

Prohibition and restriction on Synergy and Verve Energy under the *Electricity Corporations Act 2005*

Issues Paper

25 January 2011

Economic Regulation Authority

 WESTERN AUSTRALIA

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Economic Regulation Authority
Perth, Western Australia
Phone: (08) 9213 1900

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1 Introduction

On 3 December 2010, Western Australia's (WA) Minister for Energy (**Minister**) requested that the Economic Regulation Authority (**Authority**) provide its views to the Minister as to the effect that the operation of sections 38(1) and 47(1) of the *Electricity Corporations Act 2005* (**Act**) have had, and are likely to have, on the encouragement of competition in the generation, retail and wholesale electricity markets. Section 38(1) of the Act restricts Verve Energy from the direct sale of electricity to consumers for a designated period¹ and section 47(1) prohibits Synergy from generating electricity for a designated period.²

Sections 39(1) and 48(1) of the Act require the Minister to review the operation of sections 38(1) and 47(1) before the expiry of five years from the commencement of these sections of the Act. As these sections of the Act commenced on 1 April 2006, there is a statutory requirement for the Minister to review the operation of these sections by 1 April 2011.

Sections 39(3) and 48(3) of the Act require that the Minister obtain, and take into account, the views of the Authority before carrying out these reviews.

1.1 Background

At market commencement, there were a number of instruments put in place to mitigate the market power of Verve Energy and Synergy. These included:

- the 'Vesting Arrangements' (2006), which had the objective of gradually reducing the level of wholesale supply of energy and Capacity Credits from Verve Energy to Synergy;³
- Verve Energy was unable to sell electricity it generated to any party for their own consumption (herein referred to as 'retailing') until 2013 (extendable to 2016) (herein referred to as the 'Restriction') and Synergy was unable to generate electricity until 2013 (extendable to 2016) (herein referred to as the 'Prohibition'); and
- a generation capacity cap of 3,000 MW was placed on Verve Energy.

¹ Section 38(2) of the Act states that, for the purposes of section 38(1), the designated period is a period of seven years (i.e. until 1 April 2013); or if an order is made under section 40 of the Act, the period of 10 years (i.e. until 1 April 2016), after the commencement of this section of the Act (which commenced on 1 April 2006).

² Section 47(2) of the Act states that, for the purposes of section 47(1), the designated period is a period of seven years (i.e. until 1 April 2013); or if an order is made under section 49 of the Act, the period of 10 years (i.e. until 1 April 2016), after the commencement of this section of the Act (which commenced on 1 April 2006).

³ The Wholesale Electricity Market commenced operation in WA on 21 September 2006. The WEM is operated by the Independent Market Operator (**IMO**), in accordance with the Market Rules. The WEM is split into an energy market and a capacity market. Energy can be traded bilaterally outside of the formal WEM processes, with retailers and generators able to trade variations from their bilateral positions through a Short Term Energy Market which is operated by the IMO. Capacity is traded in the form of 'Capacity Credits', which are a notional unit of capacity provided by a facility during a Capacity Year (see Chapter 11 of the *Wholesale Electricity Market Rules (Market Rules)* for a more specific definition). Each year, the IMO allocates Capacity Credits to generators and retailers are required to acquire sufficient Capacity Credits to meet their requirements under the Market Rules. An overview of the WEM and a (unofficial) consolidated copy of the Market Rules can be obtained from the IMO website, <http://www.imowa.com.au>

Market power mitigation measures have been effective in assisting the introduction of new entry generation into WA's Wholesale Electricity Market (**WEM**), and have resulted in a steady reduction of Verve Energy's generation market share. Verve Energy's market share decreased from 77 per cent in 2007/08 to 61 per cent in 2009/10. In 2009/10, Synergy's market share was 80 per cent.

1.2 Scope of this issues paper

This issues paper provides background information to assist interested parties to understand the nature of the matters on which the Authority seeks public submissions. The Authority intends to assess the impact of the Prohibition and Restriction on market competition and the relative impact of extending the Prohibition and Restriction to 2016 (i.e. beyond 2013).

1.3 Authority process

The Authority aims to provide the Minister with its views regarding the effect that the operation of sections 38(1) and 47(1) of the Act have had, and are likely to have, on the encouragement of competition in the generation, retail and wholesale electricity markets by February 2011. In providing its views, the Authority will consider and address the points raised in public submissions in response to this issues paper.

1.4 How to make a submission

Submissions on any matter raised in this issues paper should be in both written and electronic form (where possible) and addressed to:

Prohibition and restriction on Synergy and Verve Energy under the *Electricity Corporations Act 2005* - Issues Paper

Postal address: PO Box 8469, PERTH BC WA 6849
Office address: Level 6, 197 St Georges Terrace, PERTH WA 6000
Email address: publicsubmissions@erawa.com.au

Submissions must be received by close of business on **Friday, 18 February 2011**.

Confidentiality

Submissions made to the Authority will be treated as in the public domain and placed on the Authority's website unless confidentiality is claimed. The submission or parts of the submission in relation to which confidentiality is claimed should be clearly marked. Any claim of confidentiality will be dealt with in the same way as is provided for in section 55 of the *Economic Regulation Authority Act 2003*.

The receipt and publication of a submission shall not be taken as indicating that the Authority has knowledge either actual or constructive of the contents of a particular submission and, in particular, where the submission in whole or part contains information of a confidential nature and no duty of confidence will arise for the Authority in these circumstances.

