

2016 Report to the Minister on the Effectiveness of the Electricity Generation and Retail Corporation Regulatory Scheme

Discussion Paper

May 2017

Economic Regulation Authority

WESTERN AUSTRALIA

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Invitation to make submissions

On 1 January 2014, Verve Energy and Synergy merged to form the Electricity Generation and Retail Corporation (**EGRC**), trading as Synergy. At the same time, the Government implemented the EGRC Regulatory Scheme (**scheme**) to mitigate the potential for the misuse of market power due to the merger. The scheme imposes requirements on Synergy, including standard product arrangements, ring-fencing, business segregation, transfer pricing and non-discriminatory wholesale electricity trading.

The Economic Regulation Authority (**ERA**) is required to review the effectiveness of the operation of the scheme at least annually and to provide a report to the Minister for Energy that includes any recommendations it has for amending the scheme.

The purpose of this discussion paper is to assist interested parties in making submissions to the ERA's 2016 review of the effectiveness of the operation of the scheme. In providing submissions to the review, stakeholders are encouraged to give evidence, data and any other information (such as case studies) to support their submissions.

The ERA recognises that this material might contain information that is confidential in nature and will treat all such information in accordance with its confidentiality guidelines below.

Interested parties are invited to make submissions on the ERA's consultation paper by

4:00 pm (WST) Friday, 30 June 2017 via:

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CONFIDENTIALITY

In general, all submissions from interested parties will be treated as being in the public domain and placed on the ERA's website. Where an interested party wishes to make a submission in confidence, it should clearly indicate the parts of the submission for which confidentiality is claimed and specify in reasonable detail the basis for the claim. Any claim of confidentiality will be considered in accordance with the provisions of section 55 of the *Economic Regulation Authority Act 2003*.

The publication of a submission on the ERA's website shall not be taken as indicating that the ERA has knowledge either actual or constructive of the contents of a particular submission and in particular, whether the submission in whole or part contains information of a confidential nature, and no duty of confidence will arise for the ERA.

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Introduction

On 1 January 2014, the government-owned electricity generation business, Verve Energy, merged with the government's electricity retail business, Synergy. The merged business is the Electricity Generation and Retail Corporation (**EGRC**), trading as Synergy.

At the same time, the Government implemented the EGRC regulatory scheme (**scheme**). This recognised Synergy's control of around three quarters of the wholesale energy supply in the Wholesale Electricity Market (**WEM**); through its own generation plant and contractual arrangements with third party generators. Merging the generation and retail businesses without imposing restrictions could provide opportunities for Synergy to preference its own retail and generation arms at the expense of third parties and thus limit the development of effective competition.

The scheme imposes requirements on Synergy to mitigate market power arising from the merger, to ensure a level playing field for competitors and new entrants, in order to facilitate competition. It comprises the:

- EGRC Regulations;¹
- Segregation and Transfer Pricing Guidelines;² and
- Standard Product Arrangements.³

The EGRC Regulations require Synergy to divide its operations into segments: the Generation Business Unit, Wholesale Business Unit, Retail Business Unit, shared service operations and any additional segment(s) approved by the Minister. Synergy is required to prepare separate statements of financial performance for each business unit, on a quarterly basis and for the annual financial report.

When offering wholesale supplies, Synergy must not discriminate between the Retail Business Unit and competitors on the terms and conditions of supply. It must also offer specified, standard wholesale products to both buy and sell energy.

The EGRC Regulations also include compliance and review provisions. The Auditor General is required to monitor compliance with the scheme and to conduct annual audits. The ERA must investigate any non-compliance reported by the Auditor General and may impose civil penalties for non-compliance. The maximum amount the ERA may impose for contravention of a civil penalty provision⁴ is \$100,000 with additional daily penalties of up to \$20,000 for continuing breaches.

Additionally, the ERA must review the operation of the scheme to assess its effectiveness at least once each year. The EGRC Regulations do not specify any criteria for making this assessment.

¹ The *Electricity Corporations (Electricity Generation and Retail Corporation) Regulations 2013*.

² The *Segregation and Transfer Pricing Guidelines 2013*.

³ The *Electricity (Standard Products) Wholesale Arrangements 2014*.

⁴ Schedule 1 of the EGRC Regulations sets out civil penalty provisions for the segmentation of EGRC operations, treatment of the 'foundation transfer price mechanism', disclosure of restricted information, separation of work areas, and the requirement for the EGRC not to discriminate between the RBU and competitors when offering wholesale supply.

This is the ERA's third review of the scheme and covers the operation of the scheme over the 2016 calendar year.

This discussion paper is to assist interested parties in making submissions as part of the ERA's review of the scheme and will assist in preparing the report for the Minister.

Appendix 1 provides a more detailed description of the scheme.

Reporting requirements and timing

Under regulation 48 of the EGRC regulations, the ERA is required to carry out a review of the operation of the scheme to assess its effectiveness at least once per year.⁵ In conducting this review, the ERA must have regard to:

- the prevailing circumstances that exist in relation to the operation of the South West Interconnected System (**SWIS**); and
- any other matters that the ERA considers relevant.

The ERA must provide a report to the Minister based on its review up to two months after the review is completed and may include any recommendations it has concerning amendments to the scheme.

The Minister must provide a copy of the report to each house of Parliament no later than 21 sitting days after the day on which the Minister receives the report.

Approach and focus of the 2016 review

In the 2016 Review, the ERA intends to continue to assess the effectiveness of the scheme based on the objective developed in its first review. It will assess how effective the scheme is in mitigating the increased potential for exercising market power which arises due to the merger of Synergy and Verve Energy by ensuring a level playing field for competitors and new entrants, in order to facilitate competition.

To do this, the ERA will assess the level of competition in both the wholesale and retail markets. Whilst the scheme primarily focusses on ensuring a level playing field in access to wholesale energy supplies, there is significant interaction between the wholesale and retail markets, with the effectiveness of competition in either market affected by the other.

The ERA will also consider significant barriers to competition, some of which the ERA has previously identified in earlier reviews of the scheme (see Appendix 2).

This approach is described in more detail below.

Assessment of the effectiveness of the scheme

A competitive retail market is dependent on retailers being able to access wholesale energy supplies competitively. Competitive tension encourages retailers to innovate and

⁵ Given the implementation of the EGRC Regulatory scheme on 1 January 2014, the EGRC reviews are conducted on a calendar year basis.

differentiate their offers from those of competitors to better meet the needs of customers. In turn, retailers competing on a level playing field for wholesale supplies underpin a competitive wholesale market, driving prices toward the efficient cost of supply. The effectiveness of competition in either market is dependent on the other.

The scheme has an important role to play in mitigating the potential for the misuse of market power by Synergy in wholesale energy supply and in ensuring a level playing field for all retailers. Synergy continues to be the largest supplier in the market, supplying 74 per cent of the total wholesale market, through its own generation and long-term contracts with other generators. Synergy's 2015 Annual Report notes that it supplies 61 per cent of the total retail market. This includes the non-contestable market, of which Synergy has 100 per cent coverage, and the contestable market in which it has the highest market share.⁶

The retail contestable market has become increasingly competitive since the WEM commenced in 2006, with many new retailers successfully entering the market. Currently, only Synergy supplies customers using less than 50 megawatt-hours per year.

In this year's review, the ERA will consider the current level of competition in both the wholesale and retail markets. Many variables may influence competition in these markets. The level of competition thus provides a general indication of the effectiveness of the scheme.

