

Discussion Paper:

2014 Annual Report to the Minister
on the Effectiveness of the EGRC
Regulatory Scheme

November 2014

Economic Regulation Authority

WESTERN AUSTRALIA

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Introduction

In late 2013, the *Electricity Corporations Act 2005 (Act)* was amended to effect the merger of the State owned Electricity Retail Corporation (Synergy) and Electricity Generation Corporation (Verve Energy). The merged entity was subsequently renamed as the Electricity Generation and Retail Corporation (**EGRC**), and began trading as 'Synergy' on 1 January 2014.

The *Electricity Corporations (Electricity Generation and Retail Corporation) Regulations 2013 (EGRC Regulations)* impose requirements on Synergy including ring-fencing, business segregation, transfer pricing and non-discriminatory wholesale electricity trading. In addition, guidelines in relation to business segregation and transfer pricing, *Segregation and Transfer Pricing Guidelines 2013 (Segregation and Transfer Pricing Guidelines)*, and arrangements in relation to standard wholesale products, *Electricity (Standard Products) Wholesale Arrangements 2014 (Standard Product Arrangements)*, have been gazetted.

Regulation 48(1) of the EGRC Regulations requires that the Economic Regulation Authority (**ERA**) review the operation of the EGRC Regulatory Scheme¹ (**Scheme**) for the purpose of assessing its effectiveness, at least once each year.

The ERA must deliver a report to the Minister for Energy (**Minister**) based on the review, not later than two months after the review is completed, and the ERA may include any recommendations it has concerning amendment to the EGRC Regulatory Scheme. The Minister must then ensure that the ERA's report is laid before each house of Parliament within 21 sitting days after the day on which the Minister received the report.

The purpose of this Discussion Paper is to assist interested parties in making submissions to the ERA's review of the effectiveness of the operation of the EGRC Regulatory Scheme.

The ERA held a Stakeholder Workshop on 25 September 2014 to seek views on what issues should be considered by the ERA in its review. In undertaking this review, the ERA intends to continue to work with the electricity industry and the broader community. In addition to seeking formal submissions, the ERA would be happy to meet with stakeholders to discuss any matters raised in this Discussion Paper. The ERA will take into account the views expressed by stakeholders in the preparation of its report to the Minister.

¹ The EGRC Regulatory Scheme includes the EGRC Regulations, the Segregation and Transfer Pricing Guidelines and the Standard Product Arrangements.

Invitation to make submissions

Interested parties are invited to make submissions on the Authority's Discussion Paper by **4:00 pm (WST) Monday, 22 December 2014** via:

Email address: publicsubmissions@erawa.com.au

Postal address: PO Box 8469, PERTH BC WA 6849

Office address: Level 4, Albert Facey House, 469 Wellington Street, Perth WA 6000

Fax: 61 8 6557 7999

CONFIDENTIALITY

In general, all submissions from interested parties will be treated as being in the public domain and placed on the Authority'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 Authority's website shall not be taken as indicating that the Authority 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 Authority.

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EGRC Regulatory Scheme Overview

The Scheme imposes requirements on Synergy in respect to ring-fencing, business segregation, transfer pricing and non-discriminatory wholesale electricity trading. The Scheme comprises the following:

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

In summary, the Scheme requires Synergy to:

- segregate its operations between generation, retail, wholesale and shared services;
- not discriminate between its Retail Business Unit and competitors when offering wholesale supplies, in relation to price and the terms and conditions; and
- offer specified standard wholesale products to both buy and sell energy.

The EGRC Regulations also include compliance and review provisions including:

- The Auditor General must conduct annual audits to ensure that Synergy has complied with the requirements of the Scheme. Any non-compliance reported by the Auditor General must be investigated by the ERA. Depending on the outcome of that investigation and the nature of the non-compliance, the ERA may impose a civil penalty. Non-compliance with certain obligations under this regulatory regime will incur a civil penalty of up to \$100,000, with additional daily penalties of up to \$20,000 for continuing breaches.
- The ERA must carry out a review of the operation of the Scheme for the purpose of assessing its effectiveness at least once each year. The ERA must deliver a report to the Minister for Energy based on its review, including any recommendations it may have for improvements.

Requirements for the ERA's Annual Review

Under the EGRC Regulations, at least once each year the ERA must carry out a review of the operation of the Scheme for the purposes of assessing its effectiveness. 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 the ERA considers relevant.

The ERA must give the Minister a report based on the review not later than two months after the review is completed. The report may include any recommendations the ERA has for amending the Scheme.

The Minister must lay a copy of the report before each House of Parliament within 21 sitting days of that House after the day on which the Minister receives the report. The ERA may request the Minister to delete a matter that is of a commercially sensitive nature from the report that is laid before a House of Parliament.

Although no specific objectives are included in the EGRC Regulations, the ERA notes the Explanatory Memorandum and Second Reading Speech for the *Electricity Corporations Amendment Bill 2013* in relation to the EGRC Regulations provide a useful indication of the intention of the Scheme. In particular the Speech notes that:

“The Government is committed to sustained private sector participation in the electricity sector. To achieve this, the merged entity must be subject to regulatory constraints.”

