ELECTRICITY CORPORATIONS AMENDMENT BILL 2013

Introduction and First Reading

Bill introduced, on motion by **Dr M.D. Nahan (Minister for Energy)**, and read a first time.

Explanatory memorandum presented by the minister.

Second Reading

DR M.D. NAHAN (Riverton — Minister for Energy) [12.11 pm]: I move —

That the bill be now read a second time.

The Electricity Corporations Amendment Bill 2013 contains amendments to the Electricity Corporations Act 2005 to implement the merger of the Electricity Retail Corporation, trading as Synergy, and the Electricity Generation Corporation, trading as Verve. It is intended that the corporations will commence trading as a single entity from 1 January 2014.

During the term of the former Court government, the then Labor opposition committed to reform of the electricity market based roughly on the changes put into place in the eastern states over the previous decade. The objective was to shift away from the vertically integrated government monopoly model to an electricity market driven by market forces, competition, private investment and risk-taking. Upon forming government in 2001, the Gallop government initiated the reform process with the establishment of the Western Australian Electricity Reform Task Force. Extensive reviews and consultations were undertaken, with the full reform process costing $154 million. The taskforce identified that the introduction of market-based reforms faced a number of major hurdles in Western Australia. These included a small, isolated, lumpy and volatile market; the dominance of Verve; and uncertainty as to whether the private sector would enter the market at the scale and of the nature needed to replace Synergy and Verve.

The review process culminated with the Electricity Industry Act 2004, the Electricity Corporations Act 2005 and the commencement of the wholesale electricity market in 2006. New regulators were established in the form of the Independent Market Operator, the Public Utilities Office—the then Office of Energy—systems management, the Coordinator of Energy and the Energy Ombudsman together with some oversight by the Economic Regulation Authority. The focal point of the reform was the disaggregation of Western Power into four publicly owned entities—that is, Verve as a generator, Synergy as a retailer, Western Power as a network provider and Horizon Power as the integrated regional provider outside the south west integrated system, known also as SWIS.

The establishment of Western Power as a separate, regulated network provider was not controversial and was supported by the Liberal Party. The establishment of Horizon Power as the regional integrated provider, although flawed in implementation and governance, was itself not controversial. The establishment of a separate retailer, Synergy, and generator, Verve, was controversial as were the arrangements governing them, their interactions and the wider market. The Labor government claimed that many benefits would flow from these changes, including that electricity prices would drop by 8.5 per cent; the newly disaggregated entities would continue to operate profitably; private sector investors would enter the market in both generation and retail and assume appropriate levels of risk; a competitive market with full retail contestability would be achieved in around five years; and innovative and efficient outcomes would be delivered. None of these promises have been delivered upon, except the privatisation of generation.

Since 2008, over 30 per cent of the capacity in the SWIS has moved into private sector ownership. However, private sector investment in generation is not an end in itself, but only potentially a means to an end—namely, lower prices, competition and innovation, none of which were achieved as promised. Prior to disaggregation, residential electricity tariffs were 13.9c per kilowatt hour and Western Power's annual profit was $400 million with no subsidy by the government, including for non-SWIS regional operations. Despite the residential A1 tariff nearly doubling to 25.9c per kilowatt hour, the combined entities have made and continue to make substantial losses requiring hefty subsidies from taxpayers. The total subsidies in 2013–14 are forecast to be $545 million. The total government subsidy to Synergy and Verve since disaggregation in 2006 has been $2.5 billion. This has been required in spite of electricity tariffs to households increasing by 78 per cent. Without change, it is clear that the level of subsidy will only increase.

In the run up to disaggregation, it was acknowledged that the model of reform chosen imposed substantial additional establishment, management and regulatory costs. The disaggregation review and implementation process alone cost taxpayers $154 million. These changes gave rise to four new entities, when before there was just one. Each new entity came with a separate team of senior executives and a board. In 2005, Western Power had six executives and eight board members being remunerated to a combined total cost of $2.3 million. Now

between the four entities, there are 28 executives and 22 board members with a combined total remuneration of nearly $12 million. The changes gave rise to additional annual management cost of $9.7 million. The disaggregation also created four new regulatory agencies, each with a large staff and executives, and expanded the remit and staff of two other oversight agencies. The combined cost of regulatory oversight of the new system is estimated to exceed $50 million per year.

