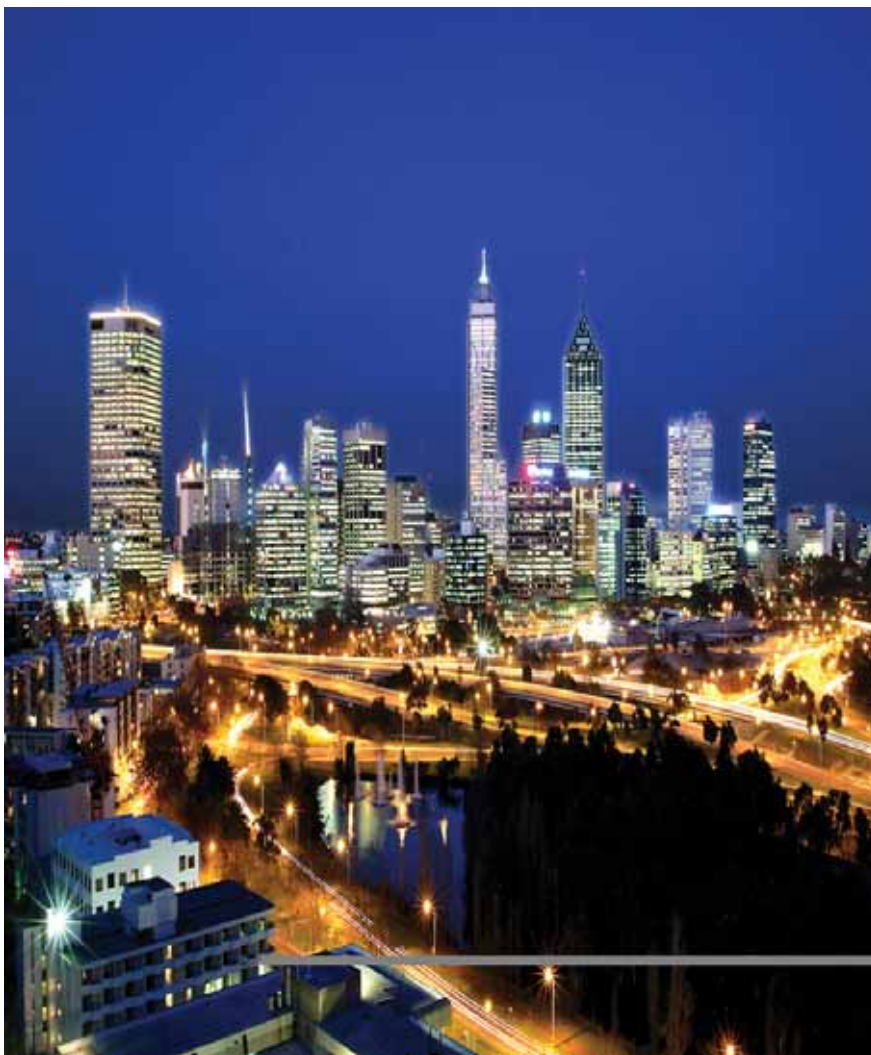




Government of Western Australia
Office of Energy

OVERVIEW OF THE VESTING ARRANGEMENTS



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1. Introduction

The disaggregation of Western Power Corporation (“WPC”) took effect on 1 April 2006. Among other things, the disaggregation provided for the creation of the Electricity Retail Corporation (“Synergy”) and the Electricity Generation Corporation (“Verve Energy”), and for the creation of contractual relationships between these two corporations.

Wholesale electricity supply arrangements are one of the most significant of the contractual relationships that needed to be established between Synergy and Verve Energy. These arrangements affect not only the financial operations of the corporations, but will also impact the development of the Wholesale Electricity Market (the “WEM”) in Western Australia.

As a result, the Minister for Energy (the “Minister”) imposed the “Vesting Arrangements” on Synergy and Verve Energy. The Vesting Arrangements provide for the initial wholesale supply of energy and Capacity Credits from Verve Energy to Synergy.¹

2. Background

The Vesting Arrangements are comprised of the “Vesting Contract”, between Synergy and Verve Energy, and a “Ministerial Direction” given to Synergy, which were established as follows:

- The Vesting Contract:

Under section 82(1) of the *Electricity Corporations Act 2005* (the “Act”), the Minister has the authority to prescribe provisions, which by statutory force, have effect as a contract between WPC’s Successor Entities. On 1 April 2006, the Minister served the *Electricity Corporations (Vesting Contract) Order 2006* on Synergy and Verve Energy to prescribe the Vesting Contract as a contract between Synergy and Verve Energy.

- The Ministerial Direction:

Under section 111 of the Act, Minister has the authority to give directions to WPC’s Successor Entities. On 1 April 2006, the Minister gave a direction to Synergy to impose restrictions on Synergy’s behaviour in relation to the Vesting Contract.

This document provides an overview of the Vesting Arrangements.

2.1 Objectives of the Vesting Arrangements

The Vesting Arrangements are a transitional mechanism to support the development of the WEM. The Vesting Arrangements provide for the initial wholesale supply of energy and Capacity Credits from Verve Energy to Synergy.

¹ The WEM is set to commence in Western Australia on 21 September 2006. The WEM will be operated by the Independent Market Operator (the “IMO”), in accordance with the Rules. The WEM is split into an energy market and a capacity market, as follows:

- Energy can be traded bilaterally outside of the formal WEM processes, but retailers and generators can trade variations from their bilateral positions through a Short-Term Energy Market (“STEM”). The STEM will be operated by the IMO.
- Capacity is traded in the form of “Capacity Credits”, which are a notional unit of capacity provided by a facility during a Capacity Year (see Chapter 11 of the Rules for a more specific definition). Each year, the IMO will allocate Capacity Credits to generators, and retailers are required to acquire sufficient Capacity Credits to meet their requirements under the Rules.

An overview of the WEM and a copy of the Rules can be obtained from the IMO website (www.imowa.com.au).

The Electricity Reform Task Force (“ERTF”)² recommended that wholesale energy contracts should be established between the Generation and Retail Corporations at the time of WPC’s disaggregation to:

- provide for supply to the existing retail customers of WPC;
- mitigate the market power of WPC’s successor entities; and
- provide for a smooth transition to the WEM.

Some additional objectives for the Vesting Contract that were identified by the Commercial Business Steering Committee (the “CBSC”)³ include:

- mitigating the market power of Verve Energy by imposing a wholesale price cap on a significant proportion of its plant portfolio at disaggregation; and
- supporting market development by providing appropriate incentives to both Verve Energy and Synergy to progressively negotiate electricity supply agreements on commercial terms outside of the Vesting Contract.

2.2 Key Features of the Vesting Contract

Some of the key features of the Vesting Contract include:

- **Bilateral Contract:**

The Vesting Contract is a bilateral contract for the wholesale supply of energy and Capacity Credits from Verve Energy to Synergy, and covers all tariff customers (franchise and contestable), and all customers on retail contracts that Synergy inherited from WPC. Synergy and Verve Energy have a balanced commercial relationship under the Vesting Contract, which gives both entities incentive to negotiate new bilateral contracts and transition to the competitive market.

- **The Contract Administrator:**

A Contract Administrator will annually recalculate specific volume and price terms under the Vesting Contract. The Contract Administrator is also to make determinations on the roll forward or backward, and on deferrals under the Displacement Mechanism; and is to resolve any issues that may arise under the Vesting Contract, such as force majeure, changes in law, or changes in the Rules.⁴

² The ERTF was established in 2001 by the former Minister, the Hon Eric Ripper MLA. The ERTF developed a framework for the reform of the State’s electricity industry, to facilitate competition and choice, improve service standards and reliability, and promote economic growth. The ERTF’s Final Report contained numerous recommendations for achieving a dynamic and competitive electricity market, including the disaggregation of WPC and the creation of the Vesting Arrangements. A copy of the ERTF’s final report is available on the OOE website (www.energy.wa.gov.au).

³ The CBSC was a committee that was established in April 2005 by the Minister to:

- oversee the implementation of the disaggregation of WPC into the four Successor Entities;
- strengthen working arrangements between WPC, the OOE, and the Department of Treasury and Finance (“DTF”) in the period prior to disaggregation; and
- facilitate inter-agency discussion on key commercial issues that may have significance to the State’s financial position or the Government’s electricity reform objectives.

The CBSC had representatives from the OOE, the DTF, the State Solicitor’s Office, and WPC.

⁴ See section 3.2 for more information on the Contract Administrator.

- The Capacity Cap:

The quantity of energy and Capacity Credits supplied under the Vesting Contract is governed by a Capacity Cap that will decline over time due to:⁵

- the expiry of Synergy’s inherited retail contracts;
- contestable tariff customers accepting new contract offers (whether with Synergy or another retailer); and
- the operation of the “Displacement Mechanism”, which reduces the quantity of energy and Capacity Credits traded under the Vesting Contract.⁶

- Netback Pricing:

The Vesting Contract applies “netback pricing”, which means that Verve Energy is paid the residual of Synergy’s sales revenue less efficient retail, networks, and other costs.⁷

- The Balancing Hedge:

The Vesting Contract includes a financial hedge to manage Synergy’s risk in the balancing market, but also exposes Synergy to increased costs for excessive nomination errors as a means to provide it with an incentive to forecast accurately.⁸

3. The Vesting Contract

3.1 Term

The Vesting Contract commenced on 1 April 2006.

Certain contract variables are reset periodically by the Contract Administrator for stipulated “Reset Periods”.⁹

In particular, the amount of energy and Capacity Credits to be traded under the Vesting Contract will be determined, in part, by a Capacity Cap. The Capacity Cap will decline over time, and will be recalculated at each Reset Period.¹⁰ The timing of the Reset Periods is as follows:

- the first Reset Period commences on 1 April 2006;
- the timing of the commencement of the second Reset Period depends on the timing of the start of the WEM;¹¹ and
- each subsequent Reset Period commences on 1 October each year thereafter.

⁵ See section 3.3 for more information on the Capacity Cap.

⁶ See section 3.5 and Appendix B for more information on the Displacement Mechanism.

⁷ See section 3.6 and Appendix C for more information on the netback mechanism.