For further information contact:

General Enquiries

Chris Brown
Acting Assistant Director
Electricity Market Surveillance
Ph: 61 8 9213 1900
Fax: 61 8 9213 1999

Media Enquiries

Sue McKenna
The Communications Branch Pty Ltd
Ph: 61 8 9254 4044
Mb: 0424 196 771

1.5 Summary of issues

The Authority invites comment on:

- the effectiveness of the generation Prohibition placed on Synergy and the retailing Restriction placed on Verve Energy in enhancing competition in the generation, retail and wholesale electricity markets; and
- the impact of terminating the generation Prohibition placed on Synergy and the retailing Restriction placed on Verve Energy in 2013 or extending these until 2016.

2 Background on the electricity industry and market reforms

2.1 Review of the electricity industry in Western Australia 2001 - 2002

In August 2001, the Western Australian Government established the Electricity Reform Task Force (**ERTF**) to investigate and make recommendations on electricity reforms to be undertaken in WA.

The Terms of Reference for the ERTF required it to develop detailed recommendations regarding the extent and phasing of the disaggregation of Western Power; the structure of the electricity market to be established in WA; a Western Australian Electricity Code; and arrangements for full retail contestability (**FRC**).

In developing its recommendations, the ERTF was guided by objectives set out in its Terms of Reference.

- The main objective was to achieve, where practicable, sustainable lower electricity prices for all customers while maintaining the uniform tariff for residential and small business customers, and adequate reliability, security, quality and safety of electricity supply.
- The uniform electricity tariff⁴ was to be provided as a safety net in a transparent manner that encouraged efficiency in the delivery of the service. Cash flows required to fund the uniform tariff system were to be provided by Western Power and other participants in the electricity system.
- The interests of consumers in relation to the supply of electricity were to be protected, by wherever possible removing impediments to effective competition between persons engaged in, or in commercial activities connected with, the supply of electricity.
- Due consideration was to be given to the role that sustainable/renewable energy was to have to provide good opportunity for gross greenhouse gas emissions to be reduced.
- A reasonable balance between the interests of electricity generators, transmitters, distributors, retailers, customers and the broader community was to be achieved while ensuring a reasonable consistency between gas and electricity access regulation.

On 15 November 2001, the ERTF issued its first discussion paper 'A Background Paper on the Reform Process'. Preliminary views, relevant to this issues paper, on which comment were sought included:

- A key reform objective of increasing competition may be assisted by the vertical disaggregation of Western Power into three separate businesses – the first comprising generation, the second consisting of the natural monopoly activities associated with transmission and distribution, and the third comprising electricity retail activities.

⁴ The purpose of uniform electricity tariffs was to enable the supply of electricity to regional customers at uniform tariffs comparable to those in the South West interconnected system.

- The generation and retail businesses emerging from any vertical disaggregation of Western Power may continue to dominate their respective sectors and therefore may need to be accompanied by further structural and regulatory reform.

On 17 April 2002, the ERTF issued its second discussion paper, 'Discussion Paper on the Reform of the Electricity Supply Industry in WA'. This paper discussed the ERTF's current views on the reform process.

- The most robust means of achieving the objectives set out in the Terms of Reference is by removing impediments to competition and putting in place structural, market and institutional arrangements to actively promote competition in the electricity supply industry.
- Structural and institutional changes are necessary early steps in the reform process toward creating an environment in which a competitive market can develop. To achieve greater efficiency, the operating environment also needs to be appropriately supported by market mechanisms and regulatory structures that facilitate even-handed competition and that continue to evolve in step with the industry's development.
- An essential element of reform is structural change, including the separation of Western Power into multiple businesses, each with clearly defined roles, objectives, functions and governance arrangements. Western Power should be separated into at least three new and independent businesses, State Generation, State Networks and State Retail. The State Generation and State Retail businesses should not be disaggregated horizontally. The residual risk of transitional market power that may be exercised by State Generation and State Retail within the new market will need to be addressed.
- Some transitional restrictions on investment and regulation of the conduct of State Generation, State Networks and State Retail will also be necessary, but these should apply only as interim measures and not become long-term features of the framework.

On 15 October 2002, the ERTF's final report 'Electricity Reform in WA, A Framework for the Future'⁵ was submitted to Government.

The most significant recommendations of the ERTF were the disaggregation of Western Power, and the establishment of a new WEM. In recommending the disaggregation of Western Power, the ERTF considered that wholesale energy contracts should be established between the Generation and Retail Corporations to: provide for supply to the existing retail customers of Western Power; mitigate the market power of Western Power's successor entities; and provide for a smooth transition to the WEM.

Implementation of these key reforms was intended to facilitate a more competitive electricity supply industry. The ERTF also noted that, ultimately, reform should progress to FRC, and therefore deliver benefits to all electricity consumers. The regulatory framework to facilitate competition and protect consumers would also need to evolve as the industry develops.

The ERTF's final report stated that its proposals incorporate an evolutionary rather than revolutionary approach to reform, and had been guided as much by consideration of the practical issues applying in WA as by reform theory.

⁵ See National Library of Australia website, *Electricity Reform in WA, 'A Framework for the Future'*, October 2002, http://pandora.nla.gov.au/pan/36781/20030730-0000/www.eri.energy.wa.gov.au/pdf/ERTF_Final_Report_October02.pdf

An independent cost-benefit study commissioned by the ERTF showed that the reforms would result in an average 8.5 per cent reduction in electricity prices, an increase in Gross State Product of up to \$300 million per year by 2010, and the creation of 2,900 new jobs.

In November 2002, the Government endorsed the recommendations of the ERTF.⁶

2.2 Implementation of reform

To implement the recommendations of the ERTF, the Government established the Electricity Reform Implementation Steering Committee (**ERISC**) in November 2002.⁷ The ERISC was supported in its work by the Electricity Reform Implementation Unit (**ERIU**).⁸

In implementing the recommendations of the ERTF, the ERISC, on behalf of Government, was guided by objectives set out in its Terms of Reference, which included:

- disaggregation of Western Power into four separate Government owned entities;
- implementation of a new WEM;
- reduction in the retail contestability threshold to 5.7 kW; and
- a number of other transitional arrangements (detailed below).

