Response to the Economic Regulatory Authority

Annual Wholesale Electricity Market Report to the Minister for Energy

Market Participant Response

Organisation: ***Griffin Energy***

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INTRODUCTION

Griffin Energy Background

Griffin Energy comprises Western Australian energy sector portfolios of the Griffin Group of companies. Companies operating under the Griffin Energy Group include: Griffin Energy, Griffin Coal and Griffin Power. The latter is the holder of both an electricity licence and a retail licence.

The role of Griffin Energy in the WEM is growing. Griffin Energy is a JV owner and is responsible for the operation of 80MW of wind generation. In addition to this Griffin Energy is currently constructing approximately 408MW of coal fired generation that is due to be commissioned in 2008 and 2009, and is developing a 330MW gas fired generation project, scheduled for operation in 2010.

Griffin Energy and Market Development

Griffin Energy is a supporter of the ongoing development of the WEM. Considerable structural change has occurred in the SWIS over the last 3 years. This change has presented numerous opportunities and challenges to new market entrants. Further development of the WEM will continue to presented opportunities and challenges. Griffin Energy expects that this further development will provide tangible benefits to consumers of electricity as a result of improvements in market efficiency.

Presently, market signals are distorted due to the imposition of market protection. Market Participants (and potential market entrants) face challenges in determining how market signals impact on economic decisions of pricing, investment and structure. The ongoing process to relax barriers to competition is expected to promote efficiency through clarifying market signals.

Regulatory intervention restricts the activities of Market Participants to act in a competitive fashion. Ultimately, Griffin Energy realises that movement towards FRC depends on matters of government policy. Griffin Energy supports the ongoing process of deregulation.

Griffin Energy and the Independent Market Operator

Griffin Energy is committed to the long-term success of the WEM and to achieving, amongst other objectives, the market objectives outlines in the Market Rules. In particular, Griffin Energy is committed to encouraging competition amongst generators and retailers in the South West interconnected system, and the efficient entry of new competitors. It is this perspective, of a new entrant seeking to encourage retail and generation competition, which Griffin Energy actively communicates to the IMO on a regular basis.

Griffin Energy acknowledges the contribution made by the IMO to the successful commencement of the WEM. Whilst the discussion points noted by the ERA (and to which Griffin Energy has provided responses) highlight a number of opportunities for improvement, these are thought to be necessary issues on the path to developing an efficient and competitive WEM. The ongoing support provided by the IMO with respect to Market Rules guidance, compliance, communication, training, Information Technology, thought leadership and market development has assisted Griffin Energy's participation in the market.

RESPONSE TO QUESTIONS

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.

Griffin Energy Response

The capacity mechanism has certainly encouraged investment in new capacity. The capacity mechanism itself however is a highly regulated process that may distort market signals relating to the type of plant required in the SWIS.

The two year capacity cycle, for the approval of capacity credits through to the obligation to supply, is very short considering most power projects are subject to lengthy development horizons, including:

- Securing of manufacturing slots from OEMs and construction timelines;
- Environmental and works approvals of up to 2 years; and
- Network access congestion and short term uncertainty on locational signals.

Griffin believes the capacity cycle, between the approval of capacity credits to the obligation to supply, would benefit from an extension of 1 year in lieu of regulatory and market timing pressures.

Griffin is concerned at the accumulation of power vested in the IMO. At present the IMO has a considerable impact on the investment decisions of Market Participants (either existing or potential). The IMO awards capacity based on a number of factors that have little to do with economic efficiency. Capacity credits, the basic currency of the WEM, are awarded if a participant can prove the they have (or will receive):

- Network access – which is a product of a queuing system in a constrained network which is managed by Western Power, an organisation with no incentive to maximise efficiency of generation investment; and
- Environmental approvals – which is a process managed by a department with an obligation to consider environmental objectives, and is not permitted to consider the efficiency of the proposed investment.

