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18 February 2011

Economic Regulation Authority
PO Box 8469
Perth Business Centre
PERTH WA 6849

Dear Sir

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

Thank you for the opportunity to comment on the Issues Paper.

Please find attached Verve Energy's submission which specifically discusses Section 38(1) of the Act that restricts Verve Energy from the direct sale of electricity to consumers.

Verve Energy's views as outlined in the attached submission can best be summarised as follows:

Verve Energy proposes that it be permitted to retail electricity directly to commercial and industrial (C&I) customers and therefore requests that the ERA endorses termination of the retailing prohibition placed on it in 2013. Verve Energy considers the proposal as being justifiable for a number of reasons including:

- the Western Australian electricity and energy markets have evolved in the last six (6) years to support competition, and limit the perceived market power the Verve Energy prohibition was designed to ameliorate;
- market power concerns related to Verve Energy leveraging its position in the wholesale market to create a dominant position in the retail market would be unfounded due to its existing highly contracted position in the energy and capacity markets;

- the 3000MW Capacity Cap and the future requirement for new competitive base load plant options has and will ensure that Verve Energy provides competitively priced wholesale electricity for the foreseeable future;
- C&I customers can backward-integrate to gain access to the wholesale electricity market, which acts as a discipline on all market participants' behaviour when pricing and providing retail services to customers;
- large C&I customers have shown strong appetite to deal directly with Verve Energy for the provision of wholesale energy; and
- removing the retail prohibition will provide benefits associated with increased competition in the retail market which should be of benefit to end users and the economy in general, encouraging improved pricing and cost control disciplines, greater product innovation and improved customer focus.

Thank you again for the opportunity to comment on the issues paper. Should any aspect of this submission need clarification please do not hesitate to contact Daniel Nocciolino, Manager Strategy on 9424 1964.

Yours faithfully

TONY NARVAEZ
GENERAL MANAGER
STRATEGY AND BUSINESS DEVELOPMENT

PROHIBITION AND RESTRICTION ON SYNERGY AND VERVE ENERGY UNDER THE *ELECTRICITY CORPORATIONS ACT 2005* – ISSUES PAPER

Verve Energy Submission to the Economic Regulation Authority

February 2011

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1 There is an opportunity to reassess the merits of allowing Verve Energy to retail electricity directly to some customers

1.1 Overview

At the request of the Minister of Energy, the Economic Regulation Authority (ERA) of Western Australia is considering whether Verve Energy should be allowed to retail electricity after the current prohibition on it doing so set down in the Electricity Corporations Act 2005 ("the retail moratorium") ends in 2013, or whether the prohibition should be extended until 2016.

At a minimum, Verve Energy believes that it should be permitted to retail electricity to larger scale customers on the South West Interconnected System (SWIS) when the current prohibition ends. These customer loads would typically exhibit relatively high average annual loads, and operations in most cases would be continuous in nature. Customers fitting these characteristics could be best classified as commercial and industrial (C&I) customers.

The retail moratorium was one of several measures put in place during the reforms of the electricity sector in 2005. At the time, Verve Energy was by far the dominant generator in the SWIS. Since then Verve Energy's total generation capacity market share has fallen from 77 per cent in 2007/08 to 52 per cent in 2012/13[1].

The entry of Independent Power Producers (IPPs) has forced Verve Energy plant up the dispatch merit order, primarily because of Verve Energy's role of balancing generator on the SWIS under the current market rules.

Some parties may be concerned that if Verve Energy was to be permitted to retail, it would be able to use its generation position in the wholesale market to establish a dominant retail position and substantially reduce retail competition.

Verve Energy considers that the prohibition is unnecessary as:

- the Western Australian electricity and energy markets have evolved in the last six (6) years to support competition, and limit the perceived market power the Verve Energy prohibition was designed to ameliorate;
- Verve Energy's existing wholesale electricity contracts are a limit to its ability to act in an anti-competitive manner; and
- even with the removal of the retailing prohibition on Verve Energy the Electricity Corporations Act 2005 (Act) still incorporates restrictions on it's commercial operations that sufficiently constrain any residual market power that Verve Energy may have.

[1] Based on IMO capacity credit assignment

Verve Energy's view is that it has neither the ability nor the incentive, considering its contracted position, to exercise market power in the retail market. Moreover, sophistication of C&I customers, including the ability to backward integrate into electricity retail at relatively low cost, effectively disciplines any generator from leveraging a strong wholesale position to reduce retail competition.