An early milestone in the ERIU's implementation of the reform process was the achievement of a detailed Project Implementation Plan⁹ for a four-year reform agenda. This plan provided a detailed breakdown of six implementation work streams, two of which were the disaggregation of Western Power and development of a WEM.

Under the WEM work stream, a Market Rules Development Group (**MRDG**) was established with the objectives of providing input into the development of the detailed market design and drafting the Wholesale Electricity Market Rules (**Market Rules**). The MRDG was supported by various expert teams, who were charged with developing parts of the market design and drafting the Market Rules. One of the MRDG teams was the 'Market Power Mitigation Expert Team'. Under its Terms of Reference, this team's overall objective was to 'assist in the design of an effective and efficient market power mitigation strategy, including detailed processes, rules and methodologies, including pricing, for the various components of the market power mitigation strategy for the WEM in the South West interconnected system (**SWIS**)'. The team's deliverables also included developing the vesting and initial contracts between State Generation and Retail and developing market power mitigation measures in the WEM's capacity and energy markets/mechanisms.

Key electricity industry reforms of relevance to this issues paper that were implemented during 2006 as a result of the work of the ERISC/ERIU included:

- the disaggregation of Western Power into four separate corporations on 31 March 2006;¹⁰

⁶ The ERTF ceased operations in November 2002.

⁷ ERISC was established under the authority of Cabinet's decision dated 25 November 2002.

⁸ The ERIU was responsible for: the timely and efficient implementation of the electricity reform agenda under the guidance of the ERISC; undertaking stakeholder consultation; managing the reform agenda budget; and reporting to ERISC on progress and major policy issues. Senior members from the Office of Energy, Department of Treasury and Finance and Western Power were seconded to the ERIU.

⁹ Approved by the ERISC on 30 June 2003.

¹⁰ The Electricity Retail Corporation (Synergy), responsible for the sale of electricity within the SWIS; the Electricity Generation Corporation (Verve Energy), responsible for power generation within the SWIS; the

- reform of legislation, in particular the enactment of the Act;¹¹ and
- the introduction of a suite of instruments to mitigate the market power of Verve Energy and Synergy to coincide with the commencement of the WEM, which are discussed in detail in section 2.3.

2.3 Overview of the market power mitigation strategy

Table 2.1 sets out the instruments put in place to mitigate the market power of Verve Energy and Synergy to coincide with the commencement of the WEM. A brief discussion of each of these measures is included in the remainder of this section.

Table 2.1 Instruments to mitigate the market power of Verve Energy and Synergy to coincide with the commencement of the WEM

Market power mitigation measure	Heads of power	Commencement
Vesting Arrangements (comprised of a 'Vesting Contract' ¹² and 'Displacement Mechanism Ministerial Direction' ¹³ on Synergy)	S. 81 of the Act (the Vesting Contract) and S. 111 of the Act (the Ministerial Direction)	1 April 2006
Verve Energy restricted to the SWIS (except renewables)	S. 37 of the Act	1 April 2006
Synergy restricted to the SWIS	S. 46 of the Act	1 April 2006
Verve Energy cannot retail until 2013 (extendable to 2016)	S. 38-40 of the Act	1 April 2006
Synergy cannot generate until 2013 (extendable to 2016)	S. 47-49 of the Act	1 April 2006
3,000 MW generation capacity cap on Verve Energy	Ministerial Direction	2006
Synergy cannot form a virtual vertically integrated company ¹⁴	Ministerial Direction	2006
WEM generation offers must reflect short run marginal cost (SRMC) when such behaviour relates to market power	Clause 6.6.3 of the <i>Wholesale Electricity Market Rules</i>	21 September 2006

Electricity Networks Corporation (Western Power), responsible for operating, maintaining and expanding the electrical transmission and distribution network in the SWIS; and the Electricity Regional Corporation (Horizon Power), responsible for the generation, transport and sale of electricity in areas outside the SWIS.

¹¹ Parts 2-8 of the Act commenced on 1 April 2006, whereas Part 1 commenced on 13 October 2005. At a high level the Act: established three corporations in place of Western Power, each with a particular function relating to the generation, supply and sale of electricity in the South West of the State; and amended and renamed the *Electricity Corporation Act 1994*, and amends other relevant Acts.

¹² See the Office of Energy's (**Office**) website, Vesting Contract, http://www.energy.wa.gov.au/cproot/1325/2/Vesting%20Contract_25052009.pdf

¹³ See the Office's website, *Electricity Corporations Act 2005*: Ministerial Direction, [http://www.energy.wa.gov.au/cproot/741/2/Exposure%20Mechanism%20-%20Ministerial%20Direction%20\(V12\)%20-%20FINAL.pdf](http://www.energy.wa.gov.au/cproot/741/2/Exposure%20Mechanism%20-%20Ministerial%20Direction%20(V12)%20-%20FINAL.pdf)

¹⁴ See the Office's website, *Electricity Corporations Act 2005*: Ministerial Direction, [http://www.energy.wa.gov.au/cproot/760/4794/ERC%20Ministerial%20direction%20\(SSO%20Final\)%20%2003%2006.pdf](http://www.energy.wa.gov.au/cproot/760/4794/ERC%20Ministerial%20direction%20(SSO%20Final)%20%2003%2006.pdf)

2.3.1 Vesting Arrangements 2006

The disaggregation of Western Power required the creation of contractual relationships between Synergy and Verve Energy, with wholesale electricity supply arrangements being one of the most significant contractual relationships. These arrangements would affect the financial operations of the corporations and impact on the development of the WEM.

