking plant.

In responding to this review, Synergy will reference the key objectives of the WEM and the characteristics of an efficient market.

Synergy will also take this opportunity to identify key structural issues associated with the Western Australian electricity supply industry, which have the potential to impinge against future WEM performance, including:

- Gas shortages
- Transmission capacity constraints
- Inadequate retail tariff headroom.

Given the commercial significance of these issues, Synergy views the Authority's Annual Review of the WEM as being timely.

Discussion Point 1

Given the current Wholesale Electricity Market design, the Authority invites comment on the extent to which the operation of the Reserve Capacity Mechanism is effective in achieving the objectives of the Wholesale Electricity Market.

Synergy has assessed the outcomes achieved through the Reserve Capacity Mechanism to date against the overarching objectives for the WEM and identified some key concerns.

Synergy's main concern in this regard reflects the fact that the Market Rules inevitably lead to an outcome of excess capacity over the Reserve Capacity Requirement. This is evidenced by the certification results for Capacity Year 2008 and 2009. For Capacity Year 2008, the Market Rules attracted an excess of 278 MW of surplus capacity, equating to a cost of some \$27M on retailers and in turn on end-use customers. The most recent certification process for Capacity Year 2009 resulted in an excess of 527.43 MW, or an additional cost of over \$57M on SWIS retailers and end-use customers, more than double the excess capacity cost for 2008.

Synergy views excess capacity as inevitable in the wholesale market, given the lumpy and indivisible nature of generation capacity. Excess capacity can be an efficient outcome if it permits new plant to enter the market to achieve economies of scale (eg to accommodate a 400 MW plant) rather than installing smaller units (e.g. 100 MW each), which will have higher levelised costs. Synergy holds that permitting excess capacity in the market can reduce barriers to entry for new plant since it allows new entrants to be paid in full for all capacity installed, rather than capacity required in a given year.

However, excess capacity imposes costs on existing generators, retailers and ultimately customers.

Excess Capacity results in a decline in the value of existing Capacity Credits via the sliding scaled administered price mechanism. This has the potential to impact both the risk profile and ongoing revenue streams of generators, who rely on the value of these Capacity Credits to finance their projects.

Retailers will attract excess capacity charges in proportion to their market share. It would be strategic for these retailers to seek to pass through these costs to customers, who will therefore be subject to increased electricity prices. However pass through of the additional excess capacity charges and other statutory charges is not always possible since price caps are in place for customers using less than or equal to 160 MWh per year. These price caps, or Gazetted Tariffs, are set by Government, with the Tariff By-Laws subject to tabling in Parliament. This makes it difficult for Synergy to effectively manage the costs of excess capacity.

Synergy has previously identified to Government and the Authority that Gazetted Tariffs are now below cost reflective levels. The burden of below cost reflective tariffs is shared by Synergy and Verve under the Vesting Contract arrangements. While Verve currently subsidises many of the costs associated with non-cost reflective tariffs, this burden will transition to Synergy over time, as Synergy replaces Verve's current supply with new contracts secured under the Vesting Displacement Mechanism.

Synergy therefore sees the need for an independent economic assessment of the level of excess capacity in any given year. If excess capacity is warranted the Authority should recommend that Gazetted Tariffs be increased to reflect the additional costs on retailers.

Synergy notes the current average age of the SWIS generation fleet is 14.5 years, which implies that a significant amount of older, less reliable plant is on the system. Having older, less reliable plant on the system can reduce the overall efficiency of the market (cost and reliability). A market mechanism that would test the value of newer plant against older, less reliable plant will improve the efficiency of the market by ensuring the optimal mix of old and new plant. Synergy suggests this could be achieved through amending the Reserve Capacity Mechanism to reinstate the original ACAP mechanism. The ACAP mechanism in effect requires all plant to bid into an annual capacity auction to establish their worth to the market. This process will reveal which older plant needs to be retired and replaced with new capacity.