⁸ See section 3.7 for more information on the balancing hedge.

⁹ Contract parameters are reset periodically (typically annually) at the end of specified “Reset Periods”. See section 3.9.3 for more information on this reset process.

¹⁰ The Capacity Cap is the highest amount of energy that can be delivered under the Vesting Contract for any Trading Interval. See section 3.3 for more information on the Capacity Cap. Note that the Capacity Cap under the Vesting Contract is different from the “capacity cap” under the Ministerial Direction that limits future investment by Verve Energy (see the OOE website at www.energy.wa.gov.au).

¹¹ There will be a “Market Start Reset” if start of the WEM is delayed until after 30 September 2006. If there is a Market Start Reset, then the second Reset Period will start on the same day as the WEM. If there is no Market Start Reset, then the second Reset Period will start on 1 October 2007. The WEM is set to commence on 21 September 2006, so there will not be a Market Start Reset.

The Vesting Contract will terminate at the end of the first Reset Period when the Capacity Cap is less than 150 MW.

As a result, the timing for the termination of the Vesting Contract is dependent on several factors that affect the Capacity Cap, including:

- churn of contestable tariff customers to contracts (whether to Synergy or to another retailer);
- growth in franchise customers; and
- implementation of the Displacement Mechanism (see section 3.5).¹²

3.2 The Contract Administrator

The Contract Administrator is the Minister, or a person delegated as the Contract Administrator by the Minister. The Minister has delegated the Contract Administrator role to the Coordinator of Energy.

The Contract Administrator has two main tasks under the Vesting Contract:

- undertake all relevant calculations for each Reset Period, in accordance with the formulae in the schedules to the contract (see sections 3.3 to 3.9.5); and
- act as an arbitrator in disputes between Verve Energy and Synergy with respect to force majeure, changes in law, and changes in the Wholesale Electricity Market Rule (the “Rules”) (see sections 3.9.7 to 3.9.10).

There is an important distinction between the Minister in his contractually mandated role as the Contract Administrator, and his statutorily mandated role under sections 80 to 87 of the Act.

3.3 Capacity Traded under the Vesting Contract

With the exception of the first Reset Period, Verve Energy must provide Capacity Credits to Synergy up to the Capacity Cap in each month. Verve Energy can provide less Capacity Credits than the Capacity Cap if the total capacity requirement for the tariff customers and the inherited contract customers minus displacement capacity is less than the Capacity Cap in that month.

The Capacity Cap for the first Reset Period is 3,305 MW. However, since the Muja A/B facility has not been certified by the Independent Market Operator (“IMO”), Verve Energy must only make 3,103 MW of Capacity Credits available to Synergy for the first Reset Period.

The Capacity Cap in each subsequent Reset Period is determined by the Contract Administrator as the lesser of three amounts:

- Synergy’s capacity requirements for customers backed by the Vesting Contract;
- Verve Energy’s amount of credited capacity under the Vesting Contract; and
- the Capacity Cap in the previous year.

Schedule 2 to the Vesting Contract provides the formulae to calculate these three amounts.¹³ The Capacity Cap will decline over time under this mechanism, thereby reducing the amount of energy and Capacity Credits traded under the Vesting Contract.

¹² Appendix B provides some scenarios to outline the Displacement Mechanism and to illustrate the potential timing for expiry of the Vesting Contract.

¹³ See Appendix A for more information about the capacity calculations under the Vesting Contract, including for the Trading Interval Minimum and Maximum Nominations, and the Monthly Energy Cap.

3.4 Energy Traded Under the Vesting Contract

The Vesting Contract provides for the supply of both “energy” and “Additional Energy” from Verve Energy to Synergy. The amount of energy and Additional Energy that Verve Energy must supply to Synergy is related to the Capacity Cap.

3.4.1 Energy

In each Trading Interval (i.e. each ½ hour), Verve Energy must supply Synergy with energy equal to or greater than the “Trading Interval Minimum Nomination”. However, during the months of December, January, February and March, Synergy can request supply 7% less than the Trading Interval Minimum Nomination for 175 Trading Intervals. Synergy pays 20% of the Energy Prices under the Vesting Contract for the amount of energy Synergy requested below the Trading Interval Minimum Nomination limit.

Also, in each Trading Interval (i.e. each ½ hour), Verve Energy is not required to supply energy to Synergy that is more than the “Trading Interval Energy Cap” (for both energy and Additional Energy).

Synergy must make a Daily Nomination to Verve Energy for the total amount of energy (MWh) to be supplied for each Trading Interval for each day.

The Vesting Contract places several restrictions on the Daily Nominations, including that:

- the total amount of energy to be supplied for each Trading Interval within the Daily Nomination must be greater than the “Trading Interval Minimum Nomination”, except for 175 intervals in December, January, February and March (see above);
- the total amount of energy to be supplied for each Trading Interval within the Daily Nomination must not be greater than the “Trading Interval Maximum Nomination”; and
- the sum of the Daily Nominations for a month must not exceed the “Monthly Energy Cap”.

Once the sum of the Daily Nominations for a month exceeds the Monthly Energy Cap, Synergy can make no further Daily Nominations for that month, and must source energy from other suppliers or from the STEM.

The Trading Interval Minimum and Maximum Nominations for each Trading Interval for the Reset Period are set out in schedule 8 to the Vesting Contract.

For each subsequent Reset Period, the Contract Administrator is to recalculate the Trading Interval Minimum and Maximum Nominations for each Trading Interval, and the Monthly Energy Cap, using the formulae set out in schedule 2 to the Vesting Contract.

3.4.2 Additional Energy

Under the Vesting Contract Verve Energy must:

- make Capacity Credits available to Synergy up to the Capacity Cap for each Reset Period (see section 3.3); and
- supply energy to Synergy in accordance with its nominations (see section 3.4.1).

However, given the methodology for determining the Capacity Cap under the Vesting Contract, the Capacity Cap plus displacement may not be high enough to service customers backed by the Vesting Contract.

As a result, the Vesting Contract provides for a mechanism known as “Additional Energy”

Additional Energy is only available when the Capacity Cap plus displacement is not high enough to service customers backed by the Vesting Contract. In this situation, Synergy also keeps additional revenue outside of the netback pricing mechanism to purchase from other sources any additional Capacity Credits or energy that it requires to meet the needs of vested customers.

The Vesting Contract provides a similar mechanism for nominating Additional Energy as it does for energy. There are restrictions under the Vesting Contract on how much Additional Energy that Synergy can nominate, including that the sum of the:

- Daily Nominations for Additional Energy in a month must not exceed the “Monthly Additional Energy Cap”; and
- Daily Nominations for energy plus the Daily Nominations for Additional Energy for a month must not exceed the Trading Interval Energy Cap.

The formulae for the Monthly Additional Energy Cap and the Trading Interval Energy Cap calculations for each Reset Period are provided in schedule 2 to the Vesting Contract.

3.4.3 Week-Ahead Forecasts

Each day, Synergy is to provide Verve Energy with a week-ahead forecast. This is only to aid Verve Energy in managing its fuel and other planning issues. The week-ahead forecast will only impact the operation of the Vesting Contract if Synergy fails to provide a valid Daily Nomination under the contract, in which case Verve Energy will use the week-ahead forecast as the fallback nomination.

3.4.4 Bilateral Submissions

Under the Rules, generators are to make “bilateral submissions” to the IMO to allow the IMO to schedule the market. Under the Vesting Contract, Verve Energy is to make bilateral submissions to the IMO for each trading day, in accordance with Synergy’s nominations under the Vesting Contract. Verve Energy is responsible for any errors it makes in making these submissions, and adjustments are made between the parties at the relevant energy prices to compensate for any errors.

3.5 The Displacement Mechanism

The Vesting Contract includes a Displacement Mechanism to gradually reduce the amount of energy and Capacity Credits traded under the contract. The Displacement Mechanism contains two types of displacement: “Negotiated Displacement” and “Mandatory Displacement”.

3.5.1 Negotiated Displacement

Synergy has the option to reduce the amount of energy and Capacity Credits sold under the Vesting Contract by negotiating alternative wholesale arrangements outside of the Vesting Contract, up to a maximum amount, as set out in the Displacement Timetable (see section 3.5.3). Synergy can negotiate these alternative wholesale arrangements with Verve Energy (outside of the Vesting Contract), or with any other generator.

3.5.2 Mandatory Displacement

Mandatory Displacement refers to the annual reduction of capacity from the Capacity Cap, in discrete amounts (i.e. tranches), in accordance with the Displacement Timetable.

Synergy is required to run a tender process to procure wholesale supply for its customers that will no longer be backed by the Vesting Contract as a result of the Mandatory Displacement. The size of the tenders is dependent on the extent that Synergy has not already procured wholesale supply for these customers via Negotiated Displacement.

3.5.3 The Displacement Timetable

Schedule 10 to the Vesting Contract provides the Displacement Timetable, which outlines the cumulative maximum amount of negotiated displacement that Synergy is permitted to procure annually, and the cumulative total displacement that must occur annually.

The amount of Mandatory Displacement that Synergy must procure via a tender process is the difference between the cumulative total displacement and the amount of negotiated displacement that Synergy actually procures for that year. The timing under which Synergy must run the tenders is also laid out in schedule 10 to the Vesting Contract.¹⁴

The Vesting Contract also provides Synergy with the ability to alter the Displacement Timetable in certain circumstances, as follows:

3.5.3.1 Rollover

Synergy may elect to bring forward or defer a set amount of displacement by 1-year. This is to allow Synergy to optimise the size and timing of the tenders that it is required to run. The amount of displacement that Synergy may rollover is provided in schedule 10 to the Vesting Contract. If Synergy elects to rollover an amount of displacement, it must first notify Verve Energy and the Contract Administrator. The period of notice which Synergy must give to Verve Energy and the Contract Administrator is provided in schedule 10 to the Vesting Contract. This is typically a period of 2-3 years. In the event of a rollover of an amount of displacement, the rest of the Displacement Timetable remains the same.

