
**Wholesale Electricity Market – Submission to Procedure Change
Proposal No: PC_2011_XX; Title: 5-yearly Review of the
Methodology and Process for Determining the Maximum Reserve
Capacity Price**

Submitted by

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Submission

Clause 2.10.7 of the Wholesale Electricity Market Amending Rules provides that any person may make a submission for a Procedure Change Proposal by filling in this Procedure Change Submission form.

Submissions for Procedure Changes that relate to the Power System Operation Procedures and IMO Market Procedures should be submitted to:

Independent Market Operator

Attn: Manager Market Development & System Capacity
PO Box 7096
Cloisters Square, Perth, WA 6850
Fax: (08) 9254 4399
Email: market.development@imowa.com.au

1. Please provide your views on the Procedure Change Proposal, including any objections or suggested revisions:

Argonaut Capital Limited (“Argonaut”) is a Perth based corporate advisor, with expertise in the Western Australian energy sector. Argonaut specialises in (amongst other things) raising capital for, and providing mergers and acquisition and corporate advice to, WA power generation businesses and companies seeking to invest in the WA power generation sector. In recent years, Argonaut has acted for multiple WA power generation companies, and has successfully attracted funding for WA power generation businesses from local, east coast and offshore investors.

Argonaut also maintains relationships with equity and debt providers who have expressed interest in investing in the Wholesale Electricity Market (“WEM”).

Given its experience in the WA power sector, Argonaut believes it is well placed to provide feedback on the current Procedure Change Proposal that is representative of the views of financial investors and lenders.

The availability of capital to market participants, along with ongoing support from existing WEM investors and lenders, is a critical part of maintaining an efficient, reliable, competitive and orderly market.

A key reason for financial investor interest in the WEM is the ability to gain indirect exposure to WA’s relatively strong economic growth outlook. Conversely, financial investors perceive that the two key risks associated with financing WEM peaking and mid-merit/intermittent projects are pricing and regulatory risk.

As peaking power stations often do not have a high quality energy sales contract, capital providers place a large emphasis on the robustness of the WEM capacity credit regime, which is unique in Australia. The pricing of capacity credits is seen as the greatest risk to financing peaking power stations, due to historical volatility and the annual setting of prices.

Power generation projects are long term investments, which require investors to be comfortable with cash flow projections over 20 to 30 years. This long term investment horizon is at odds with annual re-setting of Capacity Prices. When such a timing mismatch is combined with a volatile Capacity Price history, as is the case in the WEM, then pricing risk becomes a key hurdle for financiers.

The second largest risk to financing WEM projects is perceived to be regulatory risk. This is linked to pricing risk due to the annual price setting mechanism. However, the five yearly pricing methodology review process adds another layer of uncertainty to WEM investment returns. Considering that a 30 year investment would incorporate six methodology reviews,

significant change and uncertainty is introduced via the regulatory mechanisms that govern WEM investments.

On a recent transaction where Argonaut acted as advisor, two of the “four pillar” Australian commercial banks were not comfortable with Western Australian capacity credit regulatory risk due to volatility in capacity credit prices on an annual basis for reasons that were not always clear or expected.

Argonaut understands that the capacity credit market is new and evolving but the ongoing change in pricing and methodology creates undue uncertainty. Consequently many large capital providers will not currently consider financing WEM peaking power stations.

In addition to the above, the Proposed Procedure Changes, which if introduced would be likely to reduce Capacity Prices (both MRCP and RCP) by approximately 24%, would have dire, far reaching and long term consequences on the ability of the WEM to both attract new capital and to retain existing capital.

According to Argonaut's modelling, a 24% Capacity Price reduction would reduce the post-tax internal rate of return (“IRR”) on a typical diesel fired peaking power station from 10-11% to less than 6%. 6% IRR is substantially below the cost of equity. Consequently, a 24% price reduction would result in no further peaking power stations being built in the WEM.

Further, a 24% Capacity Price reduction would most likely precipitate significant distress for some existing market participants, as a result of lending defaults being triggered. At current Capacity Prices, the Debt Service Coverage Ratio (“DSCR”) for recently built projects geared at 60% is typically around 1.75-2.00x (excluding revenue from energy generation). The DSCR would fall to between 1.3 and 1.6x under the proposed pricing methodology. Argonaut expects that such deterioration in DSCR would result in multiple market participants breaching covenants on their debt facilities. Combined with the asset price devaluation that would occur following a 24% reduction in revenue, it is plausible that some market participants may be placed in voluntary administration.