In undertaking its assessment, the ERA intends to employ a general framework on competition review (structure, conduct and performance) and review a range of interrelated indicators to assess the effectiveness of competition.⁷

For the retail market, this will include consideration of the following indicators:

- **customer activity in the market** - A desirable outcome of a competitive market is one in which customers are aware of and can act upon the choices available to them. Customers shopping around for lower prices and better services place downward pressure on prices and drive retailers to provide the quality of service that customers demand. The ERA will consider measures such as customer engagement in choosing offers (what proportion of customers are on market offers and what proportion are on regulated offers); customer churn; and customers changing plans with a retailer (i.e. choosing new products with an existing retailer).
- **barriers to entry, exit or expansion** – In a competitive market, new retailers are freely able to enter the market and incumbent retailers can exit or expand within the market. This places competitive pressures on existing retailers to charge prices proportionate to efficient costs and to improve their offerings. The ERA's analysis will include evidence of entry, exit or expansion; retailer views on barriers to entry or expansion; and measures of contract market liquidity (i.e. are retailers able to obtain hedge products to manage risk exposure as they enter or expand in the market).⁸

⁶ Synergy's percentage share of the contestable retail market is not publicly available.

⁷ This approach is similar to that adopted by the Australian Energy Market Commissions (AEMC) in reviewing energy retail competition nationally. Refer to AEMC, 2014 Retail Competition Review, Approach Paper, 17 January 2014, Sydney <http://www.aemc.gov.au/getattachment/94c068d8-3dbe-49bf-a53a-e976cf942d85/Approach-Paper.aspx>

⁸ Many barriers to entry or expansion may be worth considering in the present context. For example, incumbency advantages may act as barriers to entry or expansion resulting from good commercial decisions in the past (e.g. investing in and patenting a successful new technology), or from the entity having preferential and systematically better access to key resources, information or customers. Additionally, where an entity has significant market power, it may be able to use the strength of its position to limit or restrain competition by requiring customers to enter into long term or exclusive contracts or

- **independent rivalry** – A high level of independent rivalry in a market, where retailers are competing to attract or retain customers, helps to drive discounting and product innovation. The ERA’s analysis will consider changes in market share and concentration over time; switching between retailers; product differentiation and the number of market offers available.
- **customer outcomes** – In effectively competitive markets, customers are generally satisfied with the available range of products and their choices. Switching does not necessarily indicate the level of competition in a market because, if customer satisfaction is high, or retailers are focused on retention, there may be less incentive to switch, even in competitive markets. The ERA will therefore also consider customer complaints to retailers and the Ombudsman, and disconnection rates.
- **retail market outcomes** – The traditional centralised energy supply model is being challenged by new technologies, products and services, creating opportunities for retailers to innovate and provide consumers with greater control over how their electricity is delivered and consumed. The ERA will assess the rate of progress and improvement over time of different products and services.⁹

To assess competition in the wholesale supply market, the ERA will consider:

- **customer demand** – including changes in demand over time (e.g., weekly and/or during summer or winter periods, or across peak and off-peak intervals);
- **aspects of independent rivalry related to the structure of the market** – including changes in the number, type and size of electricity suppliers over time; market concentration indices and changes in the market shares of electricity suppliers over time; and
- **the ability of suppliers to enter the market** – including evidence of entry, access to wholesale markets, contract market liquidity, and risk management/hedging products;
- **wholesale market outcomes** – assessment of bilateral and generation supply positions by market participant; Short Term Energy Market (**STEM**) sales and purchases and net balancing position by market participant; combined electricity supply and disposal by market participants; baseload generation capacity and demand; monthly STEM peak and off-peak standard deviation; and monthly marginal cost administer prices/balancing market peak and off-peak price standard deviation.

Analysis of customer activity in the market, barriers to entry, exit or expansion, and independent rivalry will help to provide a picture of the market structure and the conduct of its participants, whilst analysis of customer and market outcomes should provide information on the performance of the market.

producing switching costs for customers (e.g. through volume discounts or contractual penalties). Customers may shelve switching suppliers due to the perception or experience that it is costly, complex, time consuming or risky. Barriers to entry or expansion may also be created by bundling or tying the sale of particular products; selective discounting; or exclusionary conduct, which may create a barrier to entry when used systematically to reduce prices for particular customers that are more likely to switch to other suppliers.

⁹ The ERA is considering assessing business outcomes, such as revenue and profitability in future reviews.

As in its last review, the ERA will again consider the options available to retailers to source wholesale energy from suppliers and the balancing and STEM markets, as well as consider symptoms of any anomalous pricing behaviour, such as cross subsidisation.¹⁰

These indicators are not exhaustive and the ERA may consider other information during the course of the review. The ERA will not use one set of indicators to determine the effectiveness of competition in either market. It will analyse the indicators collectively and form a judgement on the overall state of competition in the wholesale and retail markets.

The ERA's assessment will be evidence based. Quantitative analysis will utilise market data provided by Synergy, the Australian Energy Market Operator and Western Power. The ERA will also draw from stakeholder responses to past and present discussion papers and ERA workshops, confidential interviews and experience and information from other jurisdictions where relevant.

The ERA invites stakeholders to comment on the effectiveness of the scheme in helping or hindering competition in the market, and to provide any evidence that supports their views.

Participant Affiliations

Synergy has control of around three quarters of the wholesale energy supply in the WEM. Synergy owns multiple generators (including Vinalco Energy). It is the registered market generator for multiple facilities and through the standard product arrangements is affiliated with other participants' generators.¹¹ As well as electricity, Synergy's portfolio includes gas supply and retail arms.

The scheme does not include provisions that address affiliations with other market generators, or portfolios containing affiliated electricity and gas service arms. Addressing all of the probable substantial forms in which enhanced market power may apply (i.e. through horizontal integration) is not always feasible and/or may make the scheme too complex to monitor and enforce.

Nevertheless, a key question is whether the incumbent generator is sufficiently independent from its generation affiliates so that regulators and third parties can be reasonably confident that the incumbent and its affiliates act individually, particularly in bidding. This is addressed in the market rules, which require bidding at a generator's reasonable expectation of the Short Run Marginal Cost (**SRMC**) of generating the relevant electricity, when such behaviour relates to market power.¹²

However, uncertainty may exist regarding whether two horizontally integrated parties are separate and independent entities for evaluating behaviour related to market power. Complicating this scenario is the fact that separate companies that have the same parent

¹⁰ In the first two reviews of the EGRC Scheme, stakeholders expressed concern that the RBU was selling energy to customers below the price charged for supply by the WBU, and that it was able to do this because it can use the Tariff Adjustment Payment to subsidise this behaviour. The ERA recommended specifying the requirements for the statements of financial performance prepared for each of the segmented business units. Among other things, this would ensure that sufficient information is provided on the allocation of costs between business units, including demonstrating that there are no cross subsidies.

¹¹ These include Southwest Cogeneration Joint Venture, Kwinana Cogeneration Plant, Bluewaters 1 and 2, and Newgen Kwinana.

¹² Refer to Market Rule 7A.2.17, page 375:
https://www.erawa.com.au/cproot/14681/2/Wholesale%20Electricity%20Market%20Rules_10.12.16.pdf

company have a responsibility to bid in ways that further the commercial interests of the entity as a whole,¹³ which can occur both with and without any sharing of information.

Measures for assessment of whether participants bid independently can include auditing, investigating complaints, scrutinising accounting results of both the regulated and the competitive affiliates of an incumbent generator, and monitoring markets to identify possible market manipulation (including withholding capacity).¹⁴ In addition to SRMC bidding, horizontal market power mitigation in the form of ring-fencing, structural separation of competitive generation affiliates or codes of conduct¹⁵ may also help to ensure a competitive market that benefits consumers.