The Speech also provides commentary on the specific regulatory measures to be introduced. These include:

- requiring some functions to be subject to ring-fencing, a transfer pricing mechanism and protocols governing the flow of sensitive information;
- a requirement to offer a range of standard wholesale electricity products on a non-discriminatory basis to the merged entity's own retail business unit and other wholesale electricity customers;
- requiring customised products to be subject to requirements on the process by which they are offered, ensuring fair and reasonable dealing with wholesale customers; and
- holding the merged entity accountable to its obligations by imposing civil penalties for non-compliance.

A key theme of the Explanatory Memorandum and Speech is that the measures are designed to ensure that “the merged entity will not unduly preference its own retail and generation arms over third party retailers and generators”. The Speech notes that this “will increase pressure on the merged entity to be efficient, reducing upwards pressure on electricity prices”.

To assess the effectiveness of the Scheme the ERA proposes to evaluate to what extent the operation of the Scheme has achieved the intentions set out in the Explanatory Memorandum and Speech. The ERA considers these can be summarised as follows:

- ensuring the merged entity does not unduly preference its own retail and generation arms over third party retailers and generators;

- providing the private sector with access to electricity on non-discriminatory terms; and
- mitigating the concerns of private-sector market participants.

The ERA considers the complexity and costs of implementing and operating the Scheme should also be considered when assessing the effectiveness as ultimately consumers or taxpayers will be funding these costs. In addition, the ERA proposes to consider to what extent the Scheme has increased pressure on the merged entity to be efficient.

As part of its Annual Report to the Minister on the Wholesale Electricity Market (**WEM**), the ERA will consider the impact of the merger of Verve and Synergy on the market. This will include assessing the extent to which Synergy's market power has potentially been mitigated by the measures put in place under the Scheme.

Stakeholders are invited to comment on:

Whether the criteria the ERA proposes to use in its assessment of the effectiveness of the operation of the Scheme are appropriate.

What prevailing circumstances or other matters the ERA should take into account when assessing the effectiveness of the operation of the Scheme, and why.

The EGRC Regulatory Scheme

The following sections consider each of the three components of the Scheme. These comprise the:

- EGRC Regulations;
- Segregation arrangements approved under clause 18(1) of the EGRC Regulations - currently these comprise the Segregation and Transfer Pricing Guidelines; and
- Wholesale arrangements approved under clause 26(1) of the EGRC Regulations - currently these comprise the Standard Product Arrangements.

1.1 EGRC Regulations

The EGRC Regulations came into effect on 1 January 2014 and are available on the Public Utilities Office's (**PUO**) website.²

Among other things, the EGRC Regulations include:

- segregation requirements, which require Synergy to divide its operations into specific segments, with ring fencing regulating the flow of restricted information between the segments and transfer pricing provisions governing the internal transactions between these segments;
- wholesale trading requirements in relation to the wholesale acquisition or supply of electricity, and to the acquisition or supply of wholesale products, by Synergy; and
- a compliance regime, including audit, investigation and civil penalty provisions.

1.1.1 Segregation Requirements

The EGRC Regulations require Synergy's operations to be divided into the following segments:

- generation business³;
- retail business⁴;
- wholesale business⁵;
- shared services operations⁶;

² Refer to the link at <http://www.finance.wa.gov.au/cms/content.aspx?id=17335>

³ Generation operations are defined as operations involving the construction or operation of generating works.

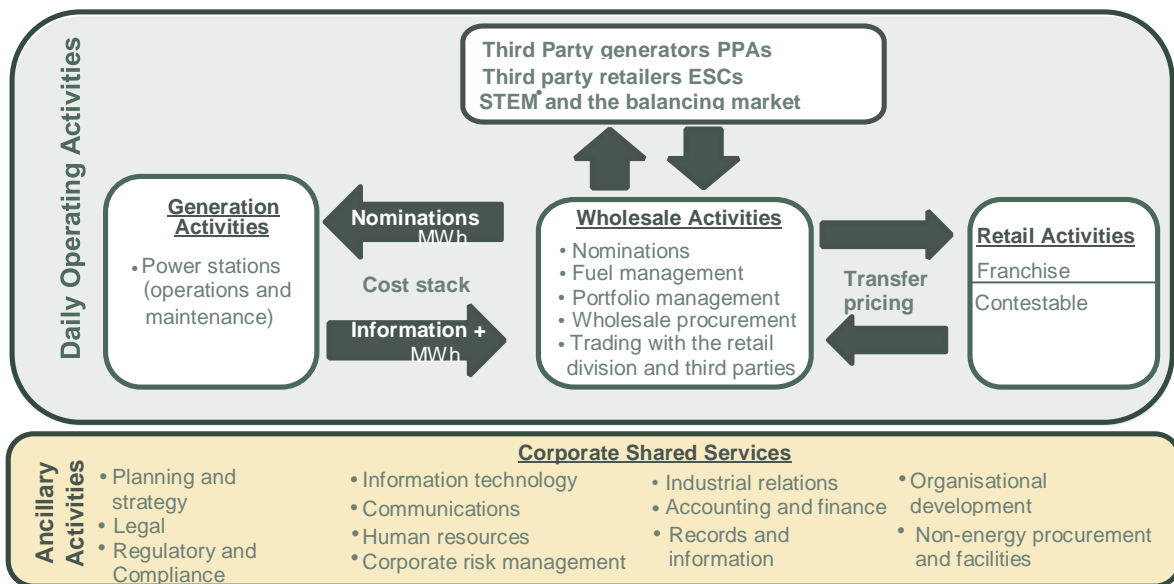
⁴ Retail operations are defined as operations involving the pricing, sale and marketing of electricity to customers served by the SWIS.

