

**STANDING COMMITTEE ON ESTIMATES AND
FINANCIAL OPERATIONS**

2012–13 AGENCY ANNUAL REPORT HEARINGS

**TRANSCRIPT OF EVIDENCE
TAKEN AT PERTH
TUESDAY, 28 JANUARY 2014**

**SESSION ONE
SYNERGY ENERGY**

Members

**Hon Ken Travers (Chair)
Hon Peter Katsambanis (Deputy Chair)
Hon Martin Aldridge
Hon Alanna Clohesy
Hon Rick Mazza**

Hearing commenced at 9.40 am

Mr WALLY BOROVAC

Chief Financial Officer, examined:

Mr JASON WATERS

Chief Executive Officer, examined:

Mr KARL MATA CZ

Chief Financial Officer, examined:

Mr GEOFF ROBERTS

General Manager Energy Markets, examined:

The CHAIR: On behalf of the Legislative Council Standing Committee on Estimates and Financial Operations, I would like to welcome you to today's hearing. Can the witnesses confirm that they have read, understood and signed the document titled "Information for Witnesses"?

The Witnesses: Yes we have.

The CHAIR: Thank you. Witnesses need to be aware of the severe penalties that apply to persons providing false or misleading testimony to a parliamentary committee. It is essential that all of your testimony before the committee is complete and truthful to the best of your knowledge. This hearing is being reported by Hansard and a transcript of your evidence will be provided to you. The hearing is being held in public, although there is discretion available to the committee to hear evidence in private, either of its own motion or at the witness's request. If for some reason you wish to make a confidential statement during today's proceedings, you should request that the evidence be taken in closed session before answering the question. Government agencies and departments have an important role and duty in assisting Parliament to review agency outcomes on behalf of the people of Western Australia. The committee values your assistance with this.

Before we commence, do any of the witnesses wish to provide an opening statement?

The Witnesses: No, we do not.

The CHAIR: For the benefit of everyone, I have one question before I open it to other members. There were a number of questions on notice that were submitted; we have received those and the committee has made them public. I am trying to clarify whether the provided answers relate to the merged entity or simply the old Synergy. One of the reasons I ask is because in answer to part 12 you indicated that you have negligible tangible assets and therefore a rate of return or weighted average cost of capital is not a meaningful metric. I can understand that for the old Synergy but I would have thought that for the merged entity that would not be the case.

Mr Waters: I think on the basis that you are asking the question for the year ending 2013, the assumption is that that was a previous financial year question, hence relating to the former Synergy electricity retail corporation.

The CHAIR: Okay; so anything that relates to pre-2013 is Synergy.

Mr Waters: That was certainly our interpretation of that question.

The CHAIR: No worries, I might ask you some questions about what you predicted going forward a bit later on. I start by inviting other members who have questions they wish to ask.

Hon ALANNA CLOHESY: I want to go to the \$558 million increase in operating subsidies over the period 2013–2014 for Synergy. Is Synergy receiving subsidies for contestable customers?

Mr Waters: I will ask my former Synergy counterparts to answer that question, Karl or Geoff. I do not believe so.

Mr Matacz: No; Synergy does not receive any subsidy for any contestable customer, be they market-based contracted customers or contestable customers on tariffs.

Hon ALANNA CLOHESY: Okay; why then has the government included Synergy's losses in the marketplace sector in the midyear financial review with respect to operating subsidies to the state's finances?

Mr Matacz: Can I ask what reference?

Hon ALANNA CLOHESY: Yes, I am just getting it. The first one is on page 43.

Mr Waters: Which document; the annual report?

Hon ALANNA CLOHESY: The midyear review. The first reference is on page 43 but I am trying to find the actual table.

[9.45 am]

Mr Waters: I think I know the table you are referring to.

Hon ALANNA CLOHESY: Okay; it is page 25.

The CHAIR: Of the midyear review.

Mr Matacz: Are you referring to table 7 on page 25?

Hon ALANNA CLOHESY: Yes.

Mr Matacz: Yes—the question being?

Hon ALANNA CLOHESY: Well, has the government included Synergy's increase in losses in the marketplace sector in this table?

Mr Matacz: This is the impact of state finances, so the variation in the midyear review was a variation that related to the increase in the CSOs; that is, the increase of \$558 million. The impact of that was the actual reduction in payments to government and that is what is reflected in the general government operating balance negative variances.

The CHAIR: So if you are not including the losses as part of the subsidies from government, how do you internally manage that? How are you accounting for it in your books? On one hand you have your subsidies for non-contestable customers, but how do you manage your losses for your contestable customers? How does that get transferred into your final bottom line if the subsidies that are provided to you for your overall operating costs are not going towards subsidising contestable customers?

Mr Matacz: First of all our results are presented as a consolidated Synergy result so it includes all customers related to the Synergy business. When we present the financial accounts as consolidated accounts it includes both the franchise and contestable customers. In establishing the subsidy that we actually receive from the franchise customers, it is on the basis of what is determined to be the cost associated with delivering the different current products. So what we do is allocate the overall costs; the costs of different current products to determine the cost-reflective rate for each tariff, excluding market-based contracts. We also assess the tariff levels to derive contestable tariffs at a cost-reflective rate. What we then do is use our allocation of cost to determine what the cost-reflective rate for the franchise tariffs should be. On the basis of that, the difference between the tariffs charged to the customer and the total cost across those tariffs is then met by way of subsidy. In terms of our reporting we do not do it on an actual basis, we do it internally on a management accounting basis for the market-based contracts and our franchise customers.

The CHAIR: That ultimately means that the state is picking up the losses for your contestable customers.

Mr Matacz: Any losses made in market-based contracts are basically consolidated into the total overall Synergy result.

The CHAIR: Yes, so if the government is recovering that cost, then effectively you are getting subsidies for your contestable customers.

Mr Matacz: We are not getting subsidies for contestable customers —

The CHAIR: You are not getting it directly but you are indirectly getting your contestable customers subsidised. If you were in the private sector you would have to write off that capital in some way, or write off that loss in some way, off your capital base.

Mr Matacz: Any losses in the market-based contracts of course are reflected in the total profit position of the business. That means that any losses reduce our overall profit, which reduces either the tax equivalent payments to government or dividend payments to government. Indirectly you could say yes; but directly no because the tariff revenue we get from our franchise customers is compensated against the actual true cost of that tariff by way of subsidy. In 2012–13 that was in excess of \$334 million.

The CHAIR: Three hundred and thirty-four million dollars is the loss?

Mr Matacz: No, that is the subsidy—the difference between the revenue from the customer and the actual cost for that tariff.

The CHAIR: For contestable customers at the moment, what is the loss that you are making each year?

Mr Matacz: We have estimated our market-based contracts lose about \$60 million on average in our forward estimates period, per year.

The CHAIR: Is that increasing?

Mr Matacz: No, it is not. We would expect that, given the merger, to actually significantly reduce. One of the things that needs to be recognised is that, given the existing contracts that Synergy operated under—in terms of its supply contracts and its capacity requirements—we had minimum take. What would happen is that if you actually lost the market-based contracts, the actual loss would then be transferred directly to the franchise customers because you would have to allocate the overall cost across a smaller base, which means that the franchise market would pick up a greater portion of the cost.

Hon PETER KATSAMBANIS: How would that differ in the new merged entity?

Mr Matacz: In the new merged entity basically what happens is that first of all the existing contracts, although they still are retained to some extent, as we enter into new contract arrangements with our contestable customers, we will be able to optimise the purchase arrangements between the wholesale business of the new entity and the retail business of the new entity. We will be able to provide competitive prices and make margins on them.

Hon PETER KATSAMBANIS: You describe it as “optimisation”—is there some capacity within that optimisation from your internal point of view or is there a possibility that that may well create anti-competitive tensions in the market more generally?

Mr Matacz: No, simply because the prices offered to the retail business unit of the new entity will be the same price that the wholesale business unit would provide any customer of the wholesale business unit. Any retailer could buy at the same price—assuming the same conditions under which they wanted to purchase—as what the retail business could. It would make no difference.

Hon PETER KATSAMBANIS: Is there some sort of equivalent, to use a relatively well-known term, terminal gate pricing that is posted and is available for purchase by both your retail side and any other company out there in the market?

Mr Waters: As part of the merger-related reforms, from about midyear onwards we will be publishing a suite of standard products which will be fixed term, fixed block pricing for access by the whole market. That will be at a price with an inclusive buy–sell spread that anyone in the market can buy or sell to as a holder of one of those contracts. In the more bespoke product sense, which is away from standards products—that is someone asking for a unique supply arrangement—the obligations on the new business are to price those arrangements in a non-discriminatory manner. There are some strong protections in the legislation, in the regulations, in regards to that matter. The optimisation that Karl was just referring to is effectively going to be available to the whole market progressively as third party retailers come to the new wholesale trade desk of the new Synergy and can access energy on the same or similar pricing basis as the internal retail business unit.

Hon PETER KATSAMBANIS: So with the more bespoke products, will the pricing be transparently reflected out in the marketplace or will it simply be contractual?

Mr Waters: It will be confidential to the extent that if someone was to make a confidential request for pricing from WBU against a bespoke product, if a third party was to ask for the exact same product confidentially, that pricing would be the same, but the reason that that aspect is confidential is that we want retailers to be able to maintain the competitive advantage of the nature of the bespoke product that they are asking for so that retail innovation is effectively rewarded in the market.

Hon PETER KATSAMBANIS: Who regulates this area? Who is the effective regulator if there is a retailer customer, if you like, or a retailer who is aggrieved by this pricing process?

Mr Waters: Various forms of regulation will apply to the new business. There are protections against this matter from various fronts. The ring-fencing provision is a critical one. My understanding is that is regulated by the OAG. I think, separately, the ERA has a role to play. Then, as an overlay to that, there is competition law which would be effectively imposed by the ACCC to the extent that there is a breach of overarching competition law. If you want more detail on the regulated structure, I would have to get further information to you. There is quite a bit of what I consider at this stage is well designed regulation utilising a number of bodies to ensure that those protections are in place and enforced.

Hon PETER KATSAMBANIS: Is there any involvement in the regulatory side of things by any of the organisations involved in regulating the NEM?

Mr Waters: Not at this stage in terms of the NEM-specific bodies, no.

Hon PETER KATSAMBANIS: In particular a lot of the regulation around the NEM is instead of the ACCC, or the ACCC's normal powers, depending upon where the NEM ends up being because it may still reside within the ACCC somewhere, the regulatory framework. It seems to me as though we may well be creating a new wheel in regulation and invoking the ACCC's powers where in the rest of Australia a regulatory regime has been created to avoid invoking the ACCC's regulatory powers.

Mr Waters: I guess I cannot pass comment on the specifics of that one. However, what I will say is that the governance and regulatory framework around the NEM is specific to the NEM design. We have a distinctly different market design over here so we have a distinctly different governance and regulatory structure around the market design. The broader regulatory framework that applies to Synergy is utilising the Western Australian agencies that are present in the electricity market generally around the ERA and OAG in the case of the entity. In regards to your thought about us creating an additional wheel, I cannot comment on it. I will simply say that our arrangements over

here are dramatically different from the east coast. We have a different market; we have a different structure. We have something that has been designed to suit our unique conditions.