Concerns about the effect of segmented electricity and gas portfolios on profitability have been raised in the British market, where gentailers are structured in segments in a similar way to Synergy. In this market, year on year, the loci of a company's profits may shift from one segment to another, such that when a company's profits from one area (e.g. electricity retail) fall to a low level, the company may make exceptionally large profits in another area.¹⁶

In order to provide better transparency regarding how company revenues, costs and profits are split across different parts of each business, the Office of Gas and Electricity Markets (**Ofgem**) requires large integrated companies¹⁷ to publicly report separate financial results annually for generation and for domestic and non-domestic electricity and gas supply.¹⁸ Ofgem considers that the publication of these consolidated segmental statements is important for consumer confidence and for facilitating new entry (and thereby competition) through informed decision making.

The ERA welcomes feedback from stakeholders on their experience of the scheme and how:

- **participant affiliations in the market have affected them; and**
- **the design of the scheme could be changed to provide increased transparency without compromising commercial confidentiality.**

¹³ Under clause 88 of the *Electricity Corporations Act 2005* the Board of Synergy must annually prepare and submit to the Minister a draft strategic development plan for the corporation and any subsidiary (for a 5 year or lesser period). Under clause 90, the matters to be included in the strategic development plan include economic and financial objectives and operational targets and how these objectives and targets will be achieved; competitive strategies (where appropriate), pricing of products, productivity levels, financial requirements, capital expenditure and personnel requirements. Refer to page 57: [https://www.slp.wa.gov.au/pco/prod/FileStore.nsf/Documents/MRDocument:29454P/\\$FILE/Electricity%20Corporations%20Act%202005%20-%20\[02-e0-00\].pdf?OpenElement](https://www.slp.wa.gov.au/pco/prod/FileStore.nsf/Documents/MRDocument:29454P/$FILE/Electricity%20Corporations%20Act%202005%20-%20[02-e0-00].pdf?OpenElement)

¹⁴ Refer to NERA Economic Consulting (2006), Review of Wholesale Market Ring-fencing: All-Island Project. Marsh and McLennan Companies.

¹⁵ Codes of conduct can include limits on sharing information, and resources (such as personnel, facilities, and equipment), bans on joint sales, promotions and marketing; restrictions on sharing of logos, separate books, and records, and regulatory access to affiliate books and records. Refer to NERA Economic Consulting (2006), Review of Wholesale Market Ring-fencing: All-Island Project. Marsh and McLennan Companies.

¹⁶ For example, refer to Wright and Rutledge (2008) and their analysis of profits made by Centrica, <http://www.oxfordenergy.org/2008/09/why-the-re-introduction-of-price-control-regulation-is-the-only-remedy-which-will-work-for-domestic-energy-consumers/>.

¹⁷ i.e. the 'Big Six' energy companies: Centrica, EDF Energy, E.ON, RWE npower, ScottishPower and Scottish and Southern Electric.

¹⁸ <https://www.ofgem.gov.uk/ofgem-publications/39707/rmrfinancialinformationreport.pdf>

Compliance monitoring

In its past reviews, the ERA highlighted the possibility of a substantial lag between the occurrence of discriminatory behaviour and reports of that behaviour. It recommended that, if cost effective, the Auditor General should report more frequently and that Synergy should self-report any non-compliance.

The Auditor General has previously reported two instances of non-compliance. In its first Financial Year audit for the period ending 30 June 2014, the Auditor General found that Synergy did not comply with regulation 6(1) of the EGRC Regulations. This is because Synergy's report to the Minister for the quarter ended 31 March 2014 did not include separate statements of financial performance for each of Synergy's business units. Additionally, Synergy's report for the March quarter was provided to the Minister on 8 May 2014, which failed to meet the requirement under section 106 of the Act for the report to be provided within one month after the end of that quarter. Ultimately, Synergy provided separate statements of financial performance for each business unit to the Minister in September 2014.

In the second financial year audit for the year ended 30 June 2015, the Auditor General found that for two of the twelve standard product transactions executed during the year, remaining availability was only disclosed on the website six and nineteen working days after execution of the transactions. The Auditor General did not consider these times as being as close to real time as practicable.

The ERA is interested in considering other avenues of information on non-compliance. Assuming a suitable complaints process,¹⁹ customers and market participants competing with Synergy may be in a strong position to report instances of non-compliance where they have a clear understanding of the scheme and appropriate resources and incentives to demonstrate the non-compliance.²⁰

On 26 September 2013, in its summary presentation of major discussion points from the private sector briefing the Merger Implementation Group²¹ noted the following:

“If a market participant alleges that the merged entity engaging in behaviour which is not consistent with the regulatory regime, a complaint can be lodged directly with the Minister for Energy or with the Public Utilities Office.”

At the time, the Merger Implementation Group was also considering a more formal reporting process. However, ultimately, the scheme did not provide market participants with a prescribed avenue for making complaints to either the Minister, the Public Utilities Office or the ERA. The Public Utilities Office has since removed this set of slides from its website.

¹⁹ For example, the Western Australian Gas Retail Market Procedures discourage complaints that are “fraudulent, vexatious or frivolous.” See page 222 of http://wa.aemo.com.au/-/media/Files/Gas/Retail_Markets_and_Metering/Market-Procedures/WA/2017/Retail-Market-Procedures-WA-version-20-Clean.pdf.

²⁰ This is suggested in point 42 of “Annex B: Remedial Action” in the Competition Commission (April 2013). CC3 (Revised) - Guidelines for market investigations: Their role, procedures, assessment and remedies. Page 100. https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/284390/cc3_revised.pdf

²¹ The Minister established the Merger Implementation Group to be responsible for the governance and oversight of the merger of Verve Energy and Synergy.

The ERA welcomes stakeholder feedback on their experience of the scheme's compliance monitoring regime and the submission, handling and outcomes of any complaints made regarding the scheme.

The ERA is interested to know whether stakeholders would support the development of an independent, formal complaints process, what form this should take, and what improvements this would bring to the effectiveness of the scheme.

Standard Product Arrangements

Among the overarching goals of the standard product arrangements described by the Merger Implementation Group were the goals to:

- maintain private sector activity in the WEM by imposing discipline on Synergy's wholesale pricing;
- act as a price discovery mechanism, providing transparency and predictability for short to medium dated contracts for market participants;
- provide a competitive benchmark price to the wholesale supply of electricity on a non-discriminatory basis; and
- provide simple products that are an alternative to customised products, reduce barriers to entry for new entrant retailers, and allow market participants to rebalance their portfolios at the margins.

The scheme specifies the type, quantity and terms of the standard products that Synergy is required to offer. It includes flat and peak (8am to 10pm on business days) quantities of electricity in increments of 0.5MWh per trading interval, over quarterly, calendar and financial year periods.

Synergy is free to set the standard product prices at any level but the scheme specifies a buy/sell spread of 20 per cent. Synergy can update standard product prices up until about a month before the period the relevant standard product commences.²² Transaction prices are the price published on the date of the transaction.

