

24 April 2018

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**Submitted online via the ERA portal**

Dear Sara

## **2017 REPORT TO THE MINISTER ON THE EFFECTIVENESS OF THE ELECTRICITY GENERATION AND RETAIL CORPORATION REGULATORY SCHEME – DISCUSSION PAPER**

Thank you for the opportunity to make a submission regarding the Economic Regulation Authority's (ERA) Discussion Paper: 2017 Report to the Minister on the Effectiveness of the Electricity Generation and Retail Corporation Regulatory Scheme (2017 Discussion Paper).

As a market participant in the Wholesale Electricity Market (WEM), Wesfarmers Kleenheat Gas Pty Ltd (Kleenheat) supports the Electricity Generation and Retail Corporation (EGRC) Regulatory Scheme (the Scheme), which aims to provide competitive neutrality to ensure efficient market outcomes occur. Kleenheat supports the approach adopted by the ERA in its 2017 Discussion Paper of providing additional information regarding how the Scheme works.

Kleenheat supports the objective of the Scheme, as defined by the ERA as "*to mitigate the increased potential for exercising market power, which arises due to the merger of Synergy and Verve, by ensuring a level playing field for competitors and new entrants, in order to facilitate competition*" and supports the need for this to be made more explicit under the Scheme. In addition, the Scheme could be further improved by defining what an even playing field looks like, in order to be able to assess the Scheme's effectiveness.

The remainder of Kleenheat's submission focuses on two main questions relevant to the efficient operation of the Scheme and outlines a number of concerns for the ERA to take into consideration in its assessment of the effectiveness of the Scheme. Several of these aspects have been identified in previous submissions.

### **1. Scope of the Scheme**

#### *Transfer pricing and ring fencing*

Kleenheat recommends the ERA investigate the margins secured by Synergy in the sale of electricity from Synergy Wholesale Business Unit (WBU) to both Synergy Retail Business Unit (RBU) and the competitors of Synergy. Excessive margins are an

indicator of the potential exploitation of market power. Kleenheat recommends that the ERA investigate if the pricing of Synergy products includes an excessive risk premium and/or margin, particularly in future years. This would include investigating the non-price terms and conditions (including Force Majeure) attached to retail offers to contestable customers, and to assess the commerciality of the retail offers from both a price and non-price perspective.

Kleenheat notes that the ERA intends to investigate the transfer pricing and ring fencing arrangements as part of its 2017 Discussion Paper, and Kleenheat looks forward to this increased transparency in the transfer pricing on the margins secured by the WBU to the RBU.

## **2. Effectiveness of the Scheme for Competition**

### *Generation Transparency*

In its 2017 submission Kleenheat agreed with the ERA's 2016 report assessment that there is too much discretion available to Synergy in determining the "relevant circumstances" applicable when offering wholesale supplies to retail or generation competitors. This has been discussed in past ERA reviews, in particular the need for transparency to define what relevant circumstances are, and when these have been applied.

As part of the ERA's review into the Scheme and as noted in the 2017 Discussion Paper, the ERA will also undertake further analysis<sup>1</sup> of competition in the wholesale electricity and contestable retail markets. Kleenheat suggests as part of this analysis that the ERA should seek clarification from Synergy on any further retirements of their generation fleet. This will provide market participants additional clarity from which to make better-informed investment decisions when considering any potential wholesale electricity supply procurement.

### *Hindering Fair Competition*

Kleenheat would like to further reiterate the point made in its 2017 submission to the ERA regarding increased detail sought in Synergy's financial reporting, to provide transparency of Synergy's results between gas and electricity in segmented reporting. Kleenheat suggests in addition to increased reporting transparency, that the ERA undertake further analysis to ensure profit margins across each of Synergy's reported segments, truly reflect 'arm's length' energy prices being offered between segments and to external customers. The analysis should also cover fuel transfer pricing.

Kleenheat again recommends that the Scheme is reformed to encompass more granular reporting of Synergy performance in the gas and electricity markets and that reporting identifies profit performance in the contestable and non-contestable segments of the electricity market.

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<sup>1</sup> As noted on page five of the ERA 2017 Discussion Paper.



### *Facility Bidding of Synergy*

Kleenheat believes that an important requirement to improve transparency in the market would be to require Synergy to adopt facility bidding.

The ERA noted in its 2016 Final Report to the Minister for Energy on the Effectiveness of the Scheme (released by the ERA in November 2017<sup>2</sup>) that in its 2017 submission Kleenheat proposed that Synergy be required to report its generation results, by facility, in any lead up to facility bidding, for at least 12 months prior to the commencement of bidding. This requirement would provide further confidence to market participants on a range of efficiencies and transparency measures including but not limited to:

- transparency of generation plant efficiency;
- availability and cost of wholesale electricity supply quantities and prices; and
- enabling other market participants to gain clarity on the likely dispatch profile and potential investment requirements in the market.

Kleenheat believes that a move towards facility bidding of Synergy would ultimately allow the dispatch of least-cost generation when the market moves away from portfolio bidding for Synergy, if implemented.

