

# 2014 Report to the Minister on the Effectiveness of the Electricity Generation and Retail Corporation Regulatory Scheme

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Economic Regulation Authority

WESTERN AUSTRALIA

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## Contents

<b>Executive Summary</b>	<b>1</b>
<b>Introduction</b>	<b>4</b>
Background	4
EGRC Regulations	5
Segregation and Transfer Pricing Guidelines	6
Standard Product Arrangements	6
Factors to be taken into account in the review	7
Dominance of Merged Entity	7
Electricity Market Review	7
Wholesale Electricity Market Objectives	7
Timing of Review	8
Objectives of Scheme	8
<b>Review of the Effective Operation of the Scheme</b>	<b>10</b>
Achieving a level playing field	10
Access to Electricity on similar terms	10
Mechanisms to ensure no discrimination	11
Access to Information	13
Confidence in the Market	15
Transparency of Regulations	15
Transparency and Efficiency of Prices	16
<b>Appendix 1 Overview of the EGRC Regulatory Scheme</b>	<b>18</b>
1.1 EGRC Regulations	18
1.1.1 Segregation Requirements	18
1.1.2 Wholesale Trading Requirements	21
1.1.3 Compliance	24
1.2 STP Guidelines	25
1.3 Standard Product Arrangements	27

## Executive Summary

The Electricity Generation and Retail Corporation (**EGRC**) Regulations<sup>1</sup> were implemented under the amended *Electricity Corporations Act 2005* to impose requirements on Synergy that included ring-fencing, business segregation, transfer pricing and non-discriminatory wholesale electricity trading.

The Economic Regulation Authority (**ERA**) is required to carry out a review of the operation of the EGRC Regulatory Scheme (**Scheme**) for the purpose of assessing its effectiveness, at least once per year. In carrying out the 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.

Following the merger in 2014, Synergy has increased its overall dominance in the market. In particular, the combination of its dominance in the generation and retail markets and the fact that it is now vertically integrated gives Synergy the potential to use its position in wholesale or retail markets to undermine competition from independent suppliers or generators, respectively.

As recognised by the Government in introducing the Scheme, merging the generation and retail businesses without imposing restrictions provides significant opportunities for Synergy to preference its own retail and generation arms at the expense of third parties, and thus limit the development of competition. This could include both contracting on less favourable terms with third parties and having access to commercial information not available to other retailers or generators.

Facilitating the development of competition and private sector investment in the Wholesale Electricity Market (**WEM**) is essential because it will lead to outcomes that are in the long term interests of consumers. The ERA considers that structural separation of Synergy would be the best means to achieve this. The ERA does not consider that segregation arrangements can be an effective substitute for structural separation. Such arrangements inevitably provide opportunities for gaming by the dominant entity. The ERA notes in particular the history of telecommunications regulation in Australia, where Telstra has continued as a vertically integrated supplier with regulatory arrangements put in place to deal with its market power rather than requiring it to structurally separate. As noted by the Federal Government in September 2009,<sup>2</sup> partly because of this integration, Telstra has been able to maintain a dominant position in virtually all aspects of the market despite open competition being introduced more than 10 years earlier. This is likely to continue to be the case in relation to Synergy if structural reform is not undertaken.

Unless and until structural separation of Synergy occurs, the ERA considers the primary purpose of the Scheme should be to mitigate the increased potential for market power that arises due to the merger, to ensure a level playing field for competitors and new entrants in order to facilitate competition. It should not be viewed as a measure for minimising Synergy's market risk.

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<sup>1</sup> [http://www.slp.wa.gov.au/legislation/statutes.nsf/main\\_mrtitle\\_13129\\_homepage.html](http://www.slp.wa.gov.au/legislation/statutes.nsf/main_mrtitle_13129_homepage.html)

<sup>2</sup> Telecommunications Legislation Amendment (Competition and Consumer Safeguards) Bill 2009, Explanatory Memorandum p.1  
[http://parlinfo.aph.gov.au/parlInfo/download/legislation/ems/r4212\\_ems\\_64695e14-efaf-4d43-b793-fa3149320799/upload\\_pdf/334176.pdf;fileType=application%2Fpdf](http://parlinfo.aph.gov.au/parlInfo/download/legislation/ems/r4212_ems_64695e14-efaf-4d43-b793-fa3149320799/upload_pdf/334176.pdf;fileType=application%2Fpdf)

As this is the first year of review, the ERA has restricted its report to high level issues that it considers need to be addressed as soon as possible if the Scheme is to be effective in mitigating market power.