⁵ Wholesale operations are defined as operations involving the wholesale acquisition or supply of electricity (including pricing) or the acquisition or supply of wholesale products (including pricing).

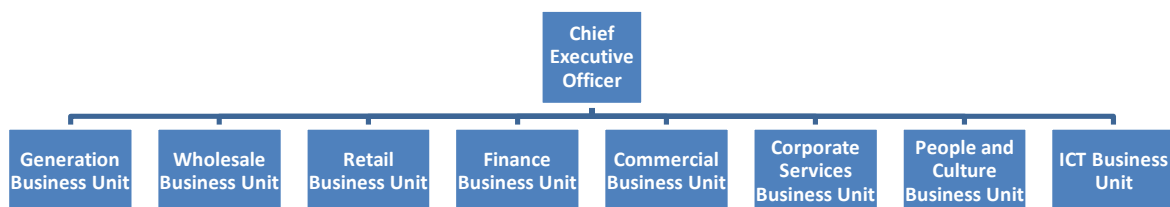
⁶ Shared service operations are defined as operations that include corporate planning and strategy; organisational development; accounting, financial and legal matters; human resources; information technology support; regulatory and compliance matters; communications; billing; record keeping, and any other operations (excluding generation operations, wholesale operations and retail operations) undertaken in connection with two or more business units.

- and any additional segments approved by the Minister.

A chart was presented by the Merger Implementation Group (**MIG**) at a Market Participant and stakeholder briefing session on 5 December 2013 setting out high level details of the new structure as shown below.



A model illustrating the new structure (refer to adapted model presented below) and a high level summary of the daily operating activities of each segment were also recently presented in Synergy's Annual Report for 2014.



The Chief Executive Officer oversees the operation of eight business units, each of which is directed by a different member of Synergy's Executive Leadership Team:

- the Finance Business Unit is responsible for Synergy's financial control, financial planning, analysis and procurement;
- the Commercial Business Unit drives Synergy's corporate value and strategic objectives through the identification, valuation, structuring, negotiation, contracting and execution of asset, project and energy transaction opportunities;
- the Corporate Services Business Unit is responsible for managing legal, internal audit, risk, regulation and compliance, environmental, company secretariat and records management;
- the Generation Business Unit is responsible for managing Synergy's generation assets, and delivering health and safety services across Synergy;

- the People and Culture Business Unit deals with all human resources matters concerning recruitment, remuneration, employee relations and organisational development;
- the Retail Business Unit services residential, business and industry customers and has a focus on marketing and sales strategies, with the aim of delivering customer expectations, return strong commercial benefits to Synergy and positively influence the value of Synergy's brand;
- the Wholesale Business Unit is responsible for optimising Synergy's wholesale electricity and fuel portfolios to create value for Synergy and meet the needs of the wholesale customers, including the Retail Business Unit and third parties; and
- the Information Communications Technology (**ICT**) Business Unit is responsible for Synergy's ICT requirements, including program delivery, infrastructure, governance, vendors, applications and ICT agreements.

Synergy is required to prepare separate statements of financial performance for each of its four 'reportable' operating business units (under the EGRC Regulations), including the Generation Business Unit, Wholesale Business Unit, Retail Business Unit and Corporate Services Business Unit, on a quarterly basis and in the annual financial report⁷.

The Finance Business Unit, Commercial Business Unit, Corporate Services Business Unit, People and Culture Business Unit and ICT Business Unit all fall within the shared services operations segment required under the EGRC Regulations. The ERA notes that the MIG's chart above includes fuel management as a wholesale activity. In contrast, the 2014 Annual Report describes the Wholesale Business Unit as managing long term fuel supplies, negotiating short-term fuel supplies for electricity and gas and providing input to the Commercial Business Unit, which sits outside of the Wholesale Business Unit, for the procurement of new long-term fuel supply arrangements.

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

- that retail restricted information⁸ must not be disclosed to retail staff and generation restricted information⁹ must not be disclosed to generation staff;
- 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

⁷ See Note 8 of Synergy's Annual Report: 1 July 2013 – 30 June 2014
http://www.synergy.net.au/docs/annual_report_2013-14.pdf

⁸ 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.

⁹ 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.

