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18 February 2011

Chris Brown
Acting Assistant Director
Electricity Market Surveillance
Economic Regulation Authority
Level 6
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Perth WA 6000

Dear Mr Brown

REVIEW OF PROHIBITION AND RESTRICTION ON SYNERGY AND VERVE UNDER THE *ELECTRICITY CORPORATIONS ACT 2005*

Thank you for the opportunity to submit our views in response to the above Issues Paper

Please find attached Synergy's submission to the Economic Regulation Authority (ERA). Synergy has provided its submission to assist the ERA to determine whether the removal the respective prohibition and restriction in 2013 will encourage competition in the generation, retail and wholesale electricity markets.

Please contact me should you have any queries or comments with respect to Synergy's submission.

Yours faithfully

Simon Middleton

SIMON MIDDLETON
ACTING HEAD OF STRATEGY AND GROWTH

SUBMISSION TO THE ECONOMIC REGULATION AUTHORITY REGULATION AUTHORITY

ON

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

FEBRUARY 2011

1. EXECUTIVE SUMMARY

The *Electricity Corporations Act 2005* (Act) provides that the Minister for Energy must review the operation of sections 38 and 47 of the Act (restriction on retail sale by Verve Energy and prohibition on generation by Synergy for a designated period) within 5 years of the commencement of the respective provisions to determine the effect the limitation has had, and is likely to have, on the encouragement of competition in the generation, retail and wholesale electricity markets.

The Act further provides that the Minister must obtain and take into account the views of the Economic Regulation Authority before carrying out the review.

It is Synergy's view that both the prohibition restricting Verve Energy (Verve) from retailing electricity (Prohibition) and the prohibition restricting Synergy from generating (Restriction) should be preserved through at least 2016 on the basis that removal of the prohibition and restriction in 2013 will not encourage competition in the generation, retail and wholesale electricity markets.

2. COMPETITION IN THE GENERATION, RETAIL AND WHOLESALE ELECTRICITY MARKETS

Synergy welcomes and supports new generation and retail market entry in the SWIS provided it results in a more competitive electricity market.

In Eastern States where full retail contestability has been introduced, competition has emerged when two fundamental conditions are met:

- Regulators have set 'safety net' tariffs at levels that reflect costs of supply and provide margin headroom for competitors to offer market-based contracts.

- Retailers can purchase energy from a competitive wholesale market.

Under these conditions, new retail entrants will be encouraged to participate and will be able to acquire wholesale supplies to meet customer demand.

Having a competitive wholesale market entails the following:

- Many wholesale sellers and buyers.

- Regulated third party access to monopoly controlled transmission and distribution networks.

- Creation of a market operator to administer the market, enforce market rules and ensure there is sufficient capacity (wholesale supply) to meet a prescribed reliability criteria (e.g. 1 in 10 year critical peaks).

- Visible short run price signals to enable the market to be in balance.

- Visible long run price signals that enable market participants to make appropriate investment signals.

- Development of financial instruments (for example contracts for differences) that enable parties to manage risk effectively.

- Access to generation sites in Western Australia – there are only a limited number of sites where green field generation can be sited

- Limited network capacity – highlighted by the planned upgrades of the northwest and the southwest transmission lines. Some capacity is available, but is currently held by existing generators.

- Gas availability – the constraints on the gas supply (commodity and transport) has reduced the number of participants who can build base load power plant.

Synergy submits that the respective Prohibition and Restriction should not be removed in 2013 unless there is demonstrable evidence that the outcome will encourage competition in the generation, retail and wholesale electricity markets. This should be assessed against a qualitative set of criteria such as that suggested by Synergy above.

3. VERVE RETAIL PROHIBITION AND SYNERGY RESTRICTION

It is Synergy's view that both the prohibition restricting Verve from retailing electricity (Prohibition) and the prohibition restricting Synergy from generating (Restriction) should be preserved to at least 2016.

Synergy considers the potential to create two significant state owned gentailers could play an inhibiting role in attracting new electricity market participants to the SWIS in the short term.

More importantly, the potential emergence of Verve as a retailer could have a major detrimental impact upon retail competition in the contestable market for the following reasons:

- Verve through its existing supply contracts with a number of retailers has unique knowledge of the pricing and terms of key supply contracts which could provide Verve with a unique advantage should it be permitted to retail. The generation cost component of the cost stack represents up to two thirds of the total delivered cost in some instances. Verve's dominance in the wholesale market and its potential utilisation of commercial in confidence contractual information may permit Verve to maximise its position in the market to the detriment of other participants and the competitiveness of the market as a whole. Verve would have the opportunity to secure the most attractive of the large industrial and commercial market opportunities on a selective customer basis on the basis of this unfair advantage.

- While initially delivering some energy users lower prices, the impact in the medium term could result in a situation where competition in retail markets is actually reduced. Existing retailers may exit the market either because of their inability to achieve acceptable margins or because they undergo financial stress in servicing their take or pay commitments to Verve because of a decrease in sales. In the event existing retailers exit the market or new retailers do not enter this would increase Verve's market dominance and therefore increase their ability to lift prices.

- Additionally existing retailers would be less likely to commit to long term purchase agreements with non – Verve generators because of Verve's dominance. The result being that Verve would be required to increase their generating capacity further reinforcing their market dominance.

These potential outcomes is not consistent with the pre-requisite for removing of the Prohibition i.e. the encouragement of competition in the generation, retail and wholesale electricity markets. It would be contrary to the encouragement of competitive entry into the SWIS market to have two large retailers (ie Verve Energy and Synergy) competing to the detriment to existing and potential new entrant retailers.