Hon PETER KATSAMBANIS: I understand that. My concern at the end of the day is that if this does get into an area where people are asking questions—hopefully it does not—but in any market structure there is the possibility that people will put up their hand and say, “We want the regulator to referee this.” We will end up eventually, from what you have described, in a federal framework. That federal framework will be completely different to the federal framework that applies to the rest of Australia. I am just trying to think out how it will play out. I do not profess to know what the magic formula is either.

The CHAIR: When you say the “OAG”, are you talking about the Office of the Auditor General?

Mr Waters: Yes.

The CHAIR: How does he, or they, police the internal operations of your organisation?

Mr Waters: My understanding is—and again I can take this one on notice and get further detail—they have a requirement for a regular audit program of processes and matters of conduct within the new Synergy that they will discharge on a regular basis.

Mr Borovac: That is right. It is mandated within the regulations that they will conduct an audit on a December year end looking at our compliance with the regulations and the requirements under the regulations.

The CHAIR: That is in your regulations?

Mr Borovac: It is under the new regulations that have been enacted in conjunction with the amendments to the bill that created the new Electricity Generation and Retail Corporation.

The CHAIR: How does anyone direct the Auditor General to what they have to do?

[10.00 am]

Mr Matacz: This is in relation to segment reporting within the new business. We will show separate reporting for the retail business unit, the wholesale business unit and the generation business unit. Its role is to ensure that there is segment reporting and that it is conducted fairly.

The CHAIR: There was an offer of further information relating to the questions asked earlier by Hon Peter Katsambanis.

[*Supplementary Information No A1.*]

Hon PETER KATSAMBANIS: The integrity of the process in which the OAG will be involved is really critical to public confidence in the whole “ring-fencing”, which is the term used before. I am heartened by the fact that the OAG will have that role. Will it have any expanded investigatory capacity beyond its normal audit function in this type of role? By way of explanation of my question, will the capacity exist for some market player to say that the market is not operating well and ask the OAG to investigate the ring-fencing arrangements or will it simply be an annual health check done through an audit process?

Mr Waters: I am not 100 per cent sure of the specifics of that. However, I guess that as with any operating system, once it is in place and we have a sense of the manner in which the new market construct is operating, there will obviously be scope for periodic review and updates. I am not certain that anything has been cast in stone in terms of the timing, nor am I 100 per cent sure at this point of the avenues by which market participants who are aggrieved by aspects of the design have a way of raising those things other than through the natural channels of elevating them to Minister for Energy, who is ultimately responsible.

Hon PETER KATSAMBANIS: Have you had discussions with the OAG as to how it will work in practice?

Mr Waters: Those discussions are scheduled to occur soon. It is obviously early days for us all.

Hon PETER KATSAMBANIS: I do understand that it is early days. There are lots of questions and, hopefully, it will all settle well, and the dust will settle and people will move on. However, in this interim period, you will appreciate we get the questions as well.

Mr Waters: To your point about the criticality of this aspect and the confidence in the market, you are absolutely right—it is critically important that having undertaken a change like we just had in regards to the merger and the regulatory changes, that the contestable and competitive aspects of the market are not lost or impacted in any way. The design has been to achieve just that and to ensure that that confidence in the market is maintained so we get continued third party retail participation and, indeed, third party private sector investment in the long term, which is the clear desire of us all in terms of the market evolution in the longer term. A key plank of the design has been to ensure that that confidence is not impacted in any way.

The CHAIR: Going back a little way, you said that the loss of contestable customers was effectively transferred to the contestable market because you had fixed assets —

Mr Matacz: Fixed contracts.

The CHAIR: But if you lost a contestable customer, it just got transferred across and picked up as part of the subsidised business. Am I right in saying that?

Mr Matacz: No, no. What we are saying is that if you lost your market-based contracts, any fixed costs that existed in the business, be it through contract arrangements or internally, would be allocated across all the customer segments, including franchise. You would not necessarily eliminate all costs if you lost a significant proportion of your market-based contracts. As a result of that, you would actually have to spread more cost into the franchise market than you would do currently.

The CHAIR: How does that change under the new system? You still have the Verve generation assets and, as I understand it, you have a significant surplus of capacity.

Mr Matacz: Yes, that is true. But what would happen is that we will be able to optimise dispatch. You can purchase through the retail part of the new business from the generation part at an optimised dispatched level and make decisions about purchasing from external or internal generation. You would be able to purchase more optimally at the retail level.

The CHAIR: How can you purchase more optimally at a retail level when the generation assets are now part of the same organisation? How can you more optimally choose to go outside of that organisation for generation than you could under the old model?

Mr Matacz: Because aside from the old Verve, we have other existing contracts. If the cheapest production was available outside of the old Verve, then you could purchase as much as you wanted.

The CHAIR: What does that do to the Verve side of things? It means it is sitting there with unutilised assets that have a fixed cost.

Mr Matacz: The incentive for it is to optimise its dispatch to reduce its costs.

The CHAIR: How does bringing them all into the one organisation assist that rather than make it harder? Mr Waters has to present a set of books at the end of the financial year that minimises the losses across the two entities.

Mr Waters: If I can try to explain it this way, the former Synergy had access to buy power under a suite of contracts. It had a combination of fixed, take-or-pay and additional variable energy available above the minimum take-or-pay limits. On the other side of that, the former Verve had those contracts with Synergy, plus other contracts with third party retailers, plus a role in bidding energy into the market where it would make a lot of trades. Effectively, what we are now saying is that all of Synergy's previous contract positions—a large part was its contracts with Verve—have

now fallen away in terms of minimum levels. In addition, the significant amount of energy that Synergy would have bought under contract has been transferred into the same body within the new Synergy, the wholesale business unit, that does both organisation of contract purchases that were previously under the former Synergy, as well as the dispatch of all Verve facilities. Rather than two businesses trying to optimise separately—obviously there are natural mismatches to the extent that you can achieve organisation under that arrangement—it all comes to a single decision-making body that is able on a given day to look at what is the most efficient allocation of fuel into the plants to achieve the lowest cost production. That is essentially what Karl was referring to. That is as opposed to a previous situation in which the former Synergy, because of its take-or-pay position, was required to effectively nominate more energy than it was able to physically take and to try to sell that energy back into the market, some of which would have been bought by Verve or other participants. What we know is that through a lack of information there was a natural reduction in efficiency in the decision-making that was taking place.

The CHAIR: As I understand it, as prices are going up, we are seeing a significant drop in demand which, according to your calculations in questions on notice, suggests a 17 per cent drop in demand. Is that right?

Mr Matacz: Yes, that 17 per cent is from 2008–09—the drop in demand.

The CHAIR: The answer to question (1) regards the additional operating subsidy payments to —

Mr Matacz: That 17 per cent is a lower demand. That is part of the impact of the increase in the subsidy to the 558. If you look at the current forward estimates period compared with the SDP, the actual drop in demand over the two budget periods—the SDP and the midyear review—is the franchise market with 7.1 per cent.

The CHAIR: What is the 17 per cent?

Mr Matacz: It is a percentage of the total 558 —

The CHAIR: Which is driven by that drop in demand.

Mr Matacz: Yes, that is a minus 17, basically.

The CHAIR: The demand has dropped by 17 per cent, but it has increased the cost by 94?

Mr Matacz: Yes, that is true.

The CHAIR: Should the \$94 million actually be a minus or a profit?

Mr Matacz: No, no. That is a subsidy impact. The drop in demand means that if Synergy is selling less energy, it gets less subsidy based on the volume—there is the volume part as well as the cost part. A drop in volume means we should get less subsidy, but that drop in volume is overshadowed by the increasing costs.

Mr Waters: The way I read it is that the \$94 million is a reduction in the extent of the subsidy as a result of the reduction in volume.

Mr Matacz: Yes. It is a volume impact, not a cost impact.

The CHAIR: That would be right for the Synergy side of the business, but with the generation side now involved, surely a drop in demand will mean that assets are sitting unutilised?

Mr Matacz: It depends because you are looking only at the franchise market. You have to look at the total market —

The CHAIR: So unless you can find contestable customers to take up —

Mr Borovac: Exactly. There is always going to be Synergy or other contestable customers with other retailers.

The CHAIR: Effectively, the \$94 million saving on the subsidy gets transferred to the other part of your business, which somehow needs to pick up that cost structure.

Mr Matacz: No. Although there is a drop of 7.1 per cent in the franchise market, there is an increase in the contestable market. The variation between the SDP and the midyear review in terms of sales across the whole market across the four years is negligible in total. But the impact is that we are seeing a significant drop in the franchise market, which had been compensated by increased sales in the contestable tariff and the market-based contract segments.

The CHAIR: Why is there excess capacity in the system? Is that just in the franchise part of the system?

Mr Roberts: No, it is across the board.

Hon PETER KATSAMBANIS: That is a different set of questions.

Mr Matacz: It is a different set of questions.

The CHAIR: One of the questions I will ask is: why are we opening up Muja A and B when there is a surplus of demand in the system? As I understand it, the expectation certainly for the domestic consumer is what has been termed a “death spiral” as basically costs go up and people use less power so the costs are increased again and people continue to use less power. You are saying that that is addressed by an increase in the contestable market, but that only works if you are able to secure that contestable market and you do not have ageing infrastructure, because people can bring on new infrastructure and provide that power at a cheaper cost.

Mr Matacz: The increase in the contestable market basically means that our forecast over the forward estimates is reasonably flat so we are not seeing any significant variation in our forecasts from one planning period to the next. The issue about capacity relates to where capacity exists in the market to a surplus extent to actually meet that. At the moment the impact is really about the excess energy in the market and the excess capacity in the market. Our load —

The CHAIR: But you just said earlier that the contestable market was increasing and now you are saying it is flat.

Mr Matacz: The aggregate is flat.

Mr Roberts: The actual size of the contestable market is not great; so, if anything, we are seeing that stabilised as a result of changes in the manufacturing sector etc. Synergy has grown its market share within that defined market. Our market share has predominantly fallen since disaggregation and now we have stabilised at about 42 per cent or 43 per cent of that market. We are not anticipating that our market share will continue to increase at that level, but the size of that market is not growing.

The CHAIR: The total market is not growing but there is a transfer from the franchise to the contestable; the contestable is growing to basically cover the drop in the franchise market, meaning the overall market is not —

[10.15 am]

Mr Matacz: It is reasonably flat based on our current forecasts in the total aspect.

The CHAIR: And you are saying you are growing the share of the contestable market.

Mr Roberts: It has grown over the 2012–13 period, but it has pretty well stabilised now. Our forward projections do not indicate that we will grow our market share within that contestable market significantly.

The CHAIR: What sort of margin were you getting on the contracts that you let to grow that?

Mr Roberts: We were not able to attract a positive retail margin because of the previous discussion where we wrote that business on the basis that we had to support existing long-term contracts with Verve.

The CHAIR: So you were basically acquiring market share by putting power out at below cost.

Mr Roberts: It was still the right financial decision, yes.

The CHAIR: Yes, it might be the right financial decision, but the cost at which you were providing that power into the market was actually below the cost for you of that power. You were doing that to minimise your losses. I get why you did it, but the bottom line is you were putting power at below the cost of production into the contestable market.

I come back to the question: why are we then continuing to refurbish Muja AB if you do not have a contract for it and further purchase of the power and there is a surplus of energy in the market?

