

2017 Report to the Minister on the Effectiveness of the Electricity Generation and Retail Corporation Regulatory Scheme

Discussion Paper

March 2018

Economic Regulation Authority

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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), which trades as Synergy. At the same time, the State Government implemented the EGRC regulatory scheme (scheme) to mitigate the potential for the misuse of market power arising from the merger. The scheme imposes requirements on Synergy, including standard product arrangements, non-discriminatory wholesale electricity trading, ring-fencing, business segregation and transfer pricing obligations.

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 including any recommendations it has for amending the scheme.

This discussion paper is to assist interested parties in making submissions to the ERA's review of the effectiveness of the scheme over the 2017 calendar year. Stakeholders are encouraged to give evidence, data and any other information (such as case studies) to support their submissions to this review.

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) Tuesday, 24 April 2018.

Submissions should be lodged online using the form on our website:

www.erawa.com.au/consultation

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 businesses Verve Energy and Synergy merged, to form the Electricity Generation and Retail Corporation (EGRC), which trades as Synergy.

At the same time, the Government implemented the EGRC regulatory scheme (scheme), recognising that Synergy had control of about three quarters of wholesale electricity supply in the Wholesale Electricity Market (WEM) through its own generation plant and through contractual arrangements with third party generators.

The scheme imposes requirements on Synergy to mitigate the potential for misuse of market power arising from the merger and comprises the:

- Electricity Generation and Retail Corporation Regulations 2013 (EGRC Regulations);
- Segregation and Transfer Pricing Guidelines 2013 (Segregation and Transfer Pricing Guidelines); and
- Electricity (Standard Products) Wholesale Arrangements 2014 (Standard Product Arrangements).

The EGRC Regulations require Synergy to divide its operations into segments: the Generation Business Unit (GBU), Wholesale Business Unit (WBU), Retail Business Unit (RBU), shared service operations and any additional segment(s) approved by the Minister. Synergy is required to establish transfer pricing mechanisms for trade between its wholesale and retail business units, and prepare separate statements of financial performance for each business unit, on a quarterly basis and for the annual financial report. The Segregation and Transfer Pricing Guidelines specify the requirements of the transfer pricing mechanisms.

Synergy's wholesale business unit is ring fenced and there are restrictions on the flow of customer information between Synergy's segregated business units that could be used to provide a competitive advantage to Synergy. Synergy must not discriminate between its RBU and competitors on the terms and conditions of a wholesale supply of electricity. In addition, Synergy must not consider the financial interests of the RBU when setting the terms and conditions for a wholesale supply of electricity.

Synergy must offer specified, standard wholesale products to both buy and sell energy. The Standard Product Arrangements specify the minimum quantities of products Synergy must make available for sale and purchase, and the maximum percentage spread between the advertised buy and sell prices for these products.

The Auditor General monitors compliance with the scheme and conducts annual audits to assess whether Synergy has complied with the requirements specified in the scheme. Any non-compliance reported by the Auditor General is investigated by the ERA.

The ERA must review the operation of the scheme to assess its effectiveness at least once each year, although the EGRC regulations do not specify any criteria for making this assessment. This is the ERA's fourth review of the scheme and covers the operation of the scheme over the 2017 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 the preparation of the report for the Minister. Appendix 1 provides a more detailed description of the scheme.

Approach and focus of the 2017 review

The purpose of the scheme is to limit the opportunity for Synergy to exploit its market position as a dominant, vertically integrated electricity business for the purposes of engaging in anticompetitive conduct, to the detriment of competing electricity businesses and electricity customers.

The ERA intends to focus on the transfer pricing and ring fencing requirements of the scheme in its 2017 EGRC review.

The transfer pricing guidelines require Synergy to prepare a foundation transfer pricing mechanism that determines the transfer price for a wholesale supply of electricity by the WBU to the RBU for a retail supply to foundation customers.¹

Ring fencing guidelines within the EGRC regulations require Synergy to divide its operations into separate business segments with restrictions on information transfer and access to IT systems.

The focus on transfer pricing and ring fencing is prompted by:

- replacement of Synergy's original foundation transfer pricing mechanism in 2017 and a need to understand the extent to which the RBU is involved in determining future energy market prices that are used to set wholesale supply contract prices for competitors, which may confound the non-discrimination requirements in the scheme;
- the requirement in the foundation transfer pricing mechanism for Synergy's segregated business units to meet to discuss operational events such as fuel price changes and outages, which may provide an advantage to the RBU and pose a threat to competition; and
- how the ring fencing guidelines manage restricted information when staff transfer between business units.

