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CHAMBER OF COMMERCE AND INDUSTRY
WESTERN AUSTRALIA

Economic Regulation Authority
PO Box 8469
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PERTH WA 6849

18 February 2011

To Whom It May Concern

RE: PROHIBITION AND RESTRICTION ON SYNERGY AND VERVE ENERGY UNDER THE ELECTRICITY CORPORATIONS ACT 2005 - ISSUES PAPER

CCI thanks the Economic Regulation Authority (ERA) for the opportunity to comment on the Prohibition and Restriction on Synergy and Verve Energy under the Electricity Corporations Act 2005.

CCI is the leading business association in Western Australia and the second largest organisation of its kind in Australia. CCI has a membership of nearly 6,000 organisations in all sectors of the economy. About 80 per cent of members are small businesses, and members are located in all geographical regions of WA.

Energy is a vital enabler of economic growth and activity. This is particularly important for Western Australia given the energy-intensive nature of our industry base. Issues pertaining to cost, security of supply and availability of energy are paramount not only to businesses, but also to households. Therefore, developing a competitive and efficient market for electricity in WA should be a priority.

CCI has long advocated for the development of a competitive market for electricity in WA. Freely operating markets provide the most efficient allocation of resources, and result in outcomes that serve to boost economic growth and productivity in the long run.

Together with other market power mitigation measures (as outlined in Section 2.3 of the ERA Issues Paper), the restrictions placed on Verve and Synergy prohibiting them from retailing and generating electricity (respectively) was intended to foster the development of a competitive electricity market in WA. The market power of the state-owned utilities has indeed fallen since disaggregation in 2006. However, competition has been slow to develop.

For example, Synergy currently holds around 80 per cent of the South West Interconnected System (SWIS) market (according to electricity sold) including both its contestable and non-contestable customer baseⁱ. It is estimated that Synergy supplies approximately 66 per cent of the contestable market itselfⁱⁱ. Verve Energy currently holds approximately 61 per cent of the market for electricity generation in the SWIS (according to capacity credits)ⁱⁱⁱ.

Projections suggest that these shares may fall further in coming years given anticipated load growth. That said, Synergy and Verve are still expected to remain the dominant retail and generation business in the WA electricity market for the foreseeable future.

With large shares of the retail and generation markets owing to the state-owned utilities, CCI is of the opinion that the market is unlikely to be sufficiently mature at present - or in the near future - to consider any easing in the retail/generation restrictions in the short term. Any such easing may entrench or increase the market power of the state-owned utilities to the detriment of competition in the long run. Therefore, our preference is for the restriction to remain in place until the market is more mature. However, government action is required to help develop a more mature electricity market in WA.

The State Government should use this legislative review of the restrictions on Verve and Synergy as an opportunity to revive the process of electricity reform in Western Australia, particularly with the Strategic Energy Initiative (SEI) running concurrently. This will be important to help develop a more mature, competitive market for electricity before any potential removal of the restrictions on Verve and Synergy from 2016. As part of the present legislative review, CCI encourages the State Government to articulate a five-year plan for the continuation of electricity reform in WA. Key elements of the plan should include:

- (1) A commitment to pursue fully cost reflective electricity tariffs for the SWIS;
- (2) A commitment to pursue a path towards cost reflective tariffs more quickly for the existing 50MWh to 160MWh contestable segment of the market to encourage competition in supply;
- (3) The establishment of a timetable for full retail contestability in the SWIS;
- (4) The development of a framework for the independent review and setting of electricity tariffs in Western Australia; and
- (5) To the extent that the above reforms help to develop a more mature electricity market in WA up to 2016, consideration must be given to restructuring and privatising Verve and Synergy, for example, into two privately competing generation-retailers from 2016.

Our position is explained in more detail below.

Concerns over Easing the Retail/Generation Restrictions

Easing the restrictions on Synergy and Verve in 2013 would effectively create two, competing state-owned generation-retailers in WA. This may be positive in the short term from the standpoint of giving energy users more choice in supply. It may be especially useful to large intensive load users who often require their electricity supply to be sourced from a highly credit-rated entity in order to secure project financing. In this scenario, having an alternative supply option like Verve (with its likely high credit rating) would be of benefit.

However, this is inherently a short term solution given the risk that in relaxing restrictions sooner to encourage Verve to compete with Synergy, the emergence of strong private sector competition (i.e. of an appropriate scale so as to engender a high credit rating) in the long run could be hampered to the extent that the utilities are able to consolidate market power by vertically integrating their operations.