As a result, the Minister imposed the 'Vesting Arrangements' on Synergy and Verve Energy as a transitional mechanism to support the development of the WEM. The Vesting Arrangements provided for the initial wholesale supply of energy and Capacity Credits from Verve Energy to Synergy.

The 2006 Vesting Arrangements were comprised of the 'Vesting Contract', between Synergy and Verve Energy, and a 'Displacement Mechanism Ministerial Direction' (**DMMD**) given to Synergy which imposed restrictions on its behaviour in relation to the Vesting Contract.¹⁵

A key feature of the 2006 Vesting Contract was the 'Capacity Cap', which represented the highest quantity of Capacity Credits and energy supplied by Verve Energy to Synergy under the contract. To distinguish this Capacity Cap from the 3,000 MW generation capacity cap placed on Verve Energy, this cap will herein be referred to as the 'Capacity Credit Cap'.

The Capacity Credit Cap in each Reset Period (other than the first period) was set as the lesser of three amounts:¹⁶

- Synergy's capacity requirements for customers backed by the 2006 Vesting Contract;
- Verve Energy's amount of credited capacity under the 2006 Vesting Contract; or
- the Capacity Credit Cap in the previous year.

The Capacity Credit Cap declined over time due to:

- expiration of Synergy's retail contracts that it inherited from Western Power;
- contestable tariff customers accepting new contract offers (whether with Synergy or another retailer); and
- the operation of the 'Displacement Mechanism', which reduces the quantity of energy and Capacity Credits traded under the Vesting Contract.

¹⁵ The DMMD was put in place to ensure that the tender processes that Synergy undertook to fulfil its obligations under the Displacement Mechanism in the Vesting Contract (2006) were open and fair and that the market was provided with appropriate information to participate in the tender processes. The key features of the DMMD were as follows. The Tender Process – the DMMD specified the guidelines that Synergy must follow in running the tender process under the Displacement Mechanism specified in the 2006 Vesting Contract, including that Verve Energy must be treated equally with all other tenderers and was not to be afforded any special treatment or benefit. The Annual Displacement Statement of Opportunities – the DMMD specified that Synergy must annually publish certain information, such as the volumes that will be available for future tender, and the average vesting price. The Annual Displacement Statement of Opportunities (ADSOO) was intended to provide potential bidders in the tender processes with appropriate information. Synergy published the ADSOO annually by 30 November with the first ADSOO published in 2006.

¹⁶ Contract parameters were reset periodically (typically annually) at the end of specified 'Reset Periods'. For further information on the features of the Vesting Contract, see the Office's website, Overview of the Vesting Arrangements, [http://www.energy.wa.gov.au/cproot/1569/2/Overview of the Vesting Arrangements 7Jul2009 FINAL.pdf](http://www.energy.wa.gov.au/cproot/1569/2/Overview%20of%20the%20Vesting%20Arrangements%207Jul2009%20FINAL.pdf)

The Vesting Contract was designed to terminate at the end of the Reset Period when the Capacity Credit Cap was determined to be less than 150 MW in a Trading Interval. As a result, the timing for the termination of the Vesting Contract was dependent on factors that affected the Capacity Credit Cap, including:

- churn of contestable tariff customers to contracts (whether to Synergy or to another retailer);
- growth in franchise customers; and
- implementation of the Displacement Mechanism.

The Office of Energy's (**Office**) 'Overview of the Vesting Contract' (September 2006),¹⁷ provided three scenarios to illustrate the timing for the termination of the 2006 Vesting Contract. Assumptions were made regarding several variables (see Table 2.2), which resulted in a fast, medium or slow termination of the Vesting Contract.

Table 2.2 Assumptions made regarding variables resulted in a fast, medium or slow termination of the 2006 Vesting Contract

Assumptions	Fast	Medium	Slow
Initial Cap	3,104 MW	3,104 MW	3,104 MW
Inherited Contract Expiry	2 years	3 years	5 years
Growth Rate	3.0%	3.5%	4.0%
Churn Rate	6.0%	5.0%	4.0%
Growth kept by Synergy	25%	50%	75%
FRC	2012	2013	2015
Deferrals	None	None	2009
Roll forward	2009	None	None

¹⁷ Office of Energy, Overview of the Vesting Arrangements, pp. 23-24.

The Office's overview paper also illustrated the effect these assumptions had under the three scenarios for reducing the Capacity Credit Cap under the Vesting Contract (see Figure 2.1).

Figure 2.1 Reduction in the Vesting Contract's Capacity Credit Cap based on assumptions of variables resulting in the fast, medium or slow termination of the Vesting Contract¹⁸