To ensure that the Capacity Mechanism achieves outcomes consistent with the objectives for the WEM, Synergy recommends the following:

- The Market Rules embrace the concept of an economic test on excess capacity, whereby the interests of new entrant and incumbent generators as well as retailers and their end-use customers are balanced.
- Pass-through of excess capacity costs in regulated tariffs.

Synergy views the IMO's forthcoming review of the Reserve Capacity Mechanism as being timely and we look forward to engaging with the IMO on these important matters.

Discussion Point 2

Bearing in mind the interaction of the capacity mechanism and the energy market, the Authority invites comment on whether the current Wholesale Electricity Market provides adequate incentives for an efficient mix of generation plant.

Synergy notes that an efficient electricity system requires a combination of services provided to meet base load, mid-merit and peaking load tranches. Generators providing these services earn the following revenue streams to finance their operations:

- Energy sales (achieved either through bilateral contracts or trading in the STEM);
- Capacity Credits (issued by the IMO)
- Ancillary services, such as balancing.

At present ancillary services are provided in the main by Verve. Synergy addresses this issue when responding to Discussion Point 18 below.

Synergy notes that peaking plant, as a reflection of its reduced capacity factor (less than 10%) is usually provided from Open Cycle Gas Turbines. This plant relies on capacity payments with limited energy sales, either from the STEM or as bilaterally contracted, to underwrite its operations. This can be compared with a mid-merit plant (with capacity factors of up to 30%), which relies on an increased quantum of energy to supplement ongoing capacity payments. Base-load plant, however, relies predominantly on energy sales, contracted over the long term to underwrite their plants.

Synergy therefore views the WEM Capacity Mechanism as providing some revenue certainty for providers of peaking plant and to a lesser extent mid-merit plant. We note, however, that these payments do not provide significant incentives for the construction of base-load plants.

From our learnings in undertaking power procurement for new generation plant, Synergy has identified the following requirements to bring a base-load plant into the market:

1. Competitively priced, long term fuel supplies (e.g. coal or gas)
2. Firm access to transportation infrastructure (eg T1 gas access, electricity transmission access)
3. Long term bilateral contracts with retailers for energy sales
4. Allocation of risks associated with climate change policies and overall certainty as to the eventual legislative obligations.

Synergy notes that without these arrangements in place, it is very difficult for base-load generators to obtain finance, especially without point 3.

There are significant barriers to entry in the market at the current time. There are shortages of gas for Combined Cycle Gas Turbines (CCGTs), limited access to network capacity in the SWIS, uncertainty about future carbon prices and above all new entrants are unclear as to how Verve, the dominant market generator, will react to proposed market entry, given that they already have access to competitive fuel contracts. Synergy acknowledges a significant potential for stranded assets and fuel contracts and that this risk may impact generator's pricing strategies.

It is our view that the Capacity Mechanism and spot energy market do provide incentives for peaking, but were never intended to provide incentives for mid-merit and base-load plant. These plants were to be facilitated through long-term bilateral contracts between retailers and generators. However, as identified, there remain a number of structural impediments to the effective entry of base-load plant.

Discussion Point 3

The Authority invites comment on whether the Wholesale Electricity Market adequately promotes efficient location of generation facilities and promotes the efficient development of transmission and distribution networks.

Synergy notes the critical interaction between the available capacity of electricity transmission infrastructure and the siting of generation plant. In particular, Synergy notes that the South West Interconnected Network (SWIN) remains primarily a radial network with generation centred at Collie, and, to a lesser extent, Kwinana, and supply radiating to extremities at Kalbarri/Kalgoorlie/Albany. The past practices of Western Power are continued under the current Revised Access Arrangement, with the costs of connection being directly applied to the proponent requiring it. As such, network capacity favours generators sited in the Kwinana and Collie regions, where there is already access to connect to the HV transmission grid. Generators sited at the extremities have had considerable difficulties in being connected at full capacity. This is especially an issue for renewable generators such as windfarms, which by nature are unlikely to be sited in either the Collie or Kwinana regions. They are likely to be sited at the extremities and the reliability and capacity of the HV grid may therefore be a significant barrier for such development.

