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Prohibition and restriction on Synergy and Verve Energy under the *Electricity Corporations Act 2005* - Issues Paper
Economic Regulation Authority
PO Box 8469
Perth Business Centre
Perth WA 6849

RE: Submission to the prohibition and restriction on Synergy and Verve Energy.

Griffin Energy (Griffin) welcomes the opportunity to provide comment on your issues paper. The issues paper specifically requests comment on the generation prohibition placed on Synergy and the retailing restriction placed on Verve. Griffin believes it is also important to comment on a further restriction – that of the 3,000MW cap placed on Verve, as it has arguably had a greatest impact on the development competition in the WEM.

Since the disaggregation of the former Western Power, Griffin has been a major investor in the Western Australian Wholesale Energy Market (WEM). Griffin has constructed a 2 x 230MW coal fired power station in Collie (the Bluewaters power station) and, as a 50:50 joint venture partner with Queensland's Stanwell Corporation, the 80MW Emu Downs Wind Farm. Griffin also maintains a portfolio of development projects. These include the 2 x 230MW expansion to the Bluewaters power station and the 130MW Badgingarra Wind Farm. Both of these development projects have full environmental approval. Other advanced development projects include the Neerabup OCGT (North Peak Power Station) and the Emu Downs wind following OCGT. Griffin has also been an active participant in the ongoing development of a competitive electricity market in the SWIS, advocating for strategic reform initiatives. Griffin considers itself well placed to comment on the issues paper.

The current WEM is delicately poised. It has been operational for nearly 4.5 years. Early investment in significant base load assets (NewGen's Kwinana CCGT and the Bluewaters power station) has led to a temporary oversupply in the market. This is common when large lumpy investments are made. Electricity markets tend to fluctuate between periods of tight supply and periods of oversupply. In the WEM, these investments were made within a small opportunistic window. NewGen's Kwinana plant won the Western Power 'Power Procurement II' process – where the government specifically sought private investment rather than build own and operate, a pattern that begun with Power Procurement I and Transfield's Kemerton OCGT. The Bluewaters power station was underpinned by securing the new very large load of the Boddington Gold Mine, with the second unit then successfully bidding into Synergy's vesting displacement process. In other words, within a small period of time, the government managed to add nearly 800MW of new base load capacity to the SWIS with no capital outlay. It also brought two significant new competitors into the generation sector. This was wholly consistent with the development of a competitive energy market.

The restrictions on Verve and Synergy have been critical to the success of bringing new entrants into the generation sector. Firstly, Synergy, if allowed to develop its own generation facilities, would likely have done so. Vertical integration allows retailers to hedge their retail energy positions. This has been a standard industry response to disaggregation and privatisation of other electricity markets. We have also seen this response in the renewable energy sector, where retailers hedge their growing REC liabilities with physical generation capacity or seed investments in emerging renewable technologies. This has an additional application in the WEM where retailers also have capacity obligations. As it is, Synergy has only been permitted to contractually hedge its positions, rather than build and own physical assets[1]. So without the prohibition on Synergy entering the physical generation sector, it is likely that less competition would have emerged there.

The 3,000MW cap on Verve is also consistent with the aim of developing competition in the WEM. The benefits of incumbency are large and underestimated. If Verve was competing with private investors to construct new generation facilities, it would benefit from a number of explicit and implicit advantages, including: access to existing development sites; access to transmission infrastructure[2]; access to existing subsidised gas reserves and gas transport; access to state credit rating and taxpayers funds[3]; an implicit financial backing from the state; an implicit relationship with Synergy[4]; an implicit access to infrastructure (such as waste water pipelines); and a perceived preferential treatment when competing for scarce resources, such as water and air-shed capacity. Generally, it would be difficult for private investors to compete based on these advantages. This is why it was necessary to introduce a cap on Verve's generation capacity. Without it, little or no new competition would have emerged in the generation sector.

With regard to the retailing restriction placed on Verve, its impact is less clear. There has not been a great deal of competition emerge in the retail sector. There are obviously sectors of the market that are not yet contestable. But in those sectors that are, the lack of competition is predominantly due to retail tariffs remaining artificially low for too long. Given it has been Verve losing money due to the low tariffs (as a result of the previous vesting arrangement), it is arguable whether their ability to retail would have made much difference to date.

[1] In doing so, however, and by being the largest buyer in the market by a long margin (effectively a monopolist with no competition in large segments of the market), they have been able to extract monopoly rents out of generators, mostly by pushing risks upstream to generators. This may be efficient risk mitigation in real-time gross-pool markets (with cost reflective bidding), but in a highly bilaterally traded market with little scope for cost pass through, this reduces the profitability of the generator and dampens efficient price discovery.
[2] After Muja AB and Kwinana B were retired, Verve was not required to compete with other investors for access to the deep transmission system (via the applications and queuing process). This appears at odds with the Access Code given there are no explicit rights to deep transmission access in the SWIS.
[3] For example, the Greenough Solar Farm has been granted a $20M taxpayer funded subsidy.
[4] While the old (and now revised) vesting contract is an explicit relationship with the monopoly retailer, there is also the perception that if the State were to fund Verve's construction of a generation facility, then the output of that facility would find a home with Synergy. This is likely to be the case with the Greenough Solar Farm. While industry expectation is that the output of the facility will not be commercially competitive when compared to other renewable facilities, Verve will likely be able to sell the output to Synergy.