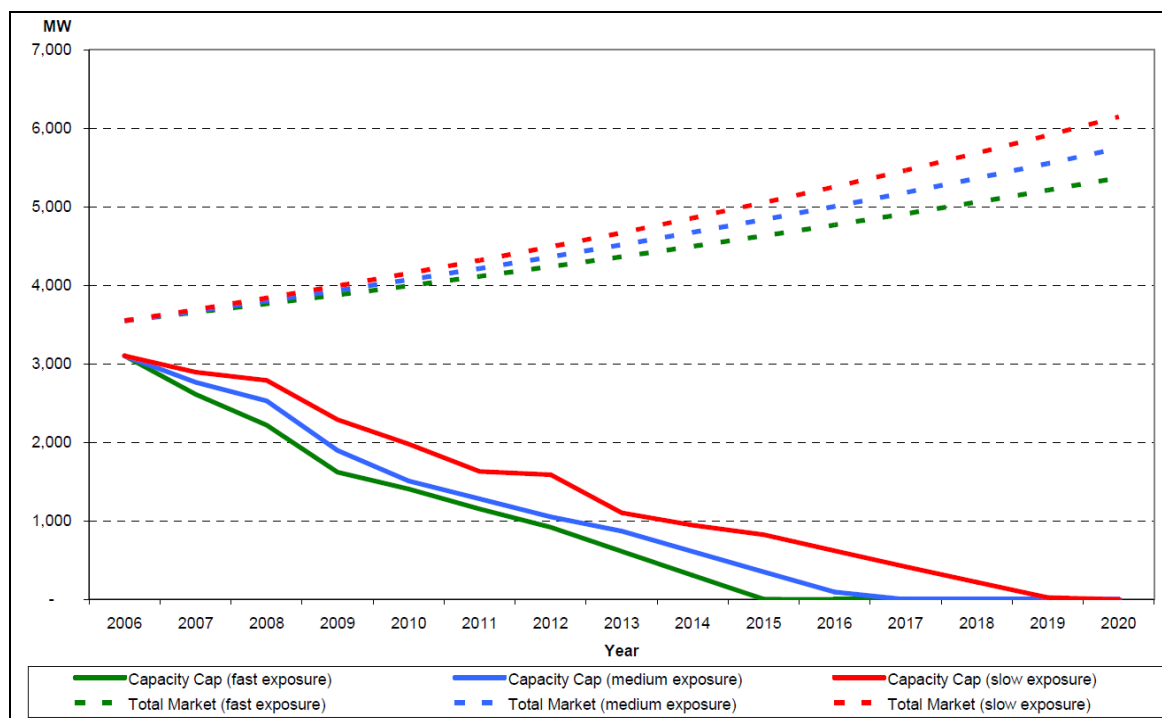


Figure 2.1 indicates that, depending on the scenario, the Vesting Contract could have terminated as early as 2015 or as late as 2019. However, the overview paper also noted that these three scenarios were provided for illustrative purposes only, and it is possible for the Vesting Contract to terminate either before 2015 or after 2019. The Office's paper noted that:

For example, if the wholesale market were to develop quickly for some other reason than those identified, then Synergy may find it advantageous to acquire wholesale supply agreements outside of the Vesting Contract, and would have an incentive to sign contestable tariff customers to retail supply contracts. This would result in a significantly higher churn rate, and would cause the Vesting Contract to expire much earlier. This would also likely bring forward the implementation of FRC, which would, in itself, also increase the prospects of an earlier termination of the Vesting Contract.¹⁹

As discussed later in section 2.6, the 2006 Vesting Contract was cancelled by the Government on 1 October 2010, which was before the contract terminated as a result of the Capacity Credit Cap being reduced to less than 150 MW.

¹⁸ The dotted lines across the top of the figure indicate the size of the total market, based on the assumed growth rate for each scenario. The difference between the dotted lines and the solid lines represents the volume of the total market that is not covered by the Vesting Contract.

¹⁹ Office of Energy, Overview of the Vesting Arrangements, p. 24.

2.3.2 **Other market power mitigation measures imposed on Verve Energy and Synergy**

In addition to the Vesting Arrangements, there were a number of other market power mitigation measures that were imposed on Verve Energy and Synergy to coincide with the commencement of the WEM.

Verve Energy cannot retail until 2013 (extendable to 2016)

Section 38 of the Act restricts Verve Energy from supplying electricity to a customer for the customer's own use until 1 April 2013, other than as authorised by the Minister. Following a review by the Minister of section 38 of the Act, this restriction is extendable until 1 April 2016 by order of the Minister under section 40 of the Act.²⁰

Verve Energy restricted to the SWIS (except for renewables)

Section 37 of the Act limits Verve Energy to generate, purchase, or otherwise acquire and supply electricity in the SWIS. However, this restriction does not apply insofar as the generation and supply of electricity is from renewable sources.

Synergy cannot generate until 2013 (extendable to 2016)

Section 47 of the Act prohibits Synergy from generating electricity until 1 April 2013. Following a review by the Minister of section 47 of the Act, this restriction is extendable until 1 April 2016 by order of the Minister under section 49 of the Act.²¹

Synergy restricted to the SWIS

Section 46 of the Act limits Synergy to the SWIS with regards to its principle functions as set out in section 44 of the Act, including the function of supplying electricity to consumers.

3,000 MW generation capacity cap on Verve Energy

In 2006, the Minister issued a Direction imposing a cap on Verve Energy's non-renewable generating capacity, in order to mitigate Verve Energy's market power in the generation market. Unless the policy in relation to the cap changes, Verve Energy cannot invest in new capacity, other than generation that is solely fuelled by renewable sources, until plant retirements bring it below the 3000 MW cap, and can then invest only to the extent the cap is not exceeded. No expiry date has been set for the cap.

Synergy cannot form a virtual vertically integrated company

In 2006, the Minister issued a Direction prohibiting Synergy from entering into any agreements that would result in Synergy being required to register, or seek exemption from the requirement to register, as a WEM Market Generator.

²⁰ The purpose of the review is to determine the effect that the operation of section 38(1) has had, and is likely to have, on the encouragement of competition in the generation, retail and wholesale electricity markets.

²¹ The purpose of the review is to determine the effect that the operation of section 47(1) has had, and is likely to have, on the encouragement of competition in the generation, retail and wholesale electricity markets.

WEM generation offers must reflect SRMC when such behaviour relates to market power

Clause 6.6.3 of the Market Rules requires generators to offer their electricity at a price that reflects “the Market Generator’s reasonable expectation of the short run marginal cost of generating the relevant electricity when such behaviour relates to market power”.²²

2.4 Post-reform outcomes

Market share

Table 2.3 sets out Verve Energy’s generation market share (of Capacity Credits) and Synergy’s retail market share (of electricity sold in the SWIS), as detailed in publically available information.