Mr Waters: I guess, in answering that, we have got to step back a little bit and look at the circumstances at the time the Muja AB project was committed to. There was certainly at that stage a substantial amount of growth forecast in the market. In addition to that, there were some fairly grave concerns post-Varanus around the fuel diversity within the system and our exposure to potential future shortages and the availability of gas, so the decision was taken at that time on the basis of a set of commercial parameters. It had to be a commercial project, which it was at the time. There is no doubt, since then, that demand has fallen away. However, the fuel diversity issue remains one of the challenges of the market generally. I guess, just as a comment also about not having a customer, Muja AB does have a private sector off-taker who buys all of the capacity out of those four units and 50 per cent of the energy that is able to be produced.

The CHAIR: But that is basically 3 and 4, though, is it not? So with 1 and 2, you do not have someone to take the —

Mr Waters: We have the capacity sold from 1 and 2. The energy out of 1 and 2 is available to be sold on a merchant sale basis into the future, although the energy was never unit specific; it was simply the fact that these units are 60 megawatts each and there are four of them. One hundred and twenty megawatts is sold as energy during the day and 60 megawatts overnight, which equates to any two of the four units, with two units available to be dispatched into the market to make a margin as and when they are required to be into the future. But, importantly, the 240 megawatts of capacity from all four units was sold under contract and committed to at the time to the third party retailer.

The CHAIR: I have one final question on all of this. How vulnerable is Synergy to a death-spiral scenario?

Mr Waters: My sense right now is that, post-merger, our emphasis is to now recalibrate this business on its new gentailer structure. The point right now is that I do not have an answer to that question until we get the ability to properly consolidate this business. Bearing in mind that we are 28 days into the merger, we certainly have not had a chance —

The CHAIR: With most mergers, you do this sort of work before the merger, with all due respect. I know it was not your decision.

Mr Waters: We have got to put a lot of work into this company. We accept that Synergy has some unique challenges in that we have a long-term commitment to power stations, both those that were formerly the Verve-owned and operated power stations and power stations under contract, as is the whole market committed to energy and capacity that is currently in excess of the demand. One of our priorities as a business is to address our fixed-cost structure. Before I make any comments about death spirals or any of those other terms that get bandied around, we have got to unpack this business and get a handle on our own cost position and try to work out what efficiencies we can now bring to bear in light of the merger structure.

If you take your question and, I guess, translate it globally, we are not alone in this phenomenon that retailers around the world are facing around the reduction in demand, I think, as you described it—reduction in demand such that the fixed costs of the structure upstream of that, including the network and generation facilities, are not met, so costs go up and people demand less. That is a global challenge for retailers everywhere. We are not simply going to be sitting adjacent to that point saying, “It’s a global phenomenon and there’s nothing we can do about it.” We need to get cracking as Synergy and do whatever we can to deal with this problem ourselves. There is going to be a review conducted this year. We will come to grips with our cost structures and no doubt, at a future point in time, we will be able to provide further advice on our position in regard to that matter.

The CHAIR: Can you guarantee that the merger will provide efficiencies and savings?

Mr Waters: There is no doubt that there are going to be efficiencies and savings out of the merger.

The CHAIR: You can guarantee it?

Mr Waters: Yes. Immediately, you have gone from two boards to one and two CEOs to one. There is the very early leading edge of savings, albeit small initially, that is already going to be realised.

The CHAIR: Although the board has got bigger.

Mr Waters: The board might have got bigger by one or something; I am not certain of the numbers. There is going to be a range of efficiencies delivered; in time we will absolutely uncover merger-related efficiencies. There is no doubt about it from my perspective.

Hon RICK MAZZA: It is my understanding that some country areas receive subsidised electricity; is that right?

Mr Waters: All franchise customers receive subsidised electricity. There are specific regional arrangements, though, that maybe Geoff can —

Mr Roberts: Yes, there are regional arrangements around air-conditioning subsidies. Clearly, Synergy in terms of operating the SWIS and Horizon operating outside the SWIS have different subsidy arrangements.

Hon RICK MAZZA: So how do you actually assess which areas should receive a subsidy for extra air-conditioning requirements or whatever the case is?

Mr Matacz: It is above some parallel.

Hon RICK MAZZA: Above the —

Mr Waters: A particular parallel.

Hon PETER KATSAMBANIS: You guys do not operate in that space, though, do you?

Mr Matacz: In some cases we do.

Mr Waters: Yes, with some of our northern customers.

Hon RICK MAZZA: There was a case reported recently in the media where a town—I am a little hazy on it, but Morawa —

Mr Waters: Morawa?

Hon RICK MAZZA: Yes, Morawa springs to mind. They had been receiving this subsidy for quite a number of years. How did Synergy overlook that subsidy that apparently they were not entitled to?

Mr Waters: I will let Geoff answer that one. My understanding was that was an administrative issue.

Mr Roberts: It was an administrative issue. I think the subsidy was reversed. A relatively small number of customers were involved, I think, because it was a small town. I think it was Morawa, from memory. That decision was reversed.

Hon RICK MAZZA: They had been receiving that subsidy for about 10 years or more, had they not?

Mr Roberts: That is my understanding, yes.

Hon RICK MAZZA: A protracted amount of time.

Mr Roberts: I would have to take some of this on notice; sorry. I am a bit hazy on the details.

Hon RICK MAZZA: I would like that taken on notice because it seems like an extraordinary amount of time that this administrative error had continued and these people were receiving the subsidy. Of course, that has, as I understand it, been written off for the preceding time and now these people are paying a higher rate. The other thing is that I would have thought that Morawa is hot enough that air conditioning was required a lot, so I just wonder: are there other ways of assessing where this subsidy should be applied besides just a line on a map?

Mr Roberts: I would have to take that on notice. I am not across the details; sorry.

[*Supplementary Information No A2.*]

Hon RICK MAZZA: Why have greenhouse emissions increased by nearly 15 per cent when the supply of electricity has increased by only around five per cent?

Mr Waters: Could you take us to that reference, please, if you do not mind? Is that in the annual report?

Hon RICK MAZZA: Yes.

Mr Waters: In the Verve annual report?

Hon ALANNA CLOHESY: Yes.

Mr Borovac: Have you got a specific page you can take us to?

Hon RICK MAZZA: It is page 10.

The CHAIR: While you are looking for that, do you mind if I give it to Martin to ask a question on the Morawa issue?

Hon RICK MAZZA: Yes; that is fine.

Hon MARTIN ALDRIDGE: Just following on from the Morawa issue that Hon Rick Mazza just raised, a letter was published in full in the *Morawa Community Scene*, which is their local newspaper, on 15 January 2014. It was a letter from the Minister for Energy and in his letter he said that he could confirm that the town of Morawa was removed in error from the list of towns receiving the air-conditioning rebate and had since been reinstated, that all customers previously eligible for the rebate in Morawa would continue to receive this as per normal, and that he understood that Synergy was backdating air-conditioning rebate payments to Morawa customers to 1 December 2013. Is that statement correct? What I have just learned from what you have just said is that they were inadvertently receiving a subsidy that they no longer were receiving.

Mr Roberts: My understanding is that they were inadvertently receiving that subsidy and then it was removed, but was reinstated very quickly. My understanding is that Morawa customers that fell into that category continue to receive that subsidy.

Mr Waters: If you do not mind, I would like to sweep that up and take that one on notice, I guess, as a broader question for us to come back with some facts around the Morawa situation, because we do not quite have the ideal mix of people to be able to answer that with any precision.

Hon MARTIN ALDRIDGE: So they were eligible, and for a period of time they stopped receiving the rebate, and that has been rectified, but you will take it on notice and clarify it.

Hon RICK MAZZA: That must be a change in policy, because obviously it must be below that parallel that you were talking about, so somehow that is not included.

Mr Waters: I am sorry; I am struggling to find the reference in the annual report.

Hon ALANNA CLOHESY: Maybe it is page 13.

The CHAIR: I will just add all that other information to A2, so it will be a combination for Hon Rick Mazza and Hon Martin Aldridge.

Hon ALANNA CLOHESY: There are two different annual reports. There is the glossy one and then there is the one that was tabled in Parliament, so the page numbers might be different.

Mr Borovac: Without having the specific drivers, in general the extent of CO₂ emissions is dependent upon the type of fuel and the type of plant that we would be using. In this instance, for example, in 2012 we would appear to have been using fewer coal-fired power stations and more gas-fired power stations, or purchasing in the market. For example, in 2012 we had some significant outages at Muja so that we would have been, in their stead, purchasing electricity in the market to make sales or using gas-fired power stations within our portfolio. You are right; the more we sell, you would think there would be more emissions. However, it really is very much dependent on the type of fleet that we are using. As a generality, we will try to use the coal-fired power stations because they are cheaper, even with the carbon tax. However, that is not always possible because of outage programs or even in instances where, for example, we have these large heat waves, we would be immediately moving to gas-fired power stations to actually meet those peaks. There is any number of reasons why there would be a variation in the dispatch.

Hon RICK MAZZA: So gas-fired power stations emit more greenhouse gases than coal?

Mr Waters: No, significantly less.

Mr Borovac: Significantly less; roughly half, you could say.

Mr Waters: It is a complex matter. If you look at the table on page 14 in mine—maybe 13 in yours—our sales increased. Naturally with that, the total greenhouse gas emissions increased from 7.5 million tonnes to 8.6 million tonnes, but at the time the carbon intensity actually fell marginally. With that uplift, we would have been burning an incremental increase in coal-fired output, because, as demand increases, we try to prioritise to put our coal into service, which is our lowest-cost fuel, but in doing so we also were able to increase the efficiency of the fleet by running the plants at slightly higher loads, which has reduced slightly the specific carbon intensity.

[10.30 am]

It is quite complicated, but I guess, as a general rule of thumb, coal is a significantly cheaper fuel than gas, but coal has roughly twice the carbon emissions of gas. That is the natural tension that we face day to day in our dispatch decisions in relation to carbon emissions.

Hon RICK MAZZA: On page 27 of the Synergy annual report there is a performance overview and you refer to the number of SmartPower customers for 2011–12 and then for 2012–13. I note that the number of SmartPower customers actually dropped off by a little over 3 500. Any reason why there is that trend?

Mr Roberts: I think one of the issues potentially there is the take-up of PV. A SmartPower customer may be attracted to PV installation. We have seen a quantum increase in the number of customers taking up PV. They may in fact revert to PV rather than —

Hon RICK MAZZA: Sorry, but PV is?

Mr Roberts: The solar cells on the roof, so it is photovoltaic.

Hon RICK MAZZA: I am not up with acronyms.

Mr Roberts: Sorry, I will watch that, but it is the solar cells. So, the customers are probably more attracted to the solar cells solution than potentially a SmartPower solution.

Mr Waters: So, on that basis, Geoff, you are suggesting that some of that 4 000-odd people could have moved into the renewable energy buyback scheme—which would move them from the classification in that table—which obviously went from 92 000 to 119 000?

Mr Roberts: Right.

Hon MARTIN ALDRIDGE: Does that measure of the number of SmartPower customers refer to a tariff arrangement rather than having a smart meter?

Mr Waters: I think they have smart meters and they pay a varying tariff arrangement based on a time-of-use basis.

Hon MARTIN ALDRIDGE: So, those people with the solar PV and accessing REBS would still have smart meters, because you need to have a smart meter, do you not, to connect to the grid?

Mr Roberts: They have smart meters as well.

Mr Waters: Yes.