The reserve capacity certification process favours projects that can meet these constraints more easily. Therefore the process might inadvertently discriminate against some technologies and has the potential to encourage excess capacity onto the system (which may reduce the value of existing generation units). This is a significant risk that is likely to discourage new investment.

Discussion Point 2

Bearing in mind the interaction of the capacity market 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.

Griffin Energy Response

The SWIS suffers from a poor load profile. The most attractive plant to meet this load profile at this point in time is mid-merit plant (e.g. combined cycle technology) that can efficiently contribute peak energy and then turn down over night. However current market signals, including gas commodity pricing and availability, gas transport availability and network access, conspire to stymie new investment in this technology. With new base load plant increasingly difficult to justify (due to the poor load profile), there is a risk that while there may be investment in new capacity, there will be an eventual shortage of energy to meet daily demand.

There is an obvious potential for over installation of peaking capacity due to the low financial risk profile inherent in capacity payments. To finance a base load plant, capacity payments alone are insufficient. There is also insufficient volume in the STEM to send a price signal for uncontracted energy. Thus without pre contracting the majority of the plant, investment in base load generation is inherently risky.

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.

Griffin Energy Response

The WEM promotes efficient location of generation facilities to the extent that the IMO only approves capacity where there is access to the network.. There are no locational signals on Western Power about where to build capacity. In fact, Western Power suggests that:

> *"Pricing signals are provided to Users of the network by Networks with the intention of optimising the development of the system including the location of new generation sources. However, Networks may not direct the location for new generation. Therefore, Networks must make prudent assumptions regarding possible generation development scenarios in its network development planning process."*[1]

A greater level of coordination between government and regulatory agencies is required to ensure the efficient development of transmission and distribution networks.

Discussion Point 4

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

Griffin Energy Response

Please refer to response to Discussion Point 2 above.

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.

Griffin Energy Response

No comment.

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.

Griffin Energy Response

The market is in its infancy and the STEM is very thinly traded. The lack of liquidity provides poor price signals and therefore introduces significant risk management issues in new capacity development due to price uncertainly.

New entrant retailers find it extremely difficult to contract for shape from other Market Participants. Therefore, retailers must contract for 'blocks' of 100% load and either top-up from, or spill into the balancing market. Given that Market Participants or other third party participants are reluctant to offer financial risk management products into the market, STEM risks could be managed better if the price signals were clear. That is Market Participants should be encouraged to develop prices for loads less than 100%, despite the fact that prices may be higher in this case.

Significant advantages accrue to incumbents when pricing new contracts as the STEM does not provide reliable price signals.

[1] The 2006 Transmission and Distribution Annual Planning Report

The high cost of trading and implementation of trading systems act as a barrier to market entry. This is exacerbated by the thinly traded STEM as the benefits (potential gains from investing in advanced systems) are minimal in such a moderate market.

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 closer to real time, encourage greater participation?
In the event the day-ahead arrangement is replaced by a real-time arrangement 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.

Griffin Energy Response

The STEM is an artificial market with a cap on prices that does not reflect the real-time demand and supply market forces (e.g. the NEM caps prices at a VoLL of $10,000). The low volumes traded in the STEM and price caps do not make it worthwhile to implement a high cost real-time mechanism. A significant revision of the market model would be required before this would be an attractive option.

Discussion Point 8

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

Griffin Energy Response

As noted in introductory comments, Griffin Energy acknowledges the contribution made by the IMO to the successful commencement of the WEM. Whilst the discussion document notes a number of opportunities for improvement, these are thought to be necessary issues on the path to developing an efficient and competitive WEM.

Discussion Point 9

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

Griffin Energy Response

Griffin Energy believes System Management's interaction with the WEM has been effective 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.

Griffin Energy Response

It is possible to achieve a level of understanding of the market rules necessary for conducting operations in the WEM. However, it is challenging to gain an in-depth understanding of the market rules. This represents a significant barrier to entry for small participants. Whilst IMO training and support has been of assistance, a rewrite of some aspects of the rules (including worked examples) is likely to promote a better depth of understanding of the rules amongst all Market Participants.