The first standard products became available on 30 June 2014 with the first quarterly product commencing on 1 October 2014 and the first annual products commencing on 1 January 2015 and 1 July 2015. There were 14 transactions in standard products from when the arrangements commenced to the end of 2015, each of which was for the maximum quantity permitted per week of 5 MW. The standard products sold were peak and flat products. All standard products bought by Synergy were flat products.²³

The 2015 EGRC Review found that the excess baseload capacity in the Reserve Capacity Mechanism (**RCM**) had reduced the risk of short-term price variation in the STEM and

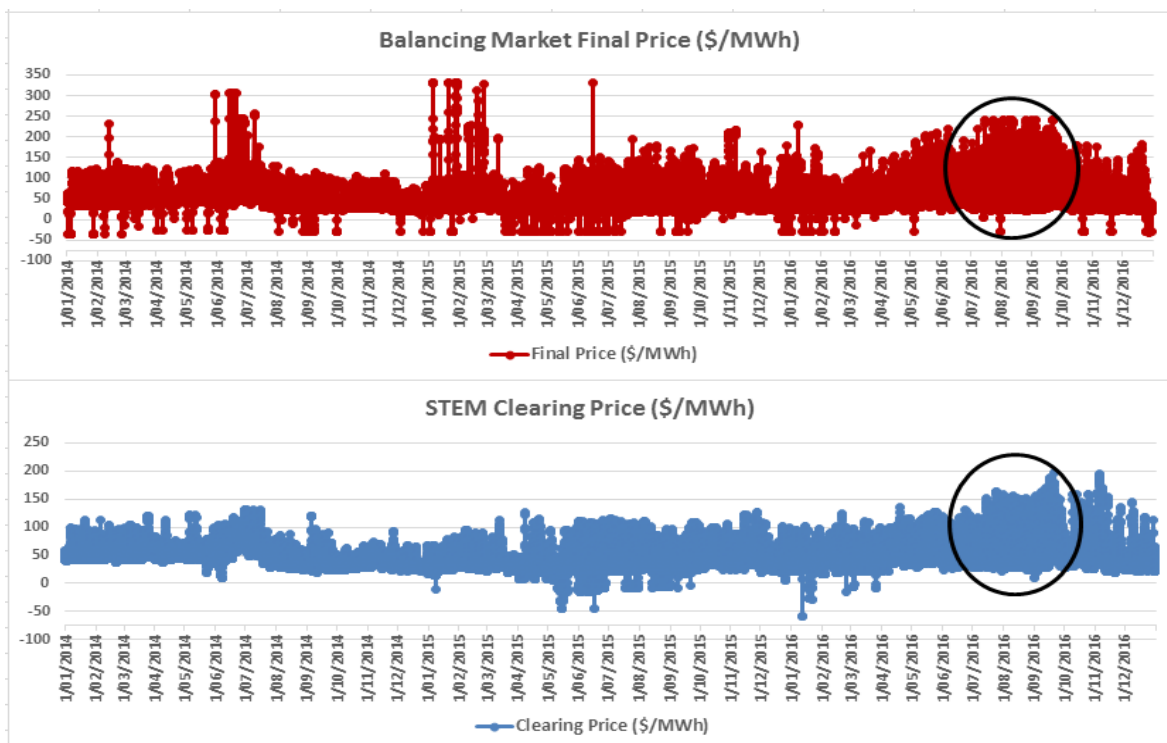
²² The *Electricity (Standard Products) Wholesale Arrangements 2014* define the Transaction Period as: "the period commencing at 10:00 hours on the date the EGRC first publishes the Availability of the Standard product and ending at 16:00 hours on the last Business Day of the month that begins 2 months before the commencement of the Standard Supply Period applicable to the Standard Product (pp. 1584)."

²³ For an overview of these transactions, refer to figure 26 on page 54 of the ERA's "Report to the Minister on the Effectiveness of the Electricity generation and Retail Corporation Regulatory Scheme (June 2016)": <https://www.erawa.com.au/cproot/14503/2/EGRC%20Report%20to%20the%20Minister%20June%202016-%20Public%20version%20for%20Minister%20to%20table.PDF>

balancing markets, thereby reducing the need for small retailers to obtain energy contracts from Synergy to mitigate the risk of short-term price variations.

The ERA noted that the planned reforms to the RCM to reduce the oversupply of capacity and bring the market into balance would probably lead to an increase in the variability of short term energy prices. This may also increase the need for small retailers to enter into contracts to hedge against these risks. A key recommendation of the 2015 EGRC Review was to reduce the spread between the buy and the sell price for standard products to 10 percent, as an incentive for Synergy to offer competitively priced energy contracts.

A review of pricing for the 2016 period indicates that, for a four-month period between July 2016 and October 2016, there was a general increase in pricing and its variability in the balancing and STEM markets.



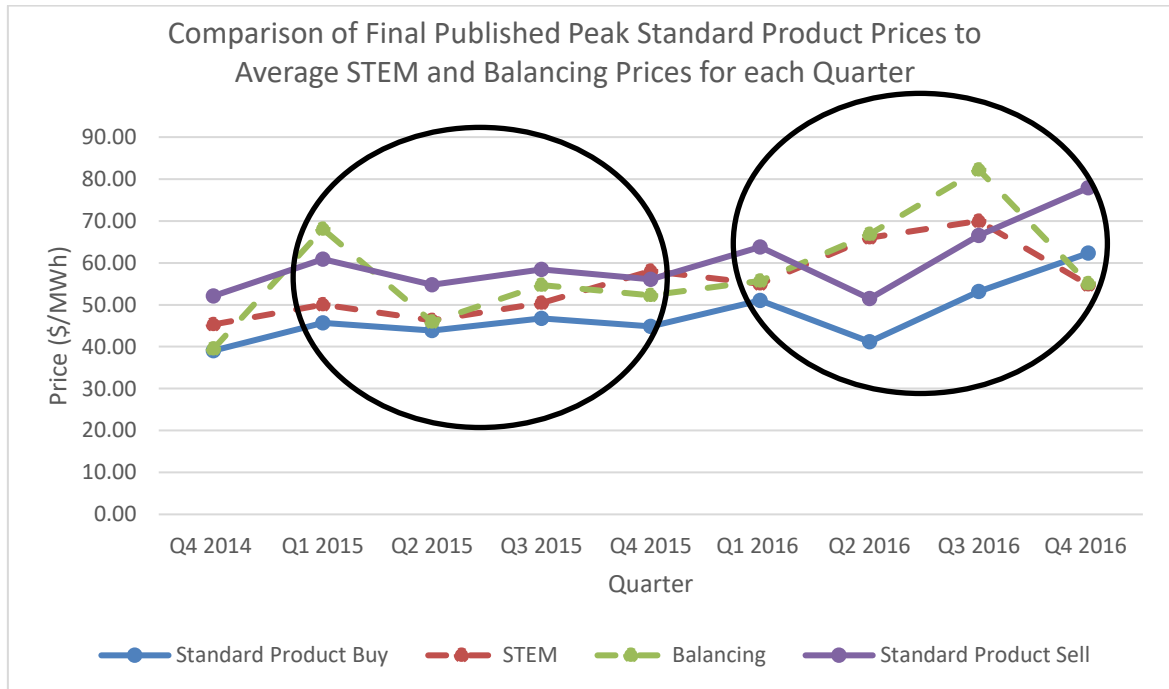
The onset and longevity of the increased price variability in the market increases the need for competitively priced short-term contracts to help retailers manage their risk and to encourage greater competition. This need may intensify, given the Minister for Energy's recent announcement of plans for Synergy to close more than 380 MW of existing generation assets by September 2018, and to reduce Synergy's generation cap to 2,275 MW (excluding renewable plant).²⁴ Additionally, AEMO's website indicates that capacity credits assigned to demand side management have reduced by approximately 450 MW between the 2016-17 and 2017-18 reserve capacity cycles.²⁵

²⁴ The assets designated for retirements include Muja AB units 1 to 4 (240 MW), Mungarra gas turbine units 1, 2, and 3 (113 MW), West Kalgoorlie gas turbine units 2 and 3 (62 MW), and Kwinana gas turbine unit 1 (21 MW). Refer to: <https://www.mediastatements.wa.gov.au/Pages/McGowan/2017/05/Synergy-to-reduce-electricity-generation-cap-by-2018.aspx>