3.5.3.2 Deferral

If it becomes clear to Synergy that a tender process that it is required under the Displacement Mechanism will not be successful, it has the ability to request a deferral of the Displacement Timetable from the Contract Administrator. In making such a request, Synergy must provide clear evidence to the Contract Administrator that the tender process is not likely to be successful,¹⁵ and must do so with a certain minimum amount of advance notice (typically 2-3 years). If the Contract Administrator approves a deferral, then the displacement requirements under the Displacement Timetable for that year and each subsequent year is deferred by 1-year.

3.5.3.3 Emergency Deferral

Synergy may request an emergency deferral from the Contract Administrator in certain force majeure situations. If the Contract Administrator approves such a

¹⁴ Appendix B provides a further explanation of the Displacement Timetable, and provides scenarios to illustrate the potential timing for expiry of the Vesting Contract.

¹⁵ The evidence that the tender process is not likely to be successful must include:

- either:
 - evidence that less than 3 tenderers made pre-qualified submissions; or
 - a summary of indicative bids (certified by an expert) indicating that no tenderers offered a price less than the price paid under the Vesting Contract; and
- calculations to demonstrate the impact on Synergy's net margin in buying and selling energy if it accepts the best price offered by a tenderer.

deferral, then Verve Energy may be required to continue to supply Synergy with energy and Capacity Credits under the Vesting Contract, to the extent that it has not already contracted the associated Capacity Credits and energy elsewhere.

3.6 Pricing under the Vesting Contract

Under the Vesting Contract, Synergy is to pay Verve Energy the following charges

- a VC Fixed Charge;¹⁶
- an ISC Fixed Charge;
- an Energy Charge;
- an Additional Energy Charge; and
- a Take or Pay Charge.

These charges (except the Additional Energy Charge) are set based on a “netback calculation”, which means that efficient retail, network, and other costs are deducted from Synergy’s sales revenue, and Verve Energy is paid the residual. That is, Synergy pays the above charges to Verve Energy, with the result that Verve Energy receives the equivalent of:

- revenue that Synergy receives from the relevant tariff and inherited retail contract sales;
- less a defined allowance for Synergy’s costs, including an efficient profit margin, which is retained by Synergy;
- less networks costs paid to the Electricity Networks Corporation (the new Western Power); and
- less other specified market and regulatory costs.

This is implemented under the Vesting Contract by setting the variable prices (i.e. the prices under the Energy Charges, and Take or Pay Charges) for the duration of the contract, and annually resetting the fixed prices (i.e. the VC Fixed Charge and the ISC Fixed Charge).

The VC Fixed Charge and the ISC Fixed Charge are set at the start of a Reset Period based on expectations of the amount of energy and Capacity Credits that will be sold during that Reset Period, and on cost expectations for that Reset Period. The formulae for resetting the VC Fixed Charge and the ISC Fixed Charge are provided in schedule 3 to the contract.

In May after each Reset Period, a “Carry Over” amount is calculated to reconcile the differences between the forecasts used in setting the VC Fixed Charge and the ISC Fixed Charge with what actually happened..¹⁷

The Additional Energy Charges is outside the netback calculation. That is, Verve Energy receives this additional revenue above the netback amount.

¹⁶ In several locations, the Vesting Contract makes use of the acronyms “VC” and “ISC”. This is because the Vesting Arrangements were originally going to contain 2 contracts:

- the Vesting Contract (hence the acronym “VC”), which would cover wholesale supply for tariff customers; and
- the Initial Supply Contract (hence the acronym “ISC”), which would cover wholesale supply for inherited retail contract customers.

However, it was subsequently decided to handle wholesale supply for both tariff and inherited retail customers under a single contract. Nevertheless, the calculations under the Vesting Contract still need to be split into tariff and inherited retail contracts. Therefore, the terms VC and ISC are not acronyms under the Vesting Contract, and instead are used only as tags to distinguish between calculations relating to tariff customers vs. calculations relating to inherited retail contract customers.

¹⁷ See section 3.8 for more information on the Carry Over. See Appendix C for more information on the calculation of the VC Fixed Charges, ISC Fixed Charges, and the implementation of the netback principle.

Further information on the various charges that Synergy is to pay to Verve Energy is as follows.

3.6.1 The VC Fixed Charge

The VC Fixed Charge is a fixed price (\$/year) that Synergy is to pay to Verve Energy in monthly instalments, in arrears. The VC Fixed Charge is specifically for the tariff customers that are covered under the Vesting Contract and for the contract customers that Synergy inherited from WPC that do not have interval meters and are covered under the Vesting Contract.

The VC Fixed Charge for the first Reset Period is specified in schedule 8 of the Vesting Contract, but is confidential and will not be publicly released. The VC Fixed Charge for each subsequent Reset Period is determined by the Contract Administrator using the formulae provided in schedule 3 to the Vesting Contract. The subsequent VC Fixed Charges will also be confidential.

3.6.2 The ISC Fixed Charge

The ISC Fixed Charge is a fixed price (\$/year) that Synergy is to pay to Verve Energy in monthly instalments, in arrears. The ISC Fixed Charge is specifically for the contract customers Synergy inherited from WPC that have interval meters, which are covered under the Vesting Contract.

The ISC Fixed Charge for the first Reset Period is specified in schedule 8 of the Vesting Contract, but is confidential and will not be publicly released. The ISC Fixed Charge for each subsequent Reset Period is determined by the Contract Administrator using the formulae provided in schedule 3 to the Vesting Contract. The subsequent ISC Fixed Charges will also be confidential.

3.6.3 The Energy Charge

The Energy Charge is an amount payable from Synergy to Verve Energy, monthly in arrears. The Energy Charge is calculated as the sum of the energy traded in each Trading Interval (see section 3.4.1), multiplied by the Energy Price (\$/MWh) for each Trading Interval. The Energy Price for a Trading Interval will vary depending on:

- Type of day: Weekdays, Saturdays, or Sundays and Public Holidays;
- Season: Hot, Cold, or Mild;¹⁸ and
- Time Period: Peak, Off-Peak, or Shoulder.¹⁹

As a result, there are a total of 27 Energy Prices under the Vesting Contract. The Energy Prices are set out in schedule 6 to the Vesting Contract, but are confidential, and will not be publicly released. The same Energy Prices apply in all Reset Periods (i.e. they will not be reset annually by the Contract Administrator). The Energy Prices were determined based on the financial modelling done by the Electricity Reform Implementation Unit (“ERIU”) of the Office of Energy (“OOE”) and WPC.

¹⁸ The Hot season is from November to March, the Cold season is from May to September, and the Mild season is April and October.

¹⁹ The Peak period is from 11:00AM to 5:00PM, the Shoulder period is from 7:00AM to 11:00AM and from 5:00PM to 9:00PM, and the Off-Peak period is from 9:00PM to 12:00PM and from 0:00AM to 7:00AM.

3.6.4 The Additional Energy Charge

The Additional Energy Charge is an amount payable from Synergy to Verve Energy, monthly in arrears. The Additional Energy Charge is calculated as the sum of the additional energy traded in each Trading Interval (see section 3.4.2), multiplied by a price that is 5% above the Energy Price (\$/MWh) for each Trading Interval. The Energy Price is the same price as is paid for energy (see section 3.6.3).

3.6.5 The Take or Pay Charge.

The Take or Pay Charge is a charge payable by Synergy to Verve Energy (monthly in arrears) if the amount of energy traded in a given month is less than the Monthly Minimum Energy Take. The Minimum Energy Take is an amount calculated in accordance with clause 3 of schedule 2 of the Vesting Contract for each Reset Period.

The Take or Pay Charge is calculated as the difference between the Monthly Minimum Energy Take and the amount of energy taken in the month, multiplied by the Take or Pay Price (\$/MWh). The Take or Pay Price was determined based on the energy prices (see section 3.6.3), and is confidential.

3.7 Balancing

The Vesting Contract includes a financial hedge to manage Synergy's risk in the balancing market, but also exposes Synergy to increased costs for excessive nomination errors as a means to provide it with an incentive to forecast accurately.

The hedge covers Synergy for all of its balancing requirements, not just its requirements for customers served under the Vesting Contract.²⁰ This is because Synergy is currently restricted from owning and operating generation plant, and therefore cannot provide itself with balancing services.²¹

However, the coverage of the balancing hedge will reduce in proportion to the reduction in the amount of the balancing market that is provided by Verve Energy.²²

The hedge works as a separate bilateral arrangement between Synergy and Verve Energy under which Synergy always pays the Energy Price (see section 3.6.3) for all balancing payments, subject to an incentive mechanism on nomination errors. This is accomplished by way of payment of a "Monthly Balancing Adjustment Amount" from Verve Energy to Synergy if there is a "Negative Imbalance Amount", or from Synergy to Verve Energy if there is a "Positive Imbalance Amount".²³ This reverses (or "hedges") the payments under the Rules for the Authorised Deviation Quantities, which are priced at a marginal cost administered price determined under the Rules.

The balancing arrangements under the Vesting Contract contain a mechanism to give Synergy an incentive to nominate accurately. This incentive works by imposing three tranches of prices for balancing energy, as follows:

²⁰ That is, Synergy is hedged for all of its Authorised Deviation Quantity (as defined in the Rules).