The ERA considers the most important improvement required is for the objective of the Scheme – i.e., to mitigate the market power arising as a result of merging the largest retailer and generator in the market – to be explicitly stated in the Regulations. Without this being made explicit, there is the potential for other considerations to be given precedence, particularly Synergy's financial position, which negates the effectiveness of the Scheme as a market power mitigation measure.

The ERA has identified a number of specific areas where the Scheme does not adequately deal with Synergy's market power:

- The Scheme requires the Wholesale Business Unit (**WBU**) to ensure that wholesale supplies of electricity are not offered to Synergy's retail business on terms and conditions that are, having regard to all relevant circumstances, more favourable than the terms on which wholesale supplies are offered to retail or generation competitors. However, the Scheme does not provide guidance on what circumstances should be taken into account and how. Consequently, significant discretion is available to Synergy in determining whether one wholesale supply offering is more or less favourable than another, which may provide the opportunity for Synergy to treat its competitors less favourably. Further guidance should be set out in the Scheme to reduce the level of discretion available to Synergy.
- As audits are conducted on an annual basis, potentially there could be a substantial lag between discriminatory behaviour occurring and it being reported. Consideration could be given to requiring the Auditor General to report on a more frequent basis if this could be done cost effectively. This could be further enhanced by requiring Synergy to self-report any non-compliance, with penalties if it fails to do so, similar to the approach in the current Electricity Licencing regime, which requires serious breaches to be reported as soon as the service provider becomes aware.
- The Standard Products could provide a useful tool for price discovery and imposing pricing discipline on Synergy. However, the current arrangements appear to have been developed with the risk to Synergy's financial position being the primary consideration. This has resulted in a small quantity of narrowly focussed products that are underutilised and unlikely to have resulted in any real pricing discipline being imposed on Synergy. An effective Standard Product Arrangement would require:
  - Sufficient range and quantity of products. Price discovery can only be achieved if the quantity and range of products offered adequately reflects the typical requirements of retailers; and
  - Setting the maximum range (i.e. spread) between the price Synergy buys and sells energy (i.e. the buy/sell spread) at a level which facilitates price discovery and ensures Synergy prices efficiently. There is an optimal spread that would exist in a workably competitive market. A spread that is higher than this enables Synergy to exercise its market power by pricing the standard product such that it sells at a higher price, and/or buys at a lower price than is efficient. The current spread of 20 per cent is significantly higher than those seen in competitive energy markets such as the NEM.

- The ring-fencing arrangements should be reviewed to ensure the Retail Business Unit (**RBU**) does not have access to any information held by the WBU that is not available to other retailers, to ensure it does not have an unfair competitive advantage.
- The Scheme requires Synergy to develop a number of policies and procedures; however not all of these are required to be published. Transparency of the Scheme would be significantly improved by requiring that all relevant policies and procedures are published.
- Stakeholders have raised concerns that Synergy is pricing retail energy below its wholesale prices<sup>3</sup> and subsidising this behaviour via the Tariff Adjustment Payment (**TAP**). It is not apparent to the ERA whether or not this is the case, but it is likely the general lack of transparency in the setting of Synergy's retail tariffs and the TAP has played a significant part in raising such concerns. Retail pricing falls outside the current scope of the Scheme and the ERA notes that the potential for subsidisation existed prior to the merger. However, stakeholders' concerns that subsidisation is occurring appears to have adversely impacted the confidence stakeholders have in the Scheme. Consideration should therefore be given to improving transparency of the retail pricing process and ensuring there is no potential for subsidisation of Synergy's contestable business via the TAP.
- Wholesale prices for Synergy's retail customers at the date of the merger appear to be based on the Revised Vesting Contract,<sup>4</sup> which the ERA has previously found<sup>5</sup> was not efficiently procured and raised Synergy's costs above efficient levels. If this is the case, the ERA is concerned it is leading to the RBU's costs being overstated and the TAP (which is based on the difference between Synergy's costs and the revenue it collects from customers) being higher than it otherwise needs to be. The ERA considers a review of the Foundation Pricing Mechanism should be undertaken as soon as possible to ensure the RBU's costs are based on efficient wholesale costs.