In conducting the review, the ERA will consider three questions:

- Does the change to the foundation transfer pricing mechanism influence the effectiveness of the scheme?
- Are provisions contained in the foundation transfer pricing mechanism consistent with the non-discrimination requirements of the scheme?
- Are the scheme's ring fencing requirements effective in restricting the flow of competitors' commercially sensitive information between different business units?

The ERA does not intend to revisit in any detail those aspects of the regulations that formed the basis for the main recommendations in the 2016 EGRC report that addressed the

¹ Foundation customers were customers of the Retail Business Unit at the time the merger took place and who have not renegotiated a contract with Synergy since the merger and who have not transferred to another retailer.

standard product spread and segmented financial reporting. However, the ERA will undertake an assessment of competition in the wholesale electricity and contestable retail markets. This may be used to reaffirm or amend recommendations in the 2016 report.

The ERA will review standard product transactions through 2017 and the effect on bilateral trade. This is prompted by observed decreases in standard product sell prices and an increase in the number of standard product transactions.

1. The ERA invites stakeholders to comment on the scope of the 2017 EGRC review.

Transfer pricing and ring fencing

The 2017 EGRC review will consider whether the replacement transfer pricing arrangements are consistent with the non-discrimination requirements in the regulations, eg who is involved in setting transfer prices, and whether the RBU has access to information through the terms and conditions of the transfer pricing arrangements earlier than its competitors. The ERA will also consider the ring fencing arrangements in the scheme that address treatment of restricted information, access to IT systems, physical separation of staff in different business units and staff training, particularly when staff transfer between different business units.

Each of these areas is considered in more detail in the sections below. Several questions are included to assist stakeholders in responding to the discussion paper.

Changes to the transfer pricing mechanism

The EGRC scheme requires Synergy to establish transfer pricing arrangements for trade between its wholesale and retail business units for the wholesale supply of electricity to retail customers. It differentiates between a wholesale supply to meet:

- foundation customer load, consisting of customers who do not have a new contestable customer arrangement, ie franchise customer load and contestable load, from prior to the merger.² These arrangements are set out in the foundation transfer price mechanism.
- additional customer load, consisting of customers who have a new contestable customer arrangement, which is an arrangement that became legally binding on Synergy after the merger. These arrangements are set out in the additional transfer price mechanism.

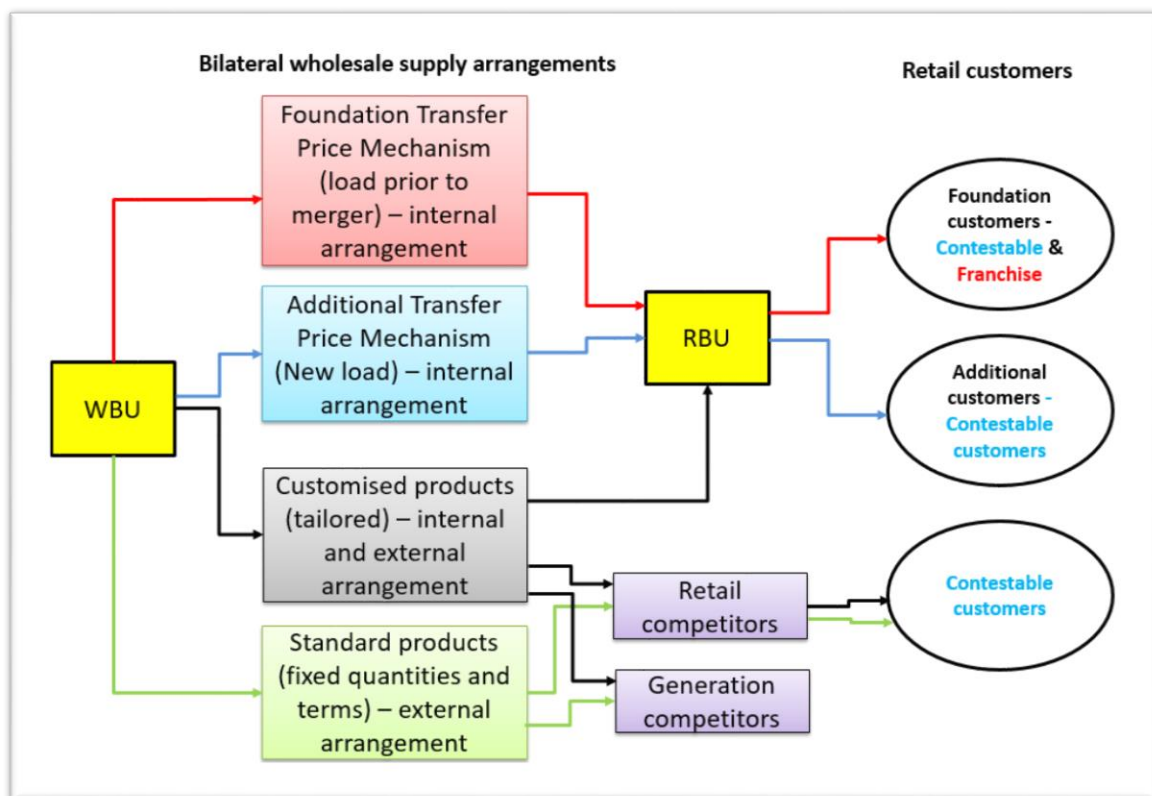
² An arrangement is not a new contestable customer arrangement if it became legally binding on Synergy after the merger as a result of the contestable customer accepting on or before 31 March 2014 (without amendment), an offer for the retail supply of electricity that was made by Synergy to the contestable customer before the merger time. Additionally, an arrangement is not a new contestable customer arrangement if it is for supply of electricity to the customer at a charge determined in accordance with the *Energy Operators (Electricity Generation and Retail Corporation) (Charges) (By-laws 2006)*.