Over the last seven years of operation, the new market has given rise to over $500 million in additional establishment, management and regulatory costs. The investment in these additional costs was supposed to be offset by lower operating costs, lower electricity prices and no government subsidies. But the benefits have failed to materialise; indeed, costs, prices and subsidies have all risen sharply and unsustainably. The key challenge of disaggregation was to encourage the private sector to compete with Verve. Without this, there would be no gains. Verve's dominant position had to be addressed: Verve had the cheapest fuel, the best sites, excellent grid access, plant diversity and a big organisation with over half a century of history and planning.

The Electricity Reform Task Force's 2002 discussion paper on the reform of the electricity supply industry in Western Australia suggested a number of options that would have realised value for the state and seen the private sector compete with Verve, such as selling or leasing Verve's assets or auctioning Verve's capacity. These were ruled out. Instead of transferring Verve's generating capacity to the private sector, the disaggregation put in place a displacement process whereby an increasing proportion of Synergy's supply requirements were put out to tender to the private sector. This process effectively led to Verve's generating capacity being duplicated by the private sector investment. This caused destruction in the value of a public asset. Because of Verve's aforementioned strengths, it should have won every displacement tender. Verve's plant was simply consigned to redundancy by Synergy contracting duplicate private generation plant. About 530 megawatts of duplicate plant was added in only a couple of supply contracts between 2006 and 2009. This laid the foundation for substantial excess capacity in the market, which has grown in recent years to about 1 700 megawatts above the reserve margin that ensures the reliable service of peak demand. In terms of capacity credits, this excess capacity cost the market about $335 million in the past year alone.

This displacement process also positioned Synergy as the dominant buyer and risk taker in the market. Synergy's task was to facilitate private investment in generation by entering into power purchase agreements with private generators. However, Synergy was formed as a pure retailer; it had no assets other than a customer base. It owned no generation plant and held no significant financial reserves. Even with the implicit backing of the government and a monopoly over the franchise market, Synergy was not a financially strong entity and had minimal capacity to deal with risks. Despite its limited standing, Synergy was expected to act as the primary counterparty in the market and support the majority of new generation capacity, taking the market risk on each contract. Due to its implicit government guarantee and its readiness to sign long-term, fixed-price, minimum-take contracts, Synergy has crowded out any significant retail competition.

The system's design has made it difficult for the private sector to enter the retail market and absorb the new private sector generation. It left Synergy as the default primary counterparty, and Synergy responded accordingly. This led to the situation in which most of the new investment in generation has been underwritten by Synergy at prices unrelated to underlying market demand and supply. In 2006, about 93 per cent of the network's generating capacity was owned or contracted by Western Power. Currently, Verve, Synergy and Water Corporation combined account for about 85 per cent of generating capacity. There are a couple of electricity retailers who operate in the market and take mercantile risk, but their share is small. The result is that Synergy has committed to about $25 billion worth of forward obligations to purchase electricity, with little ability to optimise that position. Worse still, as demand for electricity has slowed, Synergy has been exposed to increasing losses. This is not a model of innovative market solutions.

One of the aims of the disaggregation was to bring in innovation by way of the private sector. The reality is that private sector involvement has, to a great extent, been more restrictive and less innovative than that previously undertaken by the former Western Power. Prior to this disaggregation, Western Power was open to public–private partnerships, whereby the government underwrites the assets and has operational control over them. Under the current model, Synergy has no operational control but underwrites the assets. One of the identified challenges in the disaggregation process was encouraging the right type of capacity. What was, in fact, developed between 2006 and 2009 was predominantly baseload capacity, which at the time was already in oversupply. Synergy needed mid-merit and some peaking capacity, not baseload. The network today has too much baseload, intermittent plant and small peaking units that would likely not have been constructed if there had been mechanisms or incentives to optimise the generation plant mix. The costs to consumers are high, as they are paying for redundant plant.

Poor incentives in Synergy and Verve contributed to the problems in the market and to their losses. Synergy sought to maintain market share by underwriting new entrants in the market, despite its limited ability to carry

risk. Verve, meanwhile, struggled to stay afloat. Prohibited from building new non-renewable generation, facing the stranding of its assets and with much of its capacity underutilised under its contracts with Synergy, Verve was incentivised to engage with the private sector to stay afloat. These perverse incentives are what led to Verve going down the path of refurbishing Muja AB with an inadequate joint venture partner. Moreover, Verve and Synergy have been pitted against each other. Verve's loss of capacity credits due to the delay of the Muja AB refurbishment delivered a windfall refund to Synergy, while Synergy's attempts to optimise its portfolio, particularly around renewables, were done without consideration of the impact that the new generation would have on Verve's operations. The original vesting contract was also tipped heavily in Synergy's favour, to the direct financial detriment of Verve. By re-merging the two entities, we will remove these perverse incentives and minimise the risk to Synergy from its lack of assets.