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<sup>3</sup> In telecommunications regulation, a situation where retail prices are below wholesale prices is referred to as a "vertical price squeeze".

<sup>4</sup> The contract in place prior to the merger.

<sup>5</sup> Economic Regulation Authority, *Synergy's Costs and Electricity Tariffs Final Report*, 4 July 2012, p. 16. <https://www.erawa.com.au/cproot/10639/2/20120704%20Synergys%20Costs%20and%20Electricity%20Tariffs%20-%20Final%20Report.PDF>

## Introduction

Under regulation 48 of the *Electricity Generation and Retail Corporation Regulations 2013* (**EGRC Regulations**), the Economic Regulation Authority (**ERA**) is required to carry out a review of the operation of the EGRC Regulatory Scheme (**Scheme**) for the purpose of assessing its effectiveness, at least once per year. In carrying out the 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 for Energy (**Minister**) a report based on the review not later than 2 months after the review is completed and may include in the report any recommendations it has concerning amendment to the Scheme.

The Minister must cause a copy of the report to be laid before each House of Parliament no later than 21 sitting days after the day on which the Minister receives the report.

Consistent with these requirements, the ERA has conducted a review of the effectiveness of the operation of the Scheme in 2014 and has identified a number of issues, and associated recommendations, that it considers need addressing.

As part of the preparation process for the report, the ERA released a Discussion Paper seeking public submissions, which was published on 10 November 2014. Submissions received in response to the Discussion Paper are available on the ERA's website.<sup>6</sup>

In preparing this report and in forming the views set out in it, the ERA has considered the comments raised in the submissions. Matters not specifically addressed in this report will be considered in future reports. Through the process of this review, the ERA identified a number of matters of detail that it intends to explore further with Synergy, in the next review. In this report, the ERA has provided a high level analysis of the main concerns arising from its review to date.

## Background

On 10 April 2013, the Government of Western Australia announced that the State's electricity retailer, Synergy, would merge with its generator, Verve Energy, and trade as Synergy. To effect the merger, the *Electricity Corporations Amendment Act 2013* was introduced to Parliament on 16 October 2013, and received Royal Assent on 18 December 2013.

The EGRC Regulations<sup>7</sup> were implemented under the amended *Electricity Corporations Act 2005* to impose requirements on Synergy that included ring-fencing, business segregation, transfer pricing and non-discriminatory wholesale electricity trading. The Segregation and

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<sup>6</sup> Public submissions were received from Synergy, Alinta, ERM Power and Community Electricity  
<https://www.erawa.com.au/electricity/wholesale-electricity-market/reviews/the-electricity-generation-and-retail-corporation-egrc-regulatory-scheme>

<sup>7</sup> [http://www.slp.wa.gov.au/legislation/statutes.nsf/main\\_mrtitle\\_13129\\_homepage.html](http://www.slp.wa.gov.au/legislation/statutes.nsf/main_mrtitle_13129_homepage.html)

Transfer Pricing Guidelines (**STP Guidelines**)<sup>8</sup> were established under section 62(1) of the Act and published on 30 December 2013.

Subsequent to this, the Standard Product Arrangements<sup>9</sup> were gazetted on 19 May 2014, under section 38(1) of the Act and regulation 26(1).

Together, the EGRC Regulations, STP Guidelines, and Standard Product Arrangements form the EGRC Regulatory Scheme (**Scheme**).

The following section provides a brief summary of how the components of the Scheme, and the arrangements implemented by Synergy, operate. A more detailed overview of the Scheme is presented in Appendix 1.

## **EGRC Regulations**

The EGRC Regulations, which came into effect on 1 January 2014, requires Synergy's operations to be divided 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 prepare separate statements of financial performance for each business unit, on a quarterly basis and in the annual financial report.