1.2 Original reasons for prohibiting Verve Energy from retailing have not endured

The policy intent of the retail prohibition on Verve Energy was to reduce overall electricity prices by promoting competition in the provision of electricity generation and retail segments of the market.[2] At the time, a means of facilitating competition in generation and retail was to disaggregate the vertically integrated Western Power, and for a period prohibit the generation and retail entities from being able to compete in each others respective markets, as together their collective market share represented 90% of the markets.

The restrictions were intended to:

- encourage new entry into generation and retail (to facilitate the complementary introduction of full retail contestability);
- improve the diversity and reliability of generation and retail supply by the entry of more market participants; and
- incentivise the government owned generator and retailer to contract with new market entrants rather than with each other.

Since 2005, the WA electricity market has evolved, and competition has developed both in the generation and retail segments. Verve Energy's total generation market share (of capacity credits) has fallen with the entry of new generation businesses such as Alinta, Griffin Energy, NewGen (ERM Power) and Perth Energy. The introduction of partial retail competition also resulted in the entry of retailers such as Alinta, Perth Energy, Southern Cross Energy, and Premier Power Sales.

At the time, it is clear that the policy intention of the prohibition would be temporary, and subject to a sunset provision based on a clear assessment of whether allowing Verve Energy to retail would reduce or lessen competition in the generation and retail markets in the SWIS.

Assessing whether allowing Verve Energy to retail in the SWIS would reduce competition requires examination of whether Verve Energy has enduring market power, as a function of its generation market share. Identifying market power is not straight forward, and needs careful consideration of market definition, market share, and the nature of competitive behaviour in the market.

[2] A Carpenter (2005), 'Electricity Corporations Bill 2005 - Introduction and First Reading'

The Australian Competition and Consumer Commission (ACCC) in its Merger Guidelines (November 2008) outlines guidance to identify manifestation of market behaviours which might “suggest” the existence of market power. Generally, these include:

- supplying new product of poorer quality but at the same or higher price;
- reducing the range of products offered;
- lowering customer service standards but charging the same or higher price; and
- raising prices beyond the economic costs of supply.

Verve Energy considers that were it able to retail, it would be unable to act as outlined above. Verve Energy would be looking to service the retail market by efficiently and reliably supplying energy and at a price that would need to be competitive with alternatives.

Verve Energy receives regular approaches from large customers wishing to deal with it directly – empirical evidence that those customers see value in a direct relationship with Verve Energy.

1.3 Some parties may have objections to Verve Energy being permitted to retail electricity

The key economic argument for preventing Verve Energy from retailing is that it would be able to leverage market power in the wholesale energy market to create a dominant position in the retail market, thereby inhibiting retail competition, moving retail pricing away from competitive equilibrium, and reducing economic efficiency.

Market power is the ability to profitably move prices away from the competitive level. Possession of market power is principally a structural phenomenon, while the exercise of market power is behavioural. Market power would be exercised (by a generator) by withholding supply from the market, either physically (by declining to offer some or all of the participant’s capacity) or financially (by offering at prices away from competitive levels). In most cases the two methods of exercising market power are equivalent. Market power could in principle be exercised in either the capacity market or the energy market.

The exercise of market power in principle results in changes to the market clearing price and quantity that are advantageous to the party exercising market power (and possibly to others) and where the market power is enduring will have a detrimental impact on net social benefits. Importantly, the market power must not be transitory – the business must be able to maintain the behaviour for a sustained period.

Leveraging market power in the wholesale market to create a dominant position in the retail market would entail refusing to deal with, or offering high pricing to, retailers seeking wholesale supply in order that the party exercising market power could itself win retail business at prices that other market participants could not compete with.

However, objections to Verve Energy retailing on the basis of concerns that it may be able to leverage market power in the wholesale energy market to create a dominant position in the retail market, may be unfounded. Four considerations in particular lead Verve Energy to conclude that the market power issues underlying the retail moratorium are, in reality, minimal and are unlikely to materially affect competition in the retail market:

- Verve Energy has limited ability to exercise market power in the wholesale electricity market. The Replacement Vesting Contract 2010 and other bilateral contracts held with Synergy and other retailers effectively mute Verve Energy's ability and incentive to do so;
- The 3000MW Capacity Cap and the future requirement for new competitive base load options has and will ensure that Verve Energy provides competitively priced wholesale electricity for the foreseeable future;
- The quantum of value actually added to the C&I segment by retail activities (facilitating market access; risk management) is small in relation to the energy value of a typical contract. C&I customers can and do backward-integrate to gain access to the wholesale electricity market, which acts as a discipline on all market participants' behaviour when pricing and providing services to C&I customers; and
- There is evidence that C&I customers see value in dealing directly with Verve Energy. Verve Energy is regularly sought out by customers seeking access to the wholesale market.