Hon MARTIN ALDRIDGE: Okay, so that was —

Mr Roberts: SmartPower is a specific time-of-use product, which is independent of solar panels and the REBS product.

Hon RICK MAZZA: I refer to Synergy, page 750, in volume 2 of the budget papers. On the works in progress table, you have got “Asset Replacement Program and Critical Core Server Disaster Recovery”. I see there is a significant jump of the estimated expenditure for 2013–14.

Mr Matacz: So you are referring to the increase in 2013–14?

Hon RICK MAZZA: Yes. In the asset replacement program there is obviously a significant jump in the expenditure and also in the forward estimates. I am just wondering what the program entails, what assets you are actually —

Mr Matacz: The critical information technology asset replacement, for which an allocation of \$10.7 million has been provided, was actually subject to a specific business case—as referred to by the EERC, which subsequently was presented and approved—which enabled us to actually get that increase in capital expenditure. That \$10.7 million relates to replacement of most of the 80 servers that exist within the Synergy IT infrastructure base. We have somewhere in the vicinity of in excess of 70 servers and those servers range in age from predominantly plus four and five years. The \$10.7 million is basically a program of activity over the next few years to replace the server fleet, to actually look at also replacing our storage capability within our server fleet and also to ensure that we have got appropriate disaster recovery.

The CHAIR: Just noting the time, we have been going for an hour. We are going through till 12, so we will just take a five-minute break.

Proceedings suspended from 10.34 to 10.42 am

Hon PETER KATSAMBANIS: I just have some questions that are sort of coming off some of the comments Hon Rick Mazza made in relation to the carbon tax. If the carbon tax was removed, what would be the savings to the business and what of those savings would then be passed on to Western Australian electricity consumers?

Mr Waters: That is a complex question. I guess I will ask Wally. The part of the business that incurs the tax is Verve, which is now the generation side. Wally, I think our total carbon payment was \$200 and —

Mr Borovac: It was \$224 million, which was effectively a pass-through to the end consumer. There is obviously some pass-through through the retail business in addition to that, but, yes, \$224 million. So, I guess that is effectively an expense that the consumer pays directly.

Mr Waters: We obviously produce CO₂ in our power stations and pay the tax on that. We also buy power as Verve from third party generators and those arrangements are a pass-through. We then parcel up that carbon tax for the portion of our sales that was the former Synergy that is now the retail business unit, which I think was about 70 to 75 per cent of our sales. We would pass that cost through to Synergy who would pass it through to end-use customers. I think by the time it gets to the A1 tariff customers, Karl, it is about a —

Mr Matacz: Synergy collects from customers \$214 million, that is excluding GST, per annum and they did that in the 2012–13 financial year. We collected \$214 million ex GST from customers.

Hon PETER KATSAMBANIS: In carbon tax?

Mr Matacz: In carbon tax payments, yes.

Hon PETER KATSAMBANIS: So what percentage does that equate to of your revenue collection from A1 tariff?

Mr Matacz: It is the 10 per cent; it has been up just over 2c.

Hon PETER KATSAMBANIS: Sorry?

Mr Matacz: Just over 2c —

Mr Waters: It is 2.4c out of 24c or whatever.

Hon PETER KATSAMBANIS: Right, so it is 10 per cent.

Mr Matacz: Yes.

Hon PETER KATSAMBANIS: So if the carbon tax was removed, effectively there would be a 10 per cent reduction in the average electricity bill of an A1 tariff customer.

Mr Matacz: On the consumption charge, yes.

Hon PETER KATSAMBANIS: On the consumption charge. How much would that equate to across the whole bill on average?

Mr Matacz: Ten per cent of the bill. The average annual bill is, I think, between \$1 200 and \$1 300 for a residential customer.

Hon PETER KATSAMBANIS: So it could be \$120 or \$130 savings a year.

Mr Matacz: Yes.

Hon PETER KATSAMBANIS: As soon as the carbon tax is removed, then you would be in a position to pass that on immediately.

Mr Waters: We would be required to.

[10.45 am]

Hon PETER KATSAMBANIS: Terrific.

The CHAIR: But you are not actually at cost recovery, so will you pass it on or will you pass it on and then increase your tariffs by 10 per cent to try and get back to cost-reflective pricing?

Mr Waters: We do not set the tariffs; that is a different process. I guess from our perspective, we would see the cost reduce. The consumers would see the tariff effectively reduce. The fact that —

The CHAIR: That is what I am asking, but you just said you do not set the tariffs.

Mr Waters: No, we do not, but —

The CHAIR: Will the tariff reduce or does it have to be a policy decision of government to reduce the tariff?

Mr Waters: I cannot comment.

The CHAIR: No, I am just trying to understand: is it a policy? Will the tariff that the consumer pays be reduced? If the carbon tax is removed, will it automatically reduce the tariff or will that be a decision of government as to whether they reduce the tariff or not?

Mr Matacz: It is a decision of government whether they reduce the tariff or not, but the overall cost of a kilowatt hour to Synergy would be reduced by the cost of carbon. Carbon is the cost to us; if you remove the carbon cost, then we would have a 2.4c reduction in our overall cost. That is our overall cost and that recovery of the cost is either through the tariff or through the subsidy. The government can either reduce the tariff and maintain the subsidy or increase the subsidy. That decision is the government decision.

Hon PETER KATSAMBANIS: But overall there would be a 10 per cent saving one way or the other.

Mr Waters: From Synergy's cost perspective.

Mr Matacz: On our cost perspective, sure.

Hon PETER KATSAMBANIS: What is the cost to the business of the renewable energy tariff?

Mr Matacz: Of the renewable?

Mr Waters: We could not provide a specific on the RET—generally speaking, renewable energy that the business is required to buy or the renewable energy certificates that they are required to, I guess, relinquish under that arrangement. Karl may have some total figures on that.

Mr Matacz: Yes. I can tell you that, for instance in the midyear review, the total cost of the SRES program—because there are two programs; there is the small scale and the large scale. Close to over \$100 million over the forward estimates period is our cost.

Hon PETER KATSAMBANIS: Is it \$100 million over the four years of the forward estimates?

Mr Matacz: Sorry, I have got that as a percentage change. So, \$129 million per annum is our total cost.

Hon PETER KATSAMBANIS: \$129 million per annum —

Mr Matacz: In renewables.

Hon PETER KATSAMBANIS: — in renewables is what it adds to the cost of the tariff?

Mr Roberts: It is in the order of five per cent of our total cost related to renewables.

The CHAIR: That is the total cost; that is not the additional cost of renewables versus that energy being provided by a non-renewable source?

Mr Waters: We are talking about the renewable energy certificates—the REC scheme, which is made up of the small-scale certificates and the large-scale certificates. The total cost over the four-year forward estimates period is \$407 million. That is what we pay.

The CHAIR: To purchase them?

Mr Waters: To purchase them, yes, and meet our obligations. It is \$100 million a year on average.

Hon PETER KATSAMBANIS: That is passed on to the consumer either in tariff or through a CSO subsidy?

Mr Waters: That is right; it is part of our cost stack.

Hon PETER KATSAMBANIS: I will get off that for a second. I will come back later to issues around renewable energy and changes to energy mix if I get an opportunity.

We also touched on Muja AB before. Where are we at with Muja AB? The last I heard—correct me if I am wrong—units 3 and 4 were operating. I will not confuse everyone with the unit numbers. Two units were operating near or at capacity or at maximum ability based on demand, and the other two units were struggling, the last time I updated myself on that. To start with, where are we at today with the actual project and the delivery of the project?

Mr Waters: As of today the boiler repairs necessary on M1 and M2 are both complete. Unit 2 is fully reassembled a long way into its commissioning progress. It achieved first synchronisation Wednesday last week and we are expecting that sometime this week, it will achieve the operating requirements necessary to achieve IMO certification, in which case it will become a fully commercial unit, so that will bring us up to three out of the four units finished. The remaining unit, being M1, is about three to four weeks away from achieving that same milestone, so we are very, very close to the completion of work on M1 and M2.

Hon PETER KATSAMBANIS: Since a lot of this came into public knowledge in the early part of last year, as the refurbishment of those two units has continued, have any other problems been discovered?

Mr Waters: With Muja AB?

Hon PETER KATSAMBANIS: Yes, at Muja AB.

Mr Waters: With 3 and 4, which are the two that were commissioned early last year, they had run with relatively good availability over the course of the year. Any plant that is either built from new or brought back into service from refurbishment follows what we call in the industry bathtub curve availability, where it starts off with relatively poor availability and increases and you get a good run and at the end of life you get an increase in unavailability. We have seen Muja 3 and 4 go through that and we have had periods of good running and periods of clusters of little issues we have had to work through. Generally speaking, I have been pleased with M3 and M4; they have run reliably. On M1 and M2, to be honest, other than the issues that are well documented in regards to the boilers, we have found nothing else of any major concern. Certainly the fact that M2 has now achieved its system synchronisation—I was at Muja on Wednesday last week and it was running 15 megawatts part load for the day—you would like to think you have overcome the majority of major risks associated with bringing old plant back to service. Basically, everything we know about M1, given where it sat with its plan, it would have the same status. No; other than this boiler issue, we have not uncovered any other major problems with any of the four units in Muja AB at this stage.

Hon PETER KATSAMBANIS: What will be the bottom-line cost of the project if everything goes according to plan between now and the final commissioning synchronisation—whatever term is used—of all four units?

Mr Waters: Wally, correct me if I am wrong; I think the final approved budget was \$336 million.

Mr Borovac: Correct.

Mr Waters: We are currently sitting —

Mr Borovac: Around \$300 million.

Mr Waters: Is it that low? I thought maybe \$310 million. We do not have the final figures yet, but I think by the time we are finished we will be \$12 million to \$15 million under that final approved budget from government.

Hon PETER KATSAMBANIS: What is the projection for the overall cost benefit of this project. Is this project going to end up costing the taxpayer, the customer, Western Australia, or will it be revenue positive? What are the projections on that?

Mr Waters: The internal Verve view, upon understanding the full scope of the boiler repair last year, is that it will return a positive, albeit small, net-present value to the state, which means that,

given the extent of investment that has had to be undertaken to complete the project, it will still be profitable, but clearly not to the extent it was going to be profitable when the project was originally envisaged. But we stand by the fact that over the course of its operating life Muja AB will be a profitable project for the state.

Hon PETER KATSAMBANIS: Will it be profitable to the extent it will still present an appropriate business case on its profitability had the costs that are ultimately going to be borne for the project been known at the time the decision was made?

Mr Waters: Look, that is not probably something I can answer, in all honesty—to go back in time and speculate. I will say that if the extent of the boiler repair had been identified when the project was originally scoped, the costs of undertaking that repair would not have been the same because it would have been done under a totally different regime as part of the EPC works as opposed to doing it how we did, as quickly as we did during the course of the last 12 months. Arguably, you would say that you would do any investment for a sum of money that gives a positive return, although knowing what we know now, given the extent of additional costs that have been incurred, that probably would not be the case. Certainly, if you look back at the key decision point last year around the decision of do we go forward with this project or not or partially abandon it, when you consider the amount of money that had been spent at that point in time for the incremental money that had to be spent to then finish the project, that was a very sound investment decision.

Hon PETER KATSAMBANIS: As a business, you would have a rate of return that you work towards for your power stations.

Mr Waters: Yes.