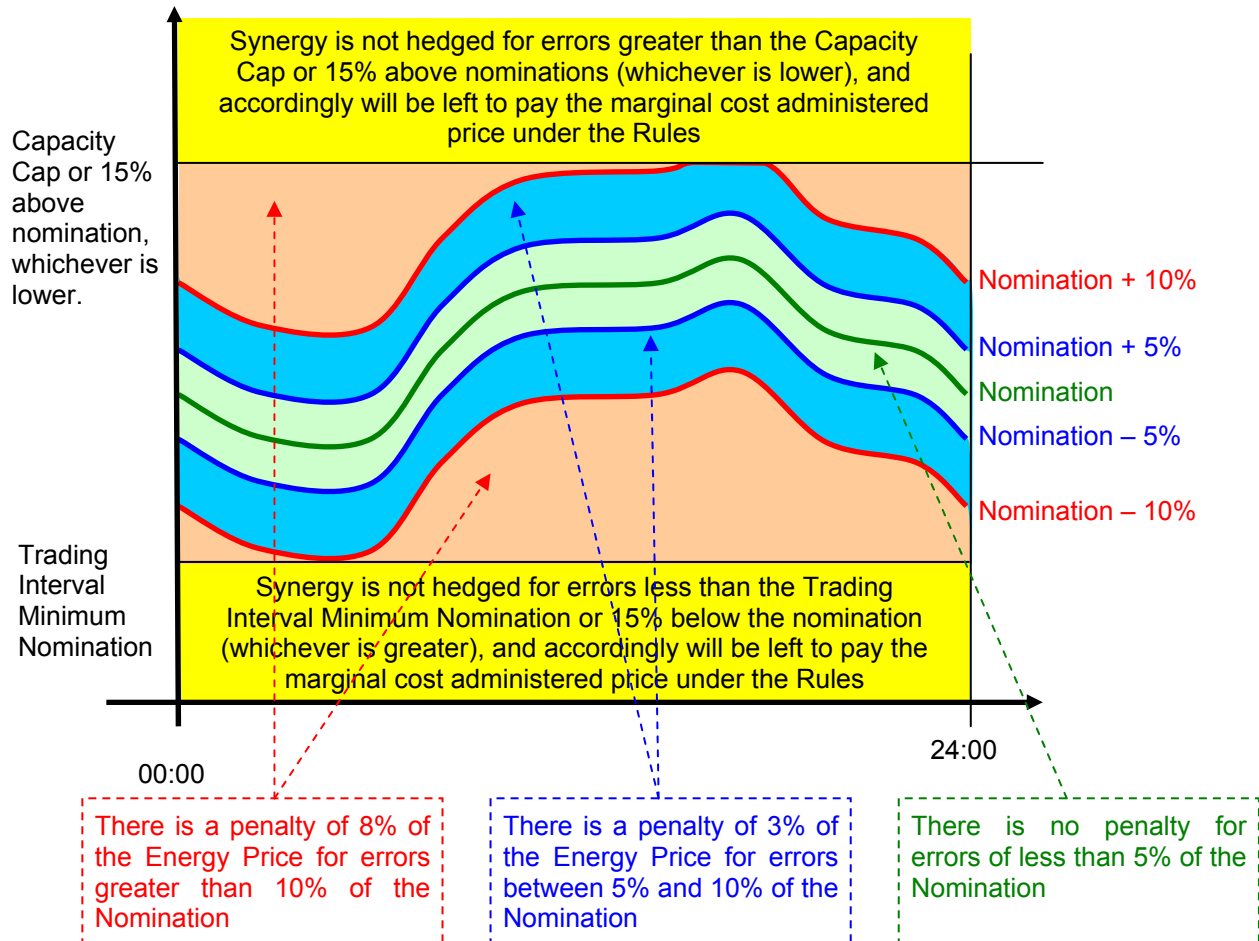
²¹ Under section 47 of the Act, Synergy is precluded from owning generation plant until at least April 2013, and under section 49 of the Act, this may be extended to April 2016. It is noted that other retailers can self-hedge in the balancing market by owning their own generation plant.

²² See schedule 7 to the Vesting Contract for the formulae to define the proportion of the balancing market provided by Verve Energy.

²³ The specific formulae for calculating a "Negative Imbalance Amount" and a "Positive Imbalance Amount" are provided in clauses 8.3 and 8.4 of the Vesting Contract, respectively.

- Synergy is to pay the Energy Price for imbalances less than 5% of its nominations;
- Synergy is to pay the Energy Price plus a 3% penalty for imbalances that are between 5% and 10% of its nominations; and
- Synergy is to pay the Energy Price plus an 8% penalty for imbalances greater than 10% of its nominations.

Graphically, the hedge arrangements and incentive mechanism are as follows.



3.8 Carry Over

As indicated in section 3.6, pricing under the Vesting Contract is based on a “netback calculation”, which means that efficient retail, networks, and other costs are deducted from Synergy’s sales revenue, and Verve Energy is paid the residual. This is implemented as follows:

- the variable prices (i.e. the prices under the Energy Charges, and Take or Pay Charges) are fixed for the duration of the Vesting Contract;
- the fixed prices (i.e. the VC Fixed Charge and the ISC Fixed Charge) are reset annually at the start of a Reset Period, based on expectations of the amount of energy and Capacity Credits that will be sold during that Reset Period, and on expectations of costs for that Reset Period; and
- a “Carry Over” amount is calculated in the May after the Reset Period to reconcile the differences between the forecasts used in setting the VC Fixed Charge and the ISC Fixed Charge vs. what actually happened in the Data Collection Period. The Data Collection Period is the period over which actual data is collected. Due to data issues it is not possible to align the Reset Period with the Data Collection Period without producing a lengthy delay

to when the Carry Over can be undertaken. Currently, the Data Collection Period is August to July, whilst the Reset Period is October to September.

Under the Vesting Contract, the Contract Administrator is to annually calculate a “Carry Over Amount”. The formulae to calculate the Carry Over Amount are provided in schedule 5 to the Vesting Contract. Effectively, the Carry Over Amount is calculated as:

- Verve Energy’s actual revenue for the Data Collection Period:²⁴
- less Verve Energy’s required revenue for the Data Collection Period;^{25 26}
 - less the cost of balancing for the Data Collection Period.^{27 28}

A payment in the amount of the Carry Over Amount is to be made from Synergy to Verve Energy if the Carry Over Amount is negative, and from Verve Energy to Synergy if it is positive. Even though the mechanism is called a “Carry Over” in the Vesting Contract, it is actually a reconciliation and adjustment payment for the Data Collection Period.

3.9 Other Aspects of the Vesting Contract

3.9.1 Invoicing and Payments

The timing of invoicing under the Vesting Contract is set to be consistent with the timing of the operation of the Rules.

²⁴ Verve Energy’s actual revenue during the Data Collection Period is the sum of the monthly fixed payments (the VC Fixed Charges and ISC Fixed Charges), energy payments (the Energy Charges and Take or Pay Charges), and the Capacity Refund Expectation Payments (monies received from the IMO as a result of plant with Capacity Credits not being available).

²⁵ Verve Energy’s required revenue is calculated using the same netback calculations used to calculate the fixed payments (the VC Fixed Charges and ISC Fixed Charges) and energy payments (the Energy Charges and Take or Pay Charges) at the start of the Reset Period, except:

- the Generation Total VC Netback (see Appendix C, section C1.1) is calculated using actual energy amounts, actual networks charges, and actual other costs; and
- the Generation Total ISC Netback (see Appendix C, section C2) is calculated using actual energy amounts, actual networks charges, and actual other costs.

²⁶ An “Excess Energy Payment” is added to the calculation of Verve Energy’s required revenue. This is to ensure that Synergy does not use the balancing hedge as a means to source energy for customers that are not covered by the Vesting Contract. The Excess Energy Payment is set so that Synergy pays a penalty of 10% of the average vesting price for any volumes defined by the following formula:

$$\left[\left(\frac{\text{sum of}}{\text{nominations}} \right) - \left(\frac{\text{sum of}}{\text{imbalance volumes}} \right) \right] - \left[\left(\frac{\text{sum of}}{\text{tariff volumes}} \right) - \left(\frac{\text{sum of inherited}}{\text{contract volumes}} \right) \right]$$

²⁷ The Cost of Balancing in the Carry Over calculation does not include any penalty payments made under the financial hedge. As a result, the penalty payments are not passed back to Synergy via the Carry Over, as this would remove the intended incentive for Synergy make more accurate nominations.

²⁸ Note that Carry Over calculation also includes a term called the “ITTCHI”. The ITTCHI is a transitional mechanism that deals with the fact that Verve Energy’s Muja A/B facility is set to be retired in 2007, and has not been certified by the IMO. As a result, Verve Energy must sell the energy produced by Muja A/B to Synergy under the Vesting Contract; but Synergy will have to acquire Capacity Credits elsewhere for the equivalent capacity of Muja A/B. The Vesting Contract is structured to give Synergy extra revenue outside of the netback calculation to source and pay for these Capacity Credits. The ITTCHI mechanism is designed to ensure that the additional revenue that Synergy is allowed to use to source and pay for these Capacity Credits in the first Reset Period does not flow back to Verve Energy through the Carry Over at the end of the first Reset Period. The ITTCHI is zero after the first Reset Period.

3.9.2 Pass Through Options

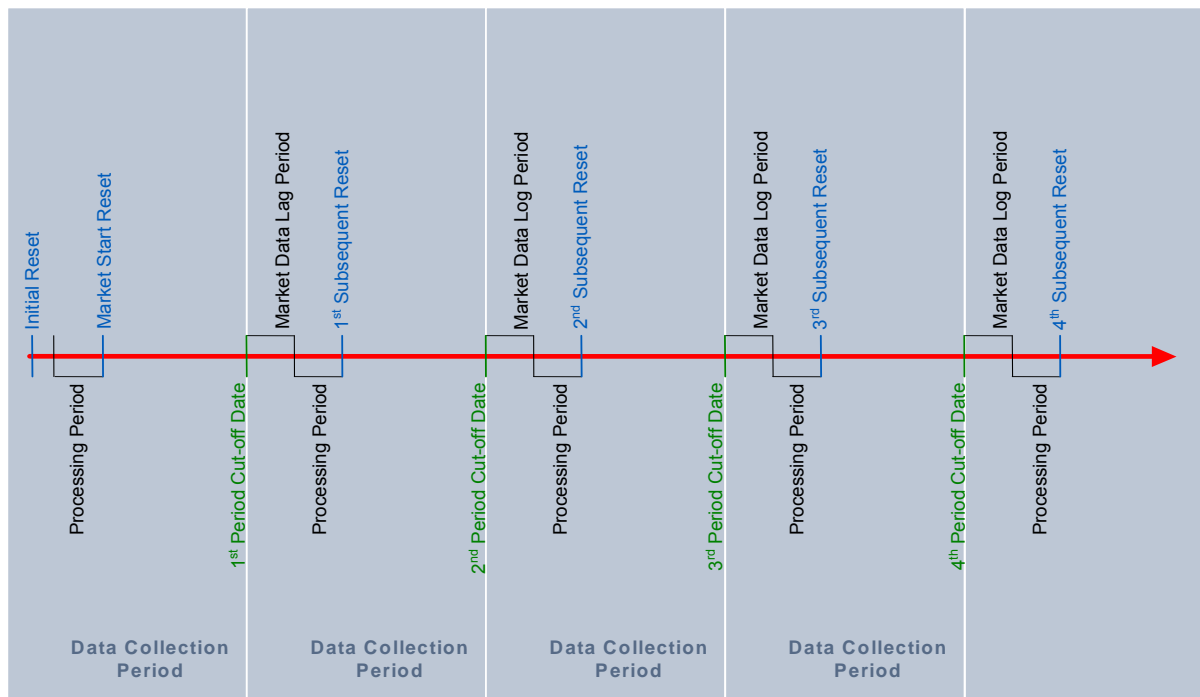
If any of the inherited retail contracts contain a provision to allow Synergy to pass through any increases in networks or other costs to the customer, then the Vesting Contract requires Synergy to exercise that option. Otherwise, Synergy would be able to keep the price of these contracts down, as a means to retain the customer, and the cost of such behaviour would be passed on to Verve Energy via the netback pricing mechanism.