This is a particular concern in the case of Verve given its incumbent position in the generation business. For Verve, building a retail business to compliment its existing generation portfolio would not be expected to entail significant cost or risk. In contrast, Synergy if allowed to generate would need to undertake significant new capital investment and risk in order to build a generation portfolio to compliment its existing retail business and effectively compete with Verve. Therefore, an easing in the existing restrictions could be of greater benefit to Verve than Synergy.

Of course, this is likely to remain the case even from 2016 if restrictions are maintained until then (i.e. Verve will continue to have the advantage of incumbency in generation while Synergy will not). Therefore, the State Government should also give consideration now to restructuring and privatising its retail and generation utilities in future.

For example, two private generation-retailers could be formed by drawing on the generation assets and retail operations of Synergy and Verve. Of course, before this can occur, the market would need to develop a competitive balancing mechanism (and provision of ancillary services), which is currently being considered by the Rules Development Implementation Working Group of the IMO. Therefore, further restructuring of the electricity market and privatisation of assets would need to be a medium term consideration.

The case for further competition and privatisation in the electricity sector is also strengthened from a fiscal standpoint. For example, CCI would be concerned about the increased risk to taxpayers that an easing in current restrictions might involve, in that two government-owned enterprises would subsequently be permitted to take on the significant risk of building and managing a portfolio of electricity generating assets. It would be more fiscally prudent for the government to encourage private sector take-up of such risks by further encouraging the development of competition in the Wholesale Electricity Market (WEM). However, further reforms that give more investment certainty to private operators would need to be implemented in order for this to be achieved.

Developing a More Competitive Electricity Market: Cost Reflective Tariffs

A key factor that has limited new entrants into the WEM is the below-cost tariffs that have prevailed in WA. Due to government policy, household and business tariffs remained largely unchanged in the 15 years prior to the disaggregation of Western Power and tariffs have remained fairly flat in the three years since. In contrast, the cost of supplying electricity has risen rapidly over this period, to the point where tariffs now do not reflect the cost of supplying power. As a result, the State Government has recently undertaken to raise tariffs, although they still remain some way off fully cost reflective levels.

In developing a more competitive market, the pursuit of fully cost reflective electricity tariffs should be a priority for the State Government.

The importance of this is underscored by the fact that despite a large portion of the total demand for electricity in the SWIS being contestable (approximately 60 per cent of the market^{iv}), the majority of this contestable segment is still supplied by Synergy (as reported above, some 66 per cent of the contestable market is supplied by Synergy).

The contestable market segment is made up of two groups of customers according to usage. The first segment pertains to those using between 50MWh and 160MWh per annum. These tend to be large use households, some small businesses and medium-sized firms. Importantly, under current rules this market segment retains access to tariffs. The second segment relates to those using over

160MWh per annum. These tend to be large-scale power users. This segment does not have access to tariffs.

According to the Oates Report of 2009, the first contestable group accounts for around 20 per cent of total SWIS demand^{iv} (some 3,100GWh) while some 40 per cent of demand (6,100GWh) relates to the second category of users^{iv}.

Contestable customers with access to tariffs (i.e. those using between 50MWh and 160MWh per annum) have tended to remain on tariffs due to the below-cost tariff regime that has prevailed in WA. Therefore, it is believed that most of this customer segment has tended to remain with Synergy in the absence of any price incentive to source supply with an independent provider (who being commercial operators are less able to profitably supply at the below cost tariff). Therefore, the existing tariff structure works to reduce the contestability of this particular market segment.

As a result, further immediate tariff rises to levels that reflect the cost of supplying power in this segment would better enable independent power providers to compete for market share in this segment. Cost reflective tariffs in this segment would give more price incentive for customers to source supplies elsewhere. Indeed, the tariff increases that have been recently applied may explain some of the 52 per cent rise in the number of non-residential contestable customers supplied by Perth Energy in 2009-10^v (note that despite Perth Energy's growth in market share in 2009-10, Synergy still supplies 86 per cent of non-residential contestable customers in the SWIS).

Developing a More Competitive Electricity Market: A Plan for FRC

Another barrier towards fostering greater competition in the State's electricity sector has been uncertainty over the timing of full retail contestability (FRC) in the SWIS. Of course, a precursor to FRC is further tariff increases to cost reflective levels in the non-contestable market segment (i.e. those using below 50MWh per annum).

This segment of the market accounts for approximately 40 per cent of total demand in the SWIS^{iv}, and users tend to be small businesses and households. Although CCI recognises the financial hardship that recent tariff increases have had on parts of the community, it is important that users pay a price for electricity that reflects the costs of supplying it.