Generally, Griffin Energy believes that market rules tend to be too prescriptive (i.e. they over regulate the market). Also, because the Market Rules cannot cover all conceivable issues, many scenarios rely on IMO interpretations. These interpretations should be set out in

guidelines (it is acknowledged that for a new market, there is a requirement to build a body of regulatory 'precedent' before substantive guidelines can be established).

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.

Griffin Energy Response

Griffin Energy believes the concept of Demand Side Management (DSM) is poorly structured in the WEM. While this is not the forum to discuss a more effective treatment of DSM in the WEM, it could be argued that the present structure leads to some confusion as to what constitutes 'effective' DSM and to the risk and reward profiles of offering capacity for DSM.

Griffin Energy believes that while the rules surrounding DSM may be relatively clear to Market Participants, little is understood about Demand Side Management by customers (the holders of the Demand). This has a large impact on the effectiveness of DSM.

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.

Griffin Energy Response

The rule change process is important, particularly in the initial years of the WEM, as there is bound to be revision as the market settles. The Market Advisory Committee (MAC) is an important forum. However, it is important that the MAC must not be captive to individual agendas. The IMO needs to firmly manage the rule change process as an independent arbiter. The membership of the MAC and their interests should be tempered by the requirement to meet the Market Objectives.

In saying this, Griffin Energy believes that there should be a separation of powers between the role of making rules, or changing rules, and enforcing rules (as in the NEM). The IMO should not be both the rule maker and rule enforcer.

Generally, Griffin Energy believes that rule changes tend to make already over prescriptive Market Rules, more prescriptive. An example of this was the rule change regarding SRMC.

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?

Griffin Energy Response

Fuel supply issues are not attributable to the WEM. However, the WEM (based on the capacity market and STEM) was designed on a suite of SWIS assumptions, peculiar to a period in time (e.g. such as gas price and availability). With significant changes to the fuel supply circumstances underpinning the WEM, the appropriateness of the WEM model perhaps requires revision. See discussion point 2 for further comment.

Discussion Point 14

The Authority invites comment on the materiality of the financial impact of consequential outages. The Authority also invites comment on the extent to which participants are able to manage their exposure to consequential outages through commercial arrangements. If participants are unable 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.

Griffin Energy Response

No comment.

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.

Griffin Energy Response

No comment.

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?

Griffin Energy Response

No comment.

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 from supplying ancillary services and, if so, how?

Griffin Energy Response

There is scope in the market rules for System Management to contract for ancillary services with a market participant other than Verve Energy. Griffin Energy is unaware of incentives for System Management to provide services as efficiently as possible. Such incentives throughout the market may help to drive structural efficiency.

Discussion Point 18

The Authority invites comment on any specific events, behaviour or matters (not covered elsewhere in this Discussion Paper) that have impacted on the effectiveness of the market. In particular, the Authority invites comments 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.

OTHER COMMENTS

Griffin Energy provides general comments with respect to the following:

Government Coordination

Griffin Energy would like to see the coordination of government approvals relating to new entrant plant in respect of issues such as: capacity certification, network access / connection, environmental approvals, easements, state agreements, water access and use of shared supporting infrastructure.

Significant costs are incurred by Market Participants (both existing and new entrants) in the development of new generation plant due to the lack of government coordination. Ultimately this inefficiency is passed on to consumers. While it is important to retain the independence of the market operator (IMO) and market regulator (ERA) and other statutory bodies (such as the EPA), Griffin Energy believes there is more scope for an overarching policy coordinator with an ability to provide an interface between Government policy objectives and investment signals. An example of this is the very large, lumpy investments required in the constrained transmission network. Investment decisions made by Western Power have a large impact on the investment decisions of Market Participants. The dynamics of the SWIS (a very large

network sparsely populated at the periphery) imposes difficult investment decisions on Western Power that balance efficient investment with State development outcomes. Some of these decisions would be best managed at a government policy level.