Synergy has calculated that its competitive tendering process has yielded over $2 billion of savings to the market since Synergy's inception. In the event that Verve was permitted to enter the retail market the competitiveness of Synergy's tendering process (and the procurement processes of other retailers in the market) would be adversely compromised.

4. A LEVEL PLAYING FIELD

In the event the state government determines the removal of the Restriction or Prohibition in advance of 2016 will result in an increase in of competition in the generation, retail and wholesale electricity markets (which Synergy does not consider to be the case), Synergy strongly opposes a relaxation of the Prohibition without a corresponding relaxation of the Restriction.

Indeed Synergy considers that the Generation Restriction should be removed well in advance of the Retail Prohibition. The reason for this is the timeframe for retail and generation market entry are materially different. The time horizon required to develop a power station versus simply selling power (particularly given the potential retailer would be Verve Energy who already have a generation position) and is likely to selectively retail electricity opposed to a mass market entry is considerably longer.

While it may take Synergy 3-5 years to get a major generation project to fruition (subject to government accepting this risk on Synergy's balance sheet) should Synergy ever decide to progress in this manner, it is likely that Verve could commence retail services to large contestable customers within months of any change in application of the existing legislation, if not sooner. Equally, implementation costs are appreciably different in scale. Synergy and its customers must not be disadvantaged by such an action without at least the theoretical opportunity to create corresponding offsetting advantages.

Synergy's recommendation is that the timing of the Prohibition and the Relaxation be decoupled. The (retail) Prohibition should be lifted prior to 2016 only upon the triggering of an event such as the commissioning of a Synergy owned power station beyond a certain size (refer other related or ancillary matters).

Finally, Synergy as a retailer in the contestable electricity market has obligations to offer to supply any small use contestable customer (i.e. a customer who consumes between 50-160 MWh). Should Verve be permitted to retail, Synergy's position is that Verve should incur corresponding obligations otherwise there is real potential for Verve to selectively target large customers with attractive load profiles only.

5. VERVE GENERATION CAP

Synergy's view is that we, our customers and the State have benefited from the willingness of independent parties to invest in generation plant in Western Australia and that the Cap has provided some level of investor confidence that competitive "State Owned" generation beyond a prescribed level would not be constructed. Notwithstanding the above Synergy also considers that Verve's ability to construct new plant provides some level of competitive tension in the SWIS wholesale market which may provide future benefit. Synergy supports preservation of the Verve generation Cap for the foreseeable future but not indefinitely. The removal of the cap should occur once government is satisfied that effective competition exists in the generation of electricity.

Excluding a situation where Verve is able to operate as a gentailer, Synergy believes that when Verve's proportion of capacity or energy delivery in the SWIS falls below some prescribed level the Cap should be lifted or restrictions relaxed.

6. OTHER RELATED OR ANCILLARY MATTERS

Small Scale Generation Exception

Synergy proposes that the Generation Restriction be relaxed so as not to apply to any facilities which would be classified as cogeneration units (situated on a customer's premises), and more specifically to any generation facility less than or equal to 10 MW in size on a case by case basis.

This relaxation is required to enable Synergy to facilitate an increased penetration of embedded and distributed generation plant most particularly combined heat and power (CHP) facilities (with their known environmental and energy efficiency benefits) throughout the SWIS. Such facilities are envisioned to be developed in conjunction with electricity customers to meet the specific characteristics of their power needs.

Such relaxation is consistent with Verve's existing right to sell electricity to customers on a case by case basis as permitted by he Minister for Energy[1].

[1] Section 38 of the Act provides that the Minister for Energy may authorise Verve to supply electricity to specified customers or any specified class of customers during the Prohibition by order published in the Government Gazette.

Ministerial Direction

On the basis that Synergy is recommending that the Generation Restriction be extended through 2016, there remains no purpose in maintaining the Ministerial Direction that restricts Synergy from entering into an agreement that requires it to register as a Market Generator. Synergy therefore seeks to have this Ministerial Direction lifted. The reason for Synergy seeking the Ministerial Direction to be lifted is to reduce the future risk of market failure or undue financial consequences being borne by Market Participants in the event of a generator failing to perform its contractual obligations.

Competitive Tension in the Market

The generation cost is the most significant cost in the cost stack and clearly suggests that the competitiveness of the wholesale generation market is critical to market outcomes. Synergy undertakes tender processes to bring about the lowest cost of procurement. Synergy recommends that if competitive tension is not adequate in the market to encourage competitive outcomes that Verve's capacity cap can be relaxed.

Synergy Restricted to SWIS

Synergy has requested that restrictions on its ability to provide natural gas services outside the SWIS be lifted. Synergy is of the view that the relaxation of this restriction will add increased competition in the gas market that will benefit end users.

Synergy believes that this should also extend to the provision of electricity retail services outside the SWIS, particularly in the instance of contestable load where the customer is seeking Synergy participation in the market.

Data Clarification

On page 12 of the Issues Paper the ERA included Table 2.3 which was used to portray the market share of Verve and Synergy. Some additional commentary on this subject was also included in section 2.7.

Verve's capacity credit share is not, in our view the best way to portray its market share. Capacity includes a significant amount of DSM and peaking plant much of which is rarely utilised; consequently, energy delivered is likely to be more meaningful.

Likewise in analysing retail market share it is only the contestable market and not the total market that should be used. There has been significant competition in the contestable market and incorrect conclusions can be drawn by including the non contestable market for this analysis.

Similarly, is it important to assess the market share that Verve represents of the market in the context of that generating capacity that is available to supply the market as opposed to total generation capacity. A proportion of generation capacity is dedicated to specific customers. This suggests that Verve's dominance of the remaining residual wholesale market is much greater than if compared to the total market and generating capacity.