The EGRC Regulations impose segregation obligations relating to ring-fencing, restrictions on information flows between the business segments, and transfer pricing provisions governing the internal transactions between these segments.

Additionally, the EGRC Regulations set out the wholesale trading requirements in relation to the wholesale acquisition or supply of electricity.

In relation to existing customers, the EGRC Regulations required preparation of the Foundation Transfer Price Mechanism, which determines the transfer price for the wholesale supply of electricity by the WBU to the RBU, for the purposes of a retail supply of electricity to a Foundation Customer.<sup>10</sup> The Foundation Transfer Price Mechanism was required to be given to the Minister by 1 January 2014 and remains in force until 30 June 2017, or a later date approved in writing by the Minister.

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<sup>8</sup> [http://www.slp.wa.gov.au/gazette/gazette.nsf/0/A3B67A09679C1F0148257C4D0081C247/\\$file/gg243.pdf](http://www.slp.wa.gov.au/gazette/gazette.nsf/0/A3B67A09679C1F0148257C4D0081C247/$file/gg243.pdf)

<sup>9</sup> [https://www.slp.wa.gov.au/gazette/gazette.nsf/searchgazette/E81FAE2E67051AB248257CDA0025714A/\\$file/Gg073.pdf](https://www.slp.wa.gov.au/gazette/gazette.nsf/searchgazette/E81FAE2E67051AB248257CDA0025714A/$file/Gg073.pdf)

<sup>10</sup> 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.



In relation to supplies to new customers<sup>11</sup> and Standard Products,<sup>12</sup> Synergy is prohibited from:

- offering a wholesale supply of electricity to the RBU on terms and conditions that are, having regard to all relevant circumstances, more favourable than the terms on which a wholesale supply of electricity is offered to retail or generation competitors; 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.<sup>13</sup>

The EGRC Regulations require Synergy to develop a policy for determining the terms and conditions for the wholesale supply of electricity, which includes processes for assessing the ability of a business to make payments for that supply, and for determining the terms and conditions on which the wholesale supply of electricity is to be offered.

As required, Synergy has published a Wholesale Electricity Supply Policy<sup>14</sup> and a Wholesale Energy Credit Policy.<sup>15</sup>

The Regulations also include a compliance regime with audit, investigation, and civil penalty provisions.

### ***Segregation and Transfer Pricing Guidelines***

The STP Guidelines set out additional requirements for the Foundation Transfer Price Mechanism and wholesale pricing requirements for new customers.

### ***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, with the first products being available from 1 July 2014. The Standard Product Arrangements specify the products Synergy is required to offer and the minimum quantities that must be made available under the Scheme.

Synergy is required to offer both flat and peak standard products on a quarterly and annual basis. For each Standard Product, Synergy is required to offer a minimum of:

- 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.

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<sup>11</sup> Refer to Part 3, Division 1, regulations 21 and 22 of the EGRC Regulations.

<sup>12</sup> Refer to Section 5.2 of the Standard Product Arrangements.

<sup>13</sup> 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.

<sup>14</sup> [http://www.synergy.net.au/docs/VMI\\_EGRCWholesaleElectricitySupplyPolicy.pdf](http://www.synergy.net.au/docs/VMI_EGRCWholesaleElectricitySupplyPolicy.pdf)

<sup>15</sup> [http://www.synergy.net.au/docs/VMI\\_EGRCWholesaleEnergyCreditPolicy.pdf](http://www.synergy.net.au/docs/VMI_EGRCWholesaleEnergyCreditPolicy.pdf)

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 2014. As of 1 January 2015, the maximum spread reduced to 20 per cent.

## Factors to be taken into account in the review

In conducting its review, the ERA is to 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 considers that the prevailing circumstances and other matters relevant to the review of the EGRC Regulatory Scheme include:

- the dominance of Synergy in the market;
- uncertainty surrounding the outcomes of the Western Australian State Government's Electricity Market Review (**EMR**);
- the Wholesale Electricity Market (**WEM**) objectives; and
- the short time the Scheme has been in operation.