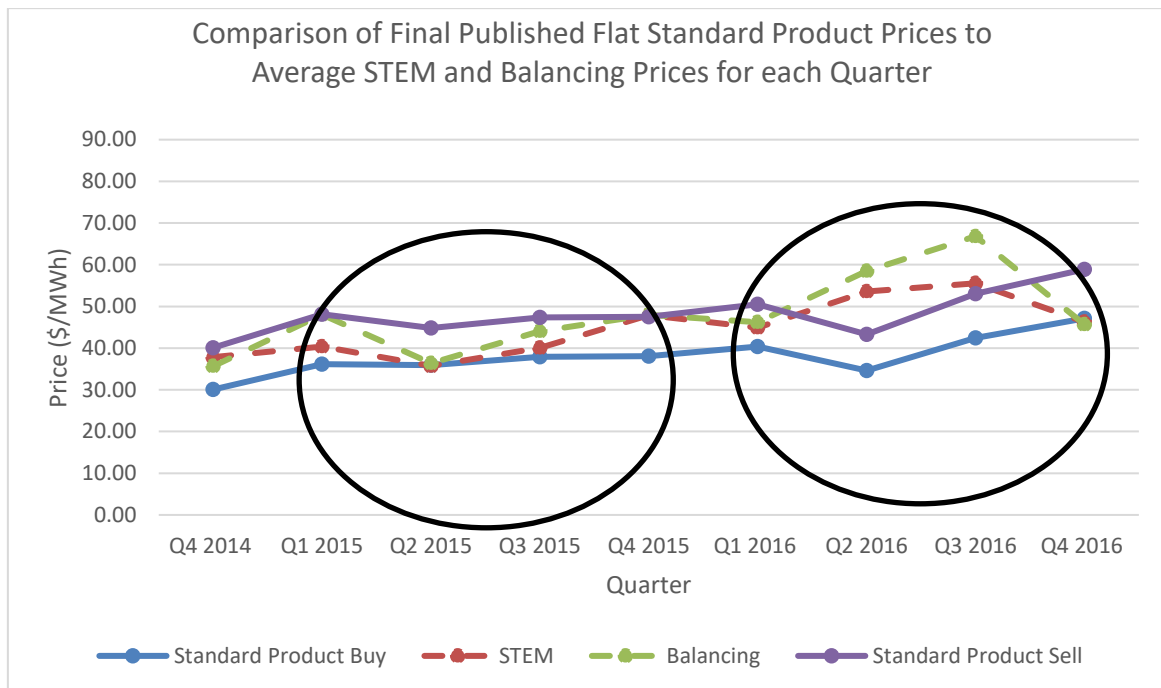
²⁵ Refer to 'Capacity Credits since market start up to 2017-18,' available at: <http://wa.aemo.com.au/Electricity/Wholesale-Electricity-Market-WEM/Reserve-capacity-mechanism/Assignment-of-capacity-credits>

Retailers have a greater need for energy contracts to hedge themselves in times of high market price volatility. However, only one standard product transaction occurred in the review period, on 4 November 2016. This was for a flat, 5 MW product covering the 2017 calendar year period.

The following figures compare final advertised standard product prices at the expiry of the sale period for each quarter, with actual average STEM and balancing prices for each quarter.²⁶ Such a comparison will not allow for the quantification of forecasting error, as would be present in forward spot price estimates. However, if viewed over time, the comparison may provide some indication of the premium added to spot prices for contracting.



²⁶ For example, the date that the buy and sell Q4 2014 standard products were last advertised for transacting was on 1 September 2014, i.e. one month ahead of commencement of supply on 1 October 2014. These prices are plotted against the actual average balancing and STEM prices for Q4 2014.



In 2015, the standard product prices largely bounded average balancing and STEM prices. However, the pattern of pricing over 2016 is substantially different, as:

- In Q2 and Q3 2016, balancing and STEM prices were higher than standard product prices.
- In Q4 2016, the price at which Synergy was obligated to buy standard products was set higher than the average STEM and balancing prices.

Standard product sell prices should include the expected spot price and a premium for contracting to remove spot price risk, and should thus be higher than the prices in the STEM and balancing markets. Where standard product prices are much lower than the energy market prices, as occurred in mid-2016, it is unlikely that these prices would provide a suitable benchmark price for contracting in customised products.²⁷

The ERA welcomes any information from stakeholders on their experience of the standard product arrangements. For example, the ERA invites responses to the following questions:

- **have the overarching goals of the standard product arrangements described by the Merger Implementation Group been met? If not, why not?**
- **why do market participants choose to use standard products?**
- **why do market participants choose not to use standard products?**
- **are the standard product regime's design specifications (e.g. volume, term, spread, lead time) appropriate? If not, why not?**

²⁷ The divergence in pricing may simply represent errors in forecasting. In Q4 2016, Synergy set peak standard product prices at a level where, if a buy transaction was undertaken, it would have been obligated to purchase energy at prices higher than the average STEM and balancing prices when it already has excess capacity.

- **what alternatives to the use of standard products are available?**
- **how can the standard product arrangements be improved?**

Appendix 1 Overview of the EGRC Regulatory Scheme

The EGRC Regulations

The EGRC Regulations came into effect on 1 January 2014. Amongst other things, the regulations include segregation and wholesale trading requirements, and a compliance regime.

Segregation Requirements

Division of EGRC Operations into Segments

The EGRC Regulations require that Synergy divide its operations into segments:

- the Generation Business Unit, comprising operations involving the construction or operation of generating works;
- the Wholesale Business Unit, involving the wholesale acquisition or supply of electricity and the acquisition or supply of wholesale products, including pricing in respect of such acquisition or supply;
- the Retail Business Unit, involving the pricing, sale and marketing of electricity to customers served by the SWIS²⁸;
- shared services operations, including operations relating to corporate planning and strategy, organisational development, accounting, financial and legal matters, human resources, information technology, regulations and compliance, communications, billing, and record keeping. It also includes any other operations undertaken in connection with two or more business units, excluding generation operations, wholesale operations and retail operations; and
- any additional segment(s) approved by the Minister.

Synergy is required to prepare separate statements of financial performance for each EGRC business unit, on a quarterly basis and in the annual financial report.

Other Segregation Obligations

The EGRC Regulations also impose segregation obligations relating to ring-fencing and restrictions on information flows between the business segments, which require:

- that retail restricted information²⁹ must not be disclosed to retail staff and generation restricted information³⁰ must not be disclosed to generation staff;

²⁸ The SWIS includes the interconnected transmission and distribution systems, generating works and associated works, located in the South West of the State and extending generally between Kalbarri, Albany and Kalgoorlie.

²⁹ Retail restricted information is defined as information relating to a retail competitor that is obtained by or provided to wholesale staff in the course of the conduct of the wholesale business and might reasonably be expected to materially adversely affect the commercial interests of the retail competitor if disclosed to retail staff.

³⁰ Generation restricted information is defined as information relating to a generation competitor that is obtained by or provided to wholesale staff in the course of the conduct of the wholesale business and might

- that Synergy must develop, implement and maintain controls that limit access to IT systems to ensure compliance with disclosure provisions;
- that staff who receive access to restricted information are made aware of the obligations imposed on Synergy through training conducted at least once a year;
- that wholesale staff are physically separated from generation and retail staff in a secure location; and
- the separation of management roles between the retail, wholesale and generation business units.