There are other options for third party retailers, generators and the RBU to obtain wholesale supplies of electricity from the WBU. These are through:

- Customised products tailored to suit the requirements of the counterparty trading with the WBU. Contractual arrangements between the WBU and third parties are set out in the Electricity Bilateral Trade Agreement.
- Standard Products which are fixed quantities of energy that Synergy must advertise for sale and purchase at published prices. The arrangements for trading in standard products are set out in the Bilateral Trade Agreement for Electricity (Standard Products). The scheme prohibits the RBU or any subsidiary from procuring wholesale supplies through the standard product arrangements.
- The balancing market: The RBU cannot trade directly in the energy market but it can access supply at balancing market prices through its Supply Balancing Cost Allocation Arrangement³ with the WBU, which is the Synergy business unit responsible for trading in the energy market.

Figure 1 illustrates the main contractual arrangements specified in the scheme.

Figure 1: Main contractual arrangements in the scheme



At the time of the merger, the *Segregation and Transfer Pricing Guidelines 2013* mandated that the foundation transfer price was to be calculated, for each trading interval, based on:

³ Through this arrangement, the RBU can nominate to the WBU a smaller quantity than it requires to meet its load. The under nominated quantity is then provided by the WBU to the RBU at energy market prices.

- existing contracts for the acquisition of electricity by the Electricity Retail Corporation (taking account of the terms and conditions of those contracts, including contracts with the 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 2017.⁴

The foundation transfer price mechanism came into force when it was provided to the Minister and was to remain in force until 30 June 2017, or a later date approved in writing by the Minister.

At least six months prior to 30 June 2017, Synergy provided the Minister with a replacement foundation transfer pricing mechanism and proposed changes to the *Segregation and Transfer Pricing Guidelines 2013*.⁵ In particular, Synergy proposed deletion of the original clauses in the *Segregation and Transfer Pricing Guidelines 2013*, and their replacement with a mechanism that provides for a foundation transfer price for electricity (in \$/MWh) in a trading interval that:

- is determined in a transparent manner between the RBU and the WBU; and
- reflects the combined RBU and WBU view of a forecast market price for electricity (such forecast also being used by the WBU to determine the price for standard products).⁶

The foundation transfer price mechanism specifies that Synergy will employ an energy forward curve⁷ to calculate the additional transfer price in the same way that it calculates its foundation transfer price and its standard product prices.⁸ Given the non-discrimination requirements, the energy forward curve must also be used to calculate the customised product prices.

Therefore, the retail and wholesale business units' views of a forecast market price for electricity underlies calculation of the prices for all of the main contractual arrangements specified in the scheme, including those that are available to Synergy's retail and generation competitors.

The non-discrimination requirements in the scheme prohibit Synergy from discriminating between its RBU and competitors when offering wholesale supplies and from taking into account the RBU's financial interests in determining the terms and conditions on which a

⁴ The *Segregation and Transfer Pricing Guidelines 2013* do not identify what information from the Mid-Year Review was used, how it was used or how the prices were calculated.

⁵ See Division 4 of the EGRC Regulations. The Minister can amend or repeal the *Segregation and Transfer Pricing Guidelines 2013* by instrument published in the Gazette and provided to each House of Parliament. Commencement times for amended or repealed segregation arrangements may be included in the instrument.