Synergy has previously drawn to the Authority's attention, the concern that the main transmission lines between Collie and Perth are also approaching full capacity. In particular, Synergy notes that Griffin's Bluewaters 1 Power Station's ability to supply Boddington Gold Mine is dependant on the upgrade of the existing 132kV line. In addition, the connection of the Pinjarra gas turbines has compromised access to transmission for further capacity expansions in that region.

Synergy is aware that in some instances network capacity has become available (physically) upon the retirement of some generation units, but has not been released by Western Power to other generators. If so, this remains a barrier to competitive entry by new generators.

While the transmission system's capacity constraints have been recognised and Western Power's construction programme brought forward, it is likely to remain a constraint on the ability of new generators to be connected.

Synergy is concerned that these network constraints will continue to have significant implications to the efficient siting of generation plant, and in doing so, impinge on the efficient pricing as required by objectives 1, 2 and 4 of the WEM objectives. We therefore request that the Authority undertake a review which assesses:

- The implications of a carbon cost on network investment.
- The state of the SWIN with regard to accommodating potential new generation siting.
- Availability of transmission capacity to the market when generation plant is retired.

We request that such a review be undertaken in time to input into the Authority's next review of the Western Power Access Arrangement.

Discussion Point 4

The Authority invites comment on whether the Wholesale Electricity Market adequately promotes investment in an efficient amount of generation capacity.

Each year the IMO forecasts the requirement for capacity needed to deliver reliability of supply to the SWIS. This is based upon sufficient capacity to cover a 1-in-10 summer peak load (that expected during a 41 degree day), coincident with the loss of the largest generator while also maintaining sufficient reserve to maintain system frequency control and an allowance for embedded generators. In 2005 the IMO forecast a need for 4,000 MW for capacity year 2007, allowing 9.4% reserve above the 1-in-10 peak load. Currently there is no limit on the amount of capacity that the IMO can certify and for capacity year 2007 4115.4 MW was credited. This has led to significant costs of excess capacity (\$15 million in Capacity Year 2007 followed by \$28M for 2008 and \$57M for 2009).

Synergy sees a clear need for the WEM to be able to accommodate excess capacity and we point to our previous comments made in response to Discussion Point 1. In this regard we recommend that:

- The Market Rules embrace the concept of an economic test on excess capacity, whereby the interests of both new entrant and incumbent generators as well as retailers and their end-use customers are balanced.
- Electricity tariffs are restructured to enable the efficient pass-through of excess capacity costs.

Discussion Point 5

The Authority invites comment on whether there are other issues with the Reserve Capacity Mechanism that materially impact on the effectiveness of the Wholesale Electricity Market.

Synergy makes no further comments to this Discussion Point, but highlights once again, the significant issues identified in Discussion Points 1 through 4.

Discussion Point 6

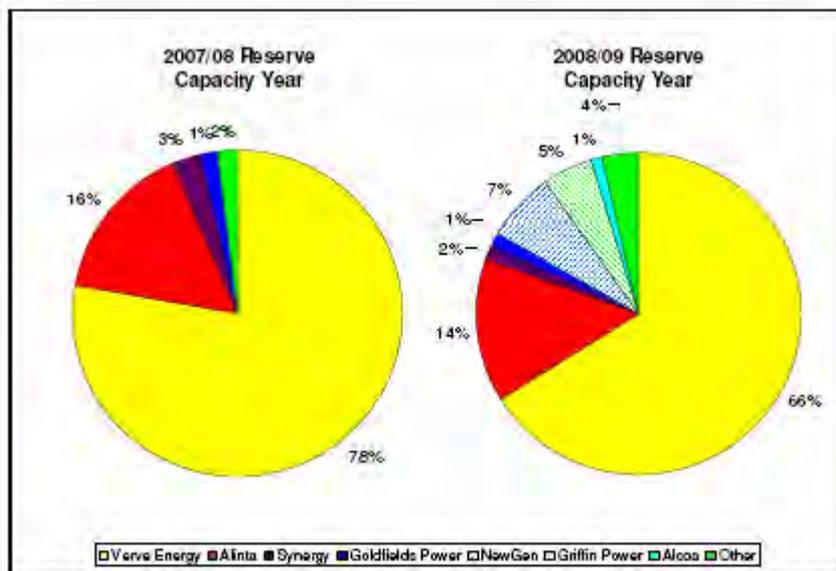
Recognising that the Short Term Energy Market (STEM) is a net pool system, and that the Vesting Contract impacts on liquidity in the market, the Authority invites comment on any aspects of the STEM design that discourage Rule Participants from trading in the Wholesale Electricity Market.

