Institutional Banking
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Mr. Matthew Martin
Director, Markets & Regulation
Government of Western Australia
Public Utilities Office
Level 1, Albert Facey House
469 Wellington Street
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Dear Matthew,

Reserve Capacity Mechanism Position Paper – CBA response

Following our discussions, Commonwealth Bank of Australia ("**Commonwealth Bank**" or "**CBA**") is pleased to present the following submission in response to the Position Paper circulated by the Public Utilities Office ("**PUO**") in relation to potential market reform of the Reserve Capacity Mechanism.

Introduction:

Commonwealth Bank welcomes the opportunity to participate in the stakeholder consultation process undertaken by the PUO. CBA has been a lender to Merredin Energy, an 82MW peaking power station financed on a non-recourse single-asset basis ("**project finance**") under the Reserve Capacity Mechanism ("**RCM**"), since the investment was made in 2011.

CBA view on existing capacity scheme:

We understand that the adoption of a 'hybrid' style electricity market (i.e. split between capacity and energy) in WA instead of the 'energy only' market that is observed in the National Electricity Market ("**NEM**") was primarily made due to the relatively small size and isolation of the local electricity network and also the dominance of Government owned entities in the market (Verve and Synergy).

Our view is that overall, the current RCM is well designed for WA and has produced efficient outcomes for the end consumers (despite the significant price volatility experienced and current level of excess capacity).

Capacity prices have been volatile since the inception of the RCM in 2006. Capacity prices are now depressed as a result of falling demand and the Independent Market Operator ("**IMO**") price adjustment which effectively allocates the cost of any excess capacity above the Reserve Capacity Target ("**RCT**"), as determined by the IMO, to generators as opposed to end consumers. As a result, the IMO capacity price has fallen by 35% from $186k/MW/annum (2012-13) to $122k/MW/annum (2016-17). This constitutes a very challenging price environment for generators to maintain economic viability or implement any project financing or refinancing.

The current IMO forecast indicates committed capacity will remain flat (no new investment) for the next 10 years while demand is likely to slightly increase over that period. We agree that the current level of capacity prices (in conjunction with historical volatility and regulatory uncertainty) is likely to deter any new investment in the medium term. However, we consider there is a material risk for demand to further deteriorate as a result of the continuing mining cycle downturn and further penetration of rooftop solar systems. In this context, capacity prices may further deteriorate under the existing capacity scheme.

The WA electricity market has been under review by the State Government for nearly 2 years and this has made project financing or refinancing very challenging in this context. Investing in a power station such as Merredin Energy is a 30 year investment, so long-term stability and visibility in the regulatory regime are key in supporting a long-term investment in essential WA infrastructure across multiple economic / mining cycles.

CBA view on proposed alternative scheme and transitional arrangements:

CBA does not support the proposed auction mechanism and transition arrangements. The proposed auction mechanism is unlikely to be bankable on a project finance basis and the proposed transition would exacerbate the current level of price volatility.

The proposed reforms to the RCM are for a transitional period (with a steeper price curve) before moving to a full auction. The effect of which will be increased volatility in capacity prices making the market more akin to one reliant on floating or merchant power prices. Historically, the appetite from commercial banks for power generators reliant on floating or merchant power prices has been very low. This is particularly the case for peaking power stations in the NEM which are unable to secure non-recourse project finance on a merchant basis. Hence the proposed auction scheme could see banks, who provide project financing to single asset power stations, exit the WA market completely. This could mean that even when capacity prices move higher, in times of short supply, the signal is not strong enough to encourage investment and WA may become short in power supply during peak demand periods. There is added risk in this strategy given the isolation of the local network.

We understand that the proposed auction mechanism and transition would result in even lower capacity prices. The effect would be further financial stress for all generators but we understand the intention is to incentivise large players such as Synergy to proactively rationalise their portfolio of power stations and consequently provide capacity price support by retiring old plants. Single asset generators such as Merredin Energy do not have the ability to optimise a portfolio. Causing financial stress to all generators with the hope that Synergy will follow a given course of action would be a dangerous exercise and would be likely to trigger financial default for a number of generators in the market. A better alternative would be for Synergy and the State Government to agree on a plant retirement plan over the medium term.