These factors are discussed below.

### *Dominance of Merged Entity*

The ERA notes that, whilst Verve Energy and Synergy were independently dominant in the generation and retail markets, merging them has increased Synergy's dominance. In particular, the combination of its market dominance in the generation and retail markets and the fact that it is now vertically integrated gives it the potential to use its position in wholesale or retail markets to undermine competition from independent suppliers or generators, respectively.

The ERA considers that the conditions necessary for vigorous competition do not exist in the WEM. Competition is important to minimise the cost of electricity to consumers and, accordingly, whilst the current structure remains in place, the Scheme is essential for mitigating the increased potential for market power to be exercised following the merger.

### *Electricity Market Review*

In March 2014, the Minister for Energy launched the Western Australian State Government's EMR, examining the structures of the electricity generation, wholesale and retail sectors within the SWIS and the incentives for industry participants to make efficient investments and minimise costs.<sup>16</sup>

As set out in its Discussion Paper, the EMR has given consideration to the structural separation of Synergy. Ultimately, any changes in industry structure and/or market design may change the requirements for the Scheme in the future.

### *Wholesale Electricity Market Objectives*

The ERA considers that the objectives of the Wholesale Electricity Market (WEM)<sup>17</sup> must be taken into account in its review of the effectiveness of the Scheme. In particular, the

<sup>16</sup> [http://www.finance.wa.gov.au/cms/Public\\_Utility\\_Office/Electricity\\_Market\\_Review/Electricity\\_Market\\_Review.aspx](http://www.finance.wa.gov.au/cms/Public_Utility_Office/Electricity_Market_Review/Electricity_Market_Review.aspx)

<sup>17</sup> Refer to section 1.2 of the WEM Market Rules.

objective of encouraging competition among generators and retailers in the SWIS, including by facilitating efficient entry of new competitors, is relevant to this review.

The Scheme should be designed to ensure it supports the WEM objective of encouraging competition.

### **Timing of Review**

The ERA notes this is the first year of implementation of the Scheme. It is likely that, as with the implementation of any new process, time is needed to establish clear understandings and refine processes.

Synergy noted in its submission that 2014 was an unprecedented year of change for its business. Due to the amount of activity required in establishing the new business and complying with the new regulatory arrangements (including the undertaking of audits and reviews in less than 12 months from the enactment of the regulations), it has had limited time to fully assess the cost and impact on its business of implementing the new arrangements.

Taking account of Synergy's comments, the ERA considers that it is not practical to evaluate the costs of implementing and operating the Scheme at this time. Consequently, such an analysis is not included in this review.

### **Objectives of Scheme**

As set out in the ERA's Discussion Paper, no specific objectives were included in the EGRC Regulations. In its Discussion Paper, the ERA proposed to assess the effectiveness of the Scheme by evaluating to what extent the operation of the Scheme has achieved the intentions set out in the Explanatory Memorandum and Second Reading Speech for the *Electricity Corporations Amendment Bill 2013 (Bill)* in relation to the EGRC Regulations.

In its submission, Synergy agreed that, given no clear objectives were set out in the Scheme, it was appropriate to refer back to materials accompanying the Bill. However, Synergy also referred to the intent of the merger being to "address the inefficiencies in the operations of the two entities and realign their incentives so they can operate in the interests of consumers and tax payers". Synergy's view is that the ERA needs to consider whether the various regulatory arrangements are fair and reasonable to both market participants and Synergy. In particular, Synergy considers it is important not to overreach and install a scheme that limits the merged entity's operational efficiencies by diluting economies of scale, to the consequent detriment of customers and tax payers.

Following the merger in 2014, Synergy has increased its overall dominance in the market through its bilateral trades and affiliations. In particular, the combination of its market dominance in the generation and retail markets and the fact that it is now vertically integrated gives it the potential to use its position in wholesale or retail markets to undermine competition from independent suppliers or generators, respectively.

As recognised by the Government in implementing the Scheme, merging the generation and retail businesses without imposing restrictions provides significant opportunities for Synergy to preference its own retail and generation arms at the expense of third parties and thus limit the development of competition. This could include both contracting on less favourable terms with third parties, and having access to commercial information not available to other retailers or generators.