The Vesting Contract is the initial supply contract between Verve and Synergy, established by the State Government of Western Australia as a core component of the State electricity reform process. The need for such a contract was well established in the Electricity Reform Task Force Report (hereafter the Task Force). In particular the Task Force recommended that wholesale energy contracts should be established between the Generation Corporation (now trading as Verve) and Retail Corporation (now trading as Synergy) at the time of Western Power's disaggregation to:

- provide for supply to the existing retail customers of Western Power;
- provide for a smooth transition to the new wholesale electricity market;
- support the objectives of the Wholesale Electricity Market;
- promote competition in the generation sector and encourage new generation entrants into the SWIS; and
- mitigate the market power of Verve by tying up the initial bulk of its capacity and energy with Synergy, but allowing a wind-down of this commitment over time as the mechanisms discussed above take effect and as the market becomes more competitive.

Synergy supports the position of the Task Force and holds that such arrangements continue to be required. To unwind them at this early stage of competition in the wholesale electricity supply market would significantly impair future competition in that market.

The graph below is extracted from the IMO's 2007 Statement of Opportunities. It is clear from this graph that Verve holds the largest share of Capacity Credits in 2007/08 and 2008/09. While Verve's share reduces from around 78% to 66% over this period as a reflection of the commissioning of new facilities owned by NewGen Power and Griffin Power, it is clear that Verve holds a dominant market position.



Source: Independent Market Operator, "2007 Statement of Opportunities" at 11

Although the Vesting Contract initially covers a significant proportion of Synergy's customer portfolio, the contract contains some specific mechanisms designed to give effect to a decline in the contract volumes over time. These mechanisms include:

- A displacement mechanism, which requires Synergy to substitute initial wholesale supply provided by Verve Energy under the Vesting Contract with new supply obtained from the market (which may be from Verve or another party). Part of this supply is to be secured via a mandatory tender process set out in a Ministerial Direction.
- A timetable stipulating the roll-off of Vesting Contract supply for Synergy's contestable sales contracts that were entered into by Western Power Corporation before disaggregation. In general Vesting Contract cover for these sales contracts cease over the first two years of the contract, culminating in a November 2008 "cliff-face" when the majority of such contracts cease to be eligible for vesting coverage;
- Trigger rules that result in customer contracts initially covered by the Vesting Contract to cease to be eligible for coverage, for example as a result of a material increase in the customer's load. These rules reinforce the need for Synergy to secure other sources of energy outside the Vesting Contract.
- A penalty mechanism to deter Synergy from using the Vesting Contract to support new contestable sales contracts entered into after 1 April 2006, with a significant penalty payable to Verve for every unit of energy that Synergy is deemed to have taken from the contract in excess of the amount required to serve those specific customer entitled to vesting coverage. This mechanism ensures that Synergy sources competitive supply outside the Vesting Contract for part of its customer portfolio.

Synergy also wishes to comment on the Authority's assertion that the Vesting Contract significantly impacts on (or reduces) liquidity in the STEM, and that as the Vesting Contract volumes decline liquidity should increase (Authority's Discussion Paper 5.4.1). Synergy asserts that there exists no such linkage between the decline of Vesting Contract volumes and increased liquidity on the STEM. As Vesting Contract volumes decline, Synergy will be replacing that supply with new bilateral contracts entered into with non-Verve generators or contracts from Verve negotiated outside the Vesting Contract. This does not necessarily lead to increased liquidity in the STEM.