Clearly this would have a negative impact on the reliability and efficiency of the WEM. Competition would also be reduced, both by the exit of existing players, and the lack of entry of any new competitors.

The logic of Argonaut's expectations outlined above is supported by comparing the proposed theoretical cost of building a 160MW peaking power station, to reality. Argonaut's experience is that peaking power stations presently cost between \$1 million and \$1.1 million per MW, fully installed. Under the proposed changes, Argonaut's understanding is that the theoretical cost of building a 160MW peaking power station would be \$800k per MW (\$127.3 million for 160MW). This is between 20% and 27% below the real cost of building a 160MW peaking station. Argonaut believes it is important to ensure theoretically set prices continue to reflect reality, in order to preserve the integrity and relevance of Capacity Prices.

A serious longer term impact of a 24% price reduction would be the large and permanent increase in regulatory risk associated with the WEM. Even if prices were increased back to a level that allowed investors to make an acceptable return, the potential for further unforeseen and uncommercial regulatory changes would be likely to deter new capital from flowing into the sector. There is unlikely to be any easy way to undo the damage that would be caused to the reputation of the WEM in financial markets as an investment option.

In summary, the currently Proposed Procedure Change would have catastrophic effects on both existing and prospective WEM financiers and would irreparably damage the WEM's reputation as an investable market in the future. Argonaut strongly recommends that Capacity Prices are maintained around the current levels to reflect the true cost of building a 160MW peaking power station, based on recent projects that we have arranged finance for, and our knowledge of the project finance market.

Argonaut suggests that long term pricing stability should be a key priority in setting Capacity Prices. Rather than setting the price annually and reviewing the methodology every five years, Argonaut proposes that Capacity Prices be set on a longer timeframe (10 to 15 years), with annual price changes linked to inflation. An annual adjustment based on surplus capacity could continue to be built into prices in a similar fashion to the current formula, in order to provide price signals to encourage or discourage new capacity depending on projected supply-demand conditions, without significantly and unfairly disadvantaging existing capacity.

Argonaut suggests that the automatic 15% reduction in MRCP could also be removed, as it appears to be superfluous and arbitrary, and only serves to complicate the pricing process.

The above approach would provide greater stability and visibility of prices, and increased investment certainty for financiers, whilst retaining sensitivity to supply/demand dynamics and embedding price signals to adjust new capacity accordingly. This approach would reduce regulatory and pricing risk; encourage competition, and increase efficiency and reliability. Administration costs would also be reduced due to the removal of the current lengthy and expensive annual price setting process, resulting in minimisation of the long term cost of electricity supply.

2. Please provide an assessment whether the Procedure Change Proposal is consistent with the Market Objectives and the Wholesale Electricity Market Amending Rules.

Argonaut believes the current Procedure Change Proposal is in direct conflict with four of the five Wholesale Market Objectives, as follows:

A – Changes that result in a 24% Capacity Price reduction would reduce the efficient and reliable production of electricity as a result of no new capacity being added to the SWIS, and the possibility of existing peaking power station owners being placed in voluntary administration, and older units being retired.

B – It is expected that no new “peaking” participants would enter the market under a 24% lower pricing regime. Existing competition is also expected to reduce as a result of withdrawal from the market by current market participants.

C – A 24% Capacity Price reduction would have the largest impact on peaking power stations (gas and diesel) and the least impact on base load power stations (coal and gas). Mid-merit and intermittent producers (including wind, solar and gas) would be impacted more than base load but less than peak providers. Clearly this would favour coal (and to a lesser extent gas) fired base load power stations, and discriminate against renewable and peaking projects, which are intended to be the target capacity in the Market Rules and Market Objectives.

D – By halting future capacity increases and possibly putting existing participants into administration and/or receivership, the proposed changes will result in higher long-term electricity prices in the SWIS. Ultimately, additional incentives and substantially higher long-term prices would be required to encourage new capacity in an environment of far higher regulatory risk.

3. Please indicate if the Procedure Change Proposal will have any implications for your organisation (for example changes to your IT or business systems) and any costs involved in implementing these changes.

Not applicable to Argonaut.

4. Please indicate the time required for your organisation to implement the changes, should they be accepted as proposed.

Not applicable to Argonaut.