This has significant economic benefits in that it helps to ensure that our energy resources are used more efficiently (i.e. users receive the right price signal for electricity and tailor their usage accordingly). It also has positive fiscal implications in reducing the value of the subsidy paid by taxpayers to electricity users to cover the gap between the true cost of electricity and the artificially low tariff currently paid.

A move towards cost reflective tariffs in this segment sets the stage for FRC in the SWIS in future. That is, prior to removing the current restriction prohibiting independent power providers to supply to this segment, the tariff chargeable must be raised to cost reflective levels in order to allow independent suppliers to effectively compete in this segment.

Therefore, in synchronisation with the move toward cost reflective tariffs, CCI would encourage the State Government to articulate a clear plan and timetable for allowing FRC in the SWIS. This would provide greater investment certainty to independent power providers and the state-owned utilities, and in turn engender higher investment into the state's electricity sector.

Developing a More Competitive Electricity Market: Independent Tariff Setting

The current process for setting electricity tariffs in WA is heavily influenced by the political process. This rarely results in the most efficient economic outcome being implemented.

For example, in January 2009 the WA Office of Energy (OOE) completed a review of electricity tariff arrangements in WA and recommended that the State Government apply a series of tariff increases in order to lift electricity prices in WA up to cost reflective levels.

However, because the final decision over how much of an increase is finally applied rests with the Minister for Energy, the State Government eventually approved a staged tariff increase of 10 per cent in April 2009, followed by 15 per cent in July. A similar staged increase was adopted for 2010 of 7.5 per cent and 10 per cent within that year. The OOE recommendation was for a 52 per cent increase in 2009-10, followed by rises of 26 per cent and 13 per cent in the subsequent two years to bring residential tariffs up to cost-reflective levels.

This requirement for Ministerial review and approval has resulted in electricity prices becoming a 'political football' in Western Australia, with the Government conscious of wearing blame for unpopular yet necessary tariff increases. The end result is that consumers continue to pay a sub-optimal price for power, and the growth of a competitive market is therefore hampered.

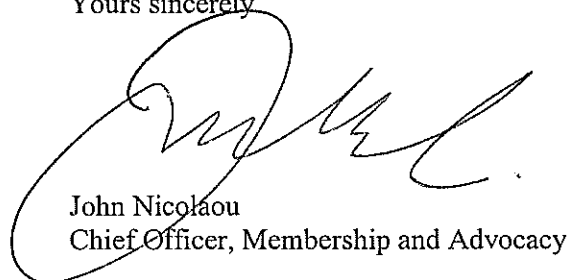
This highlights the need for greater integrity and independence in the process of setting electricity tariffs in WA. Independent determination of electricity tariffs is already a feature in interstate jurisdictions. In Queensland for example, the increase in the retail price of electricity is determined and set by the independent Queensland Competition Authority (QCA), and includes a process of public consultation. In that jurisdiction, the relevant Minister has delegated the authority to set tariff rises to the QCA. Reviews of the components which make up the base tariffs, and the way the base is calculated, is at the discretion of the Minister but would also likely be carried out by the QCA.

It is also notable that a recent OOE report^{vi} reviewing the setting of residential gas tariffs in WA has recommended that gas tariffs here be set under an independent regulatory framework, with an independent body responsible for administering, reviewing and setting retail price controls for gas.

CCI believes that a similar independent tariff setting framework needs to be developed and adopted for electricity in WA. The current process is ad-hoc and therefore entails significant uncertainty for industry participants.

We are willing to discuss our views in more detail if required. For more information or assistance, please contact Noel Richards (CCI Senior Policy Adviser, Resources and Energy) on 9365 7720.

Yours sincerely



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References

ⁱ Synergy Annual Report 2009-10. Page 8.

ⁱⁱ Verve Energy Review, August 2009. Page 26.

ⁱⁱⁱ Economic Regulation Authority, *Prohibition and restriction on Synergy and Verve Energy under the Electricity Corporations Act 2005*, Issues Paper, 25 January 2011. Table 2.3, page 12.

^{iv} Verve Energy Review, August 2009. Page 18.

^v Economic Regulation Authority, *2009-10 Annual Performance Report Electricity Retailers*, January 2011. Page 3.

^{vi} The WA Office of Energy, *A Review of Retail Gas Tariff Arrangements under the Energy Coordination (Gas Tariffs) Regulations 2000*. Draft Recommendations Report, December 2010.