Further, the STEM has specifically been designed to accommodate the fact that the Western Australian electricity market is essentially a long term bilateral contract market. For example, the STEM allows retailers and generators to adjust their bilateral contract positions a day ahead of the Trading Day and also optimise their contractual arrangements. However at the same time, the STEM has not been designed to function as a long-term source of supply for a significant portion of a retailer's customer portfolio, given its day-ahead nature and relatively lower price risk associated with the alternative of bilateral contracts.

Given the market power of some wholesale participants, it would be unwise for retailers to have any significant exposure to the STEM. The IMO has attempted to address the market power issues by requiring that suppliers bid at their short run marginal cost (SRMC) in the STEM. While this rule, plus price caps in the STEM, provides some protection to buyers, problems with the interpretation of SRMC give suppliers some potential to utilise their market power.

Discussion Point 7

The Authority invites comment on the day-ahead feature of the Short Term Energy Market (STEM). In particular, does the day ahead feature of the STEM discourage Rule participants from trading in the STEM and would introducing two gate closures, or gate closures or gate closures closer to real time, encourage greater participation?

In the event the day-ahead arrangement is replaced by a real-time arrangements or the arrangement where the gate closure time to offer and bid into the STEM is closer to real time events, the Authority invites comment on how the potential exercise of market power by larger participants could be mitigated.

As identified in Synergy's response to Discussion Point 6 (above), the STEM has specifically been designed to accommodate the fact that the Western Australian electricity market is essentially a long term bilateral contract market. For example, the STEM allows retailers and generators to adjust their bilateral contract positions a day ahead of the Trading Day and also optimise their contractual arrangements. However at the same time, the STEM has not been designed to function as a long-term source of supply for a significant portion of a retailer's customer portfolio, given its day-ahead nature and relatively lower price risk associated with the alternative of bilateral contracts.

Synergy perceives a weakness in the current market design in that it limits the interactions between Market Participants by insisting that trading positions, being a demand forecast for a retailer and a resource plan for a generator, be determined in the morning of the day before the trading day. No flexibility to adjust these positions closer to real time is allowed. This is particularly significant for Western Australia given that the majority of loads are weather dependent. Greater flexibility would allow retailers to adjust their requirements closer to the actual trading interval, based upon current weather forecasts. It is Synergy's position that generators should be authorised to change their resource plan to account for changes to retailers' demand forecasts, the replacement of one generator with an equivalent unit (thereby not impacting total supply) and the inclusion of generators returning early from planned outages¹. The inability of a market participant to adjust their contracted position or resource plans within the trading day without incurring penalties for deviations, results in a less than efficient outcome with any costs or penalties ultimately being borne by customers.

¹ If a generator scheduled out for maintenance returned early and produced electricity it would suffer a penalty because its production was not included in a resource plan. Similarly the generator in the resource plan producing less to accommodate the returning generator would suffer a penalty by not meeting its resource plan.

Discussion Point 8

The Authority invites comment on the effectiveness of the Independent Market Operator in carrying out its functions.

Synergy is generally satisfied with the manner in which the IMO has undertaken its role to date, particularly given the substantial volume of tasks required to establish the WEM. However, Synergy has developed some concerns with regard to the separation of governance functions within the IMO. In particular, Synergy notes that the IMO fills the roles of interpreting, enforcing and amending the Market Rules as well as operating and administering the market. There therefore remains the potential that issues which impact on IMO market systems and procedures may not achieve the most efficient/appropriate resolution from the perspective of Market Participants – perverse incentives may potentially direct IMO behaviour. Importantly, the arrangements put in place within the National Electricity Market (NEM) address this concern, with NEMCo operating and administering the market and the Australian Energy Regulatory (AER) being accountable to oversee the effectiveness of the Market Rules.