⁶ In view of this, Synergy also proposed that a new definition be added to the *Segregation and Transfer Pricing Guidelines 2013* noting that 'Standard Products' means the products created under the *Electricity (Standard Products) Wholesale Arrangements 2014* approved by the Minister under the EGRC Regulations.

⁷ Refer to Appendix 1, p22

⁸ Section 6(5) states that the energy price is, for the 'purposes of regulation 9(3)', the 'transfer price for the wholesale supply of electricity and is also the foundation transfer price.' Notably, regulation 9(3) relates specifically to a supply transaction between the WBU and the RBU for the purposes of a retail supply of electricity to a customer under a 'new contestable customer arrangement,' not to a foundation customer. Part 4 of the *Segregation and Transfer Pricing Guidelines 2013* applies to any written arrangements referred to in regulation 9(3) as additional transfer price mechanisms.

wholesale electricity supply is offered to retail or generation competitors. The WBU is required to treat the RBU as it would treat any other independent retailer.

The 2017 review will consider how the two business units work together to determine a forward energy curve under the replacement foundation transfer pricing mechanism and if this process is consistent with the non-discrimination requirements of the scheme.

Privileged access to information

When revising the foundation transfer price mechanism, the Segregation and Transfer Pricing Guidelines provide Synergy with discretion to either:

- define the scope of wholesale force majeure events and provide for the manner in which the financial consequences of a wholesale force majeure event will be dealt with; or
- specify that the financial consequences of a wholesale force majeure event will be dealt with as a cost allocation.⁹

The foundation transfer price mechanism requires that, if there is an event that is or 'is likely to be' a change in circumstance, the WBU must notify the RBU of such an event.¹⁰ The ERA will examine whether the RBU has access to outage information affecting the market earlier than other participants.

The force majeure provisions in the foundation transfer price mechanism¹¹ also provide for a meeting of Synergy's wholesale and retail business units to negotiate and agree on cost allocations arising from the financial consequences of a change to the price or the cost of fuel (including changes to costs incurred in fuel storage, transport or delivery). The ERA will consider whether the RBU has access to fuel information affecting the market earlier than its competitors.

The EGRC Regulations allow for the regard of 'all relevant circumstances' in determining whether the terms on which a wholesale supply of electricity is offered to the RBU are more favourable than those offered to Synergy's competitors. The term 'relevant circumstance' is not defined within the scheme, which may afford Synergy significant discretion in determining what is a relevant circumstance and what is not, and ultimately, whether it discriminates between the RBU and its competitors.

The ERA will review the instances since the merger where the RBU and WBU have met and whether these meetings could have provided a competitive advantage for the RBU, against the intent of the non-discrimination requirements in the regulations.

⁹ See guideline 2.3(1)(a) and (b).

¹⁰ See sections 8.1.4 and 8.2.

¹¹ See section 8 (in particular) 8.1.3, 8.2 and 8.4 of the original Internal Synergy Wholesale Arrangements, and section 7 of the replacement Internal Synergy Wholesale Arrangements.

Information transfer

The EGRC Regulations contain restrictions on the disclosure of restricted information. Synergy must ensure that retail restricted information¹² is not disclosed to retail staff and generation restricted information¹³ is not disclosed to generation staff. Controls must be in place to limit access to information technology systems containing restricted information.

Synergy must implement training to ensure that staff who receive or have access to restricted information understand their obligations. Wholesale staff who have access to restricted information must occupy work areas that are separate from work areas occupied by retail and generation staff.¹⁴ Staff in management roles in a particular business unit, except for shared services, must not have management responsibility for the other specified business units.

There are no provisions within the scheme to constrain the movement of staff who have access to restricted information from employment by one business unit to employment by another business unit. A staff member with knowledge of commercially sensitive information about negotiations between a particular business unit and a competitor can be moved to another business unit where that information could be used to Synergy's advantage. The possibility for, and extent of, staff movements between segregated business units creates opportunities for sensitive information to be shared, even if inadvertently.

Precedents exist in other jurisdictions and industries for addressing concerns about the sharing of sensitive information through staff movements between ring fenced business units. The Irish Commission for Electricity Regulation imposes regulation around the directors of ring fenced entities. Where projects or business activities are ring fenced as separate entities, joint ventures or separate subsidiaries, such as new renewable projects, directors of the ring fenced unit must not have worked for a distribution or network service provider for the preceding three months.

Similarly, there are ring fencing requirements in the U.K. banking sector restricting staff movements between ring fenced businesses. Directors of ring fenced businesses are required to be independent and are not considered independent if they receive remuneration (apart from their directors' fees) from the ring fenced body or another member of its group. Former employees can be considered independent only after five years away from employment with the ring fenced body.