Table 2.3 Verve Energy’s generation market share (of Capacity Credits) and Synergy’s retail market share (of electricity sold in the SWIS)

Year	Verve Energy ²³	Synergy
2007/08	77%	
2008/09	66%	80% ²⁴
2009/10	61%	80% ²⁵
2010/11	60%	
2011/12	57%	

Financial performance

Historically, Synergy has operated profitably between the 2006/07 and 2009/10 financial years.

In contrast, between the 2006/07 and 2008/09 financial years, Verve Energy incurred significant losses each year.²⁶ According to the *Verve Energy Review* (August 2009) (**Oates Report**),²⁷ \$212 million of pre-tax loss (of a total \$454 million²⁸ pre-tax loss) over these three financial years was a result of mechanisms or terms in the Vesting Contract, including:

- network access charges from Western Power were \$175 million higher than forecast and this impacts on Verve Energy through the Vesting Contract’s

²² For further information on SRMC, see the Authority’s website:

http://www.erawa.com.au/2/602/42/short_run_marginal_cost.pm

²³ Percentage of Verve Energy’s Capacity Credit allocation against the total allocation for the Reserve Capacity Year, which runs from 1 October (8AM) until the following 1 October (8AM).

²⁴ Synergy 2008/09 Annual Report.

²⁵ Synergy 2009/10 Annual Report.

²⁶ Full year actual results for the 2007 to 2009 financial years.

²⁷ Oates Report, p. 29

²⁸ Includes a forecast result for the 2008/09 financial year of -\$195 million, whereas the actual was -\$239 million.

Netback Mechanism, since electricity retail tariffs have not been fully adjusted to reflect the network access costs; and

- anomalies in (or interpretations of) the terms of the Vesting Contract cost \$37 million.²⁹

However, in the 2009/10 financial year Verve Energy achieved a full-year net profit after tax of \$97.5 million. The significant turnaround in Verve Energy's financial performance in the 2009/10 financial year was largely due to two factors, the tariff increases that came into effect in April 2009 (following a 10 year tariff freeze) and Community Service Obligation (**CSO**) payments to Synergy implemented by the State Government.³⁰

2.5 Verve Energy Review – 2009

Early in 2009, Mr Peter Oates was appointed³¹ to undertake a review of the financial position of Verve Energy. The Oates Report considered the reasons for Verve Energy's poor historical financial performance, its current outlook and options for addressing a number of identified issues with respect to the structure of the market. The Oates Report was accepted by Government, and Mr Oates was re-engaged in 2010 to assist with the implementation of the reports' recommendations. This is discussed further in section 2.6 below.

The Oates Report made six recommendations, two of which are of relevance when considering the current Prohibition and Restriction (pursuant to the Act) on Synergy and Verve Energy in the SWIS, i.e. to retail and generate electricity respectively. First, that tariffs and charges in the contestable sector should be increased to cost reflective levels as soon as possible to remove the barrier to retail competition.³² Second, that the Vesting Arrangements between Verve Energy and Synergy required urgent revision, particularly in respect of its timetable for the Vesting Contract's Displacement Mechanism.

The Oates Report posited that the Displacement Mechanism should be amended such that Verve Energy's supply to Synergy is contracted without prescribed displacement, to the extent of Synergy's price protected market (represented by the dotted black line in Figure 2.2).³³

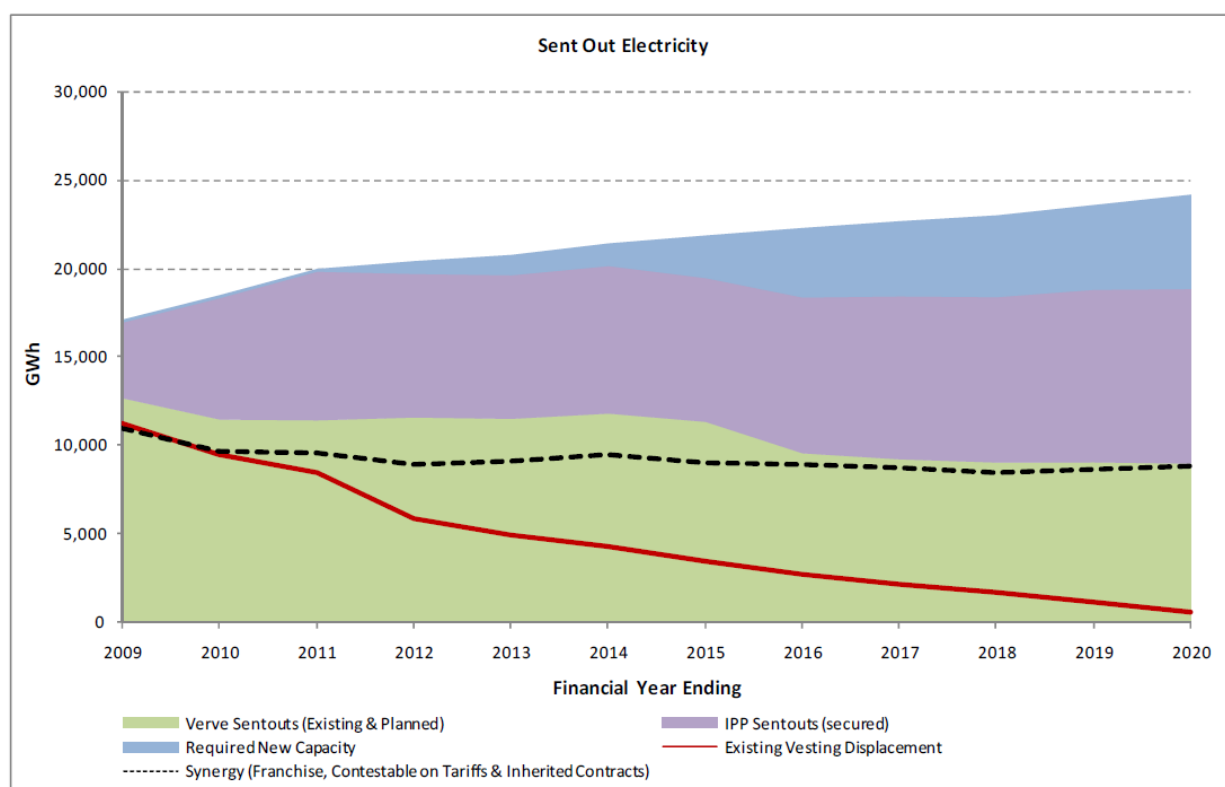
²⁹ Of which an estimated \$31 million is profit to Synergy and are a direct unbudgeted cost to Verve Energy. See the Oates Report, p 27.