Wholesale Trading Requirements

Supply Arrangements

The EGRC Regulations set out the requirements for the four types of wholesale supply arrangements under the Scheme, involving the Wholesale Business Unit (**WBU**), including:

- the WBU provides wholesale supply to Retail Business Unit (**RBU**), for retail supply to foundation customers;
- the WBU provides wholesale supply to RBU, for retail supply to new contestable customers³¹;
- the WBU provides wholesale supply of customised products to RBU, or other retail or generation competitors; and
- the WBU provides wholesale supply of standard products to other retail competitor or receives wholesale supply of standard products from other generation competitor.

Internal Synergy Wholesale Arrangement

The EGRC Regulations require Synergy to have a written arrangement in place before any supply transaction occurs between the WBU and the RBU, for a retail supply of electricity to a customer other than under a new contestable customer arrangement. This written arrangement must state that the transfer price under this arrangement is the foundation transfer price i.e., the price determined for that supply in accordance with the foundation transfer price mechanism.³²

To address this requirement, Synergy has implemented the Internal Synergy Wholesale Arrangement. Synergy made this arrangement in accordance with regulation 11 of the EGRC Regulations, as the foundation transfer price mechanism to apply to the operations of the WBU and the RBU. The transfer prices and pricing mechanisms for the wholesale supply of energy under this arrangement constitute the foundation transfer price for the

reasonably be expected to materially adversely affect the commercial interests of the generation competitor if disclosed to generation staff.

³¹ A new contestable customer arrangement is an arrangement between Synergy and a contestable customer that imposes a legal obligation on the EGRC to supply electricity to the contestable customer on a retail basis and becomes legally binding on Synergy after the merger time.

³² According to the Merger Implementation Group, the foundation transfer pricing mechanism covers franchise tariffs, contestable tariffs, and existing contestable contracts up to their expiry. This includes contracts signed prior to 1 January 2014, where supply had commenced; contracts signed prior to 1 January 2014, where supply had not yet commenced; formal contract offers made by Synergy prior to 1 January 2014, which the customer accepted prior to 1 April 2014; and any contractual options contained within the aforementioned agreements.
http://www.finance.wa.gov.au/cms/uploadedFiles/Public_Utility_Office/Synergy_and_Verve_Energy_Merger/Market-participants-and-stakeholder-briefing-session-December-2013.pdf

purposes of regulations 9(1) and (2) of the EGRC Regulations. Section 2 of the Segregation and Transfer Pricing Guidelines (see below) also applies, with prices determined in accordance with clause 2.2(e) and energy forecasting and nominations made in accordance with 5.1(3) and 5.1(4).

New Load Wholesale Arrangement

Before any supply transaction is entered into between the WBU and the RBU for a retail supply of electricity to a customer under a new contestable customer arrangement, Synergy must have one or more written arrangements in place to apply to supply transactions of that kind. A written arrangement for supply transactions of this kind must include a mechanism for determining the transfer price (i.e., referred to as an 'additional transfer price mechanism' under the Segregation and Transfer Pricing Guidelines).

To address this requirement, Synergy has implemented the New Load Wholesale Arrangement. Synergy produced this arrangement in accordance with regulations 9(3) and 9(4) of the EGRC Regulations, and section 4 of the Segregation and Transfer Pricing Guidelines.

Master Bilateral Trade Agreement and Bilateral Trade Agreement (Standard Products)

Under regulation 9(6) of the EGRC Regulations, before any transactions with third parties occur, Synergy must have one or more written arrangements that set out the terms and conditions that are to apply to those transactions in place.

In addressing this requirement, Synergy has implemented two arrangements; i.e., the Master Bilateral Trade Agreement and the Bilateral Trade Agreement (Standard Products).

The Master Bilateral Trade Agreement addresses regulation 9(6) and is used in the request for quotation process for trading in customised products, including the bilateral trade of electricity, capacity credits and contracts for differences.

The Bilateral Trade Agreement (Standard Products) provides for trading in standard products, and addresses requirements in the *Electricity (Standard Products) Wholesale Arrangements 2014* and regulation 9(6). The Bilateral Trade Agreement (Standard Products) is publicly available from Synergy's website.³³

Wholesaling Obligations

The EGRC Regulations prohibit Synergy from:

- discriminating between its RBU and competitors when offering wholesale supplies; and
- from taking into account the financial interests of the RBU in determining the terms and conditions on which a wholesale supply of electricity is offered to retail or generation competitors.³⁴

The EGRC Regulations require Synergy to develop a policy for determining the terms and conditions for the wholesale supply of electricity, including processes for assessing the

³³ <http://wholesale.synergy.net.au/Documents/EGRC%20Standard%20Product%20Agreement.pdf>

³⁴ In relation to this, the financial position of the RBU is to be taken to be the financial position of the EGRC, when assessing the ability of the RBU to make payments for wholesale supply, and the standard processes must not be more favourable to the RBU than to a retail or generation competitor.

ability of a business to make payments for that supply, and for determining terms and conditions on which the wholesale supply of electricity is to be offered.

Synergy must keep records of each assessment of a business to make payments: each request for a wholesale supply of electricity, the response given to the request, and the documents or other material relied upon in giving the response. Synergy must also record its ability to offer a wholesale supply of electricity at the time of each request, taking into account any contracts, agreements or other supply arrangements entered into by Synergy.

Synergy has published a Wholesale Electricity Supply Policy³⁵ and a Wholesale Energy Credit Policy.³⁶

Together, the two policies:

- provide for standard processes for the WBU to respond to requests from customers for the wholesale supply of electricity, including:
 - assessing the ability of the customer to make payments for the wholesale supply of electricity; and
 - determining the terms and conditions on which the wholesale supply of electricity is to be offered in response to a request, taking into account the customer's ability to make such payments);
- ensure the standard processes are not more favourable to the RBU than another customer in relation to an offer to supply wholesale electricity to the RBU; and
- outline a response standard for customer requests to the WBU for the wholesale supply of electricity.

Synergy Wholesale Electricity Supply Policy

Synergy's Wholesale Electricity Supply Policy was implemented to meet the requirements of the Electricity Corporations Act 2005, and Regulations 23 and 24 by setting out standard processes to be followed in offering a wholesale supply of electricity to the RBU, a retail competitor or a generation competitor.

Synergy Wholesale Energy Credit Policy

Synergy's Wholesale Energy Credit Policy was also implemented to meet the requirements of Regulation 23, and sets out the credit processes to be followed for wholesale energy trading activities with approved counterparties, including activities between the WBU and the RBU).

The objective of this policy is to safeguard Synergy's financial resources through implementing a credit risk management framework and credit risk control procedures, to minimize credit risk associated with Synergy's wholesale energy trading activities, and ensure that Synergy complies with its non-discrimination and other regulatory obligations.

³⁵ http://www.synergy.net.au/docs/VMI_EGRCWholesaleElectricitySupplyPolicy.pdf

³⁶ http://www.synergy.net.au/docs/VMI_EGRCWholesaleEnergyCreditPolicy.pdf

Synergy Wholesale Trading Policy

Synergy has also developed a Wholesale Trading Policy that is not required under the EGRC Regulations. This policy is a self-regulatory mechanism that all personnel involved in wholesale trading activities have been required to comply with from 1 January 2014.

The intent of the policy is to establish effective and appropriate mechanisms for the governance of wholesale trading activities through the definition of roles and operating procedures, including approval of specified trading commodities and instruments and delegated financial authority. The policy does not apply to energy trading between the wholesale and generation business units, and is not binding on any subsidiary of Synergy, nor any other entity in which Synergy holds an interest.