- the separation of management roles between the Retail, Wholesale and Generation Business Units.

The ring-fencing and restrictions on information flows do not apply to shared service operations which the EGRC Regulations define as including:

- corporate planning and strategy;
- organisational development;
- accounting, financial and legal matters;
- human resources;
- information technology support;
- regulatory and compliance matters;
- communications;
- billing;
- record keeping; and
- any other operations (excluding generation operations, wholesale operations and retail operations) undertaken in connection with two or more Synergy business units.

The ERA notes that ring-fencing has been employed in industry reform across various jurisdictions over the last few decades, particularly when attempting to establish competitive markets in sectors that were previously vertically integrated monopolies (e.g., in electricity, rail and telecommunications).

The ERA will consider the experiences with ring-fencing of other jurisdictions and industries, with consideration given to its purpose, how it is implemented, and its efficacy, in its review of the ring fencing obligations imposed on Synergy by the EGRC Regulations.

The EGRC Regulations also set out transfer pricing requirements for transactions between the segments. This is discussed in section 1.2.

Stakeholders are invited to comment on how effective the operation of the Scheme is in mitigating any concerns that stakeholders may have, in terms of:

- the requirements in relation to segregation and ring-fencing; and
- how the requirements have been implemented by Synergy.

Additionally, stakeholders are invited to comment, to the extent that stakeholders have any knowledge or evidence, on how effective the operation of the Scheme has been in:

- ensuring Synergy does not unduly preference its own retail and generation arms over third party retailers and generators; and
- providing the private sector with access to electricity on non-discriminatory terms.

The ERA is also interested in any practical experience stakeholders may have of these requirements and Synergy's implementation of them, including in relation to:

- the complexity and cost of implementing the requirements; and
- whether the requirements have increased pressure on Synergy to be efficient.

Stakeholders may wish to consider the following points when making a submission:

- Whether the level of segregation and ring-fencing required by the EGRC Regulations is adequate to ensure the Generation or Retail Business Units do not have an unfair advantage in comparison to their respective competitors.
- How effective the controls around access to third party information are in ensuring the Generation or Retail Business Units do not have an unfair advantage in comparison to their respective competitors.
- Whether there is sufficient information publicly available to enable stakeholders to fully understand how activities have been segregated.

1.1.2 Wholesale Acquisition or supply of electricity

The EGRC Regulations prohibit Synergy from discriminating between its Retail Business Unit and competitors when offering wholesale supplies, or from taking into account the financial interests of the Retail Business Unit in determining the terms and conditions on which a wholesale supply of electricity is offered to retail or generation competitors.¹⁰

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 has published a Wholesale Electricity Supply Policy¹¹ and a Wholesale Energy Credit Policy¹².

Synergy's Wholesale Electricity Supply Policy applies to requests from customers to the Wholesale Business Unit for the wholesale supply of electricity. It sets out the practical steps and processes required of the Wholesale Business Unit, Retail Business Unit and applicable staff to ensure that it complies with its obligations and outlines a response standard for dealing with Customer requests.

The Wholesale Energy Credit Policy aims to safeguard Synergy's financial resources through the implementation of a credit risk management framework and credit risk control procedures. Additionally, the policy aims to ensure that Synergy complies with its non-discrimination obligations.

¹⁰ In relation to this, the financial position of the Retail Business Unit is to be taken to be the financial position of the EGRC, when assessing the ability of the Retail Business Unit to make payments for wholesale supply, and the standard processes must not be more favourable to the Retail Business Unit than to a retail or generation competitor.

¹¹ See http://www.synergy.net.au/docs/VMI_EGRCWholesaleElectricitySupplyPolicy.pdf

¹² See http://www.synergy.net.au/docs/VMI_EGRCWholesaleEnergyCreditPolicy.pdf

Together, both policies aim to:

- provide standard processes for the Wholesale Business Unit to respond to requests from Customers (including the Retail Business Unit, a retail competitor or a generation competitor) for the wholesale supply of electricity, including processes for:
 - 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.
- provide standard processes that are not, having regard to all relevant circumstances, more favourable to the Retail Business Unit than another Customer.

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.

The ERA assumes that these records will be reviewed by the Auditor General as part of its compliance audit. The ERA will discuss this further with the Auditor General.

Stakeholders are invited to comment on how effective the operation of the Scheme is in mitigating any concerns that stakeholders may have, in terms of:

- the requirements in relation to the wholesale supply and acquisition of electricity; and
- how the requirements have been implemented by Synergy.

Additionally, stakeholders are invited to comment, to the extent that stakeholders have any knowledge or evidence, on how effective the operation of the Scheme has been in:

- ensuring Synergy does not unduly preference its own retail and generation arms over third party retailers and generators; and
- providing the private sector with access to electricity on non-discriminatory terms.

The ERA is also interested in any practical experience Stakeholders may have of these requirements and Synergy's implementation of them, including in relation to:

- the complexity and cost of implementing the requirements; and
- whether the requirements have increased pressure on Synergy to be efficient.