Investors chose to enter the WA market based on the existing capacity market structure which combines a regulatory determination of the Maximum Reserve Capacity Price ("**MRCP**") and a market based price adjustment that allocates the cost of any excess capacity (above the RCT) to generators. We understand that some energy retailers or industrial consumers may have some legacy long-term fixed-price capacity purchase agreements in place. Whether these parties are paying more (or less) than the current IMO price is a commercial outcome related to a commercial decision to enter into a long-term fixed-price contract. This is unrelated to the adequacy or effectiveness of the existing RCM scheme.

A sudden move by the WA Government away from this existing regime to a floating or market price might be construed by some investors as Sovereign Risk and could negatively impact on private sector investment appetite going forward.

If major changes were implemented, "grand-fathering" arrangements and financial compensation would need to be considered. The proposed potential changes would result in significant impairment of asset values and possibly bankruptcy for a number of project-financed generators in the market.

CBA recommendations regarding changes to the current scheme:

We question any major amendment of the RCM as the single tool of choice to adjust the current overcapacity given there are a number of key factors, which have mainly caused the current overcapacity being experienced in the market:

- Under the existing RCM, the price signal has not led to any new plant being built since the Merredin Energy investment was made in 2011. This implies that the RCM has not contributed to any new capacity over the past 5 years;
- A slowing resources sector has meant that in recent years, the IMO forecasting of demand has been well above actual demand;
- Generous renewable energy rebates caused a strong uptake of rooftop solar PV which further reduced net demand from the market;
- Under the Vesting Contract, Synergy (then retail only) was able to tender for its capacity requirements. If Verve was not the successful tenderer, it undertook to close down the equivalent capacity of the successful tender to maintain market balance. In the end, Synergy / Verve actually awarded over 1,000MW of capacity purchase agreements and refurbished Muja AB, with the only plant closure (Kwinana C) being completed under the direction from the relevant Minister;
- The rules regarding inclusion of Demand Side Management ("**DSM**") as 'capacity' in the market are too generous. These are proposed to be tightened under the PUO proposal and we see this as a step in the right direction. The Reserve Capacity Price ("**RCP**") is based on the cost of an optimal peaking power plant's build costs which tends to be much higher than the cost incurred by DSM who face no capital outlay. Therefore it provided a strong incentive to market participants to register under DSM to receive the relatively high capacity payments with the expectation that the probability of being called to provide the required service would remain very low.

Given that none of the specific attributes (size, redundancy, competition) of the WA market have changed, we believe the best course of action includes minor adjustments and improvements to the existing capacity regime rather than major reform.

We suggest the following amendments and improvements should be considered as part of the current review and consultation process:

- DSM being excluded from the capacity market;
- 85% discount factor (applied to the MRCP to derive the RCP) to be removed as MRCP is already the efficient cost to build and operate a benchmark peaking power station;
- Synergy to consider closing down some of its older power stations under a medium term plan;
- Although any investment in new capacity is extremely unlikely, a moratorium on new capacity (until the market reaches an equilibrium) may provide additional comfort.

Conclusion:

In conclusion, we believe that material changes to the RCM are not warranted because the current scheme is a good fit to WA and the current excess capacity (above the RCT, as determined by the IMO) has not had any negative cost impact to end consumers paying the IMO capacity price. The current capacity scheme has been successful in attracting sufficient investment in capacity and maintaining reliability standards at an efficient cost for the end consumer. In combination with the balancing market, it has ensured lower energy price volatility for WA (up to $305/MWh, compared to $13,100/MWh in the NEM).

We thank you for considering this submission and would be pleased to clarify any point presented above at your convenience.

Yours sincerely,

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