WA Independent
Power Association Inc.

‘An independent voice for a competitive power industry’

Frontier Economics Report on Proposed Re-aggregation of Verve Energy and Synergy

The WA Independent Power Association Inc (WA IPA) commissioned the economic consulting firm Frontier Economics to advise on its response to the potential re-aggregation of Verve and Synergy.

While no formal decision has been made by the WA Government to merge the two government-owned energy companies, the WA IPA believes that the public comments by the WA Premier and Energy Minister should be taken seriously and it is important for there to be a public debate and serious economic analysis on the merits of the proposal.

Why Western Power Was Split Up

The breaking up of Western Power in 2006 into Verve Energy, Synergy, Horizon Power and Western Power Networks was designed to bring about a fundamental shift in the way electricity is produced and supplied in the State. The reform was about:

- Moving from a monopoly State-owned system to a competitive, open market, where private generators and retailers could invest and compete with the State owned companies and one another; and
- Separating Verve from Synergy to ensure there was opportunity for private investment to fund new power station developments.

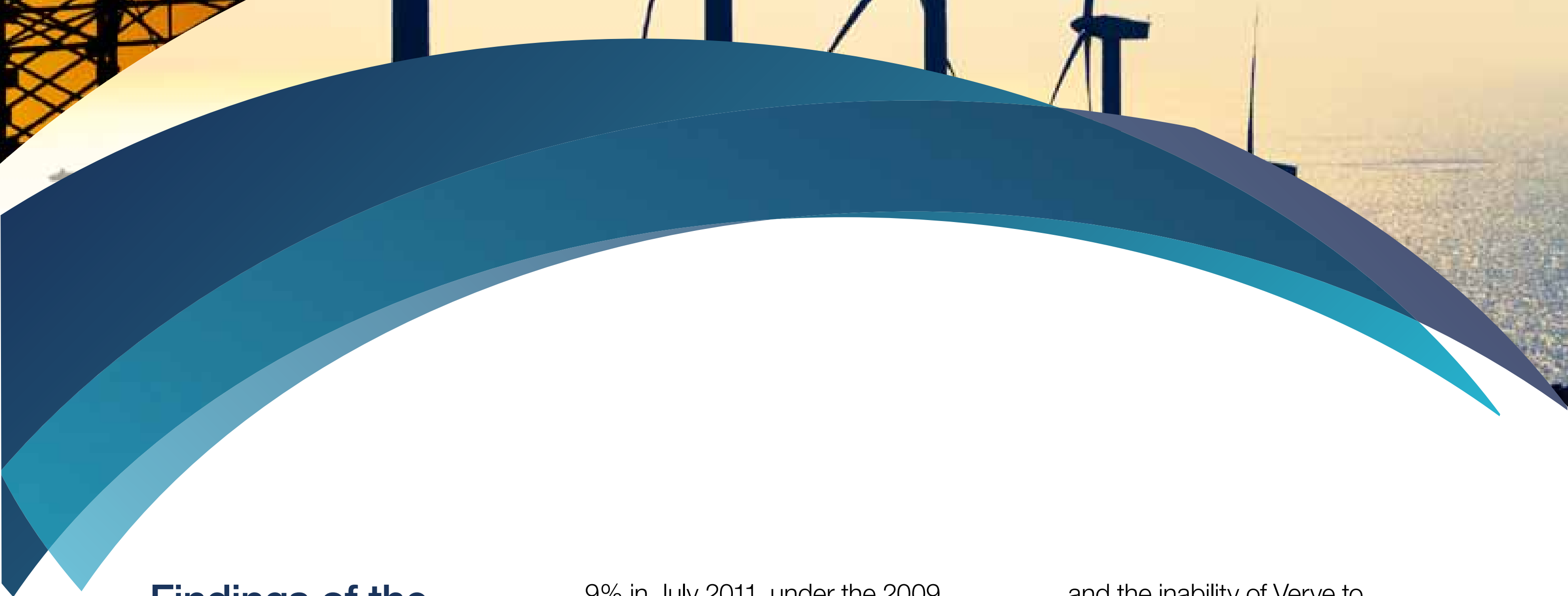
Since the break up, Frontier Economics estimates that $2.6 billion has been invested in new generation capacity as at 2010, over 75% of it from private companies.