Discussion Point 9

The Authority invites comment on the effectiveness of the System Management in carrying out its functions.

Synergy is generally satisfied with the manner in which System Management has undertaken its role to date.

Discussion Point 10

The Authority invites comment on any further steps that could be taken to assist Rule Participants in understanding the Market Rules.

Synergy notes that the WEM is governed by the Wholesale Market Rules. These rules, and the concepts embodied therein, are complex and readily open to varying interpretations by Market Participants and the IMO alike. Further, Synergy has drawn to the IMO and Office of Energy's attention previously, that the level of knowledge required to effectively participate in the WEM, all but precludes the involvement of small generators and retailers, effectively making the market design a real barrier to market entry.

Synergy appreciates the support provided by the IMO in providing training in the functionality of the Market Rules and the operation of the underlying procedures. Synergy sees a clear need for this training to be continually refreshed and highlights the need for the IMO to be resourced, on an ongoing basis, to perform this function.

Synergy acknowledges the benefits of the Market Advisory Committee (MAC) in providing a forum for Market Participants to discuss issues associated with the interpretation and operation of the Wholesale Market Rules.

Discussion Point 11

The Authority invites comment on any aspects of the participation of Demand Side Management in the Wholesale Electricity Market that remain unclear to Rule Participants.

Under the Wholesale Market Rules, a DSM aggregator can use DSM resources in three ways:

1. Offer the capacity into the Capacity Mechanism, to be assigned Capacity Credits in return making the capacity available for dispatch by System Management.
2. Enter into a retail contract with individual customers under which the customer seeks to reduce its Individual Reserve Capacity Requirements (IRCR) which results in a corresponding reduction in the retailer's capacity obligations– known as peak load lopping; and
3. Sell its capacity to the IMO on a short-term basis (up to 12 weeks) if a capacity shortage occurs.

The integrated Western Power Corporation has previously been effective in utilising DSM to provide capacity support to System Management. With the disaggregation of Western Power Corporation, Synergy subsequently undertook to provide this support, taking over the Western Power Peak Demand Saver Program. With the creation of the WEM, Synergy certified this program with the IMO.

Synergy has developed some key insights into the risks and issues associated with the capacity certification of DSM within the Market Rules.

Synergy notes that Market Rule 4.11.1(a) requires the IMO have regard, when assigning the quantity of Certified Reserve Capacity to a facility, that the total amount of capacity be available over the period December to July. This effectively sets the minimum level of availability (eight months) that would need to be demonstrated before the IMO could certify the reserve capacity. Synergy sees the operation of this rule as having a significant impact on the viability of a substantial volume of DSM customers – given that many are only available for four months of the year (December to March). Having regard for the load profiles of customers, it is clear that DSM capacity is available on a vastly different basis to traditional supply side capacity – generators.

Synergy is also concerned that the Market Rules do not currently allow customers to hold multiple contracts for the provision of energy and/or capacity. As customers churn retailers are required to contract for new DSM capacity from alternative sources within the customer portfolio in order to meet capacity commitments to the IMO. This is particularly an issue as retailers are required to register their DSM programs some three years in advance to meet the capacity cycle timetable and there is therefore a significant risk of customer churn within that portfolio.

Synergy has also noted that in today's buoyant economy there is an increasing preference by customers to avoid interruption to their production processes, particularly if they have full order books. This manifests itself in a general lack of commitment by many customers to traditional DSM programs.

Having regard for these issues, while Synergy has previously elected to pursue the capacity certification of our DSM program, we now have cause to reconsider this.

Synergy sees clear benefits to both Synergy and our customers, however, of utilising DSM for peak load lopping, thereby reducing our customers' ongoing IRCR and reducing Synergy's capacity credit obligations. We note, however, that this is not without its challenges, particularly in identifying and managing the peak trading intervals.

As a reflection of our understanding of the relative merits of DSM within the WEM, Synergy has for some time called for a review to be conducted by the IMO. We are keen to actively participate in any such review.