Stakeholders may wish to consider the following points when making their submission:

Does the Wholesale Electricity Supply Policy ensure a fair and reasonable process for dealing with wholesale customers? If not, why not?

Does the Wholesale Energy Credit Policy ensure a fair and reasonable process for dealing with wholesale customers? If not, why not?

Any evidence that the terms offered in the Wholesale Electricity Supply Policy and/or Wholesale Energy Credit Policy are any less favourable than those offered to Synergy's Retail Business Unit.

Whether the Regulations include adequate controls to ensure that Synergy meets its obligations.

1.1.3 Compliance

Under the EGRC Regulations, the Auditor General is required to audit the Scheme, whilst 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 two audits each year, including:

- a Financial year audit, which covers 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 report to both the board of the EGRC and to the ERA, as soon as practicable after the report is given to the Minister. The Auditor General's reports are tabled in Parliament.

The ERA's investigative and enforcement role is dependent on the Auditor General forming an opinion that the EGRC has not complied with one or more provisions of the regulatory scheme that it is required to audit. That is, under Regulation 33 of the EGRC Regulations:

If the Auditor General has formed an opinion, as detailed in a report under regulation 31, 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 Year Audits. These are specified in Schedule 1 of the EGRC Regulations. Briefly, the civil penalty provisions relate 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. Civil penalties paid to the ERA must be credited to the Consolidated Account.¹³

The ERA can apply to the Western Australian Electricity Review Board (**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.

The Explanatory Memorandum acknowledged that it is unusual for such penalties to apply to a government trading entity but considered that it demonstrated that the merged entity would be appropriately penalised for non-compliance with the regulatory regime.

In addition to investigating any non-compliance, the ERA is also required to undertake an annual review of the operation of the Scheme for the purpose of assessing its effectiveness which is the subject of this issues paper.

The requirement for a compliance audit to be conducted by the Auditor General could potentially provide material for assessment, and the opportunity to assess the effectiveness of the operation of the Scheme, as well as identifying any non-compliance. However, there are no requirements on the Auditor General to publish the specifics of their audit, including such things as the methodology employed in auditing the various components of Synergy's operation or the particular components that were audited. Additionally, the ERA notes that the Regulations do not include any provisions for the ERA to be consulted or involved during the audit process. As the Auditor General will be required to follow normal confidentiality processes in respect of the audit, this may make it more difficult to utilise any work performed for the purposes of the audit to assist with assessing the effectiveness of the Scheme. Although the ERA will seek to avoid it, potentially this may lead to some duplication of work between the Auditor General and ERA. The ERA recognises that the Auditor General's audit reports for the current year may not be publicly available until after the completion of the consultation period for the current Discussion Paper, which may make it difficult for stakeholders to comment on this component of the Scheme.

¹³ That is they are returned to Treasury and not retained by the ERA.

Stakeholders are invited to comment on how effective the operation of the compliance requirements of the EGRC Regulations have been, or are likely to be, in mitigating any concerns they may have.

Additionally, stakeholders are invited to comment, to the extent that stakeholders have any knowledge or evidence, on how effective the operation of the Scheme has been in:

- ensuring Synergy does not unduly preference its own retail and generation arms over third party retailers and generators; and
- providing the private sector with access to electricity on non-discriminatory terms.

The ERA is also interested in any practical experience stakeholders may have of these requirements and Synergy's implementation of them, including in relation to:

- the complexity and cost of implementing the requirements; and
- whether the requirements have increased pressure on Synergy to be efficient.

Stakeholders may wish to consider the following points when making a submission:

- Whether the compliance requirements are sufficient to ensure Synergy is held accountable to its obligations under the EGRC Regulations.
- Whether the audit process could be better aligned and integrated with the review of the effectiveness of the operation of the Scheme.
- Whether the penalty provisions are suitable for discouraging Synergy from engaging in discriminatory behaviour.

1.2 Segregation and Transfer Pricing Guidelines

As noted above, the Regulations include transfer pricing requirements which include:

- Written arrangements setting out the terms and conditions for the Wholesale Business Unit transacting for the wholesale supply of electricity with the Retail Business Unit (i.e., transfer pricing arrangements), for the purpose of the retail supply of electricity to foundation customers and to new contestable customers.¹⁴ These arrangements were required to be in place prior to any transactions being

¹⁴ The Segregation and Transfer Pricing Guidelines 2013 define foundation customers as those customers of the EGRC referred to in regulation 9(1), which refers to customers otherwise than under a new contestable customer arrangement. Regulation 4(2) specifies that an arrangement is not a new contestable customer arrangement if the arrangement becomes legally binding on the EGRC after the merger time as a result of the contestable customer accepting, on or before 31 March 2014, and without amendment, an offer for the retail supply of electricity that was made by the EGRC to the contestable customer before the merger time. Additionally, an arrangement is not a new contestable customer arrangement if the arrangement is for the supply of electricity at a charge determined in accordance with the Energy Operators (Electricity Generation and Retail corporation)(Charges) By-Laws 2006.

entered into and Synergy must keep records of each transaction. The Regulations do not include any requirements for these arrangements to be published.