### *Introduction of Security-constrained Dispatch Engine*

While recognising the separate functions that the ERA and the Public Utilities Office (PUO) perform in the Western Australian energy industry, Kleenheat recently submitted to the PUO as part of their *Electricity Sector Reform Initiatives* and the associated public consultation papers, a proposal regarding the adoption of a security-constrained dispatch engine (**dispatch engine**).

Kleenheat recognises that most other advanced electricity markets<sup>3</sup> utilise a dispatch engine in managing their electricity systems, and that such a tool will become increasingly important in Western Australia as generation and fuel mix change with the increased penetration of new energy technologies.

Kleenheat recognises that whilst the introduction of a sophisticated dispatch engine in the South West Interconnected System (SWIS) may be out of the scope of the Scheme and ERA's 2017 Discussion Paper but, it should be considered by the ERA as an important mechanism, to assist in the move towards facility bidding of the Synergy portfolio.

## **3. Stakeholder Feedback on Synergy Standard Products**

Kleenheat recommends that the existing Standard Products regimes be reformed to achieve the objective of the Scheme.

As stated in Kleenheat's submission to the ERA in 2017, Kleenheat maintains the view that the Standard Products regime is ineffective as either a price discovery tool

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<sup>2</sup> The ERA made this report publicly available after submission to the Minister for Energy on 29 November 2017.

<sup>3</sup> These markets include but are not limited to the NEM in eastern Australia, the National Electricity of Singapore, and the New Zealand Electricity Market.

(given the excessive buy/sell spread<sup>4</sup>) or as a competitively priced option for procurement of wholesale energy.

Kleenheat recognises the increased frequency of transactions in the Synergy Standard Products and commends the efforts of Synergy to ensure a competitive market price by offering a lower priced Standard Product Price, however further enhancements can be made to the Standard Products Regime.

While the frequency of transactions under the Standard Products Regime did increase throughout 2017, as noted in the ERA's 2016 Report to the Minister that for smaller electricity retailers there has been negligible growth in their market share. This apparent lack of growth can, at least partially, be attributed to the price-driven attributes that seemingly dictate customer behaviour and ultimately customer churn.

As stated in Kleenheat's previous submission in 2017, Kleenheat maintains that the Standard Products is still fundamentally flawed in terms of lack of transparency. The methodology that underpins the Standard Products regime is opaque, reinforcing the suspicion that its outcomes do not represent fair market value.

To address these flaws, Kleenheat again recommends the ERA investigate a 'Dutch Auction' as a fair market value framework to determine the optimal buy/sell spread, or conversely explore an alternative market mechanism that will be fit-for-purpose. A Dutch auction would entail Synergy being obliged to offer blocks of wholesale electricity to an auction whereby market participants bid for these blocks of wholesale supply on a closed tender basis, and multiple bids are permitted per party. An auction of this type would determine a fair market value for the Standard Product in contrast to the uncompetitive pricing of these products under the existing regime which has been proven ineffective. This would result in a market based price determination process that would address the current problems of Synergy's market power. Kleenheat believes that the operation of the Dutch auction is the lowest cost, administratively simple and effective means to determine a fair market price for Standard Products.

Kleenheat continues to believe there is more than adequate competitive tension amongst existing and new retailers to ensure the price of Standard Products is fair to all, including Synergy.

In summary, Kleenheat believes that the ERA should consider in its review whether:

- Standard Product Prices are set too high to offer a reasonable 'hedge' for an electricity portfolio of a retailer,
- whether the ERA could undertake analysis to explore enhancements to be made to increase transparency in the Standard Products regime by introducing a market based mechanism to benchmark. Kleenheat suggested such a mechanism in its 2017 submission to the ERA and has reiterated this above. This will enable a clearer definition of the pricing methodology to assist market participants understand the trajectory of future energy prices under the Standard Products regime, and

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<sup>4</sup> It is noted by the ERA that notwithstanding the slight decrease in the buy/sell spread, that further reductions can be made – see MAC Meeting [Minutes](#) held on 14 February and the ERA's presentation to MAC Members [here](#). The ERA has suggested a 'narrower spread of 10 percent between buy and sell price to ensure that pricing discipline is placed on Synergy'.



- whether the Standard Product Force Majeure clauses<sup>5</sup> remove any remaining hedging benefit – when the higher price may well be justified, it may not be available due to the Force Majeure clauses. Kleenheat considers that these Force Majeure clauses need to be amended to prevent Synergy unduly enacting such clauses without due regard for the materiality of the resultant higher price.

#### 4. Conclusion

Going forward Kleenheat supports the ERA in continuing to increase transparency around the Scheme and in particular how this has been implemented by the EGRC.

The retail electricity market in the SWIS cannot achieve the same degree of competitiveness and dynamism as the West Australian retail gas market until similar access to competitive wholesale supply is achieved.

Kleenheat would appreciate the opportunity to discuss these matters in more detail with the ERA and again looks forward to a more effective Scheme as a result of this review.

Yours sincerely



Sarah York  
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<sup>5</sup> These Force Majeure clauses are contained in Synergy's Bilateral Trade Agreement for Electricity (Standard Products) and specifically clause 10.1(c).