Hon PETER KATSAMBANIS: I do not know what that is, but if we were to spend \$300 million, \$310 million or \$330 million—somewhere in that ball park—would the projected return on this project be the sort of projected return that you or your board would accept as a decent return to go ahead with the project?

Mr Waters: The project will have a risk-weighted discount rate, or rate of return, as a fundamental component of that business case and utilising that calculated rate of return on the total costs that have been spent, the project will yield a positive net-present value which on the basis means you would get the tick as a business.

The CHAIR: What is the risk rate of return estimated on that project?

Mr Waters: That is something I would have to come back with on notice, if you do not mind.

[Supplementary Information No A3.]

Hon PETER KATSAMBANIS: I would appreciate that.

The CHAIR: What is your target rate of return?

Mr Waters: Our WACC. Yes that is something we could provide as well?

Mr Borovac: We operate around 12 per cent before tax.

Mr Waters: As Verve.

The CHAIR: As your rate of return on assets —

Mr Borovac: That is our target. It obviously fluctuates depending on the year.

Hon PETER KATSAMBANIS: That is as Verve.

Mr Borovac: As a portfolio, correct.

The CHAIR: Once Muja comes on stream and you have got the access to the full 240 megawatts, what impact will that surplus capacity then have on the rest of your business? When you did your

calculations, did they include what impact that would have in terms of creating surplus capacity? I assume you will then have to switch off other units somewhere else.

Mr Waters: The actual dispatch will be optimised via the market, so it is not a default decision that says, “Well, when Muja AB comes on something else goes off”, because over the course of the year between summer and shoulder periods in autumn and spring and again the winter peak period, the production of Muja AB will fluctuate. The upshot though, of the question around what will be the impact on our portfolio, is that it is a positive impact because it enables us to have access to lower cost coal-fired energy in the period beyond about 2015 to 2017, when we transition from our legacy gas contracts into new market-based gas contracts that will see an uplift in our gas price, Muja AB, gives us a hedge, if I can explain it that way, against those high gas costs. From that period of time Muja AB actually comes into its own, given the fact it is significantly lower cost energy in relation to, I guess, the marginal energy cost available in the market, which is based on the higher cost gas that will flow through to the system towards the end of this decade.

[11.00 am]

The CHAIR: Does the rate of return that you are talking about factor in all your assets or is that purely based on Muja as a standalone asset?

Mr Waters: At one point, one component of the business case will have assessed Muja AB as a standalone asset, but then as a part of the summation of cost and benefit from the project, it will have included the broader portfolio impact.

Mr Borovac: Correct.

The CHAIR: The other side of that, though, is that your greenhouse gas emissions will go through the roof if you go across to coal from gas.

Mr Waters: Yes; so, the go-forward optimisation includes that on the basis that we assumed at that point in time there was going to be some form of carbon impost into the future. It effectively optimises for that factor. We have some quite sophisticated modelling tools that run these models. The basis for that, even in light of some form of carbon impost going forward—we do not expect it will be in place from 1 July but I guess it may be at some point during its forward life—is that the cost of, as I said, relatively low cost energy burning coal, inclusive of a carbon impost, still results in —

The CHAIR: Yes, but if you do not have that and you just transition across to coal, there will be an increase in greenhouse gas emissions. If we as a nation want to meet our international obligations, we will have to find greenhouse gas emission reductions in some other form.

Mr Waters: Sure.

The CHAIR: If you are moving across, I think you were saying, to double emissions, although it will be cheaper power, it will significantly increase your greenhouse gas emissions, which will then impact on any capacity to meet any international obligations about greenhouse gas emissions.

Mr Waters: That is at the core of our challenge as a business in the longer term in regard to reducing our greenhouse gas emissions. We all understand clearly the challenge around reducing CO₂ emissions. It really comes down to the time frame over which we can do that with the least economic cost. Right at the moment, when we look at the factors in this market, particularly around two things—the availability of technologies and the price of alternative fuels—it is actually very hard to see an economic transition away from our traditional fossil fuel base towards cleaner sources of electricity in the near term. By that, I mean the 10 to 15-year horizon, simply because we do not have alternative technologies available to us yet, and to simply start burning gas and halving our carbon emissions would lead to such a dramatic increase in price that would be largely unsustainable economically. We are looking at the longer carbon solutions around carbon

abatement, which is going to bring us into more advanced forms of renewable energy and potentially clean coal down the track.

Hon PETER KATSAMBANIS: That is something Verve as a company has been highlighting as an issue since the time of your predecessor, if I am correct.

Mr Waters: Yes; correct.

Hon PETER KATSAMBANIS: It seems to be effectively impossible, without a massive price slug, to achieve massive abatement in a shorter time frame, particularly given the investment that has already been sunk into various forms of power production.

Mr Waters: Absolutely.

Hon PETER KATSAMBANIS: That would also now translate across into the bigger issue that Hon Ken Travers touched on earlier in relation to changes in demand—changes in consumption really, rather than demand. I do not know whether either Verve or Synergy has, as a baseline, worked out whether the reduction in demand for power has correlated with any actual reduction in consumption of power. I am not sure if I need to explain that.

Mr Waters: No; I understand your point exactly. It depends from my perspective—correct me if I am wrong, Karl—it comes down to the specifics of the market segment you are looking at. My sense is that in the C&I and small-to-medium enterprises—being commercial-industrial segments—we have seen a real decline, and if not a real decline, we have seen forecast loads not emerge. In the residential sector, my sense is that we have seen a flatlining, but clearly I do not think we have seen the dip in consumption that we have experienced as a dip in demand because of the extent of self-generation that is occurring behind the meter through the rollout of PVs.

Hon PETER KATSAMBANIS: Are you able to measure the consumption of self-generated power or are the meters not able to provide you with that information?

Mr Matacz: No, but we estimate it. At the moment, our view is that approximately 50 per cent of the installed capacity and the energy generated is used within the household and 50 per cent is actually exported.

Mr Waters: We estimate that amount is around 300 megawatts of total domestic solar capacity.

Hon PETER KATSAMBANIS: What has the reduction in demand been in megawatts?

Mr Matacz: In sales?

Hon PETER KATSAMBANIS: Yes—for residential customers.

Mr Matacz: For residential customers, we have seen almost a 13 per cent reduction in the average consumption per household over the last four years.

Hon PETER KATSAMBANIS: I am trying to get a sense of whether this is actually a change in consumption patterns or simply a change in “purchasing patterns”. It is important because I believe that if it is a change in consumption pattern, that is great, but if it is a change in purchasing patterns, it raises a massive equity issue that we as a society will have to face. That is because the way we price our power tends to suggest a further cross subsidy from people at a lower socio end to people at a higher socio end, and the trend really is a change in purchasing patterns where people who can afford PVs and have the capacity, or even the legal ability, to install PVs are able to get another cross subsidy.

Mr Matacz: I can say that some of the analysis that we have been able to undertake has shown that the biggest driver of consumption patterns amongst the franchise market is price elasticity. As the tariffs are increasing, the actual impact on the customer’s consumption is probably the single largest contributor followed by efficiency of home appliances. Over time most people are buying more home appliances, but those appliances are far more efficient than the ones they are replacing. Then,

of course, there is the introduction of solar PVs, which is also reducing average consumption over the whole franchise market.

The CHAIR: How much of the demand is driven by drop in demand that is driven by price elasticity?

Mr Waters: That is a hard one.

Mr Matacz: That is a very difficult one to estimate. We model that if you get a four or five per cent increase in tariffs you are likely to get a one per cent reduction in average consumption per household. That is for modelling purposes, and trying to validate that is extremely difficult.

The CHAIR: There must be a point at which you reach a minimum. People might turn off their second fridge, but they will always want to keep one fridge, and they will still have to do their washing and have some lighting, although they might convert to other forms of power for heating and what have you.

Mr Matacz: Sure.

Hon PETER KATSAMBANIS: Again, appliance substitution also raises an equity issue. It is all well and good to replace your old washing machine with a far more water and power efficient one, but it is going to cost you \$800 or \$900 upfront. The purchasing decision is different for different classes of people.

Mr Waters: My sense is that for existing households it is a tight business model to justify the move away from, as you said, to more efficient fridges. For example, you only buy a fridge every 15 years; they are a high-cost item. The opportunity extends into efficiency at a household level, which is certainly a change that is coming with regard to increasing efficiency standards in the building code for new homes. That is when people outlay the money from the start. They put in low-wattage lighting and better design for cross ventilation giving a reduced requirement for refrigerative cooling. They are a couple of examples in which we are likely to see the tail to this play over a long period of time. For the existing housing stock, I agree with your point that you can only go so far in reality.

Mr Matacz: Also, the uptake of air conditioning has almost reached its peak. Now it is replacement rather than a further increase in the number of households that have air conditioning, because most households now have some form of air conditioning.

Hon ALANNA CLOHESY: Why did Verve close its renewable energy unit?

Mr Waters: It was, at its core, a commercial decision. If you look at the last few years, Verve has been extremely busy in the renewable energy space. We extended the Albany wind farm and increased its output by about a half—if I am correct, Wally?

Mr Borovac: Yes.

Mr Waters: We built the Mumbida wind farm and the Greenough River solar project in joint venture. We ended up with a fairly big group as a result of the extent of projects we were running. Then, all of those projects came to a natural close, so we had a group of engineers who were, I guess, just not busy enough for the organisation to retain. The view we have now, which I think will prevail for the new Synergy, is that with the flattening demand we have talked about, we do not see the continued rate of investment in the market that we saw over the last few years. We are installing this plant ahead of what we saw was going to be continued steady growth in demand. The fact is that that has not happened and we are seeing a flat spot in development as well. Like any commercial business, we need to make tough decisions sometimes in regard to reductions in staff. In addition, the energy minister has been clear that he sees more private sector investment in future projects in lieu of Verve undertaking the body of work that it has done over the last few years. In response to that, we have also made the decision to reduce numbers in that group. Bearing in mind, from the generation side, a business like Verve, when you look back through its history into

Western Power and SECWA, has always gone through periods of construction and lulls in construction. We were building Collie power station in the nineties as Western Power, and we had hundreds of people—then we finished Collie and we had to shrink. These groups by design are quite scalable. What we always retain is the core intellectual property around the process, so we still have a small group of people that if circumstances were to prevail in the future and we needed to undertake a project for government again —

Hon ALANNA CLOHESY: As in increased demand?

Mr Waters: Yes, and maybe a decision that wants us to make that investment in lieu of the private sector for some reason, then we will be able to rescale that group back up. We have not thrown the baby out with the bathwater. In the same way that other commercial businesses upscale and downscale their business groups depending on need for those services, we simply had to make that tough call.

Hon ALANNA CLOHESY: In the new merged world, I hear you saying that there are no real plans for upscaling any renewable energy?

Mr Waters: We see a need for ongoing investment in renewables, because Synergy, being a big retailer—the biggest retailer in the state—will have a large obligation for meeting the LRET–SRES is separately handled. We are talking about LRET here, which is the large renewable energy scheme. However, right at the moment, everyone is on hold on that until we get some direction from the federal government in terms of the targets it is going to reset for us under that scheme. Everyone had been working previously to a 41–terawatt hour target by 2020, which in fact is not 20 per cent, but 28 per cent. It is likely that target will be softened—although until that decision is made, we cannot be certain. Once we get some certainty federally, Synergy business will then make a decision on when, how and by whom we procure our obligations to meet the LRET target. That is something that I gather in the next 12 to 18 months we will have to revisit as a business and get a handle on.