The Australian Energy Regulator provides Ring Fencing Guidelines for network service providers that have both regulated and non-regulated business segments. The service provider must ensure that there is no sharing of staff except in certain circumstances.¹⁵ There is also a separate requirement to establish, maintain, and publish a register of the

¹² Retail restricted information is information relating to a retail competitor that is obtained by or provided to wholesale staff in the course of the conduct of wholesale business and that might reasonably be expected to materially adversely affect the commercial interests of the retail competitor if disclosed to retail staff.

¹³ Generation restricted information is information relating to a generation competitor that is obtained by or provided to wholesale staff in the course of the conduct of wholesale business and that might reasonably be expected to materially adversely affect the commercial interests of the generation competitor if disclosed to generation staff.

¹⁴ Work areas are separate from those occupied by generation or retail staff if they are protected by controls that prevent these staff from entering them.

¹⁵ Refer to [AER ring-fencing guidelines 2016](#), clause 4.2.2.

nature of any staff position shared between segments that are not covered by the exclusions.¹⁶

Excluding individuals from moving between roles within Synergy for set periods is impractical in Western Australia, which has a small electricity sector and a limited pool of experienced electricity professionals. However, the ERA will consider the number of staff transfers between business units, concentrating on the job functions that may have access to competitors' confidential information. This can give an indication of the risk of sharing sensitive information and if the risk warrants an amendment to the ring fencing guidelines.

- 2. The ERA welcomes feedback from stakeholders on whether or not the effectiveness of the scheme is affected by the replacement transfer pricing mechanism or the transfer pricing arrangements.**
- 3. The ERA welcomes feedback from stakeholders on their experience of the scheme's ring fencing guidelines and their views on circumstances that might warrant amendments to the ring fencing guidelines.**

Competition and Standard Product Analysis

The ERA will employ the same structure, conduct and performance framework to assess competition that was employed in its 2016 EGRC review. The performance framework uses several interrelated indicators of retail and wholesale competition and the ERA analyses these indicators to assess the overall state of competition in each market.

The ERA undertakes quantitative analysis on market data provided by Synergy, the Australian Energy Market Operator and Western Power to inform its assessment. It may 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.

Competition in the retail market

In assessing competition in the contestable segment of the retail market, the ERA considers the extent of independent rivalry, customer activity, barriers to entry, exit or expansion, customer outcomes, and market outcomes.

A high level of independent rivalry characterises an effectively competitive retail market. Independent rivalry leads retailers to compete to attract or retain customers, placing downwards pressure on prices and helping to drive product innovation. To assess the extent of independent rivalry, the ERA considers changes in the number of retailers active in the market, retail market share (in terms of volume of energy sales) and market concentration.

In well-functioning competitive retail markets, customers know the choices available to them and can act accordingly. They actively seek lower prices and better services, placing downward pressure on prices and driving retailers to improve customer service. Customer

¹⁶ Typical exclusions are where staff do not have access to electricity information, or who have access to information but have no opportunity to use that information in conduct contrary to the service providers' obligations.

activity is analysed through customer churn (customer transfers between retailers), customer engagement in choosing offers, and customers changing plans.

Analysis will include evidence of market entry, exit or expansion, retailer views on barriers to entry or expansion, measures of contract market liquidity, and whether retailers are able to obtain hedge products to manage risk exposure as they enter or expand in the market. New retailers entering the market and incumbent retailers exiting or expanding within the market can place competitive pressure on existing retailers to charge prices proportionate to their costs, improve their efficiency and retail offers to gain competitive advantage.

Customers in competitive retail markets are able to change to alternative products and suppliers that better meet their needs. The ERA considers the level of complaints reported in its annual performance review of energy retailers as a means of assessing customer satisfaction with the electricity retail market.

Competition in the wholesale market

To assess competition in the wholesale market, the ERA considers independent rivalry, the ability of suppliers to enter, exit or expand in the market, and wholesale market outcomes.

Independent rivalry in the wholesale market is assessed by considering changes in the number, type and size of electricity suppliers over time, changes in market concentration, and changes in the market shares of electricity suppliers.

The ability of suppliers to enter, exit or expand within the market is assessed through consideration of changes in the structure of the market over time and the impact of the prevailing circumstances (eg government policy and changes in technology) on operational and investment decisions.

In the wholesale market, demand levels can influence market prices, which in turn can also influence the operational and investment decisions made by energy suppliers. In assessing wholesale market outcomes, the ERA considers changes in generation capacity and demand, price volatility in the energy markets, and the net supply and disposal positions of market participants.