3.9.3 Information Requirements and the Reset Process

The Vesting Contract specifies the timing for when Synergy and Verve Energy are required to provide data to the Contract Administrator to allow the Contract Administrator time to make the necessary calculations under the schedules to the Vesting Contract. The timing for the reset process is as follows:

- for each reset process, there is a 1-year “Data Collection Period”, as discussed briefly under section 3.8;
- after each Data Collection Period, there is a “Data Lag Period” to give Synergy and Verve Energy time to collect the data from the Data Collection Period;
- after the end of the Data Lag Period, there is a “Processing Period” to give the Contract Administrator time to make the necessary calculations; and
- the Reset Period starts at the end of the Processing Period.

Diagrammatically, this reset process is as follows:



The Vesting Contract also allows for Synergy to use estimated data in certain circumstances, for a 2-month period at the end of the Data Collection Period. This is to cover situations where actual data may not be available within the timeframe required for the operation of the Vesting Contract. The Vesting Contract gives the Contract Administrator the authority to penalise Synergy if it were to strategically manipulate the estimation process to its benefit.

3.9.4 Operation of the Vesting Contract before the Start of the WEM

Several key portions of the Vesting Contract (such as the supply and sale of Capacity Credits, and the operation of the balancing hedge) will not be necessary prior to the start of the WEM. Schedule 11 to the Vesting Contract indicates which clauses of the Vesting Contract do not apply for the period between 1 April 2006 and the commencement of the WEM, and indicates how the Vesting Contract is to operate for this period with respect to these sections.

3.9.5 Computational Errors

The Vesting Contract provides for Synergy and Verve Energy to request amendments to calculations if computational errors have been made in the reset process.

3.9.6 Redetermination

The Vesting Contract provides for the Contract Administrator to recalculate and redetermine any calculations and amounts, such as the Carry Over of Fixed Charges, after these calculation have been performed and determined. This is generally to allow any errors to be corrected after calculation of parameters that result in substantial revision of the payments between Synergy and Verve Energy.

3.9.7 Force Majeure

If a Force Majeure Event occurs, the Vesting Contract provides a mechanism to adjust the Trading Interval Minimum Nomination, the Trading Interval Maximum Nomination, the Fixed VC Charges, and the Fixed ISC Charges. The Vesting Contract also provides a mechanism to amend the terms and conditions of the Vesting Contract, if necessary, in event of a Force Majeure Event (see section 3.9.8).

3.9.8 Change Events

The Vesting Contract defines a Change Event as a material Change in Law, a Change in the Rules, or a Market Disruption Event (i.e. a Force Majeure Event). If a Change Event occurs, and either Synergy or Verve Energy require a compensatory payment from the other corporation, or an amendment to the Vesting Contract; then both parties are to make representations to the Contract Administrator regarding the allocation of costs from the Change Event, or the need for an amendment to the Vesting Contract. The Contract Administrator is to make a decision on the matter. If the Contract Administrator agrees that the Vesting Contract needs to be amended, the Contract Administrator is to recommend the change to the Minister. The Minister has the power under section 84 of the Act to amend the Vesting Contract.

3.9.9 Dispute Resolution

Synergy and Verve Energy are to meet to resolve any disputes under the Vesting Contract. If the parties are not able to resolve a dispute, then the dispute is to be taken to the Contract Administrator, and the Contract Administrator is to resolve the dispute in any manner he or she considers appropriate.

3.9.10 Contract Amendment and Assignment

Neither Synergy nor Verve Energy may amend or assign the Vesting Contract. The Vesting Contract may only be amended by the Minister, under section 84(2) of the Act. This includes amendments as a consequence of a Change Event.

3.9.11 Confidentiality

The Vesting Contract is not confidential, with the exception of some specific price information. Both Synergy and Verve Energy are required to post the Vesting Contract on their website (excluding the specified confidential price information).

4. The Ministerial Direction

The Ministerial Direction imposes two sets of restrictions or requirements on Synergy's behaviour in relation to the Vesting Contract, including:

- it puts requirements on the operation of the tender for energy and Capacity Credits displaced under the Displacement Mechanism (see section 3.5); and
- it requires Synergy to publish an "Annual Displacement Statement of Opportunities".

4.1 The Tender Process

The Ministerial Direction requires that the tender that Synergy runs to acquire the energy and Capacity Credits under the Displacement Mechanism (see section 3.5) incorporate the following elements:

- Synergy must publicly specify the amount of energy and Capacity Credits that it is seeking to acquire via the tender;
- Synergy must treat Verve Energy equally with other tenderers;²⁹
- Synergy is to seek to minimise the cost of energy and Capacity Credits;
- to assist with the tender processes, Synergy must give tenderers a supply contract under which they will be obliged to provide energy and Capacity Credits if they win the tender;
- Synergy must require tenderers to submit the prices at which they are prepared to supply energy and Capacity Credits, and any minimal amendments to the supply contract that they have been provided with; and
- Synergy must treat all tenders in a fair and non-discriminatory manner.

4.2 The Annual Displacement Statement of Opportunities

Synergy must publish the Annual Displacement Statement of Opportunities (the "Statement") by 30 November each year.³⁰ The Statement is to provide the market with specific information regarding Capacity Credit and energy amounts, and prices, as follows.

4.2.1 Capacity Credit and Energy Amount Information

The Statement must include the following information regarding the energy and Capacity Credit amounts:

1. the Capacity Cap and Energy Cap as of 1 April 2006;³¹
2. the Capacity Cap and Energy Cap for the first Reset Period following the commencement of the WEM;³²
3. the amount of displacement up to the end of the Reset Period in which the Statement is published;
4. the Capacity Cap for the current Reset Period;

²⁹ That is, Verve Energy is to have no special treatment or benefit over other tenderers.

³⁰ Synergy is to publish the first Statement by 30 November 2006.

³¹ This will provide tenderers with information on the starting point for the Vesting Contract.

³² This is to provide tenderers with information on the starting point for the Vesting Contract after the commencement of the WEM, which will account for whether or not there is a Market Start Reset (see section 3.1).

5. the amount by which the Capacity Cap and the Energy Cap has declined since 1 April 2006;
6. the Displacement Timetable as set out in schedule 10 to the Vesting Contract;
7. any displacement amounts that Synergy has brought forward or backward under the Rollover mechanism (see section 3.5.3.1);
8. any Deferral of displacement amounts that has been approved by the Contract Administrator (see sections 3.5.3.2 and 3.5.3.3);
9. the minimum displacement threshold for the current Reset Period (accounting for all rollovers and deferrals);
10. the total amount of Negotiated Displacement that Synergy has acquired up to the current Reset Period;
11. the total amount of Tendered Displacement that Synergy has acquired up to the current Reset Period; and
12. details of the future highest and lowest possible Tendered Displacement amounts.

4.2.2 Price Information

The Statement must include the following information regarding prices:

1. a standard description of the methodology to determine the VC Fixed Charge and the ISC Fixed Charge;
2. The value for the components of the Average Vesting Price for each Reset Period since 1 April 2006,³³ which includes:
 - the revenue from tariff and inherited retail contract customers (averaged across all tariff and inherited retail contract customers);
 - the network costs for tariff and inherited retail contract customers (averaged across all tariff and inherited retail contract customers);
 - the other costs for tariff and inherited retail contract customers (averaged across all tariff and inherited retail contract customers);
 - the average vesting price (averaged across all tariff and inherited retail contract customers);
 - the Total Fixed Charge;³⁴
 - the Average Energy Price;³⁵ and
3. Synergy's good-faith estimates of all of the items listed under number 2 above for a 10-year period.

³³ The Average Vesting Price is defined as

$$\left(\begin{array}{c} \text{Average Vesting} \\ \text{Price} \end{array} \right) = \frac{(\text{Total VC Netback}) + (\text{Total ISC Netback})}{(\text{The sum of tariff volumes}) + (\text{the sum of inherited contract volumes})}$$

³⁴ The Total Fixed Charge is the sum of the VC Fixed Charge and the ISC Fixed Charge.

³⁵ The Average Energy Price is the load-weighted average energy price for all vested supplies (tariff customers and inherited retail contract customers).

APPENDIX A: THE CAPACITY AND ENERGY VOLUME CALCULATIONS

A1 The Capacity Cap

As indicated in section 3.3, the Capacity Cap in each Reset Period (other than the first Reset Period) is determined by the Contract Administrator, in accordance with the formulae in schedule 2 of the Vesting Contract, as the lesser of three amounts:

- Synergy's capacity requirements for customers backed by the Vesting Contract;
- Verve Energy's amount of credited capacity under the Vesting Contract; and
- the Capacity Cap in the previous year.

A1.1 Synergy's Capacity Requirements

Synergy's capacity requirement is essentially calculated as:

- Synergy's Individual Reserve Capacity Requirement ("IRCR");³⁶
- + plus demand side management ("DSM");³⁷
- less churn;³⁸
- less displaced capacity;³⁹
- less capacity credited from the Emu Downs facility;⁴⁰ and
- + plus any increases (pursuant to existing contractual rights) in contracted capacity under contracts that Synergy inherited from WPC at disaggregation.