³⁰ The CSO is paid to Synergy and is designed to compensate Verve Energy for the gap between the economic cost of generation and non-cost reflective electricity retail tariff revenues. The CSO paid to Synergy flowed through the Vesting Contract's Netback Mechanism to Verve Energy. This CSO to Synergy commenced in the 2009/10 financial year.

³¹ Mr Oates was appointed on a Ministerial contract for service by the Department of the Premier and Cabinet.

³² It was assumed in the Oates Report that FRC for smaller customer loads less than 50MWh per annum is deferred for the medium term to allow the industry to focus on the more immediate priorities identified in this review. It was recommended that the timing be reconsidered following the implementation of the recommendations.

³³ Customers with consumption less than 50 MWh per annum on tariffs and contestable customers on subsidised tariffs.

Figure 2.2 Displacement schedule as at August 2009 (from the Oates Report)

The Oates Report added that if and when the Government decides to pursue FRC, the Vesting Contract would drop away, depending on the extent to which price protection in electricity retail tariffs remains, and both Verve Energy and Synergy would be required to compete for market share. The report noted that if price protection was to be removed gradually, then the Vesting Contract displacement could be aligned with the volume of energy consumed by the remaining price protected customers.³⁴

2.6 Replacement Vesting Contract 2010

Following on from the Oates Report recommendations, the Minister determined that the contractual arrangements between Verve Energy and Synergy relating to the supply of Capacity Credits and energy from Verve Energy to Synergy would continue on different terms and conditions from 1 October 2010, and that a replacement Vesting Contract would supersede the original 2006 Vesting Contract.

In order to give effect to the Minister's requirements, the Minister made orders under section 84(1) of the Act, first cancelling the 2006 Vesting Contract and secondly prescribing a document to replace the 2006 Vesting Contract.

The Government considered that the 2006 Vesting Contract needed to be replaced as it was flawed and had directly resulted in the:

- procurement of excess generation capacity from independent power producers, which lead to either the underutilisation or inefficient utilisation of State-owned generation; and

³⁴ Oates Report, p. 9.

- significant financial losses incurred by Verve Energy between the 2006/07 and 2008/09 financial years.³⁵

The Government also considered that:

- the last two contracts awarded under the 2006 Vesting Contract's Displacement Mechanism timetable were won convincingly by Verve Energy; and
- Verve Energy would have won the further displacement contract required under the 2006 Vesting Contract's Displacement Mechanism timetable (according to the Minister, by 2014 this further displacement would have been 15 per cent of Synergy's load).³⁶

2.7 Market shares

Verve Energy's market share after the last round of displacement (under the 2006 Vesting Contract) was 57 per cent (for the 2011/12 Reserve Capacity Year). Under the Replacement Vesting Contract (2010), there is no mechanism calling for the further (potential) displacement of capacity contracted to Verve Energy. Therefore, it would seem unlikely that Verve Energy's market share will decrease below 40 per cent before 2020,³⁷ unless there is significant load growth that is supplied in the majority by independent power producers.

The contestable retail market in the SWIS only applies to consumers who use at least 50 MWh of electricity per annum. During the 2009/10 financial year:

- contestable customers within the SWIS represented only 0.48 per cent of residential customers and 10.5 per cent of non-residential customers;
- Synergy supplied all contestable residential customers and 86 per cent of contestable non-residential customers;³⁸ and
- Synergy's market share of electricity sold in the SWIS remained at around 80 per cent (see also section 2.4).

³⁵ See for example, Extract from Hansard [COUNCIL - Tuesday, 21 September 2010], p6884d-6885a, Hon Kate Doust; Hon Peter Collier, p. 1.

³⁶ Extract from Hansard [COUNCIL - Tuesday, 21 September 2010], p6884d-6885a, Hon Kate Doust; Hon Peter Collier, p. 1.

³⁷ The supply end date specified in the Replacement Vesting Contract 2010 is 30 September 2020. However, the Minister may cancel the contract before this date by an order made under section 84(1) of the Act.

³⁸ See ERA web site, *Economic Regulation Authority 2011, 2009/10 Annual Performance Report – Electricity Retailers*, <http://www.erawa.com.au/cproot/9257/2/20110114%202009-10%20Annual%20Performance%20Report%20-%20Electricity%20Retailers.pdf>

3 Market power mitigation and the prohibition/restriction on Synergy and Verve Energy

A feature of the WEM is the continuing dominance of Verve Energy and Synergy, by virtue of their incumbent market position, and for Verve Energy, by its extensive generation portfolio. Section 38(1) of the Act restricts Verve Energy's retailing of electricity for a designated period³⁹ and section 47(1) prohibits Synergy from generating electricity for a designated period.⁴⁰ The retailing restriction placed on Verve Energy and the generation prohibition placed on Synergy limit the extent of vertical integration in the WEM. Vertical integration can lessen competition given a business has significant market share in one segment of the market, which can then be levered to the advantage of the business in the other market segments.