Synergy Ring Fencing Policy

Synergy has voluntarily developed an internal ring fencing policy, contained in its Wholesale Energy Credit Policy.³⁷

Compliance

Under the EGRC Regulations, the Auditor General is required to audit the scheme, while the ERA is required to investigate any non-compliance identified in the Auditor General's report and can impose civil penalties.

The Auditor General is required to undertake:

- financial year audits, which cover segmentation of Synergy's operations, financial administration, segregation arrangements, wholesaling obligations and wholesaling arrangements; and
- a calendar year audit, which covers certain segregation obligations (disclosure of restricted information, information technology controls, training, separate work areas and separation of management roles).

The Auditor General must give the Minister a report on each of the required financial and calendar year audits and include the opinions formed, and details of any deficiency, failure or shortcoming in respect of the matters referred to in the respective regulations.

The Auditor General must then give a copy of the reports to both the board of the EGRC and to the ERA, as soon as practicable after the report is given to the Minister. The Minister is required to table the report in each House of Parliament within 21 sitting days of that House after the day on which the Minister receives the report. There are no provisions for the removal of commercially sensitive matters.

If the Auditor General forms an opinion that the EGRC has not complied with one or more provisions of the EGRC regulatory scheme, it is a function of the Authority to investigate the matter.

Following an investigation, the ERA is able to impose civil penalties for non-compliance with a limited number of regulations that are audited as part of both the calendar and financial

³⁷ Synergy's Wholesale Energy Credit Policy, section 1.2 notes that the Credit Policy "should be read with the Wholesale Electricity Supply, Ring Fencing and Wholesale Trading Policies."

year audits. Schedule 1 of the EGRC Regulations specifies these regulations, with civil penalty provisions relating to:

- the division of the EGRC operations into segments;
- the foundation transfer price mechanism;
- disclosure of restricted information;
- the maintenance of separate work areas; and
- discrimination between the EGRC retail business unit and competitors when offering wholesale supply.

If the ERA considers that the EGRC has contravened a civil penalty provision, it may give the EGRC a warning notice. Alternatively or in addition to a warning notice, if the ERA considers that the EGRC has contravened a civil penalty provision, the ERA may impose a civil penalty of an amount that does not exceed the maximum of an amount of \$100 000 and, in addition, a daily amount of \$20 000.

In determining the amount of a civil penalty, the ERA must have regard to all relevant matters, including the nature and extent of the contravention, and the circumstances in which the contravention took place. The ERA must credit civil penalties to the Consolidated Account.³⁸

The ERA can apply to the Western Australian Electricity Review Board to order payment if the EGRC does not pay the amount imposed. Additionally, the ERA can enforce an order of the Board by lodging a certified copy of it and an affidavit stating to what extent it has not been complied with, with the Supreme Court.

In addition to investigating any non-compliance, the ERA is also required to undertake an annual review of the operation of the scheme to assess its effectiveness, which is the subject of the current report.

Segregation and Transfer Pricing Guidelines

The EGRC Regulations require:

- preparation by Synergy of the foundation transfer price mechanism (i.e., the instrument by which the foundation transfer price is determined), and revisions to, or replacement of, the foundation transfer price mechanism. This instrument must be given to the Minister (at which time it comes into force) and remains in force until 30 June 2017 or a later day approved in writing by the Minister.
- preparation by Synergy of the additional transfer price mechanisms (i.e., the mechanisms for determining the transfer price for a wholesale supply of electricity by the WBU to the RBU, for a retail supply to a new contestable).

Further requirements addressing transfer pricing and the foundation transfer price mechanism are set out in the Segregation and Transfer Pricing Guidelines, which were gazetted on 30 December 2013 under section 62(1) of the Act.³⁹ Among other things, the

³⁸ That is, they are returned to Treasury and not retained by the ERA.

³⁹ The *Segregation and Transfer Pricing Guidelines 2013* are available at:
[https://www.slp.wa.gov.au/gazette/gazette.nsf/0/A3B67A09679C1F0148257C4D0081C247/\\$file/gg243.pdf](https://www.slp.wa.gov.au/gazette/gazette.nsf/0/A3B67A09679C1F0148257C4D0081C247/$file/gg243.pdf)

Segregation and Transfer Pricing Guidelines set out the requirements for the foundation transfer price mechanism and the additional transfer price mechanisms.

The foundation transfer price mechanism determines the transfer price for the wholesale supply of electricity by the WBU to the RBU, for the purposes of a retail supply of electricity to a foundation customer. Under the guidelines, the foundation transfer price mechanism must:

- establish terms and conditions to apply to supply transactions for the purposes of retail supply of the foundation load;⁴⁰
- establish a procedure that is consistent with the procedure for the RBU making foundation load trading interval forecasts in respect of the foundation load in a particular trading interval;
- provide that the WBU may supply electricity to the RBU only for the purposes of retail supply of the foundation load, in accordance with a foundation load trading interval forecast;
- provide for a foundation transfer price for electricity (in \$/MWh) in a trading interval that is consistent with the modelled cost of electricity to the then Electricity Retail Corporation in that trading interval, based on:
 - existing contracts for the acquisition of electricity by the then Electricity Retail Corporation, taking into account the terms and conditions of these contracts and including contracts with the then Electricity Generation Corporation; and
 - information contained in the Mid-Year Review prepared by the Electricity Retail Corporation in respect of the financial years ending in each of the calendar years 2013 to 2017⁴¹; and
- a procedure to apply in wholesale force majeure events.

The Segregation and Transfer Pricing Guidelines also include the obligations of Synergy's RBU when submitting foundation and new supply load forecasts for trading intervals, the records it must keep, and how variances should be settled.

Although the foundation transfer price mechanism is provided to the Minister, the foundation transfer price mechanism and the additional price mechanism have not been (and are not required to be) published.

However, Synergy has provided a copy of these arrangements to the ERA for the purposes of its review.

Standard Product Arrangements

The Standard Product Arrangements were gazetted on 19 May 2014 under section 38(1) of the Act and 26(1) of the EGRC Regulations.

The Standard Product Arrangements specify the products Synergy is required to offer and the minimum quantities that must be made available. Synergy is required to offer both flat

⁴⁰ In respect of a period, the foundation load is the aggregate quantity of electricity in MWh consumed during that period by the foundation customers.

⁴¹ For the 2013-14 Government Mid-year Financial Projections Statement, refer to: http://www.treasury.wa.gov.au/cms/uploadedFiles/Treasury/State_finances/2013_14_midyear_review.pdf

and peak standard products on a quarterly and annual basis. Across all product types and durations, Synergy is required to offer a minimum 150 MW for sale and 100 MW for purchase.

The standard products must be offered in units of 1 MW (0.5 MWh per Trading Interval) and Synergy must offer to buy and sell 5 MW per week.

The Standard Product Arrangements specify the percentage spread between the buy and sell price. A maximum buy/sell spread of 25 per cent applied from 1 July 2014 to 31 December 2015. As of 1 January 2015, the maximum spread reduced to 20 per cent.

Synergy is required to publish details of historic prices and update the details on each occasion that it enters into a transaction. Additionally, Synergy must publish and update, on a monthly basis, information on price trends for transactions in standard products.

Synergy is also required to develop and publish details of its procedures for entering into a standard product agreement with an approved counterparty. A number of publicly available procedures have been produced by Synergy to address this requirement,⁴² including the:

- Standard Product Agreement, which outlines the process for entering into a standard product agreement and requires that, to transact in standard products, an interested party must (among other things) be a WEM market participant, an approved counterparty, and have entered into a Standard Product Agreement⁴³;
- Procedure for becoming an approved counterparty, which outlines the process that a party must comply with to become an approved counterparty to transact in standard products;
- Procedure for entering into transactions, dealing with limited availability and simultaneous offers; and
- Carbon referencing price calculation.