These points are detailed in Sections 2, 3 and 4 of this paper.

2 Verve Energy has limited ability to exercise market power in the wholesale market for energy

2.1 Verve Energy has a limited amount of un-contracted energy and capacity

Verve Energy has limited ability to exercise market power if pricing for new retail loads because a significant proportion of its existing generation portfolio capacity and energy output capability is under contract, is utilised to perform market obligations or is traded in the Wholesale Electricity Market (WEM).

Much of Verve Energy's base load plants are currently operating at unfavourably low capacity factors relative to their optimal design intent. This is primarily a result of a current over supply of base load capacity on the SWIS in combination with Verve Energy's role as balancing generator under the current market design rules. Until SWIS Energy demand grows sufficiently, this outcome is likely to persist in the short to medium term, especially given the growing penetration of intermittent wind farm generation onto the SWIS which is likely to relatively increase the operational burden on Verve Energy's peaking and mid-merit plant.

Given the under-utilisation and sub optimal operation of Verve Energy base load plant it could be incorrectly perceived that Verve Energy has substantial latitude to contract for new volumes. In fact the flexible arrangements in a number of its existing long-term electricity supply contracts allow its wholesale electricity customers (namely Synergy) to potentially increase their contract energy nominations to satisfy their own changing retail contract position. These flexible arrangements would limit Verve Energy's ability and incentive to directly contract to potential large scale customers such as the C&I customer segment.

Therefore a large proportion of Verve Energy's maximum energy generation capability (assuming an economic and optimal dispatch of its existing generation portfolio) is effectively under contract at specified prices through its existing wholesale electricity supply arrangements. Analysis indicates that each year, approximately 10 to 15 per cent of Verve Energy's energy generation capability may be available for sale outside of existing contract commitments over the next decade.

Similarly, a large proportion of Verve Energy's existing generation portfolio capacity (based on capacity credit assignment) is assigned to existing long-term electricity supply contracts. Of Verve Energy's existing total generation capacity, approximately 15 per cent will be available for sale each year outside of existing contract commitments over the next decade. Verve Energy is currently restricted from investing in new generation (except renewables) where that investment would lead to a breach of the 3,000MW cap imposed by government, hence there is currently limited opportunity for the business to increase its uncontracted capacity. Therefore, Verve Energy's ability as a retailer to satisfy its individual reserve capacity requirement (IRCR) from its own generation portfolio would be limited if it were able to retail directly to end users.

2.2 The 3000MW capacity cap has served to create competition as will the future requirement for new base load generation

Verve Energy believes there is likely to be strong competition for C&I customers for the next five years at least and that this competition will continue thereafter. The entry of IPP base load plant – arguably earlier than required, has resulted in excess of base load capacity on the SWIS. Based on existing SWIS load forecasts (which assume large-scale magnetite iron ore processing loads come on line) it is unlikely that new base load plant will be required on the SWIS until around 2018. Verve Energy's ability to invest in new base load capacity would require removal of the 3000MW cap and/or the retirement of existing assets in its generation portfolio.

Wholesale electricity competition in Western Australia has been, and will continue to be, greatly fostered by fuel competition. Cheaper gas has in the past supported the entry of gas generators such as Alinta and NewGen competing with Verve Energy's base load coal and gas plant. As legacy gas contracts expire in the next five years, incumbents' fuel cost advantages will be eliminated thereby possibly providing commercial opportunities for new entrant base load gas generation to enter the market in due course to compete with Verve Energy.

However rising gas prices have led to a coal versus gas price disparity in Western Australia to such an extent that in the absence of an adequate carbon price signal, the base load investment decision can be weighted in favour of coal fired generation under certain scenarios. Even in the event of this outcome Verve Energy would still be likely to face competition from new entrant (or existing) coal generators seeking to satisfy existing and new loads such as those in the mid-West region.

3 The threat of backward integration by customers means there is little benefit for Verve Energy in trying to increase retail margins

Ultimately, what is at issue in deciding the future of the retail moratorium is not only whether Verve Energy has market power and the incentive to exercise it in the wholesale market, but whether it can use the effects to advantage itself in the retail market. Verve Energy is of the view that most, if not all, of the entities with which it would compete for large scale customers would either be other generator-retailers, or entities specifically incorporated to facilitate wholesale market access for a single customer.

Retail margins for example in the C&I segment are very low, reflecting the fact that retailers serving such customers generally provide (and customers generally require) a very simple service, the costs of which do not change much with contract volume. It is difficult to envisage a pure portfolio retailer without any physical asset backing, either on the supply or demand side, being successful in the C&I segment alone.