The competition indices considered are not exhaustive and other information may be considered during the review.

- 4. The ERA invites stakeholders to comment on the effectiveness of the scheme in encouraging competition in the wholesale electricity market, and to provide any evidence in support of their views.**

Standard products

Substantial increases in price volatility occurred in the Short Term Energy Market (STEM) and balancing market in the second half of 2016. With increasing volatility in the energy markets, demand for bilateral contracts might be expected to increase.

During 2016, five large participants (three retailers and two generators) did engage in bilateral contracting for customised products. However, only one standard product sell transaction was entered into on 4 November 2016. This was a flat, 5 MW product covering the 2017 calendar year period.

Market prices were still volatile over 2017. Peak prices did not quite reach the energy price limit (\$240/MWh), as often as in the latter part of 2016. However, off peak prices were

markedly higher than previously observed. The energy price limit increased to \$351/MWh on 1 October 2017, an increase of \$110/MWh. Therefore, unhedged small retailers have increased exposure to potentially higher wholesale electricity prices.

Synergy reduced its annual peak standard product prices by approximately \$10/MWh at the start of the 2017 calendar year. From March 2017, Synergy entered into 26 standard product sell transactions with counterparties for both flat and peak products, with quarterly and annual terms. This is the highest number of transactions entered into over a 12-month period since the standard product regime commenced in mid-2014. Until the start of 2017, there were only 15 standard product transactions in total.

Changes in the number of trades have occurred without changes to the product specifications, the credit requirements, the force majeure provisions or the maximum buy-sell spread of 20 per cent.

- 5. The ERA welcomes any information from stakeholders on their experience of the standard product regime and its effectiveness in providing access to wholesale electricity supplies.**

Appendix 1: Overview of the EGRC regulatory scheme

The EGRC Regulations

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

Segregation requirements

Division of Synergy's operations into segments

The EGRC Regulations require that Synergy divide its operations into the following:

- a Generation Business Unit (GBU), responsible for operations involving the construction or operation of generating works;
- a Wholesale Business Unit (WBU), responsible for the wholesale acquisition or supply of electricity and the acquisition or supply of wholesale products, including pricing;
- a Retail Business Unit (RBU), responsible for the pricing, sale and marketing of electricity to customers served by the SWIS¹⁷;
- a shared services operations business unit.¹⁸; 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 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 information¹⁹ must not be disclosed to retail staff and generation restricted information²⁰ must not be disclosed to generation staff;

¹⁷ 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.

¹⁸ This unit is responsible for 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 is also responsible for any other operations undertaken in connection with two or more business units, excluding generation operations, wholesale operations and retail operations.

¹⁹ 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.

²⁰ 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 reasonably be expected to materially adversely affect the commercial interests of the generation competitor if disclosed to generation staff.

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

Wholesale trading requirements

Supply arrangements

The EGRC Regulations set out the requirements for the types of wholesale supply arrangements under the Scheme. These are:

- the WBU provides a wholesale supply of electricity to the RBU for retail supply to foundation customers. Synergy does this through its Internal Synergy Wholesale Arrangement;²¹
- the WBU provides a wholesale supply of electricity to the RBU for retail supply to new contestable customers. Synergy does this through its New Load Wholesale Arrangement;²²
- the WBU provides a wholesale supply of electricity as a customised product (tailored product) to the RBU or another retail or generation competitor. Synergy does this through its Bilateral Trade Agreement; and
- the WBU provides a wholesale supply of electricity as a standard product to other retail or generation competitors or receives a wholesale supply of electricity as a standard product from other generation competitors. Synergy does this through its Bilateral Trade Agreement for Electricity (Standard Products).

Each of these are explained in more detail below.

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, ie the price determined for that supply in accordance with the foundation transfer price mechanism.²³

²¹ Foundation customers are contestable and non-contestable customers of Synergy's from prior to the merger.

²² A new contestable customer arrangement is an arrangement between Synergy and a contestable customer that imposes a legal obligation on Synergy to supply electricity to the contestable customer on a retail basis and becomes legally binding on Synergy after the merger time.

²³ According to the Merger Implementation Group, the foundation transfer price mechanism covers franchise tariffs, contestable tariffs, and existing contestable contracts up to their expiry. This includes contracts signed

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 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 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 (ie 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.

Bilateral Trade Agreement and Bilateral Trade Agreement for Electricity (Standard Products)

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

To address this requirement, Synergy has implemented two wholesale supply arrangements; ie the Bilateral Trade Agreement and the Bilateral Trade Agreement for Electricity (Standard Products).

