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Attn: A/Group Manager, Development and Capacity
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By email: capacity@imowa.com.au

Dear Erin

DRAFT REPORT: MAXIMUM RESERVE CAPACITY PRICE FOR THE 2018/19 CAPACITY YEAR

Synergy welcomes the opportunity to make a submission to the Draft Report: Maximum Reserve Capacity Price (**MRCP)** for the 2018/19 Reserve Capacity Year.

The MRCP sets the maximum price that may be offered in a Reserve Capacity Auction and is also used to set an administered Reserve Capacity Price if no auction is required. The MRCP aims to establish the marginal cost of providing additional Reserve Capacity in each Capacity Year and is calculated by undertaking a technical, bottom-up cost evaluation of the entry of a 160 MW open cycle gas turbine generation facility in the Wholesale Electricity Market (**WEM**) in the relevant Capacity Year.

The proposed $156,400 per MW per year for the 2018/19 Capacity Year represents a decrease of $8,100 or 5.1% from the 2015 MRCP of $164,800 per MW.

Synergy considers that it is a reasonable principle that the IMO should adopt the latest regulatory thinking and application of the methodology for determining the rate of return. That is, where allowed by the Market Procedure, the IMO should use what has actually been applied by regulators in recent decisions rather than the methodology outlined in the Economic Regulation Authority's (**ERA's**) 2013 Rate of Return Guideline which the IMO has adopted.

Specifically, Synergy considers that the debt risk premium (**DRP**) used by the IMO in the calculation of the Weighted Average Cost of Capital (**WACC**) should be revisited. Particularly as the Market Procedure specifically states that the DRP should be consistent with current accepted Australian regulatory practice.

In calculating the WACC used in determining the draft MRCP, the IMO engaged PricewaterhouseCoopers (**PwC**) to provide advice on the DRP, which it derived by applying the ERA's "bond yield" methodology to BBB rated bonds. In deriving the DRP, PwC noted that the average term to maturity of the sampled bonds was approximately 4.89 years, which is lower than IMO's target 10 year benchmark term to maturity. As such, PwC specifically highlighted in its report to the IMO that it's proposed weighted DRP is likely to be under-estimated.

Synergy is concerned that the DRP methodology used has not incorporated the most recent changes adopted by the ERA in its Final Decision for the Mid-West and South-West Gas Distribution Systems Access Arrangement 2015 – 2019 (as remade in September 2015)[1]. Rather relying on the 2013 Rate of Return guidelines – which is now a superseded and outdated methodology. There is further evidence that the application of a 10 year term for debt being the accepted regulatory practice with AER's decisions in May, October and November 2015 for electricity and gas businesses on the East Coast.

Synergy notes that the ERA Rate of Return guideline is due for review in 2016 and, given it is likely that the next guideline will reflect the more recent decisions, Synergy strongly suggests that the IMO review the DRP and recalculate using a 10 year term for debt.

Finally, Synergy is concerned that the WACC used in determining the MRCP is based on regulated network businesses and does not sufficiently reflect an appropriate risk profile for developing generation assets in the WEM. This should be addressed in the next five year review of the MRCP methodology. Further, Synergy considers that it is timely for the theoretical power station adopted as the basis for the MRCP calculation be revisited to take into account any changes in technology or products available in the market.

Should you require any additional information please contact Jacinda Papps by email at: Jacinda.papps@synergy.net.au or by phone on: (08) 9424 1917.

Yours sincerely

Will Bargmann

WILL BARGMANN
GENERAL MANAGER CORPORATE SERVICES

[1] Specifically the use of a 10 year term for debt.