Verve Energy considers therefore that it is extremely unlikely that a generator-retailer with market power in the wholesale market could create any benefit for itself additional to what could be gained simply by the exercise of market power in the wholesale market. The costs to large end user customers of backward-integrating to provide retail services themselves are simply too low to permit excessive pricing of retail services.

Even if Verve Energy was able to price retail services above competitive levels, it would ultimately be disciplined by customers entering the retail market directly. C&I customers are sophisticated buyers that are able to examine the nature and price of services, seek out the best alternative retail offer, and if necessary backward-integrate to bypass retailers entirely.

The process for obtaining a retail license is relatively simple and low cost, and several retail licensees (BHP Billiton Nickel West, Gold Fields Power Pty, Newmont) serve primarily their own 'captive' demand. This option is expected to act as a limit on all market participants' service and pricing behaviour.

4 Large customers see the value of dealing directly with Verve Energy

Verve Energy believes that C&I customers would be generally supportive of the retail moratorium being lifted in 2013 to enable themselves the opportunity and flexibility to deal directly with Verve Energy for the purchase of wholesale electricity. Large scale customers understand that the ability to contract their loads directly with Verve Energy would provide them with the benefits of being able to access wholesale pricing as part of an efficient and unconstrained supply chain.

These customers also have the ability to secure their own retail licenses in order to deal directly with Verve Energy. However despite the relatively low costs of doing so, it nevertheless represents an operational and financial burden for the end user in terms of market registration, compliance and other trading requirement costs. Removing the retail moratorium would at least provide C&I customers with the option and flexibility to decide whether to contract directly with Verve Energy or via its own retail entity.

Recently and in the past a number of C&I customers have made contact with Verve Energy seeking out the possibility to deal directly with Verve Energy. At least ten major users have sought or enquired about direct service from Verve Energy in the past 12 months. A number of these customers have indicated to Verve Energy that they are likely to provide their public support for the lifting of the retail moratorium by responding to the issues paper.

5 Allowing Verve Energy to directly serve C&I customers could be beneficial to the state and national economy

The development of resources projects supports, in large part, continued economic growth in Western Australia (WA). Many of these are energy-intensive, including iron ore projects in the State’s north-west and the mid-west, and require large volumes of base load electricity – often sufficient volume to require investment in new generation plant.

Meeting new large loads has been an ongoing challenge for the WA electricity sector as investment in generation to support such loads is inherently risky. It is capital-intensive, with high initial sunk costs, and it exposes both the generator and retailer to counterparty risks with little, if any, portfolio effect when serving such singular large loads – the failure of the customer partially strands the assets that serve them.

There are currently few retailers in Western Australia – possibly only one – that have the credit rating and/or risk appetite to underwrite generation development for new electricity loads.

Verve Energy’s wholesale portfolio, long-term fuel contracts, familiarity with infrastructure development issues and strong credit rating make the business a natural player in supplying energy to such large-scale projects, which Verve Energy will increasingly have the ability to do within its capacity cap as older, less efficient plants are retired. Allowing Verve Energy to deal directly with end users would remove a layer of counterparty risk, simplify the negotiation process and allow Verve Energy to compete on an equal footing with other large generators.

6 Recommendation and Conclusions

Verve Energy proposes that it be permitted to retail electricity directly to commercial and industrial (C&I) customers. Verve Energy therefore requests that the ERA endorses termination of the retailing prohibition placed on it in 2013.

For these purposes, Verve Energy proposes that C&I customers be defined as those with an average annual demand of 10MW or more. These customers would comprise mainly mining and processing, heavy manufacturing and water treatment businesses. Due to the scale of their energy purchases, such customers are generally in a good position to manage their electricity consumption and negotiate electricity contracts directly.

Verve Energy considers the proposal as being valid for a number of reasons including:

- the Western Australian electricity and energy markets have evolved in the last six (6) years to support competition, and limit the perceived market power the Verve Energy prohibition was designed to ameliorate;
- market power concerns related to Verve Energy leveraging its position in the wholesale market to create a dominant position in the retail market would be unfounded due to its existing highly contracted position in the energy and capacity markets;
- the 3000MW Capacity Cap and the future requirement for new competitive base load plant options has and will ensure that Verve Energy provides competitively priced wholesale electricity for the foreseeable future;
- C&I customers can backward-integrate to gain access to the wholesale electricity market, which acts as a discipline on all market participants' behaviour when pricing and providing retail services to C&I customers;
- large C&I customers have shown an appetite to deal directly with Verve Energy for the provision of wholesale energy; and
- removing the retail prohibition will provide benefits associated with increased competition in the retail market which should be of benefit to end users and the economy in general, for example better pricing and cost control disciplines, greater product innovation and improved customer focus.