The 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 for Electricity (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 for Electricity (Standard Products) is publicly available from Synergy's website.²⁴

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.

²⁴ <http://wholesale.synergy.net.au/Documents/EGRC%20Standard%20Product%20Agreement.pdf>

Wholesaling obligations

The EGRC Regulations prohibit Synergy from:

- discriminating between its RBU and competitors when offering wholesale supplies; and
- 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.²⁵

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 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 the ability of a retail 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 Policy²⁶ and a Wholesale Energy Credit Policy.²⁷

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 when offering a wholesale supply of electricity; and

²⁵ 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.

²⁶ 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. http://www.synergy.net.au/docs/VMI_EGRCWholesaleElectricitySupplyPolicy.pdf

²⁷ 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. http://www.synergy.net.au/docs/VMI_EGRCWholesaleEnergyCreditPolicy.pdf

- outline a response standard for customer requests to the WBU for the wholesale supply of electricity.

Synergy wholesale trading risk policy

Synergy has developed a Wholesale Trading Risk Management Standard that is not required under the scheme. The intent of the policy is to establish effective and appropriate mechanisms for the governance and management of trading risk across Synergy.

Synergy ring fencing policy

Synergy has also developed an internal ring fencing protocol that applies to all Synergy staff. The protocol is designed to ensure that information that relates to a competitor, that might reasonably be expected to materially adversely affect that competitor's commercial interests if the information were disclosed, is not passed to a business unit that could use that information to obtain an unfair advantage in relation to its competitors.

Compliance

Under the EGRC Regulations, the Auditor General is required to audit the scheme.

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 the Synergy Board and 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 Synergy has not complied with one or more provisions of the scheme, the ERA must investigate the matter.

Following an investigation, the ERA is able to impose civil penalties for non-compliance with a limited number of regulations. Schedule 1 of the EGRC Regulations specifies these regulations, with civil penalty provisions relating to:

- the division of Synergy's operations into segments;
- the foundation transfer price mechanism;
- disclosure of restricted information;
- the maintenance of separate work areas; and

- discrimination between the retail business unit and competitors when offering a wholesale supply of electricity.

If the ERA considers that Synergy has contravened a civil penalty provision, it may give Synergy a warning notice. Alternatively or in addition to a warning notice, the ERA may impose a civil penalty 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.²⁸

The ERA can apply to the Western Australian Electricity Review Board to order payment if Synergy 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 in the Supreme Court.

Segregation and Transfer Pricing Guidelines

The EGRC Regulations require:

- preparation by Synergy of the foundation transfer price mechanism 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 (ie 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.²⁹ The Segregation and Transfer Pricing Guidelines set out the requirements for the foundation transfer price mechanism and the additional transfer price mechanisms.

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.

²⁸ That is, they are returned to Treasury and not retained by the ERA.

²⁹ 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)

Original foundation transfer price mechanism

Under the guidelines, the original foundation transfer price mechanism (at the time of the merger) was required to:

- establish terms and conditions to apply to supply transactions for the purposes of retail supply of the foundation load;³⁰
- 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 Electricity Retail Corporation, taking into account the terms and conditions of these contracts and including contracts with the 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 2017;³¹ and
- provide a procedure to apply in wholesale force majeure events.

Replacement foundation transfer price mechanism

The EGRC regulations (11(3)) require that at least six months before the day on which the original foundation transfer price mechanism, or any replacement mechanism, was due to expire (30 June 2017), the EGRC must prepare a replacement foundation transfer price mechanism and provide it to the Minister. This mechanism must comply with each applicable provision and comes into force on the day after expiry of the original foundation mechanism, remaining in place for a period of three years or a longer period if approved in writing by the Minister.

Consistent with this, Synergy prepared a replacement foundation transfer price mechanism and provided it to the Minister. The replacement mechanism provides for a foundation transfer price for electricity (in \$/MWh in a trading interval) that:

- is determined in a transparent manner between the retail business unit and the wholesale business unit; and
- reflects the retail business unit and wholesale business unit's view of a forecast market price for electricity (such forecast also being used by the wholesale business unit to determine the price for Standard Products).

³⁰ In respect of a period, the foundation load is the aggregate quantity of electricity in MWh consumed during that period by the foundation customers.

³¹ 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

Under the replacement foundation transfer price mechanism, the energy price, which comprises an on-peak and an off-peak price, is determined by applying an energy forward curve, which is Synergy's forecast of the future market energy price for each hour in each trading day in the period covered by the curve.