[11.15 am]

Hon ALANNA CLOHESY: So, it is 28 days into the merger to the new world and you would have to admit it was a rushed process; much more rushed than any merger of an organisation that you would have seen in the past. What sort of problems have you identified as part of the merger process for the new Synergy?

Mr Waters: That is a good question. The merger process; my sense on these things and maybe I take a hard line on these matters, but we were given nine months effectively to get ready and that was enough. If we had been given 18 months we would have taken 18 months. The fact is that we were given nine months and we got it done within nine months. Looking back on it, my preference would be for a shorter, tighter time frame because if you want to get people motivated to a common cause then you give people a tight time frame to work towards. Everybody involved in that merger process from broadly within government and certainly within the two entities really stepped up and worked—can I say it?—bloody hard over that nine months to get us ready by 1 January. My sense is that we were extremely successful and I think everybody did a very good job.

What I am incurring now are the typical leadership challenges you incur as a CEO. I have separate businesses; I have to make decisions in the near term on appointing an executive team and ultimately appointing staff to a new structure, particularly in the shared services area. That is going to be a very busy six months for the organisation to complete that task. Post-merger there are some issues we have to sort out. We touched on it a minute ago in regard to Synergy's IT infrastructure. Verve has separate IT infrastructure so the new Synergy effectively has two IT services, if you like, internally. We have to make some decisions as to how we integrate those in the future. We have to re-establish a whole suite of new business systems. We have to start thinking like a consolidated entity; we have to start delivering a new vision for the business and installing the culture that we

want across the new organisation. At the moment we have two very strong cultures but they are fit-for-purpose for the specific roles of the two businesses. Synergy, from the retail side, is an extremely customer-focused business. The previous Verve does not really have customers; its focus is on safety, engineering and running plant. So there have to be some changes made in that regard.

But, I guess, the overarching issue that I come back to and touched on earlier this morning is that as a business we have a significant challenge in regard to our fixed cost structure—right across the business now. We are being heavily subsidised and we need to do everything we can within our business to take the cost pressures off the consumers in the state in regard to matters that we can control within our business. We are going to be very much internally-focused for the near future while we learn about ourselves and unravel the new business, look at what efficiencies we can extract and then ultimately, try and work out what we can do to do our bit to reduce the supply chain cost of electricity. I have not come across any real problems though. The business is actually going along quite well at the moment.

Hon ALANNA CLOHESY: I know Hon Peter Katsambanis raised this before, but one of the major issues or concerns that was raised during the debate on the merger was around ring-fencing. Have you identified any problems in relation to how the supposed ring-fencing is going and what you might have to do to change some of the ways that you operate to ensure that —

Mr Waters: That we meet our obligations?

Hon ALANNA CLOHESY: That is right.

Mr Waters: Initially we have taken a really conservative stance to the ring-fencing. As we said before, we have to ensure that people do not lose trust in this market and trust in us. We have physically ring-fenced a group in the business; that is, put them behind a lockable door and only people who under the regulations are allowed to have access to that information have access to that group and there are elements of the business that do not. We are being conservative in that regard. When you get down into the detail there are going to be issues that we will have to confront. I will give you an example. We will have a final executive team running this business and as part of a normal business team we will share information, we will share business reports, how we are performing, what our P and L is and we will sign off on approvals for projects. We have to yet get our head around the business processes associated with ring-fencing so that we do not unintentionally share any information that we should not.

The CHAIR: Ultimately it all comes back up to you and the board to make the final decisions and that cannot be ring-fenced can it?

Mr Waters: No; so myself and a large core of the executive that will be in the shared services group will not be subject to ring-fencing. It is really only, for example, if the wholesale business unit signs a contract with a third party retailer. The information contained within that contract is known as “retail restricted information” which means that the retail business unit that is competing with that third party retailer cannot have access to that information. If that was to come up to the board as an approval, we would have to have an approvals process that protects the interests of that third party retailer by ensuring that no one within the internal retail business unit is able to have access to it. That is the sort of stuff I am talking about. We are clearly thinking about it now but there are some finer points that from a business process viewpoint that we still have to get to.

Hon ALANNA CLOHESY: Absolutely; and in the design of your IT systems no less.

Mr Waters: Yes; that will be the centrepiece of where the protections will be delivered. We do have a new document management system that is being rolled out through the business and, as part of that, specific restrictions will be able to be placed on documents through the structuring of files and various groups who will and will not be able to see things. The risk is still that something gets left on a photocopier—it is that sort of handling. Albeit in our sense —

Hon ALANNA CLOHESY: Especially when you are sharing accommodation and cost-saving measures.

Mr Waters: I was going to say that, as it stands, the wholesale business unit and the retail business unit are currently physically separate. The wholesale business unit is located in Verve's former offices on William Street and the retail business unit is in the former Synergy office at 228 Adelaide Terrace. There is about a kilometre between them at the moment.

Hon ALANNA CLOHESY: But is not shared accommodation one of the proposals as a cost-saving for the merger?

Mr Waters: There is no firm proposal in that regard but personally I think that is something that we will get to down the track. We have not made any big decisions like that at this stage because both organisations have existing leases. The organisation—I keep saying both—has existing leases in those locations. In time for those leases to roll off we will make a decision around a more efficient use of accommodation. That may or may not include a combined office somewhere. If that was the case then WBU and RBU would need to be on separate floors.

The CHAIR: You talked about the ring-fencing. At what level do contracts come to the board to be signed, as opposed to being done by the business units themselves?

Mr Waters: All the analysing and processing is undertaken within the business unit but clearly the board is given a high degree of transparency around the costs or financial aspects of the deal, the risks, and the long-term projections on profitability. The board is given a significant amount of information and, obviously, it depends on the size of the deal. There might be very, very small deals that might be within the delegated authority of the wholesale business unit.

The CHAIR: That is what I am asking.

Mr Waters: Not every deal comes to the board.

The CHAIR: At what level do they come to the board?

Mr Waters: I think over \$20 million at face value.

The CHAIR: Those go to the board and anything under that is done at the business unit.

Mr Waters: That is right.

The CHAIR: Will that still need to be signed off by a director that is outside of that ring-fencing role?

Mr Waters: No; the directors have provided delegated authority into the business for deals of a particular size. Then we have internal trading policies that establish the specifics of who has to sign off on that deal. So if it was a deal that came in just under the board's threshold, as CEO I would need to sign that off and obviously see a suite of reviews and approvals on the way through to me.

The CHAIR: The point I am trying to get to is the big deals, which are the ones which I suspect people will be most interested in—the contestable market. If it is a small retailer that has just come into the contestable market it will shop around, go to you and your competitors, get the best price and a deal is done. That is never going to be much different. It is actually when you get to those higher levels that people are going to want to be guaranteed that there is ring-fencing. When it gets to you and the board you still have an obligation to maximise the benefit for the organisation. How do you stop yourself turning around and saying, "Hang on a minute! If we make this a bit more efficient or do X down the gen side of it, we can actually take that contract back in house rather than putting it out"?

Mr Waters: Yes; that would be a —

The CHAIR: Which you should be doing anyway but it is going to give you that incentive if you know that you are only one per cent off, so you drive it to find one per cent.

Mr Waters: No; the regulations would not permit us to discriminate or operate anti-competitively in that regard. If it is a large end-use customer and the retail business unit within Synergy and an external retailer that is being supplied out of WBU are competing for that load, and that external retailer is successful and they have a deal with WBU that comes to me to sign, I can assure you that I will not be saying to the RBU guys, “Go and do X, Y, Z and win this customer.” That would be a very, very clear breach of the regulations and probably a breach of competition law as well.

The CHAIR: But you will know what the price is, so you can then go and say to your retail business unit that they have to bring down their costs by two or three per cent because then you will be competitive on the next tender.

Mr Waters: The reality is that every retailer, at the end of the day, when a large load is won, knows the price.

The CHAIR: Do they?

Mr Waters: And there is a significant amount of tracking of successful prices in the market—Geoff, correct me if I am wrong—through normal market intelligence processes. Everyone is always tracking market prices.

Mr Roberts: At the end of the day in an oversupplied market the key thing that defines the price is the market price. A lot of work within the retail business unit is to understand and gather that intelligence to know where that market price sits.

Mr Waters: You might not get it right to the cent but ultimately through analysis everybody gets to the point of understanding what the market price is. We have seen that curve come down in recent years with oversupply; prices have been lowered.

The CHAIR: In an oversupplied market—you were suggesting earlier that you supply power at a low cost of production—does it then not become an issue that it is just a question of how much you lower the cost of your power below the cost of production for those big contracts to ensure that you are actually selling it and getting something if you have already locked into the contract to supply it?

Mr Waters: The way it works is that WBU will offer the energy to the retailers at a commercial rate. It will then be up to the retailers to handle the detailed negotiation in terms of that price.

Mr Roberts: Bearing in mind that —

The CHAIR: But you are taking losses on some of your contracts are you not? So it is actually not about the cost of production; it is about how much you are prepared to lose to at least recoup some money for the cost and lay off the contracts you have for purchase.

Mr Roberts: Yes; which was very relevant pre-merger when we were supporting those legacy supply contracts. In the new world we will negotiate commercial supply contracts with the wholesale business unit and if we cannot make a positive retail margin on that then we would not sell. In the new world I would not expect our retail unit to be selling below cost.

The CHAIR: That then becomes a problem for Verve if their assets are not able to provide the power at a price that is competitive as part of the wholesale business unit.

Mr Borovac: I think you have made a valid point; however, there is a distinction between what the retail business unit is purchasing based on its legacy contracts and how the generation business unit will work to firstly ensure that it covers its short-run marginal costs—which is fuel and immediate repairs to maintenance—then get a long-term recovery on its overheads and then its capital employed. Generally speaking we have historically been able to do that and we would anticipate doing that and continuing to do so. The wholesale business unit will then work out a price that it will offer to the retail market; which we would anticipate being sufficient to cover the generation business unit’s cost of operation.

The CHAIR: But if you have a surplus capacity in the market your competitors in that market will be looking to sell power, will they not? Yes, there are some assets that can just sit there and not be used, but ultimately, depending on the type of asset, you want them to actually be using them to get a return on investment and capital costs.

[11.30 am]

Mr Borovac: I think you need to look at it from a whole of market position because at the end of the day the way this market operates, having your capacity certified almost ensures that you get that capacity payment. Your real obligation then is to ensure that you are getting your cost of production, recovery is short and marginal costs recovered, and then your overheads recovered. There are some nuances in this market that make it a little bit difficult to say they need to be recognised in this particular conversation.

The CHAIR: That goes to my question 6 on notice which, I have to say, I am not sure you have answered. How much of the revenue that you receive is actually from the capacity payments and how much is from the actual selling of power?

Mr Waters: The reason that that is so hard to answer is that organisations that own assets like ours have effectively two choices in regards to how they earn revenue for the capacity of their facilities. One option is that you can simply certify the capacity in the market and be uncontracted for capacity and be a price taker from the IMO's published capacity price. If that were the basis, you could calculate the number. The alternative means that you embed your capacity cost and your energy costs into a contract, but by design of doing that you cannot then backwardly separate out what was your capacity revenue and what was your energy revenue, because they effectively become combined.