- 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.

Further requirements in relation to 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.¹⁵ Among other things, the Guidelines set out the requirements applicable to the foundation transfer price mechanism and to additional transfer price mechanisms for new customers.

The Foundation Transfer Price Mechanism determines the transfer price for the wholesale supply of electricity by the Wholesale Business Unit to the Retail Business Unit, 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 load¹⁶;
- establish a procedure that is consistent with the procedure for the Retail Business Unit making Foundation Load Trading Interval forecasts in respect of the Foundation Load in a particular Trading Interval;
- provide that the Wholesale Business Unit may only supply electricity to the Retail Business Unit 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 2017¹⁷; and
- a procedure to apply in wholesale force majeure events.

In relation to the Additional Price Mechanism, the Segregation and Transfer Pricing Guidelines require the retail business unit to establish a procedure for making nominations

¹⁵ The *Segregation and Transfer Pricing Guidelines 2013* are accessible from the link on the PUO's website at <http://www.finance.wa.gov.au/cms/content.aspx?id=17335>

¹⁶ In respect of a period, the foundation load is the aggregate quantity of electricity in MWh consumed during that period by the foundation customers.

¹⁷ 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

in respect of each Trading Interval and prohibit the retail business unit from supplying electricity to the wholesale business unit.

The Segregation and Transfer Pricing Guidelines also include requirements in respect to the obligations of Synergy's retail business unit when submitting foundation and new supplies load forecasts for Trading Intervals, the records it must keep and how variances should be settled.

As noted above, the Foundation Transfer Price Mechanism is required to be given to the Minister. However, the Foundation Transfer Price Mechanism has not been, and is not required to be published. The Additional Price Mechanism has also not been, and is not required to be, published.

The Auditor General is required to form an opinion as to whether Synergy has complied with the EGRC Regulations and Segregation and Transfer Pricing Guidelines including in respect to establishing the foundation transfer price and transfer prices in relation to new supplies. The ERA will discuss this further with the OAG to establish if it needs to carry out a further review to assess the effectiveness of the Scheme.

Stakeholders are invited to comment on how effective the operation of the requirements of the Segregation and Transfer Pricing Guidelines have been in mitigating any concerns they may have. Also, to the extent that they have any knowledge or evidence, how effective the operation of the Scheme has been in:

- ensuring Synergy does not unduly preference its own retail and generation arms over third party retailers and generators; and
- providing the private sector with access to electricity on non-discriminatory terms.

The ERA is also interested in any practical experience stakeholders may have of these requirements and Synergy's implementation of them, including in relation to:

- the complexity and cost of implementing the requirements; and
- whether the requirements have increased pressure on Synergy to be efficient.

Stakeholders may wish to consider the following points when making a submission:

- Whether the Guidelines include sufficient requirements to provide transparency around the transfer pricing process.
- Whether the information required to be published by Synergy is sufficient to demonstrate compliance with its obligations.

1.3 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.¹⁸

The Second Reading Speech for the Electricity Corporations Amendment Bill 2013 notes:

“The purpose of the standard products is to provide the private sector with access to electricity on non-discriminatory terms and to mitigate concerns of private-sector market participants. The standard products will be offered under approved terms and conditions, and the prices will need to be non-discriminatory as compared with the notional prices available to the merged entity’s own retail arm for an equivalent product under the transfer pricing methodology.”

The Standard Product Arrangements specify the products Synergy is required to offer and the minimum quantities which 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 applies from 1 July 2014 to 31 December 2015. The maximum spread reduces to 20 per cent from 1 January 2015.

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 requirement¹⁹, 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 Agreement²⁰;

¹⁸ *The Electricity (Standard Products) Wholesale Arrangements 2014* can be accessed from the link on the PUO’s website at <http://www.finance.wa.gov.au/cms/content.aspx?id=17335>

¹⁹ Refer to the Standard Product Homepage for access to these procedures <http://wholesale.synergy.net.au/SitePages/Home.aspx>

²⁰ 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>

- 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 (CRP) Methodology.

The details of the Standard Product Arrangements were developed by the MIG which was set up by the Minister to be responsible for the governance and oversight of the merger. The MIG held a number of briefings explaining its rationale for the development of the Standard Product Arrangements.²¹ The following summarises the main points from the briefings.

The MIG considered the overarching goals of the Standard Product Arrangements were:

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

The MIG did not expect the Standard Products to be a significant source of volume for other Participants, at this stage, and the intent was to provide short to medium contracts that do not unduly influence liquidity in the Short Term Energy Market (**STEM**). The MIG expected that customised products would continue to provide the primary source of volume in the WEM for Synergy.

The MIG indicated that in developing the Standard Product Arrangements, it was not intended to create a market and that the regime would not operate as a market at present. However, it considered the capability for a market had been put in place and intended that the regime would evolve over time, based on demand.

The MIG selected small contractual volumes of 1 MW which it considered would lower the effective cost for smaller participants and new entrants.