Why Re-merge Verve and Synergy?

While the reasons for the Government considering the re-aggregation of Verve and Synergy have not been well articulated, some comments from the WA Premier and Energy Minister suggest that the separation has:

- led to inefficiencies in the use of Verve's capacity;
- been at least partly responsible for higher electricity prices; and
- caused financial problems for Verve and Synergy.

The findings of the Frontier Economics analysis show that none of these claims stand up to scrutiny.



Findings of the Frontier Economics Report

Verve's Ageing Plant the Main Cause of Underutilsed Capacity

Frontier Economics found that the central reason for underutilisation of Verve's electricity generation is the high cost and ageing nature of Verve's plant compared to the newer, more efficient private generators. Prior to the breakup of Western Power, the company itself was looking to retire some of its older plant. Re-aggregating Verve and Synergy would not improve Verve's efficiency but would more likely mean that Synergy would buy electricity from Verve's old plant rather than newer, more efficient cost effective sources.

Higher Gas Prices and Network Charges Causing Electricity Price Increases

Echoing the findings of the Economic Regulation Authority, Frontier found that the main factors explaining rising electricity prices have been increased network charges and rising gas prices. Network charges increased by 12.9% in March and July 2010 and 9% in July 2011, under the 2009 Access Arrangement and since 2006 gas prices have risen four fold. There would be very limited savings, if any, in corporate costs through re-aggregation, amounting to less than 0.4 per cent of a typical residential electricity bill, or around $5 per customer per year.

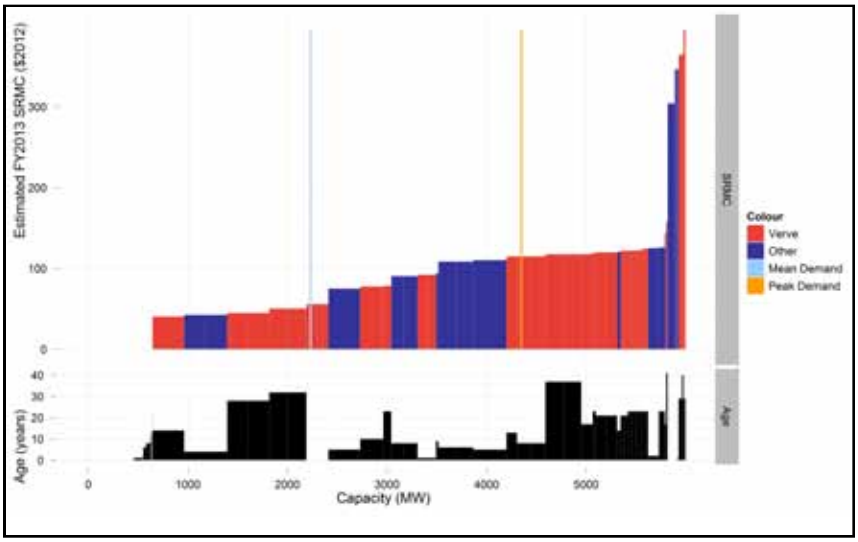
Poor Financial Performance of Verve

Frontier found that the main problems causing Verve's poor financial performance, as also outlined in the 2009 Oates Review were, until recently:

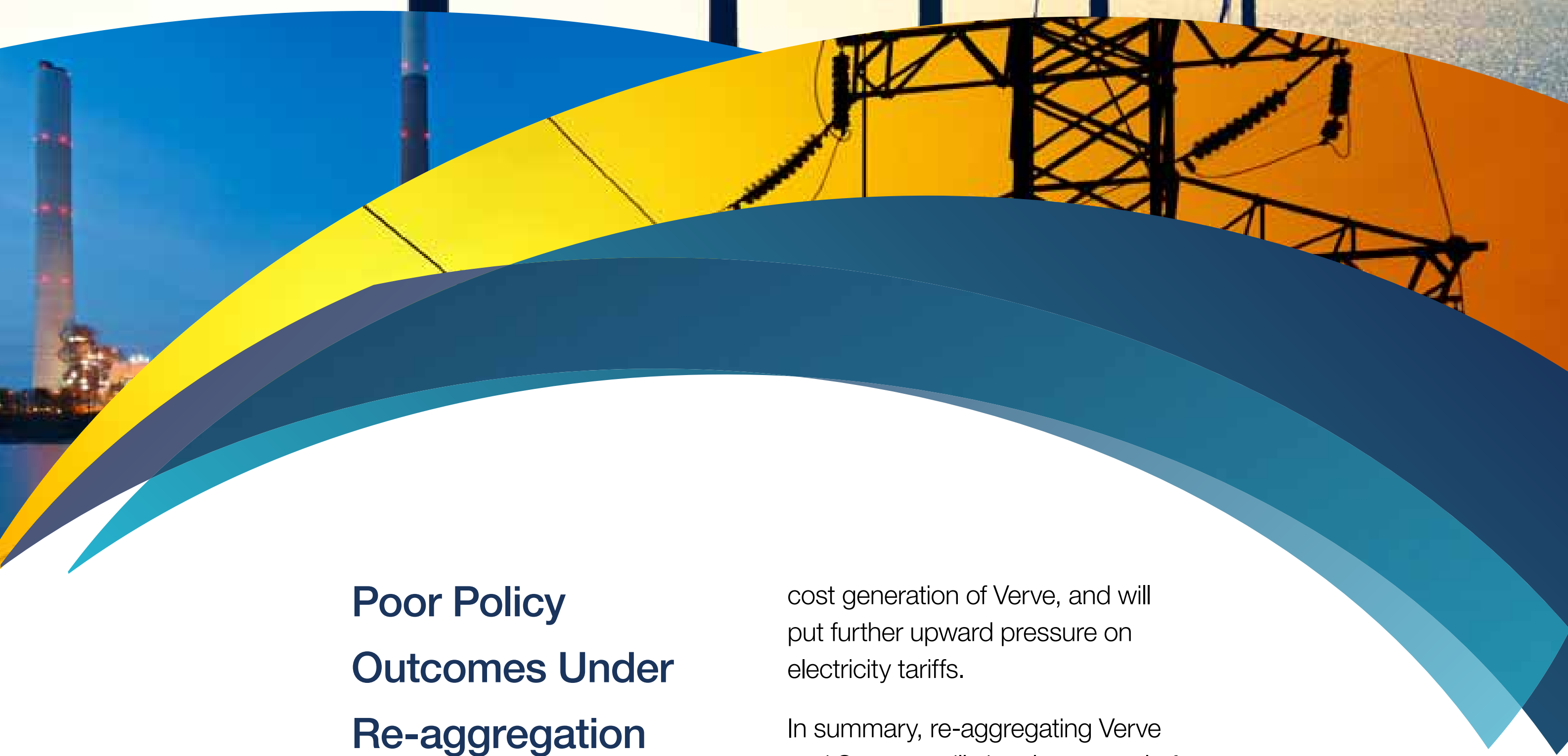
- the increased costs of fuel and network charges, the effects of the Varanus Island explosion, and the inability of Verve to pass those costs on to Synergy under the Vesting Contract put in place at the break up of Western Power; and
- the poor performance of Verve's plant (increased forced outages and high maintenance costs).

The Vesting Contract, which was the commercial contract for sale of power from Verve to Synergy, did not allow Verve to pass on any increasing costs to Synergy. This contract has since been replaced reallocating risks and costs, but none of the other factors affecting Verve's financial performance are associated with the disaggregation.

Western Australian electricity generation merit order and plant age



Source: Frontier Economics.



Poor Policy Outcomes Under Re-aggregation

The Frontier report finds that putting Verve and Synergy together at this point in the market's evolution would cause significant competition issues, as there would be a strong incentive for the retail arm of the business to contract almost exclusively with the generation arm. Not only does this cut off a major avenue for independent power producers to compete to supply to the retail arm, it will also mean locking in the higher cost generation of Verve, and will put further upward pressure on electricity tariffs.

In summary, re-aggregating Verve and Synergy will signal a reversal of the policy of using competition to encourage private investment and providing choice for consumers, and will lead to the State having to take greater responsibility – and risks – in the supply of electricity, including spending significant and scarce capital to pay for new generation.

Download a full copy of the Frontier Economics Report at www.waipa.com.au

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