The CHAIR: Are you able to break out how much you are getting from simply capacity payments versus how much you are getting from contract payments which include capacity and energy?

Mr Waters: You could, but —

Mr Matacz: You can only do it on the basis of fully understanding your cost structure, which we do. For instance, we know that of the total cost structure, say for an A1 customer, slightly in excess of 25 per cent is the capacity component. If our total revenue is \$2.5 billion, then 25 per cent of that is related to recovery of revenue against the cost that we incur.

The CHAIR: For some of your assets, all you are getting is the capacity payment for them, are you not?

Mr Waters: Yes, but only for a small portion of it. We have a fairly conservative contract cover policy or strategy, whatever you want to call it. I think, Wally, about 90 per cent of our capacity is covered under contract?

Mr Borovac: Correct.

Mr Waters: Only about 10 per cent is sold into the market. What do we make for that, Wally? Do you have a rough figure for that line?

Mr Borovac: Gross WEM capacity sales were in the vicinity of around \$89 million last year.

Mr Waters: But that is only a small portion. The rest of it that we sell under contract with Synergy and other buyers includes the transfer of capacity credits under contract.

The CHAIR: I think the tennis ball has just gone back into Synergy's court! They may have a contract but they are not selling that. If demand has dropped, no-one is buying that power. Someone is then wearing the cost of that. They are paying you a contract price but if they do not then onsell the power —

Mr Waters: Under Synergy's contract that is probably the take-or-pay amount, if you like. That is the fixed volume they have to buy. We will generally embed the fixed cost potentially within there. All the contract structures are different.

Mr Roberts: In the new world the retail unit will pay IMO market rates for that capacity.

Mr Matacz: But if you look at Synergy the old way, we incur capacity costs in the vicinity of in excess of \$800 million per annum. That is the total component of our capacity—charges that we actually have to pay.

The CHAIR: The other thing I am interested in is: what percentage of your total revenue is generated through the contestable market and what percentage is generated through the non-contestable market?

Mr Matacz: In our contestable tariff and market-based contracts, we have —

The CHAIR: Either dollar figures or percentages.

Mr Matacz: Basically \$904 million is our sales value in revenue terms in our contestable market segment.

Mr Waters: That is for which year, Karl?

Mr Matacz: This is for the current completed year, 2012–13. Our total electricity revenue in that particular year was \$2.5 billion.

The CHAIR: Effectively \$1.6 billion would have been non-contestable market.

Mr Matacz: Yes.

The CHAIR: Is that pretty much flatlining or is that expected to grow? It is basically in line with the tariff increases, obviously.

Mr Matacz: Along with the tariff increases we expect the contestable portion to remain at the same sort of levels or similar levels because of the price pressures whereas in the tariff section we would expect the value to increase because of the ongoing tariff increases that are factored into our forward estimates period.

The CHAIR: What does it grow by each year? There is a tariff increase but I assume there is also an increase in the number of customers as Perth grows. There are 20 000 new houses a year.

Mr Matacz: I think the growth in customer numbers is in the vicinity of two per cent.

Hon ALANNA CLOHESY: I want to ask about Synergy's now old billing system from 2013 and to check how the billing system was and whether there were any problems with the billing system in 2013.

Mr Waters: My understanding is that the performance of the billing system has improved dramatically. Maybe Geoff would like to add something.

Mr Roberts: We are certainly over the traumas that we had a few years ago with our billing system. We have now just gone through a major upgrade of our platform as well. That went very smoothly, which is an indication our billing system is pretty much stabilised now. It means we are in a good position to be able to leverage that going forward in terms of new technologies. I think that is also demonstrated in terms of the significant reduction in complaints that we have had over that period as well, which is a good indication. We have had about a 54 per cent reduction in complaints from 2011–12 to 2012–13 and a 29 per cent reduction in complaints referred to the Ombudsman. That is a good indication that we have addressed all those issues associated with our billing platform. A large proportion of our back office functions continue to be outsourced and performed in India. We have also this year gone through a process of bringing them back onshore to be able to drive efficiencies from that process as well. I think the outcome of that is we are over all those billing traumas. We are now in a good position to be able to leverage that investment.

Hon ALANNA CLOHESY: What sort of efficiencies do you think you will be looking to drive?

Mr Roberts: Drive from our current billing system? I think we touched on it a little while ago. The customers' expectations of a retailer are very different to what they were a few years ago. We are now in a good position to be able to offer customers more applications through mobile technologies, start to reduce our calls into the contact centre, shift those onto more customer-friendly aware channels and start to really be prepared for some of the new technologies that will start to come into play.

Hon ALANNA CLOHESY: Such as?

Mr Roberts: We are seeing PVs—obviously a good take-up in terms of solar technologies. We are now starting to see potentially battery storage come into play and play a role in distributed generation and storage as well. We think some of those are the new technologies that will start to come into play within WA. Our customers will have an expectation that we can manage those, the same as we have managed PVs.

Hon MARTIN ALDRIDGE: I refer to page 22 of your annual report. It is not often you see in an annual report —

Mr Waters: The Synergy annual report or Verve?

Hon MARTIN ALDRIDGE: Synergy. It is not often you see in an annual report that an agency receives a ministerial direction but Synergy did in 2012–13. It is noted in there that it was prior to the merger of Synergy and Verve and the direction was not effective until after the end of the reporting period and had no financial impact. Could you advise the committee what the nature of the direction was?

Mr Waters: That referred to the fact that for the period from 1 July—hence the reference to it being out of the reporting period, although the direction came prior to that, so it was within the reporting period—we went to the common board model where we had the same six directors sitting jointly, if you want, on the boards of both Synergy and Verve Energy, which were separate corporations with a common board. The directions were effectively to enable the directors to operate independently in regards to the two businesses but required or requested of the directors that in making decisions relevant to each specific entity, they do nothing that is going to materially harm the other, if you like. An intention that for the pre-merger period of the six months from 1 July to 31 December the common board runs the two businesses as independent businesses but does nothing within either that was going to have what I think was termed as a “material adverse effect” on consumer costs or something in that regard.

Hon MARTIN ALDRIDGE: Why did that have to be a ministerial directive? Why could that not be a decision taken by Verve and Synergy?

Mr Waters: Correct me if I am wrong, gents: because the act requires a director to make commercial decisions only for the benefit of that entity, which means that if you were to sit on Verve and Synergy, given that their businesses are so interrelated it is very hard to make a decision solely for the commercial benefit of one. The direction was to enable the directors to make broader decisions in the best interests of the consumer.

Hon MARTIN ALDRIDGE: The other issue that I want to talk about—which probably has greater scope in our discussions with Western Power and Horizon Power later today but I did not want to miss the opportunity if they say, “You should have talked to Synergy about that this morning”—relates to street lighting. We have had some issues raised with us from local government about some of the changes being made to the infrastructure relating to street lighting around the place with Western Power removing the switching wires and moving to a different style of street light activations. Are you able to give me some information in relation to street lighting, the tariffs that are applied, whether or not you are aware of these changes and whether or not you are seeing significant increases in the charges paid by local government?

Mr Roberts: I know when I look at the street light power, because there is basically a whole page of different tariffs based on the wattage and whether it is a mercury globe versus all the other —

Hon MARTIN ALDRIDGE: Is that because they are not metered? Is it because it is nominal; a local government has 50 street lights of this type of —

Mr Roberts: It is based on the boundaries for that local government and the stock of the different types of globes that they have and the different style, whether it is decorative lamps as well. That flows through to the current structure.

Hon MARTIN ALDRIDGE: You work out the nominal energy use of each street light in that local government area and they get billed accordingly; it is not a metered cost?

Mr Roberts: No. Effectively the stock of the street lights are tracked through Western Power's asset management system. That flows through to Synergy. We then take stock of those street lights, apply the tariff and then bill the customer from there.

Hon MARTIN ALDRIDGE: I understand the change is they have removed these switch wires. Now you have dawn-to-dusk lighting so it senses the outside light and turns the lights on. Before that, could local governments have some discretion over their ability to only have street lights on between certain hours because it was controlled by the switch wire?

[11.45 am]

Mr Roberts: I do not have enough detail about that—sorry. It is not something I have come across.

Hon MARTIN ALDRIDGE: I assume that if Western Power was able to provide that flexibility under the previous infrastructure, then you would have charged accordingly. If streetlights were on half the night as opposed from dusk to dawn, they would have been charged accordingly.

Mr Roberts: I am not aware of a tariff structure that is based on dusk to dawn or time plans defined by the local government. I have not come across that before.

The CHAIR: Do you charge them or does Western Power charge them?

Mr Roberts: We charge the customer based on information about the stock that is provided by Western Power.

The CHAIR: It is a flat figure no matter how long they are on for?

Mr Roberts: That is my understanding.

Hon MARTIN ALDRIDGE: Are you able to take that question on notice? I do not want you to breach the privacy of customer information with local governments or your customers, but can you provide some general information about street lighting costs and whether there have been increases in the last few years of a significant nature?

Mr Waters: We can specifically respond to the question of dusk to dawn versus controlled output if we have any information on that.

Hon PETER KATSAMBANIS: Are you able to provide the tariff sheet to which you referred?

Mr Roberts: I can provide that easily.

[*Supplementary Information No A4.*]

Hon PETER KATSAMBANIS: A reduction in demand tends to indicate that the requirement for further involvement in generation capacity will either be deferred or put into question. What is Verve's planning for further additions to generation stock either in the replacement of existing stock, new generation capacity or both?

Mr Waters: We have seen a substantial shift in what we see as the asset investment pathway or "road map", as we call it. We generally plan 15 years to 20 years into the future typically to maintain security of the power system, bearing in mind that it is about not only building the plant,

but also ensuring that the network access exists, that the fuel is available and that we are compliant with various legislation and environmental controls. It is very much a long-run business and we plan a long way into the future. I do not have the specific dates, but to give an example, there was a period only three or four years ago during which we saw the need for a new baseload power station on the system for around 2017–18. By baseload I mean a big 300-megawatt or 400-megawatt coal or gas-fired plant that is built to run all the time. The latest indications based on the current load forecast for the system is that the planned date has been moved out to 2022–23. There has been a six-year slippage or stretching of the road map on the basis of reduced demand and on other things. For example, we still expect a fairly significant build in renewable energy to come into the system prior to the end of the decade. We are looking at one or two big wind farms and we expect to see further residential solar being rolled out. We may see commercial/industrial solar. We mainly see the need for another investment in a mid-merit peaking gas plant. By that I mean plants that come on and off during the day and meet the peaks. We might need something like that late in the decade. But in terms of the big expensive investments, they have been pushed out to the early or mid-part of the next decade.

We have announced the retirement of Kwinana Power Station, which will occur in September next year. That will put the system more into balance. We do not see any further plant requirements at this stage until post the 2020 period. Effectively from 2025 to 2030, Muja A, B, C and D will all retire, taking a substantial amount of energy out of the system. From the 2023 milestone onwards, there will be a significant build period in the latter part of the 2020s. Hopefully by that time we will have a handle on where we are going with carbon emissions as a nation, and globally, and better technology that will help us understand better the science of carbon capture and storage. Based on the trend in renewables, I expect the availability of a better range of dispatchable lower cost renewables in the market. We will be investing in a very different market at that point.