The MIG intended that the prescribed volume limits (150 MW for sale, 100 MW for purchase, and a minimum of 5 MW per week serviced from each of these volumes) would be used to control Synergy's risk exposure and maintain liquidity.

The MIG considered that pricing efficiency would be underpinned by the buy/sell spread. The buy/sell spread for the Standard Product Arrangements was estimated based on looking at the average buy/sell spreads in the STEM (average spread in 2013 of 10 – 40 per cent) and the Futures market in the NEM (March 2014 average peak maturity spread of less than 8 per cent, and an average base maturity spread of less than 2 per cent).

²¹ Copies of the slides presented at the briefings can be found at <http://www.finance.wa.gov.au/cms/content.aspx?id=17335>.

Consideration was also given to the anticipated activity within the regime and Synergy's risk exposure. The MIG noted that its decision was made taking into account the fact that less liquid markets tend to have wider buy-sell spreads.

Details of the Standard Products currently offered by Synergy and any transactions entered into can be found on its website.²²

1.3.1 Use of Standard Products in Other Markets

The ERA is aware of a number of Standard Product Regimes (or similar arrangements) that have been employed in other jurisdictions, in order to:

- encourage new entrant retailers and retail competition;
- reduce electricity prices; and
- provide confidence and comfort to smaller retailers.

For example, Standard Products were recently introduced in the NEM as a result of the acquisition of Macquarie Generation Assets by AGL Energy Limited (**AGL**). The acquisition would result in the largest source of generation capacity in NSW being owned by one of the three largest retailers in New South Wales (**NSW**), and the three largest retailers (Origin, AGL and EnergyAustralia) owning a combined share of 70 to 80 per cent of electricity generation capacity or output.²³

AGL applied to the Australian Competition Tribunal who granted authorization for the acquisition, noting (among other things) that it accepted the conditions proposed by AGL that it would continue to make available not less than 500 MW of hedge contracts per year to small retailers, for a period of seven years. The availability of the conditions of the undertaking by AGL were accepted as providing comfort to smaller retailers.²⁴

Similarly, in Tasmania, a single Government owned entity, Hydro Tasmania, is the dominant counterparty for wholesale contracts, and is responsible for a significant proportion of all generation output within the region and control of Basslink interconnector flows.²⁵ Hydro Tasmania's dominant market position has led to concern that wholesale market risk will be perceived to be higher in Tasmania than in other NEM regions, possibly deterring the entry of some private sector retailers into the Tasmanian Market.

To provide confidence to retailers, and in an attempt to support full retail competition, the Tasmanian Government opted to regulate the wholesale electricity contracts provided by Hydro Tasmania. Under the Wholesale Contract Regulatory Instrument²⁶, Hydro Tasmania is required to:

- offer a number of contract products that are broadly consistent with the standard products offered in the National Electricity Market (**NEM**)²⁷ to retailers operating in Tasmania;

²² <http://wholesale.synergy.net.au/SitePages/Home.aspx>

²³ <http://www.accc.gov.au/media-release/accc-opposes-agls-proposed-acquisition-of-macquarie-generation>

²⁴ <http://www.judgments.fedcourt.gov.au/judgments/Judgments/tribunals/acompt/2014/2014acompt0001>

²⁵ <http://www.economicregulator.tas.gov.au/domino/otter.nsf/allsv/53E76EC4AC7B6CA3CA257C4A000921FF>

²⁶ [http://www.economicregulator.tas.gov.au/domino/otter.nsf/LookupFiles/134094_Wholesale_Contract_Regulatory_Instrument_20131106.pdf/\\$file/134094_Wholesale_Contract_Regulatory_Instrument_20131106.pdf](http://www.economicregulator.tas.gov.au/domino/otter.nsf/LookupFiles/134094_Wholesale_Contract_Regulatory_Instrument_20131106.pdf/$file/134094_Wholesale_Contract_Regulatory_Instrument_20131106.pdf)

²⁷ In the NEM, in order to manage the risk of price movements in the spot market, generators and purchasers can enter into hedge contracts to insulate them from variations in the spot price of electricity. Unlike the

- offer standard terms and conditions for each regulated contract product;
- offer contract products at prices that are produced from an approved pricing methodology; and
- make sufficient volumes of the regulated contract products available to enable retailers operating in Tasmania to adequately manage the wholesale spot price risk associated with their Tasmanian customers.