A1.2 Verve Energy's Amount of Credited Capacity

Verve Energy's credited capacity is essentially calculated as:

- Verve Energy's Capacity Credits;⁴¹ and
- less a capacity credit adjustment amount ("CCAA").⁴²

A1.3 Capacity Cap in the Previous Year

The Capacity Cap in the previous year is essentially calculated as:

- The Capacity Cap in the previous year, and
- + plus any increases (pursuant to existing contractual rights) in contracted capacity under contracts that Synergy inherited from WPC at disaggregation.

³⁶ This is the IRCR as determined by the IMO under the Rules.

³⁷ This is the credited DSM as determined by the IMO under the Wholesale Market Rules. Note that the DSM is added here because it is subtracted elsewhere in the Vesting Contract, and Synergy should be kept whole in determining its capacity requirements when determining the Capacity Cap.

³⁸ This is the capacity that would be required to serve any tariff customers that have signed a supply contract, whether that contract is with Synergy or with another retailer.

³⁹ This is the capacity reductions that result from the Displacement Mechanism (see section 3.5).

⁴⁰ The Vesting Contract treats the Emu Downs facility separately from the rest of Verve Energy's facilities.

⁴¹ This is the amount of Capacity Credits that Verve Energy has initially been credited with by the IMO.

⁴² This CCAA is a schedule of capacity credits which are deducted from the initial amount of Capacity Credits credited by the IMO. The CCAA is based on Verve Energy's planned plant retirement schedule, and is defined in schedule 8 of the Vesting Contract.

A2 The Monthly Energy Cap

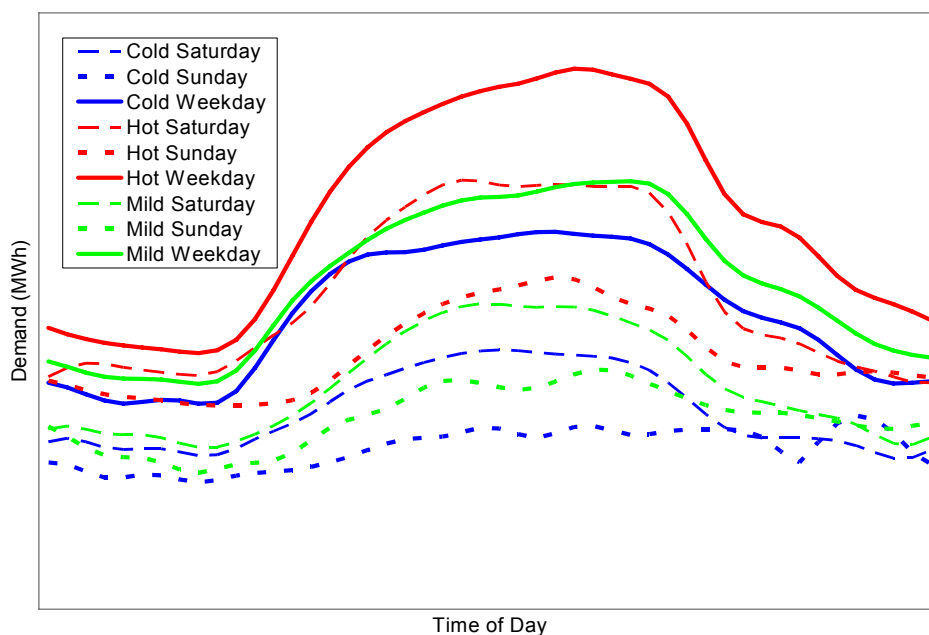
As indicated in section 3.4.1, the sum of the Daily Nominations for a month must not exceed the Monthly Energy Cap. The Monthly Energy Cap is calculated as the sum of the Monthly Expected Energy for the month,⁴³ plus the Monthly Uplift Energy for the month.⁴⁴

A3 The Trading Interval Nomination Limits

As indicated in section 3.4.1, the Contract Administrator is to calculate the Trading Interval Maximum Nominations and Trading Interval Minimum Nominations for each Trading Interval for each Reset Period (other than the first Reset Period), in accordance with the formulae in schedule 2 to the Vesting Contract. These calculations work as follows:

- The Contract Administrator calculates the Trading Interval Maximum Nomination for each Trading Interval as:
 - the “Expected Nomination” for the Trading Interval;⁴⁵ and
 - + plus a “Daily Uplift Factor” for the Trading Interval.
- The Contract Administrator calculates Trading Interval Minimum Nomination based on the “Monthly Expected Energy” multiplied by the lowest of the Trading Interval Profile Factors that is calculated as part of the daily energy profiles.

The energy profiles are set depending on the time of day (peak, off-peak, or shoulder), time of week (weekdays, Saturdays, or Sundays and public holidays), and time of year (hot, cold, or mild season).⁴⁶ The specifics of these calculations are provided in schedule 2 to the Vesting Contract, which will result in profiles that will graphically look something like the following.



⁴³ The Monthly Expected Energy is calculated by applying an “Average Monthly Load Factor” to the Capacity Cap. The Average Monthly Load Factor for the first Reset Period is specified in schedule 8 to the Vesting Contract, and for each subsequent Reset Period is set by the Contract Administrator in accordance with the formulae in schedule 2 to the Vesting Contract.

⁴⁴ The Monthly Uplift Energy is calculated by applying a “Load Factor Adjustment Percentage” to the Capacity Cap. The Load Factor Adjustment Percentage is specified in schedule 8 to the Vesting Contract.

⁴⁵ The Expected Nomination and the Daily Uplift Factor are determined based on the Monthly Energy Cap (see section A2) and applying daily energy profiles.

⁴⁶ The specific meanings for these times of the day, days of the week, and season are the same as is specified for the 27 different Energy Prices (see section 3.6.3).

A4 Additional Energy

As indicated under section 3.4.2, Synergy has the right to purchase Additional Energy under the Vesting Contract in the situation where when the Capacity Cap plus displacement is not high enough to service customers backed by the Vesting Contract.

The Vesting Contract provides a similar mechanism for nominating Additional Energy as it does for energy. There are restrictions under the Vesting Contract on how much Additional Energy Synergy can nominate, including that:

- the sum of the Daily Nominations for Additional Energy in a month must not exceed the “Monthly Additional Energy Cap”; and
- the sum of the Daily Nominations for energy plus the Daily Nominations for Additional Energy for a month must not exceed the “Trading Interval Energy Cap”.

The calculations to determine the Monthly Additional Energy Cap and the Trading Interval Energy Cap are provided in schedule 2 to the Vesting Contract.

A4.1 The Monthly Additional Energy Cap

The Monthly Additional Energy Cap is calculated as the “Additional Energy Cap”, adjusted by the Average Monthly Load Factor and the Load Factor Adjustment Percentage.⁴⁷ The Additional Energy Cap is calculated as:⁴⁸

Synergy’s IRCR:

- + plus DSM;
- less churn;
- less displaced capacity;
- less capacity credited from the Emu Downs facility;
- less the Capacity Cap for the reset period; and
- + plus any increases (pursuant to existing contractual rights) in contracted capacity under contracts that Synergy inherited from WPC at disaggregation.

A4.2 The Trading Interval Energy Cap

The Trading Interval Energy Cap is effectively the Capacity Cap adjusted to a Trading Interval basis (i.e. it is the Capacity Cap divided by 2, to reflect that there are 2 Trading Intervals in an hour).

⁴⁷ See footnote 43 for more information on the Average Monthly Load Factor, and footnote 44 for more information on the Load Factor Adjustment Percentage.

⁴⁸ The Additional Energy Cap should typically be zero. However, it is possible that the Additional Energy Cap will be a positive, particularly in the early years, when the Vesting Contract covers most of Synergy’s customers, and when Verve Energy is not able to expand its plant capacity as a result of the capacity cap that has been imposed on it.

APPENDIX B: THE DISPLACEMENT TIMETABLE AND THE TERMINATION OF THE VESTING CONTRACT

B1 The Displacement Timetable

The displacement timetable is provided in schedule 10 to the Vesting Contract. The first table provides a schedule of the displacement amounts, as follows.

Capacity Year	Cumulative Maximum Negotiated Displacement Amount	Cumulative Minimum Total Displacement Amount
2006	100 MW	0 MW
2007	100 MW	0 MW
2008	150 MW	300 MW
2009	150 MW	500 MW
2010	200 MW	750 MW
Each year after 2010 but before full retail contestability ("FRC")	Previous year + 30% of the amount by which the Cumulative Minimum Total Displacement Amount exceeds the Cumulative Minimum Total Displacement Amount in the previous year	Previous year + the higher of: <ul style="list-style-type: none"> • 20% of the current Capacity Cap; or • 150 MW
Year FRC is introduced	No limit	Previous year + $\frac{1}{3}$ of the Capacity Cap in the year FRC is introduced
First year after FRC	No limit	Previous year + $\frac{1}{3}$ of the Capacity Cap in the year FRC is introduced
Second year after FRC	No limit	Previous year + $\frac{1}{3}$ of the Capacity Cap in the year FRC is introduced

As discussed, Synergy is able to defer or roll over an amount in two ways.