Hon PETER KATSAMBANIS: In the short to medium term—and discounting for a moment any major advances in battery storage—how much more growth is there in domestic PV? Have we reached the peak, have we reached a slower uptake or is there still a significant amount of movement to go in that space?

Mr Matacz: At the moment we have slightly in excess of 130 000 customers with solar PVs on their roofs. We are seeing an uptake of probably in excess of 2 000 installations on average per month. We have probably seen that level of installation occur over the past 12 months, but to see it continue at that rate is what we are forecasting. I suppose it is yet to be seen as to whether that is optimistic or pessimistic. We are seeing a consistent 2 000 installation per month.

Mr Roberts: My own view is that it will reach the point of affordability. The PV solutions may go from the residential market but they will become very active in the commercial market. Residential installations may fall, but we will see whether there is a pickup on the commercial PV side.

Hon PETER KATSAMBANIS: Are costs continuing to come down quickly or have they stabilised?

Mr Roberts: Some of the business cases I have seen for large commercial units, depending on the quality of the panel, range from less than two to five years. It is still good payback.

Mr Waters: As to whether we will see much more improvement, I have a sense that we are starting to plateau in terms of that business case. There was a period during the last decade of significant investment in panel manufacturing capability globally, which led to a glut of panels in the market and, obviously, prices have fallen dramatically. I do not know whether we will see further efficiencies or reductions in panels. The cost of panels is probably starting to plateau. Further to Geoff's point, what we have not seen yet is the deployment of panels on a large scale into the commercial and industrial segment. That is where we are likely to see significant uptake in the future.

Hon PETER KATSAMBANIS: That will place further pressure on the existing business model, which was built before this came into being and had such a long shelf life that it was subject to these sorts of disruptions.

The CHAIR: You referred to the installation of 2 000 panels. Are those being installed on newly-built homes or are they being retrofitted to existing properties? Do you have an idea how many are being installed on newly-built homes? Going back to your requirements to meet energy star ratings, solar panels is one way of doing that.

Mr Matacz: I do not have those numbers.

The CHAIR: Is that data something you are likely to have in the organisation?

Mr Matacz: It is possible. We would have to take it on notice

[Supplementary Information No A5.]

Mr Waters: It may be a substantial body of work to pull it together. We will endeavour to do it, and if we can do it easily we will provide it.

The CHAIR: I referred in the questions on notice to the capacity margin. It is often called the reserve margin. It may be that it is not being used because there is surplus capacity and you are not setting a target. Do you normally have a target?

Mr Waters: We do not, but the IMO does. Back in the old days, Western Power would have had when it was the central planning body. Now the IMO maintains a criteria for system reserve margin. My understanding is that it is a percentage. I would be happy to answer the question again now that I understand what you were getting at.

The CHAIR: Does that then flow through to you? How does it apply to Verve and Synergy?

Mr Waters: What it means is that each year the IMO—stage 1 is a precertification process during which people submit plants for certification. If the megawatt quantity from a capacity viewpoint of plants being certified exceeds the IMO's criteria—that is, plant plus demand side management—there is no further auction or action by the IMO to procure further capacity. In the event that having completed that process there is a shortfall in capacity between what was certified and the IMO's criteria, then the IMO would run a further auction seeking additional capacity to fill that gap. Since market start, I am not aware it has ever had to do that because we have always had people bringing capacity to the system ahead of the margin. In round figures, if the target for capacity in the year is 5 000 megawatts, then you would procure 5 400 or 5 500 megawatts to give cover in the event there is a breakdown on a one-in-10-year hot day-type event. Quite a bit of mathematics is used to establish the number, but it is really only there if you get below the target. Under the previous Western Power central planning days, it was always planned to be at or around that target. Under this market design, we have seen excess capacity go well beyond that target.

The CHAIR: Can you provide those figures?

Mr Waters: Yes, on the actual reserve margin.

[Supplementary Information No A6.]

The CHAIR: I note that your corporate hospitality expenses are expected to increase by 17.5 per cent. Is that because the two entities have merged or do you expect an increase in your corporate hospitality between 2103 and 2015?

Mr Waters: The answers are for the old Synergy, as I understand it, because the previous Verve had a relatively insignificant amount.

Mr Roberts: That relates to our actual spend whereas the next one relates to our budgeted spend. When I look at our projections at the moment, they are significantly lower than the 370s. My expectation is that we would come in with the same level of expenditure as we did last year.

The CHAIR: Why have you budgeted such a significant increase?

Mr Roberts: I think it was the original budget. It is an area on which we are very much focused. We treat it as a significant spend that is largely spent on our 9 500 contestable customers. We manage that area very closely. I hope it does not come in above the figure of the previous year.

The CHAIR: The Minister for Energy has estimated some 900 megawatts of excess capacity by 2015–16. I am not sure whether that is whole market or just within your organisation.

Mr Waters: That would be the whole market.

Mr Matacz: Who provided those numbers?

The CHAIR: The minister referred to going out to 900.

Mr Matacz: What we have factored into our budget is the excess capacity that exists in the market at the moment, based on what we submitted in the midyear review, is 704 megawatts for 2013–14. It increases to 743 megawatts for 2014–15 then, as Kwinana C comes off, the excess capacity of the market drops to 496 megawatts and it drops thereafter for the next few years. But at the moment, for the current year, the 2013–14 financial year, the excess capacity is 704 megawatts, and Synergy bears 76 per cent of the cost associated with that excess capacity.

[12 noon]

The CHAIR: So who bears the rest?

Mr Matacz: The other retailers.

Hon PETER KATSAMBANIS: So when Kwinana comes off, will the percentage that Synergy bears reduce as well?

Mr Matacz: No.

Mr Waters: No; it is based on market share.

The CHAIR: Is that still expected to be higher than you would want in terms of excess capacity?

Mr Matacz: Yes; it should be zero.

Mr Waters: In a perfectly efficient market —

The CHAIR: This does not include your reserve.

Mr Waters: This is over and above the reserve. The reserve margin is another 400 megawatts, which is why, when you are talking about excess, some people talk about excess over the reserve target; other people talk about excess over the target.

The CHAIR: So 400 megawatts is a pretty big power station really, is it not? I remember in the old days 600 was considered to be too big and we went back to 350, I think. What are you doing to manage that? How do we deal with that?

Mr Waters: With the oversupply?

The CHAIR: It must mean that you also have assets sitting idle, so how are we managing those?

Mr Waters: You have a mix of assets in the system, so we do have what you would call some idle assets, which are our gas-fired peaking plants, but they are the ones that will rarely run—when it is 40 degrees in mid-February—and you always have those plants on a system that run for maybe one day a year or a couple of days a year. Where the oversupply has particularly bitten this time around is the extent of oversupply and displacement at the baseload end. Our lowest-cost producing plants, like Muja and Collie power stations, as opposed to running at an efficient capacity factor of around 80 per cent—these are big engines; you want to run them hard and leave them running hard—we are running them on and off because of the extent of demand reduction and the extent of renewable energy penetration from wind farms overnight. It is the extent of oversupply at the baseload end that I think has created the cost concerns for the business, not so much the concept of idle plant, which

is, like I said, peaking stations that, by design, are idle most of the time anyway but they have very, very low fixed costs attached to them. They do not cost you anything to sit there, but when you turn them on on a hot day, you need them to run.

The CHAIR: They would have capital costs, would they not?

Mr Waters: Yes, but —

The CHAIR: If you did not need to build them, you would not build them.

Mr Waters: That is absolutely right. The bulk of that fleet is fairly old and pretty depreciated now. The cost of ownership is extremely low. The issue is more around the baseload mid-merit end, which is, for us, where Kwinana power station fits. To answer your question about what you do about this situation, it is exactly the review we conducted of Kwinana, which said, “Can we continue to own and operate what was effectively a baseload power station, designed and built in the 1970s, and operate as a baseload plant for a large portion of its life?” Being a baseload plant, though, it requires a hundred people to operate it and it has fixed costs that are attached to that. If you cannot maintain its operation, it is no longer economic to own. That was the decision point we came to with Kwinana C back in June last year when we announced its retirement. Depending on the future direction this market goes in, that is the sort of review that you need to undertake in running a business like this.

The CHAIR: So you are decommissioning Kwinana. Are there any other assets that you are looking at the option of decommissioning?

Mr Waters: Not at this point in time. Like Karl said, beyond the retirement of Kwinana C, within a year or so after that, the market actually starts to come back into balance.

The CHAIR: So when do you expect it to be around zero again?

Mr Waters: I cannot forecast when it will get to around zero, but within about three to four years my understanding is it comes back to what you would consider an acceptable band around the target.

The CHAIR: What is that band that is acceptable?

Mr Matacz: The total reserve capacity requirements in 2017–18 are about 5 400 megawatts. At that point in time, they have credited 5 800, but there is that 400 megawatt difference. Beyond that, there are other plant closures that will probably occur, and that is when you would expect it to actually be aligned.

The CHAIR: Is there any debt left on Kwinana?

Mr Borovac: No. If you look at our debt structure, we have got a bit over \$530 million at the moment, and that is against our whole portfolio.

The CHAIR: You do not allocate it out to individual assets.

Mr Borovac: No, we do not. A lot of that debt actually came about as a result of the initial disaggregation. We were running at substantial losses for a large portion of that time and that debt, I think—I cannot remember exactly what it started at—peaked at about \$1.1 billion in about 2009 and has been steadily coming back. When we disaggregated, there was no debt allocated to individual assets; we could have notionally, but we did not.

The CHAIR: So is something like the Muja AB refurbishment done through cash flow or through debt?

Mr Borovac: The current funding is done through cash flow.

The CHAIR: Is that treated as a shareholder injection?

Mr Borovac: Yes. Currently, we are 100 per cent owned —

The CHAIR: Does that come off your dividends?

Mr Borovac: At the moment, we are funding that through cash flow. Effectively, it has got an impact on state debt, but it is into the subsidiary. Effectively, it is a subsidiary of ours at the moment. Muja AB is held as a separate entity.

The CHAIR: It does not sit on your books as debt?

Mr Borovac: It does, absolutely. It is consolidated, and our annual report went to great lengths to explain the consolidation process that occurred on 20 June, but it still remains as a subsidiary. It is a moot point, perhaps, in relation to your question, but it is an elaboration.

Mr Waters: In terms of where the money is coming from, I think the underlying question was that it is being funded out of cash flow.

The CHAIR: Do you have targets for continuing to decrease your debt?

Mr Borovac: We have an amortisation schedule between ourselves and Western Australian Treasury Corporation and there is periodic repayments on a quarterly basis going forward as debt matures. Certainly, in the next two to three years, there is no provision to actually change that debt repayment. Towards the back end of the forecast, there is perhaps some slowing down in terms of that debt repayment.

The CHAIR: Unless members have any other questions, I might conclude the hearing.

The committee will forward any additional questions it has to you via the minister in writing in the next couple of days, together with the transcript of evidence, which includes the questions you have taken on notice. Responses to these questions will be requested within 10 working days of receipt of the questions. Should you be unable to meet this due date, please advise the committee in writing as soon as possible before the due date. The advice is to include specific reasons as to why the due date cannot be met. If members have any unasked questions, I ask them to submit them to the committee clerk at the close of this hearing.

On behalf of the committee, again I thank you all very much for your attendance today.

Mr Waters: It is our pleasure. Thank you.

Hearing concluded at 12.08 pm