Tasmania's Wholesale Contract regulation commenced on 1 January 2014, and like the Standard Product Regime in the WEM, is relatively young.²⁸

In contrast, the Electricity Hedge Contract Market in New Zealand has been in operation for a number of years.²⁹ In 2009, a Ministerial review of the New Zealand Electricity Market indicated that the rate at which retail prices had risen, especially for residential customers, appeared excessive when compared to the increase in the cost of new supply, a finding that was explained partly due to insufficient competition in the retail market.³⁰ As a result, the Government placed obligations on major generators (i.e., with over 500MW of capacity) to put in place a liquid electricity hedge market, involving standardised tradable contracts, by 1 June 2010. The five major generators at the time selected the Australian Stock Exchange (**ASX**) electricity futures as the exchange-traded hedge market of choice³¹ and four generators signed market making agreements with the ASX.³²

In an evaluation of hedge market liquidity undertaken in June 2011, Energy Link³³ noted that significant progress had been made in the preceding five months, with trading volumes averaging about 200 GWh per month and open interest growing steadily to sit at around 600 GWh.³⁴ However, this was well short of the Government's 3,000 GWh target at the time, and liquidity was considered to be lower than desirable as was evidenced in the "large" bid ask spread, which averaged around 7 to 8 percent, though this value had reduced somewhat from the maximum of 10 percent. Energy Link noted that the market could be left to evolve naturally on its own but did not consider that this would occur in a reasonable time, and accordingly recommended changes to the market-making agreements as the best way forward.

products in the WEM, ASX Australian electricity futures and options are standardised, centrally cleared financial contracts, that are structured as cash-settled Contracts For Differences (CFDs) against the New South Wales, Victorian, Queensland and South Australian regional reference nodes. Base and Peak load (Quarterly, Monthly and Calendar/Financial Year), cap and strip futures provide a mechanism for companies that have an interest in or exposure to the NEM to anonymously manage their price and counterparty risks. Refer to <http://www.asx.com.au/products/energy-derivatives/australian-electricity.htm>

²⁸ Refer to the following link for information related to Tasmania's Wholesale Contracts, including the weekly regulated price: <http://www.hydro.com.au/energy/tasmanian-contract-prices>

²⁹ Refer to the following link for a detailed overview of hedge market developments <https://www.ea.govt.nz/development/work-programme/wholesale/hedge-market-development/>.

³⁰ <https://www.ea.govt.nz/dmsdocument/10822>

³¹ Note that the New Zealand electricity market also includes several different over-the-counter hedge types in addition to its ASX futures contracts, such as: contracts for difference (CFD), fixed price fixed volume, fixed price variable volume and options.

³² <http://www.asx.com.au/products/energy-derivatives/new-zealand-electricity.htm>

³³ Energy Link was engaged by the Electricity Authority in May 2011 to evaluate the progress of the major generators toward achieving the Government's expectations concerning a liquid electricity hedge market, and to recommend actions to address any shortcomings identified in the evaluation.

³⁴ <https://www.ea.govt.nz/dmsdocument/10822>

The new market-maker arrangements sharply reduced the bid-ask spreads for futures contracts (providing for a maximum 5% spread) and substantially boosted trading volumes by requiring market-makers to offer 3MW of futures contracts at each of Otahuhu and Benmore for 3:30 – 4:00pm each business day, and also requiring them to refresh their offers at least once during the time period by 1MW.³⁵

The hedge market in New Zealand has been the subject of ongoing research and review by the Wholesale Advisory Group (**WAG**), which provides independent advice on risk management contracts (among other things, including market design) to the Electricity Authority Board. Key findings indicate that the level of participation in the ASX New Zealand electricity futures and the depth and liquidity of the market have improved, though there may still be scope for improvement, with options such as encouraging broader participation or moving to a smaller unit size (i.e., less than 1 MW) having been put forward.

The ERA will consider the experiences of other local jurisdictions in the development of standard contract markets in its review of the WEM's Standard Product Regime.

Stakeholders are invited to comment on how effective the operation of the requirements of the Standard Product Arrangements has been in mitigating any concerns they may have. Also, to the extent that they have any knowledge or evidence, how effective the operation of the Scheme has been in:

- ensuring Synergy does not unduly preference its own retail and generation arms over third party retailers and generators; and
- providing the private sector with access to electricity on non-discriminatory terms.

The ERA is also interested in any practical experience stakeholders may have of these requirements and Synergy's implementation of them, including in relation to:

- the complexity and cost of implementing the requirements; and
- whether the requirements have increased pressure on Synergy to be efficient.

Stakeholders may wish to consider the following points when making a submission:

- How effective the Standard Products are in imposing discipline on Synergy's wholesale pricing?
- To what extent the Standard Products have provided a competitive benchmark price to the wholesale supply of electricity on a non-discriminatory basis?
- To what extent the Standard Products have provided an alternative to customised products?

³⁵ Refer to the following link for current NZ Electricity Contract Information
http://www.emi.ea.govt.nz/Datasets/Browse?directory=%2FWeekly_electricity_hedge_contracts_reports&parentDirectory=%2FDatasets%2FForward_markets

- Whether the Standard Products have reduced barriers to entry for new entrant retailers and allowed Market Participants to rebalance their portfolios.
- Whether the type of products and minimum volumes specified in the Standard Products Arrangements are appropriate and useful.
- The level of the spread between Buy and Sell and whether it has been effective in underpinning price efficiency.
- Are fair and reasonable procedures employed in the operation of the Standard Product Regime? If not, which procedures require amendment and why?
- What improvements, if any, could be made to the Standard Product Regime?