Synergy has the right to defer or bring forward an amount of displacement as shown in Schedule 10, Table 2:

Year (Capacity Year)	Date at which Displacement is measured	Maximum Displacement Eligible to be Deferred (or Brought Forward) by One Year	Advance Notice Required
2006	Reset Date in 2006	0MW	Not applicable
2007	Reset Date in 2007	0MW	Not applicable
2008	Reset Date in 2008	0MW	Not applicable
2009	Reset Date in 2009	200MW	3 years
2010	Reset Date in 2010	200MW	3 years

Year (Capacity Year)	Date at which Displacement is measured	Maximum Displacement Eligible to be Deferred (or Brought Forward) by One Year	Advance Notice Required
Each year after 2010 but before FRC	Reset Date for relevant Capacity Year	200MW	2 years
Year FRC is introduced	Reset Date for relevant Capacity Year	0MW	Not applicable
First year after FRC	Reset Date for relevant Capacity Year	0MW	Not applicable
Second year after FRC	Reset Date for relevant Capacity Year	0MW	Not applicable

Synergy is also able to defer a different amount if the Contract Administrator approves it, or if it becomes clear to Synergy that a tender process, that it is required to undertake under the Displacement Mechanism, will not be successful and the Contract Administrator approves the deferral amount. The amount Synergy can defer and by when this deferral must occur is in Schedule 10, Table 3 and is as follows:

Year (Capacity Year)	Date at which Displacement is measured	Latest Date for Submission of Application to Defer	Maximum quantity which may be deferred
2006	Reset Date in 2006	Not applicable	Not applicable
2007	Reset Date in 2007	Not applicable	Not applicable
2008	Reset Date in 2008	Not applicable	Not applicable
2009	Reset Date in 2009	3 years prior to Displacement date	200MW (which is the maximum capacity that may need to be tendered)
2010	Reset Date in 2010	3 years prior to Displacement date	200MW (which is the maximum capacity that may need to be tendered)
Each year after 2010 but before FRC	Reset Date for relevant Capacity Year	2 years prior to Displacement date	The value equal to the Tendered Displacement Amount in the Annual Displacement Statement of Opportunities published one year prior to the deferral deadline

Year (Capacity Year)	Date at which Displacement is measured	Latest Date for Submission of Application to Defer	Maximum quantity which may be deferred
Year FRC is introduced	Reset Date for relevant Capacity Year	No deferral allowed	Not applicable
First year after FRC	Reset Date for relevant Capacity Year	No deferral allowed	Not applicable
Second year after FRC	Reset Date for relevant Capacity Year	No deferral allowed	Not applicable

The displacement timetable is set to take FRC into account. As a general principle, FRC will not be introduced until there is an efficient WEM, and once such a market exists, there should be no further need for the Vesting Contract. As a result, the displacement timetable provides for the Vesting Contract to expire within 3 years of FRC.

B2 Termination of the Vesting Contract

As indicated in section 3.1, the Vesting Contract will terminate at the end of the first Reset Period when the volume traded under the contract (i.e. the Capacity Cap) is less than 150 MW.

The timing for termination of the Vesting Contract is dependent on several factors, including:

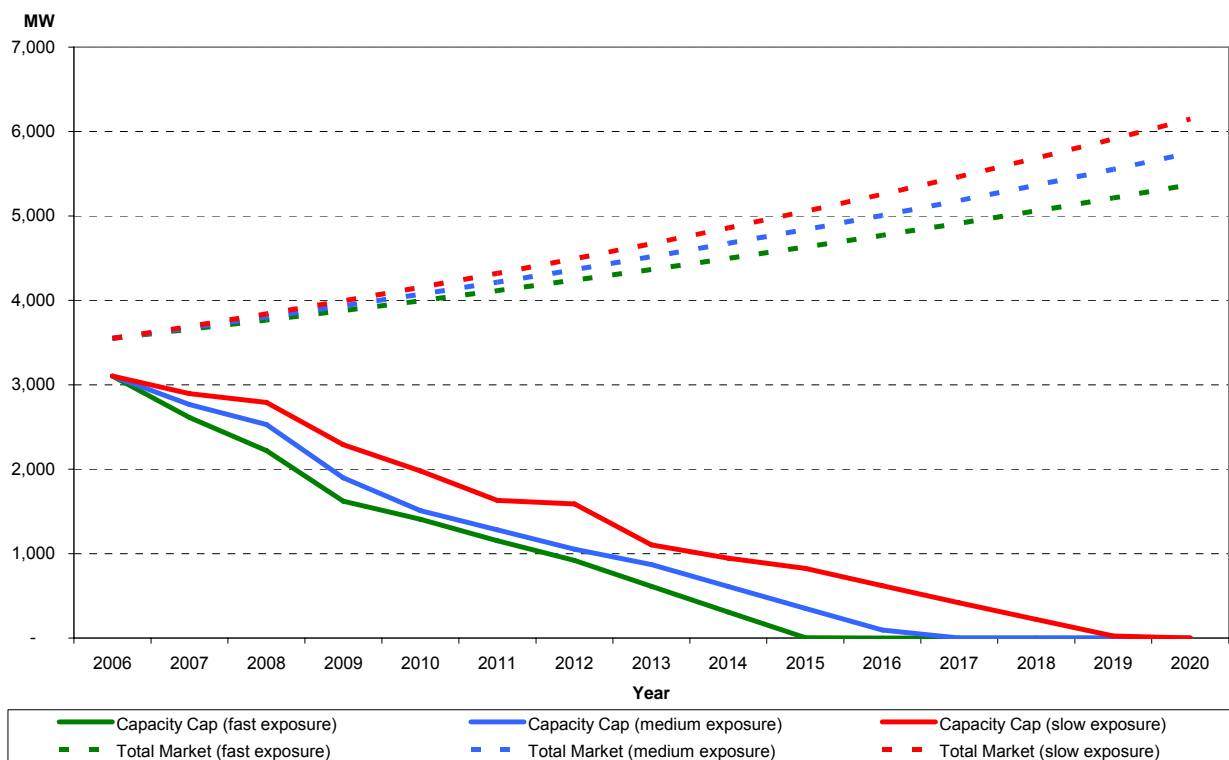
- the timing for the expiry of the inherited retail contracts;
- the growth rate in the tariff customers;
- the level of churn of tariff customers to contract (whether to Synergy or to another retailer);
- the amount of the growth in contestable customers that are retained by Synergy;
- the timing of implementation of FRC; and
- the implementation of the Displacement Mechanism (i.e. whether there are any deferrals, and whether any tenders are rolled forwards or backwards).

Assumptions can be made regarding these variables, which will result in a fast, medium or slow termination of the Vesting Contract, as follows:

Assumptions	Fast	Medium	Slow
Initial Cap	3,104 MW	3,104 MW	3,104 MW
Inherited Contract Expiry	2 years	3 years	5 years
Growth Rate	3.0%	3.5%	4.0%
Churn Rate	6.0%	5.0%	4.0%
Growth kept by Synergy	25%	50%	75%
FRC	2012	2013	2015
Deferrals	None	None	2009
Roll forward	2009	None	None

Roll back	None	None	2012
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Based on these assumptions, the Capacity Cap under the Vesting Contract would be as shown in the following chart:



This chart indicates that the Vesting Contract could terminate as early as 2015 or as late as 2019. However, it should be noted that these three scenarios are provided for illustrative purposes only, and it is likely that reality will be different from the above 3 scenarios. It is also possible that the Vesting Contract could terminate either before 2015 or after 2019. For example, if the wholesale market were to develop quickly for some other reason than those identified, then Synergy may find it advantageous to acquire wholesale supply agreements outside of the Vesting Contract, and would have an incentive to sign contestable tariff customers to retail supply contracts. This would result in a significantly higher churn rate, and would cause the Vesting Contract to expire much earlier. This would also likely bring forward the implementation of FRC, which would, in itself, also increase the prospects of an earlier termination of the Vesting Contract.

The OOE takes no position on which of these scenarios is most likely to occur.

Also, note the dotted lines across the top of the above chart. These lines indicate the size of the total market, based on the assumed growth rate for each scenario. The difference between the dotted lines and the solid lines represents the volume of the total market that is not covered by the Vesting Contract.

APPENDIX C: THE VC FIXED CHARGE, THE ISC FIXED CHARGE, AND THE NETBACK PRINCIPLE

As indicated in section 3.6:

- the charges that Synergy pays to Verve Energy under the Vesting Contract are the VC Fixed Charge, the ISC Fixed Charge, an Energy Charge, an Additional Energy Charge; and a Take or Pay Charge;
- these charges are set based on a “netback calculation”, which means that efficient retail, networks, and other costs are deducted from Synergy’s sales revenue, and Verve Energy is paid the residual (although Additional Energy Charge is a payment above the netback amount);
- in practice, this is implemented by setting the variable prices for the duration of the Vesting Contract (i.e. the prices under the Energy Charges and Take or Pay Charges) and annually resetting the fixed prices for each Reset Period (i.e. the VC Fixed Charge and the ISC Fixed Charge);
- the ISC Fixed Charge and the VC Fixed Charge are set at the start of a Reset Period based on expectations of the amount of energy and Capacity Credits that will be sold during that Reset Period, and on expectations of the costs and revenue for that Reset Period; and
- a “Carry Over” amount is calculated in May after the Reset Period to reconcile the differences between the forecasts used in setting the VC Fixed Charge and the ISC Fixed Charge vs. what actually happened in the Data Collection Period (see section 3.8) and to make an adjusting payment.

C1 The VC Fixed Charge

The VC Fixed Charge is calculated for each Reset Period as:

- The “Genco VC Revenue Component” for the Reset Period;
- less estimated Energy Charges; and
- less estimated Capacity Refunds.

C1.1 The Genco VC Revenue Component

The methodology for calculating the Genco VC Revenue Component is as follows:

1. “Total VC Netback”

The Total VC Netback is calculated as the sum of tariff revenues, less network costs, less a gross margin for Synergy, less other costs.⁴⁹

⁴⁹ More specifically, the Total VC Netback for each Reset Period is calculated as:

- The sum of revenue from each tariff;
- less the sum of networks costs for each tariff;
- less a gross margin; and
- less other costs.

Note:

- The Gross Margin is in turn composed of a VC Margin Payment and a VC Fixed Payment.
- The VC Margin Payment (\$/MWh) is set to cover Synergy’s net margin and the costs for its Renewable Energy Credit (“REC”) requirements relating to serving its tariff customers. Values for the VC Margin Payment are specified in schedule 8 to the Vesting Contract for 2006, 2007, 2008, 2009, and 2010 forward; but are confidential and will not be publicly released.
- The VC Fixed Payment (\$/year) is set to recover Synergy’s cost to serve its tariff customers. The VC Fixed Payment will scale down as the amount of energy traded under the Vesting Contract declines.