To calculate the applicable peak price³² the hourly forward energy price represented on the applicable energy forward curve is multiplied by the forecast load for the foundation customers in the relevant on-peak trading interval. The product for each trading interval is then added together. This amount is then divided by the total forecast load for the foundation customers in all on-peak trading intervals occurring in the relevant month. This gives an average price for the month but gives more weight to the price in the on-peak trading intervals where the load is higher. A similar approach is then used to determine the off-peak price.

The replacement foundation transfer price mechanism specifies that Synergy employs the same energy forward curve to calculate the additional transfer price. Therefore, the energy forward curve is used in the calculation of the standard product price, the foundation transfer price, and the additional transfer price. Given the non-discrimination requirements, the energy forward curve must also be used to calculate the customised product prices.

The new arrangements set out in the replacement foundation transfer price mechanism commenced on 1 July 2017 and expire on 1 July 2020.

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 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, on a monthly basis, Synergy must publish and update information on price trends for transactions in standard products.

³² For each on-peak trading interval in a month in the term (ie the period covered by the ISWA) or remainder of the term, as applicable.

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,³³ 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 Agreement;³⁴
- 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.

³³ Refer to the standard product homepage for access to these procedures:

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

³⁴ 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>

Appendix 2: Findings and recommendations from the 2016 EGRC review

A substantial increase in price volatility occurred in the STEM and balancing markets in the second half of 2016, with Synergy setting prices in the balancing market roughly 84 per cent of the time. There was increased demand for bilateral contracting in customised products, but only one standard product transaction.

The contestable retail market showed signs of good competition occurring between six main participants which also have generation assets and the ability to self-hedge. There was no growth in the market share of small retailers that don't own generation assets and are exposed to the volatility in the energy markets. Synergy was the largest supplier in the wholesale electricity market, with ownership or control of some 74 per cent of the market. This is expected to persist until the mid-2020s.

From 1 July 2017, Synergy has employed an energy forward curve representing its forecast of future energy market prices to calculate transfer prices for supply. This same curve is used to calculate standard product prices and must be used to calculate customised product prices.

Efficient pricing in the WEM depends upon pricing at short-run marginal cost in the energy markets, reliable and efficient forecasting of future energy market prices by Synergy, and an appropriate buy-sell spread in the standard product regime to constrain Synergy's bilateral contract pricing.

The ERA recommended setting a spread of 10 per cent between the buy and sell price to ensure that pricing discipline is placed on Synergy, and to revisit this 12 months after implementation to assess changes in the level of trade. The ERA also recommended exploring varied spreads, with smaller spreads employed for more frequently traded products.

As part of the 2017 replacement transfer pricing mechanism, Synergy proposed that the RBU and the WBU jointly determine the energy forward curve upon which all contract prices are set. The RBU involvement in setting contract prices may confound the ring fencing requirements.

The *Segregation and Transfer Pricing Guidelines 2013* do not identify the new method for calculating transfer prices. Market participants, in particular new entrants, may not be aware of the replacement foundation transfer price mechanism or how it relates to market prices. Synergy can revise this mechanism at any time for changes of a minor or technical nature, but there is no requirement for Synergy to inform the ERA to allow for regulatory scrutiny. Accordingly, to provide transparency, the ERA recommended that Synergy publishes its foundation transfer price and the method it uses for calculating this price.

Stakeholders considered that the standard product credit requirements are burdensome and intrusive, and that the standard product specifications are too rigid and do not provide simple products that are an alternative to customised products. The force majeure provisions for the standard products are asymmetric. If Synergy is a seller in a transaction, interruption to generation of only one of a list of specified plants triggers a force majeure event, and suspension of Synergy's obligations.

The ERA recommended that Synergy relaxes its credit requirements so that they are proportionate to Synergy's exposure to the risk of counterparty default under the standard product regime. It recommended review and amendment of the standard product

specifications and amendment to the force majeure provisions to make them less conservative and symmetric.

Synergy's financial reports do not separate gas and electricity or contestable and non-contestable financial results. The reports have varied in the information provided and the time periods covered, limiting the ability to scrutinize the financial results. This leads to concern about the potential for cross-subsidisation and effects on competition in the retail market.

The ERA recommended that Synergy provides segmented financial reports to ensure transparency regarding how its revenues, costs and profits are split across Synergy's different electricity segments, with a confidential version of the information provided to the ERA for regulatory scrutiny and a public version provided to the market for information.

Further areas for improvement of the scheme were identified through discussion of privileged access to information, staff movements, a scheme objective, structural separation and continuance of the scheme, compliance monitoring, penalty provisions, a complaints process, the review process, and consultation on a draft of the final EGRC report.