The review of the restrictions is timely. However, there is a fundamental omission in its scope. There was a clear rationale for introducing the restrictions in the first place. Without them, new competitors would have been less likely to enter the market while competing against the incumbents. This would have impacted the desired outcome of attracting competition and new entrants into the SWIS. The question must now be asked of the rationale for maintaining or terminating the restrictions. That is, what is the medium-to-long term energy policy for the SWIS? We have successfully introduced some competition in the generation sector; and less successfully so in the retail sector. But electricity markets in other jurisdictions have shown that a natural progression from here is for the development of several competing privately owned gentailers – vertically integrated utilities competing across all segments of the market[5]. Is this the expectation in the WEM? The WEM has some of the building blocks to achieve this, but is still deficient in other areas. There are a number of private generation assets and IPPs, many of which are in the process of, or have recently been, traded to third parties. This change in ownership is common as electricity markets evolve from their old vertically integrated state owned structures and newer private investors seek to develop competitive portfolios within the new structures. The WEM also has a major gas retailer in Alinta, and limited competition in the gas retail sector (with Synergy). What is missing in the WEM is competition in the retail sector. Synergy's 80% hold on the electricity retail market must be reduced. Only when there are several evenly matched retailers can the process of private vertical integration begin.

Griffin believes the pathway for the natural progression of a competitive market in the SWIS lies in the splitting of Synergy into multiple entities[6]. These entities would then be privatised in a bidding process, similar to those recently held in Queensland and NSW[7]. This should be run in conjunction with a process for establishing Full Retail Contestability (FRC), possibly by 2013/14. Verve Energy, whether kept in government hands or eventually privatised, should continue to reduce its proportion of generation capacity in the SWIS, before it is permitted to compete for new generation facilities[8]. It is understood that in order to do this, it must be demonstrated that the market is able to introduce competitive balancing and ancillary service provision. This essential reform is currently being undertaken by the IMO RDIWG, though it would be expected to be a number of years before it has been conclusively demonstrated[9]. The State is not limited to achieving the reduction in Verve's share of generation capacity by attrition only. Targeted asset sales should also be considered. Importantly, Verve should also be restricted from competing in the renewable generation sector, where its 3,000MW cap does not apply. Given the relatively small market in the SWIS, which has annual (mainly peak) load growth of around 120MW; and given the need to meet the MRET 20% by 2020 renewable energy target, there is a likelihood that a sizable amount of new generation built in the SWIS over the next decade will be renewable. Not capping Verve's participation in this sector may lead to lessening of new entrant competition in renewable generation and increasing Verve's total share of generation capacity. This is

[5] We have seen this development in most jurisdictions in the NEM, where government retailers have been sold and the new entities backward integrate into generation and, more recently, fuel supply in order to manage their risks. This has been achieved in some jurisdictions by private ownership only (such as in Victoria), or with a mix of state owned ownership in the generation sector (such as Queensland and NSW).

[6] We would envision either a split into 2 entities, or at most 3. For example, SWIS Metro North; SWIS Metro South; and SWIS Regional could be an example of a three way split of Synergy's current customer base.

[7] We would recommend against adopting the complicated gentrader models as in NSW.

[8] Around 25% to 35% would appear appropriate in the medium term.

[9] 2012/13 would likely be the earliest that the market could be confident that Verve's backup position as provider of balancing and ancillary services could be removed.

contrary to the desired outcomes for a more competitive WEM. Verve's ability to retail under the market structure considered here would become redundant.

Summarising the discussion above, with regard to the legislative restrictions, Griffin believes that for the ERA to be confident of achieving a more competitive market in the SWIS, they should only recommend the removal of the restrictions in 2013 if they were accompanied by an aggressive timetable for further structural reform, similar to that outlined in this submission. Given the slow nature of reform to date in the SWIS, this is unlikely. Griffin thus recommends that the restrictions be extended to 2016, with the caveat that if significant structural reform is achieved before this time, they may be relaxed. Griffin also recommends that the government continue to reduce the proportion of generation capacity owned by Verve in the SWIS, either through a continued (or even reducing) cap on its capacity, or through targeted asset sales.

Should you have any questions regarding our comments, I can be contacted on 08 9261 2908; shane.cremin@thegriffingroup.com.au

Yours sincerely

Shane Cremin
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