When the Liberal–National government came to power in 2008, it realised there were serious problems with the electricity market. It undertook a review and took steps to address the problems. It did away with the displacement mechanism, thereby ending the process of forced duplication of Verve's plant and slowing the growth in excess generating capacity. Those were much-needed reforms. The government also changed the vesting contract to be more in Verve's favour, stopping its balance sheet from deteriorating further. There was consideration of re-merging Synergy and Verve; however, the decision not to was made because it was considered at that time that the market was new and should be given time to work itself through. It is now clear that there remain fundamental flaws in the wholesale market that must be addressed. Overall, this market has cost the state an additional $3 billion in additional regulatory costs, management costs and subsidised losses. It is clearly a failed process. The regulatory and management costs will continue to mount, and the losses will do nothing but increase unless major changes are made in the system.

The Liberal–National government is re-aggregating Verve and Synergy. Its aim is not to re-establish a government monopoly, but to address the inefficiencies in the operations of the two entities and realign their incentives so they can operate in the interests of consumers and taxpayers.

The bill contains amendments to vest all assets, rights and liabilities of the Electricity Retail Corporation, or Synergy, in the Electricity Generation Corporation, or Verve Energy. The Electricity Generation Corporation will be renamed as the Electricity Retail and Generation Corporation. It is intended that this merged entity will trade under the name "Synergy". Verve Energy was selected as the continuing legal vehicle for the merged entity, as it holds the majority of the combined assets of the two corporations in the form of electricity generation plant. By retaining Verve Energy as the legal vehicle, there is no need to transfer these assets.

The Electricity Retail Corporation will not continue as a statutory body. The bill will transfer all Synergy employees to the merged entity at the time of the merger. There is no need to transfer the employees of Verve Energy to the merged entity, as the Verve Energy legal entity continues in the form of the Electricity Generation and Retail Corporation.

The government is committed to sustained private sector participation in the electricity market. To achieve this, the merged entity must be subject to regulatory constraints. The amended act will allow regulations to be made to segregate certain functions within the merged entity. Under these regulations, some functions within the merged entity will be subject to ring-fencing, a transfer pricing mechanism and protocols governing the flow of sensitive information. These mechanisms and protocols are designed to ensure that the merged entity will not unduly preference its own retail and generation arms over third party retailers and generators. This will increase pressure on the merged entity to be efficient, reducing upward pressure on electricity prices. The amended act will also contain the regulation-making power to allow the Minister for Energy to approve arrangements for wholesale trading of electricity by the merged entity. It is intended that this power will be used to oblige the merged entity to offer a range of standard wholesale electricity products on a non-discriminatory basis across the merged entity's own retail business unit and other wholesale electricity consumers.

The purpose of the standard products is to provide the private sector with access to electricity on non-discriminatory terms and to mitigate the concerns of private sector market participants. The standard products will be offered under approved terms and conditions, and the prices will need to be non-discriminatory as compared with the notional prices available to the merged entity's own retail arm for an equivalent product under the transfer pricing methodology. The merged entity will also be free to offer customised electricity products in response to requests from market consumers, as Verve Energy currently does. These customised products will be subject to requirements on the process by which they are offered, ensuring fair and reasonable dealing with wholesale customers. To ensure the merged entity is held accountable to its obligations under the regulations, the bill provides that civil penalties can be imposed on the merged entity for noncompliance. The civil penalty regime will demonstrate to the private sector that the merged entity will be appropriately penalised for any noncompliance with regulations. The associated explanatory memorandum contains further detail on amendments contained in the bill.

In addition to the merger-related amendments, the bill contains several ancillary amendments to the Electricity Corporations Act 2005. These ancillary amendments are designed to provide more flexibility in terms of the governance of the corporations, and also to provide the option to remove limitations on where in the state the electricity corporations are permitted to function. These ancillary amendments are described more fully in the explanatory memorandum.

I commend the bill to the house.

Debate adjourned, on motion by **Mr D.A. Templeman**.