2. “VC Vesting Component”

The VC Vesting Component is calculated by scaling the Total VC Netback by a factor to allow Synergy to keep additional revenue if the amount of energy and capacity credits supplied by Verve Energy under the Vesting Contract and displacement is not able to supply Synergy with all of the energy and Capacity Credits that it requires to supply vested customers. The VC Vesting Component is used for further calculations under the Vesting Contract. The other amount that results from these calculations that is not captured by the Vesting Contract (if any) retained by Synergy to source Additional Energy (see sections 3.4.2 and 3.6.4) and any other Capacity Credit requirements to cover the shortfall in what is available from Verve Energy.

3. “Genco VC Revenue Component”

The Genco VC Revenue Component is determined by deducting the “NonGenco VC Supply Component” from the VC Vesting Component. The NonGenco VC Supply Component is the money that Synergy is to use to fund other wholesale supply sources (i.e. wholesale supplies for displaced volumes and volumes under the contract that resulted from the Power Procurement Stage 2 [“PP2”] process).⁵⁰

Diagrammatically, this methodology for calculating the Genco VC Revenue Component is represented as follows.

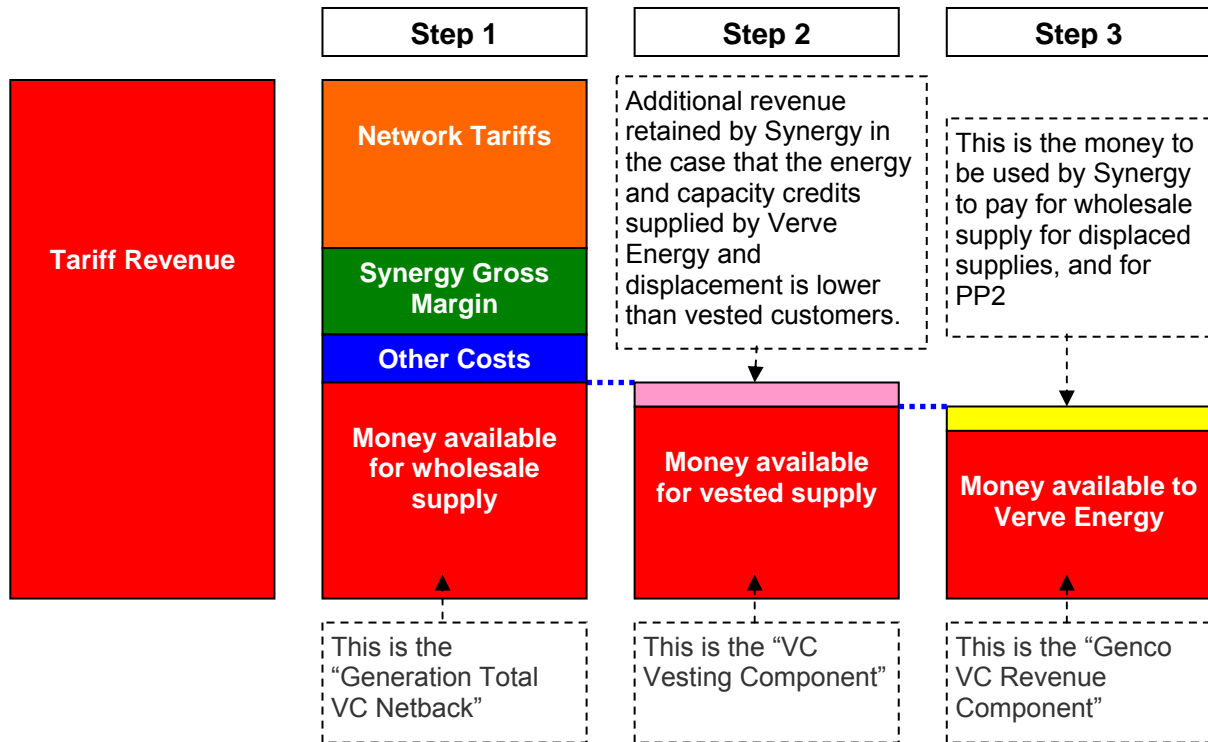
However, to recognise that a significant portion of Synergy’s fixed costs are tied to franchise customers, only 30% of the VC Fixed Payment will scale down as the amount of energy traded under the Vesting Contract declines (i.e. as the ratio of the Capacity Cap to Synergy’s IRCR declines). Synergy will retain the other 70% of the VC Fixed Payment in each Reset Period.

- The Other Costs include ancillary services costs, load following service payment costs, commitment and outage compensation settlement amounts, reconciliation settlement amounts, market fees, system operator fees, regulator fees, and excess capacity costs. Since the “Other Costs” are a deduction in calculating both the Total VC Netback calculation and the Total ISC Netback, the Other Costs are scaled in proportion to the amount of energy traded to supply tariff customers and to supply inherited retail contract customers, respectively. This ensures that the Other Costs are not double counted.

⁵⁰ More specifically, the NonGenco Supply Component, and is calculated as:

$$\left(\frac{\text{Displaced}}{\text{Volume}} \right) \times \frac{\text{VC Vesting Component}}{\text{Total Tariff Volume}} + \left(\frac{\text{PP2}}{\text{Quantity}} \right) \times \left(\frac{\text{PP2}}{\text{Price}} \right)$$

The PP2 Price is specified in schedule 8 to the Vesting Contract, but is confidential.



C1.2 The VC Estimated Energy Component

The VC Estimated Energy Component is calculated as the sum of the Expected Nominations for the Reset Period multiplied by the relevant Energy Prices (as provided in schedule 6 to the Vesting Contract).⁵¹

The Expected Nominations for the Reset Period are calculated in accordance with the formulae in schedule 2 to the Vesting Contract (see section A3).

C1.3 The Capacity Refund Expectation

The Capacity Refund Expectation for the relevant Reset Period is calculated as the Capacity Cap for the Reset Period, multiplied by the expected forced outage rate (as specified in schedule 8 to the Vesting Contract), and multiplied by the average refund rate for the month (as per the Rules).

C2 The ISC Fixed Component

The ISC Fixed Component is conceptually calculated in the same way as the VC Fixed Component, but is based on revenues and volumes for inherited retail contracts rather than tariffs.⁵²

⁵¹ As indicated above, the Energy Prices in schedule 6 to the Vesting Contract are confidential, and will not be released publicly.

⁵² For example, the Total ISC Netback for the Reset Period is calculated as the sum of:

- revenue (the sum of revenue from all of the inherited retail contracts);
- networks costs (for all inherited retail contracts);
- less a gross margin; and
- less other costs.

Each term in the Total ISC Netback Calculation is multiplied by a “Duration” term as it is summed and then adjusted by a weighted volume term to account for inherited contracts that expire during the Reset Period and move to non-Vesting. See above for an explanation of the Duration term.

The primary difference between the calculations for the ISC Fixed Component and the VC Fixed Component is that each term in the Total ISC Netback Calculation is multiplied by a “Duration” term and then adjusted by a weighted volume term to account for the fact that some inherited contracts expire during the Reset Period and become non-Vested. The value for the Duration term for each inherited retail contract is determined as outlined in schedule 4 to the Vesting Contract.⁵³

This Duration term was inserted into the Total ISC Netback calculation to meet the policy decisions outlined in recommendations 31 and 32 from the ERTF’s Final Report.⁵⁴ In summary, the policy as implemented under the Vesting Contract is as follows.

Inherited Retail Contract		Wholesale Supply Under the Vesting Contract
Type	Explanation	
Short-term Contracts	Contracts where the right of renewal occurs before 30 November 2008, and the additional term also expires before this date.	Verve Energy will provide wholesale supply until expiry of the additional term.
Medium-term Contracts	Contracts where the right of renewal occurs before 30 November 2008, and the additional term extends beyond this date.	Verve Energy will provide wholesale supply until 30 November 2008.
Long-term Contracts	Contracts where the expiry or right of renewal occurs after 30 November 2008.	Verve Energy will provide wholesale supply for the duration of the contract, but not for any extension.
Evergreen Contracts	Contracts where either Synergy or the customer has the right to terminate the contract, and the date after which they are allowed to terminate is before 30 November 2008.	Verve Energy will provide wholesale supply until this termination option is exercised or 30 November 2008, whichever is earlier.

The Total ISC Netback calculation is essentially the same as the Total VC Netback calculation for each Reset Period (see footnote 49), with the differences being:

- The Gross Margin is composed of an ISC Margin Payment and an ISC Fixed Payment.
- The ISC Margin Payment (\$/MWh) is set to cover Synergy’s net margin, the costs for its REC requirements related to its inherited retail contract customers, and half of its cost to serve its inherited retail contract customers. Values for the ISC Margin Payment are specified in schedule 8 to the Vesting Contract for 2006, 2007, 2008, and 2009 forward; but are confidential.
- The ISC Fixed Payment (\$/year) is set to recover half of Synergy’s cost to serve its inherited retail contract customers. The ISC Fixed Payment is scaled down as inherited retail contracts expire, recognising that the cost to serve these customers will decline as they expire.
- The Other Costs included in the Total ISC Netback are the same as in the Total VC Netback. To ensure that the Other Costs are not double counted, the Other Costs are scaled in proportion to the amount of energy traded to supply tariff customers and to supply inherited retail contract customers, respectively.

⁵³ The Duration term for each inherited retail contract will be set such that $0 \leq \text{Duration} \leq 1$. Effectively, the Duration of an inherited retail contract will be 1 if its expiry date is after the end of the Reset Period, 0 if its expiry date is before the beginning of the Reset Period, and a number between 0 and 1 if it expires during the Reset Period.

⁵⁴ A copy of the ERTF’s final report is available on the OOE website (www.energy.wa.gov.au).

Inherited Retail Contract		Wholesale Supply Under the Vesting Contract
Type	Explanation	
	Contract where either Synergy or the customer has the right to terminate the contract, and the date after which they are allowed to terminate is after 30 November 2008.	Verve Energy will provide wholesale supply until the date of the termination option.
	Contracts where only the customer has the right to terminate the contract (if any).	Verve Energy will provide wholesale supply until the customer terminates the contract.
	Contract where only Synergy has the right to terminate the contract (if any).	Verve Energy will provide wholesale supply until the date of the termination option, or 30 November 2008, whichever is later.