Discussion Point 12

The Authority invites comment on the adequacy of the existing rule change process. In particular, the Authority is interested in whether or not the current process achieves an appropriate balance between cost, timeliness and transparency.

Synergy notes that there has been a significant number of the Market Rules subject to review and amendment and this has created a significant regulatory impost for Synergy. The Rule Change processes in place are onerous, with a twenty week process required to amend most Market Rules, although in limited circumstances a fast track approach may be adopted. This being said, from Synergy's perspective it is more appropriate to have a substantial, but sound, review of all prospective Market Rules, rather than expediting them in a manner that results in unforeseen consequences, and the need therefore for subsequent review and amendment. This would result in unacceptable regulatory risk for Market Participants. Synergy therefore views the IMO's current processes as being appropriate given the relative infancy of the market.

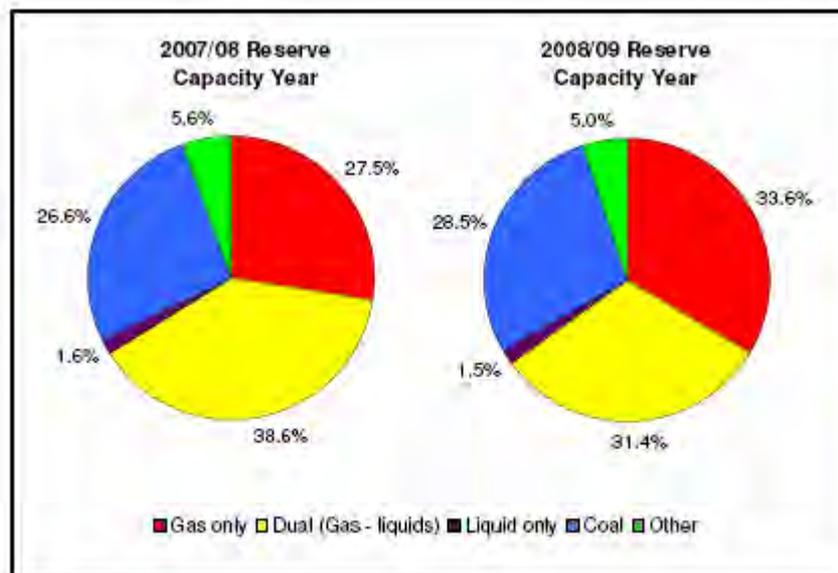
Discussion Point 13

The Authority invites comment on any fuel supply constraints faced by Market Participants, and the impact that any such constraints have on the effectiveness of the Wholesale Electricity Market. In particular, what impact, if any, do fuel supply constraints have on the operation of markets for capacity and energy?

The Western Australian economy has benefited greatly from access to relatively cheap gas (for example \$3.00/Gj, comprising of a \$2.00 commodity charge and a further \$1.00 for transportation). The availability of this cheap gas has driven the penetration of gas-fired generators in the SWIS.

The advent of gas-fired generation has had a number of advantages for Western Australia:

- The lower emissions footprint of gas plant has meant that Western Australia was better placed to adopt to a carbon-constrained economy and the possibility of carbon prices.
- The availability of gas from the North West Shelf has enabled new entrant generators into the WEM (including Alinta and ERM) to compete against the incumbent coal-fired generators (such as Griffin, Wesfarmers/Verve). This has put competitive pressure on these incumbents and increased competition in the WEM.



Source: Independent Market Operator, "2007 Statement of Opportunities" at 10

As shown in the graph above, this paradigm has shifted over the last 18 months, with commodity prices rising from \$2.00 per Gj to almost \$6.00. This shift implies that CCGTs are now unlikely to be competitive with new subcritical coal plant. In fact, the levelised costs of CCGTs are almost 14% higher than that of subcritical coal plant. Synergy views that a carbon price in excess of \$25/tonne CO_{2e} would be required to ensure base-load gas plant is able to compete with base-load coal plant.