3.1 Retail sector

In the ERTF recommendations on electricity reforms to be undertaken in WA, one option considered for constraining the market power of the incumbent retailer was the creation of multiple retail businesses, each with an associated (initial) franchise on geographic boundaries in the SWIS. However, given the significant economies of scale in retailing, the ERTF considered that it was not clear that this option would deliver sufficient benefits to outweigh the costs of creating separate business entities and that it was more likely that contestability would drive consumer gains.⁴¹ In the implemented reforms, the State retailer remained a single entity, with a number of market power mitigation instruments then placed on Synergy, including being unable to generate until 2013 and being restricted to retailing in the SWIS.

The ERTF also considered that retail contestability would be a key element in driving consumer gains and noted that 'the nature and timing of new entry in the retail sector will be determined by the extent and phasing of retail contestability and the success of reforms in the wholesale market'.

Competition in the retail market has been slow to develop, at least in part due to the price protected electricity retail tariffs⁴² not reflecting wholesale costs and FRC not being introduced in WA. In the absence of a clear timetable for the introduction of FRC, retailers other than Synergy will be unable to achieve critical scale and the entry and expansion of new retailers is likely to be delayed.

³⁹ Section 38(2) of the Act states that, for the purposes of section 38(1), the designated period is a period of seven years (i.e. until 1 April 2013); or if an order is made under section 40 of the Act, the period of 10 years (i.e. until 1 April 2016), after the commencement of this section of the Act (which commenced on 1 April 2006).

⁴⁰ Section 47(2) of the Act states that, for the purposes of section 47(1), the designated period is a period of seven years (i.e. until 1 April 2013); or if an order is made under section 49 of the Act, the period of 10 years (i.e. until 1 April 2016), after the commencement of this section of the Act (which commenced on 1 April 2006).

⁴¹ See National Library of Australia website, Discussion Paper on the Reform of the Electricity Supply Industry in Western Australia (Volume 1) Structure and Market Design for the Electricity Supply Industry in Western Australia, http://pandora.nla.gov.au/pan/30506/20030730-0000/www.ertf.energy.wa.gov.au/paper/Volume1_Complete.pdf

⁴² Residential electricity tariffs in Western Australia did not increase over the period 1997/98 to 2008/09 (except for the introduction of GST), while business tariffs did not increase between 1991/92 and 2007/08.

3.2 Generation sector

The Authority notes that the market design, including market power mitigation measures (e.g. Verve Energy being unable to retail until 2013, the Displacement Mechanism in the 2006 Vesting Contract and the Verve Energy generation capacity cap), have assisted the entry of new generation into the WEM. There has been a steady reduction of Verve Energy's market share of generation capacity from 77 per cent in the 2007/08 Reserve Capacity Year to an anticipated 57 per cent in the 2011/12 Reserve Capacity Year.

Market power mitigation continues to be an issue in electricity markets that have greater maturity and competitive elements than the WEM. In the National Electricity Market (NEM), the exercise of market power⁴³ is not specifically addressed by the National Electricity Rules (NER). Clause 3.1.4(b) of the NER states that the market rules are not intended to regulate anti-competitive behaviour by market participants which, as in all other Australian markets, is subject to relevant provisions of the *Trade Practices Act 1974*.⁴⁴ One of the key factors in the ability to exercise market power is the size of market share. As a comparison to the SWIS, there is a greater diversity in generators in the NEM. For example:

- the largest NEM market share (of registered capacity) is around 10 per cent for both Delta Electricity and Macquarie Generation (with both being NSW Government enterprises);⁴⁵ and
- the aggregate NEM market share for the five largest generators is around 40 per cent.⁴⁶ Of these five generators, only one entity, AGL, is a private enterprise.

4 Invited comments

Given developments since market commencement, including the recent termination of the 2006 Vesting Contract, the Authority invites stakeholder comments on the Prohibition placed on Synergy being unable to generate until 2013 (extendable to 2016) and the Restriction placed on Verve Energy being unable to retail until 2013 (extendable to 2016).

⁴³ In the electricity market, this includes the ability of generators to sustainably and profitably maintain their market price above their SRMC of production.

⁴⁴ AER 2010, Submission to the AEMC Consultation Paper on Proposed Rule Change: Reliability Settings, December 2010. <http://www.aemc.gov.au/Media/docs/AER-fea34d07-9c2b-401f-aaae-ea77f7e63b57-0.pdf>
<http://www.aemc.gov.au/Media/docs/AER-fea34d07-9c2b-401f-aaae-ea77f7e63b57-0.pdf>

⁴⁵ Derived from the registered capacity caps in the AEMO Registration and Exemption lists (updated 11 January 2011). Note that three of the top five generators are owned by the NSW Government. In January 2011, the NSW Government announced its intention to divest its electricity businesses, which may include long-term leases and/or sales of its generation facilities.

⁴⁶ Macquarie Generation, Delta Electricity, Eraring Energy, Stanwell Corporation, and AGL.

The Authority invites comment on:

- **the effectiveness of the generation Prohibition placed on Synergy and the retailing Restriction placed on Verve Energy in enhancing competition in the generation, retail and wholesale electricity markets; and**
- **the impact of terminating the generation Prohibition placed on Synergy and the retailing Restriction placed on Verve Energy in 2013 or extending these until 2016.**

APPENDICES

Appendix 1 Glossary

ADSOO	Annual Displacement Statement of Opportunities
DMMD	Displacement Mechanism Ministerial Direction
ERISC	Electricity Reform Task Force
ERTF	Electricity Reform Implementation Steering Committee
ERIU	Electricity Reform Implementation Unit
IMO	Independent Market Operator
NEM	National Electricity Market
NER	National Electricity Rules
MRDG	Market Rules Development Group
SRMC	Short run marginal cost
STEM	Short Term Energy Market
SWIS	South West Interconnected System
WEM	Wholesale Electricity Market