Details of the standard products offered by Synergy and standard product transactions are available on Synergy's website.⁴⁴

⁴² Refer to the standard product homepage for access to these procedures:
<http://wholesale.synergy.net.au/SitePages/Home.aspx>

⁴³ For the form of the agreement between the EGRC and an approved counterparty refer to the Bilateral Trade Agreement for Electricity (Standard Products)
<http://wholesale.synergy.net.au/Documents/EGRC%20Standard%20Product%20Agreement.pdf>

⁴⁴ <http://wholesale.synergy.net.au/SitePages/Home.aspx>

Appendix 2 Approach and key recommendations from earlier reviews

2014 EGRC Review

The 2014 EGRC Review was the first review of the scheme. Parts of the scheme had been in operation for less than one year and so the ERA focussed on addressing fundamental design issues in its assessment of the scheme.⁴⁵ The ERA provided its final report to the Minister on 1 April 2015. The Minister tabled the ERA's first report in Parliament on 25 June 2015.

The ERA's most important recommendation for improvement was for the inclusion of an explicit statement of the objective of the scheme in the EGRC Regulations. The ERA considered that the primary purpose of the scheme should be to mitigate the increased potential for market power arising from the merger, to ensure a level playing field for competitors and new entrants, in order to facilitate competition.

The ERA also identified a number of specific areas where the scheme does not address opportunities to misuse market power. These are summarised in the table below.

⁴⁵ Implementation of the EGRC Regulations and the Segregation and Transfer Pricing Guidelines occurred on 1 January 2014, whilst the Standard Product Arrangements were not implemented until 1 July 2014.

Finding	Past recommendation
<p>The scheme affords Synergy significant discretion in determining what circumstances are relevant to whether one wholesale supply offer is more or less favourable than another. This does not support the requirement that Synergy is not to discriminate between the RBU and other competitors on terms and conditions when offering wholesale supply.</p>	<p>Further guidance should be set out in the scheme to reduce the level of discretion available to Synergy.</p>
<p>There is the potential for a substantial lag between the occurrence of discriminatory behaviour and reports of that occurrence.</p>	<p>The Auditor General should report more frequently than once per year, if cost effective, and require Synergy to self-report any non-compliance, with penalties if it fails to do so.</p>
<p>The standard product regime comprises a small quantity of underutilised, narrowly focussed products.</p>	<p>An effective standard product arrangement requires a sufficient range and quantity of products that adequately reflects the typical requirements of retailers.</p>
<p>The spread of 20 per cent between standard product buy and sell prices is significantly higher than observed in other competitive energy markets.</p>	<p>Set the maximum spread at a level that facilitates price discovery and ensures Synergy prices efficiently.</p>
<p>The scheme seeks to ensure that Synergy does not have an unfair competitive advantage. Ring-fencing arrangements should ensure the RBU does not have access to information held by the WBU that is not available to other retailers.</p>	<p>The ring-fencing arrangements should be reviewed to ensure the RBU does not have access to any information held by the WBU that is not available to other retailers, to ensure it does not have an unfair competitive advantage.</p>
<p>The Scheme requires Synergy to develop a number of policies and procedures; however not all of these are required to be published.</p>	<p>Significant improvements in transparency of the scheme would result through requiring publication of all the policies and procedures that Synergy is required to develop under the scheme.</p>
<p>The general lack of transparency in setting Synergy's retail tariffs and the Tariff Adjustment Payment (TAP) probably played a significant part in raising concerns amongst stakeholders that Synergy was pricing retail energy below its wholesale prices and subsidising this behaviour via the TAP⁴⁶.</p>	<p>Consideration should be given to improving transparency of the retail pricing process and ensuring there is no potential for subsidisation of Synergy's contestable business via the TAP.</p>
<p>Finally, the ERA noted that wholesale prices for Synergy's retail customers at the date of the merger appeared based in part on the Replacement Vesting Contract. In 2012, the ERA found that this contract had not delivered an efficient outcome to Synergy, raising its costs above efficient levels.⁴⁷</p>	<p>A review of the foundation price mechanism should be undertaken as soon as possible to ensure the RBU's costs are based on efficient wholesale costs.</p>

⁴⁶ The TAP covers the shortfall between electricity revenue (from tariffs) and electricity supply costs.

⁴⁷ Refer to section 3.6.1.1, 'The Vesting Contract,' on page 48 of 'Synergy's Costs and Electricity Tariffs: Final Report' (4 July 2012).
<https://www.era.gov.au/cproot/10639/2/20120704%20Synergys%20Costs%20and%20Electricity%20Tariffs%20-%20Final%20Report.PDF>

2015 EGRC Review

In the ERA's second review, the scheme had been in operation for two years, with significantly more information, including trends in retail market share, available to the ERA. The ERA provided the final report to the Minister on 6 July 2016. The Minister tabled the ERA's report in Parliament on 20 October 2016.

The ERA considered that the prevailing circumstances affecting the operation of the SWIS and relevant matters included:

- the significant market share that Synergy has in both the generation and retail segments of the market;
- that Synergy is a net seller of electricity, as its combined generation and energy purchases are greater than its own customer (wholesale and retail) requirements; and
- the WEM objectives.

The ERA assessed the effectiveness of the scheme based on the objective developed in its first review. The ERA also revisited the recommendations that it made in its first review and considered them in the context of how the scheme has operated since that review. The ERA also analysed the level of competition in the wholesale and retail markets as an indicator of the effectiveness of the scheme in ensuring a level playing field for all retailers, and explored methods for setting the spread between the standard products buy and sell prices.

The ERA found that the excess baseload capacity in the Reserve Capacity Mechanism was reducing the risk of short-term price variation in the STEM and balancing markets. Thus, retailers were less reliant on obtaining energy contracts from Synergy to reduce their exposure to short-term price variations.

However, the planned reforms to the Reserve Capacity Mechanism to reduce the oversupply of capacity and bring the market into balance would probably lead to an increase in the variability of short-term energy prices. This would increase the need for retailers to enter into contracts to hedge against these risks.

The ERA considered that the scheme needs to be effective to achieve long-term sustainable competition in the WEM and in the 2015 Report recommended:

- A method for calculating the spread between the buy and sell price for standard products based on variation in STEM. Applying this method reduces the spread to ten percent; and
- Specifying the requirements for the statements of financial performance prepared for each of the segmented business units. This will ensure that they are prepared on a consistent basis and provide sufficient information in relation the allocation of costs between business units, including that there are no cross subsidies.

The ERA also recommended that the process for undertaking annual reviews of the scheme would be more efficient if the ERA collected the information required for the EGRC review in conjunction with the information required for the review of the effectiveness of the WEM, conducted under the market rules.

The market rules restrict the use of the information provided under the rules, such that the ERA can only use the information for the WEM review. Consequently, the ERA has to collect the necessary data for each EGRC review using its information gathering powers under section 51 of the *Economic Regulation Authority Act 2003*. Amending the market rules to enable the ERA to use the information for the EGRC review as well would simplify and streamline the process for both the ERA and the parties that provide the information, including AEMO.

Finally, the ERA reiterated some of its earlier recommendations from the 2014 review, in particular that:

- the objective of the scheme should be clearly stated in the regulations to remove the potential for other considerations to be given precedence;
- consideration is given to increasing the frequency of the compliance audits and reporting, provided this can be done cost effectively; and
- Synergy self-reports any non-compliance to the OAG and ERA as soon as it is identified.