This provides an enormous competitive advantage to incumbent coal generators who, in the absence of the development of a new coalfield in the South West, are now able to set prices at the Long Run Marginal Cost (LRMC) of a new entrant gas plant. This implies that wholesale electricity prices are likely to be higher than the LRMC of subcritical coal plant (the efficient market price) until competitive gas or a new coalfield is developed.

Synergy, as a stand-alone energy retailer who is dependent on going to the market to purchase additional power supplies, is in a vulnerable position. Without gas or a new coalfield, Synergy will be highly dependent on the incumbent suppliers. In these circumstances it is likely to be very difficult to undertake a competitive tender process in this environment.

Given this paradigm, Synergy sees a clear need to retain the existing vesting arrangements, thus ensuring that generators cannot use market power (either high prices or quantity restrictions) to extract maximum revenues from buyers, and ultimately, consumers.

Synergy has identified a range of strategies that should be progressed in order to ameliorate this situation:

- Synergy has for some time been an advocate for the private development of onshore gas resources that are dedicated to the domestic gas market, rather than seeking to share fields with LNG producers and competing with netback pricing for major offshore gas development.
- Synergy sees advantages for the development of new coal deposits for electricity generation.
- Synergy sees a clear need for Government to promote the development of new sources of generation to compete against incumbents. Synergy sees the 15% Renewable Energy Target as beneficial in this regard - assisting through the encouragement of wind and biomass opportunities.

We note that these are all long-term options and we therefore recommend that the vesting contract remain in operation, albeit with some price revision, to protect Synergy and customers until the Authority has evidence of a competitive wholesale market being in existence.

Discussion Point 14

The Authority invites comment on the extent to which participants are able to manage their exposure to consequential outages through commercial arrangements. If participants are unable to manage their consequential outages through commercial arrangements, the Authority invites comment on the impact of consequential outages on the effectiveness of the Wholesale Electricity Market

Synergy makes no comment on this Discussion Point.

Discussion Point 15

The Authority invites comment on whether the process for scheduling network outages affects the achievement of the objectives of the Wholesale Electricity Market.

Synergy makes no comment on this Discussion Point.

Discussion Point 16

The Authority invites comment on whether the confidentiality of information has impacted on the effectiveness of the Wholesale Electricity Market and, if so, how?

Synergy makes no comment on this Discussion Point.

Discussion Point 17

The Authority invites comment on whether a more competitive process for the supply of ancillary services would promote the effectiveness of the Wholesale Electricity Market. In particular, do the current requirements under the Market Rules for an ancillary service contract prevent or deter participants for supplying ancillary services and, if so, how?

Synergy makes no comment on this Discussion Point.

Discussion Point 18

The Authority invites comment on any specific event, behaviour and matters (not covered elsewhere in this Discussion Paper) that have impacted on the effectiveness of the market. In particular, the Authority invites comment on any specific events, behaviour or matters that are relevant to the achievement of the objectives set out in clause 1.2.1 of the Market Rules.

Synergy notes that the bilateral or physical dispatch nature of the WEM is limiting its efficiency in comparison to a financial energy market by not allowing optimal dispatch to occur and instead relying on contracted dispatch. Synergy perceives clear advantages for a financial dispatch approach in that it places risk upon generators in relation to meeting their contractual obligations - their dispatch is related to their offer price not their contract position. In this regard financial dispatch encourages the development of hedge or derivative products, which ultimately reduce the risks for both generators and retailers by introducing price certainty. Synergy notes that this driver, and the associated financial hedging products are not readily evidenced in the WEM.

A subset of the optimal dispatch is competitive balancing. Synergy notes that Verve currently fulfils the key role of balancing out the difference between demand forecasts, actual generation dispatch and actual SWIS load. Verve effectively controls the balancing mechanism by acting as the swing generator. It is Synergy's view that a more efficient approach would be to allow all generators to offer balancing via incremental offers and decremental bids from each generator. This was a feature of the original market design, but was deleted in the final version of the market rules because Western Power was not disaggregated at the time the market design was finalised. This should now be rectified.