The merger also reduces liquidity in the market, with trading between the largest retailer and generator now being an internal transaction. Whilst the Short Term Energy Market (**STEM**) and Balancing Market provide all participants with access to day ahead and balancing energy, access to longer term contracts is more restricted, with Synergy controlling the majority of generation either through direct ownership or contractually. If, as a result, third parties are less able to hedge their demand or supply (i.e., contract wholesale electricity in advance of delivery as protection against spot price changes), it places them at a competitive disadvantage and/or is a barrier to entry or expansion.

The ERA considers the primary purpose of the Scheme is to mitigate the increased potential for market power, which arises due to the merger, to ensure a level playing field for competitors and new entrants in order to facilitate competition. Greater competition is essential because it will lead to outcomes that are in the long term interests of consumers. The ERA considers that taking measures to ensure a sustainable competitive environment for the long term outweighs any short term efficiencies that may be said to be lost as a result of such measures.

The ERA considers this is consistent with the Second Reading Speech for the *Electricity Corporations Amendment Bill 2013* in relation to the EGRC Regulations, which noted 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.

As set out in its 2014 Wholesale Electricity Market Report to the Minister for Energy, the ERA considers that structural separation of Synergy would be the best means to facilitate the development of competition and private sector investment in the WEM. However, unless and until such reform occurs, the Scheme will need to ensure that Synergy is not able to exercise market power arising as a result of merging the largest generation and retail businesses in the market, to the detriment of consumers.

The ERA considers this objective must be explicitly included in the Scheme. Without this being made explicit, there is the potential for other considerations to be taken into account, particularly Synergy's financial position, which negates the effectiveness of the Scheme as a market power mitigation measure.

In this review, the ERA has examined how effective the Scheme is in terms of mitigating the increased potential for market power, as discussed above. As this is the first year of review, the ERA has restricted its report to high level issues in relation to achieving a level playing field and ensuring confidence in the market, which it considers needs to be addressed as soon as possible if the Scheme is to be effective in mitigating market power.

## Key Findings

The Scheme is necessary to address the market power arising as a result of the merger of the dominant generator and retailer in the market. The objective should be to mitigate Synergy's market power to ensure a level playing field for competitors and new entrants to the wholesale and retail electricity markets in order to facilitate competition. This objective must be clearly stated in the Scheme.

## Review of the Effective Operation of the Scheme

In undertaking its review, the ERA analysed:

- The regulatory mechanisms prescribed under the Scheme, including:
  - the EGRC Regulations;
  - STP Guidelines; and
  - Standard Product Arrangements; and
- The wholesale trading arrangements and policies produced by Synergy to ensure compliance with the EGRC Regulatory Scheme and provided to the ERA for the purposes of the current review (refer to Appendix 1 for an overview of these documents).

The key findings and recommendations of the review have been summarised below, categorised under the criteria the ERA has adopted to make its assessment:

- Achieving a level playing field; and
- Ensuring confidence in the market.

### Achieving a level playing field

In broad terms, achieving a level playing field means:

- third party competitors are able to buy or sell wholesale electricity on similar terms to the RBU or GBU;
- mechanisms to ensure that discrimination does not occur are in place; and
- the RBU or GBU does not have access to information that is held by the WBU, that is not available to other retailers or generators, or is not available to them in an easily accessible form or in a timely manner.

Each of these is discussed below.

### *Access to Electricity on similar terms*

As noted above, according to the Second Reading Speech one of the main intentions of the Regulatory Scheme was to ensure that the merged entity does not unduly preference its own retail and generation arms over third party retailers and generators.<sup>18</sup>

This intent is reflected in the EGRC Regulations,<sup>19</sup> which requires the WBU to ensure that a wholesale supply of electricity is not offered to the RBU on terms and conditions that are, having regard to all relevant circumstances, more favourable than the terms on which a wholesale supply of electricity is offered to retail or generation competitors.<sup>20</sup>

<sup>18</sup> [http://www.parliament.wa.gov.au/Parliament/Bills.nsf/34142247BD1BD20948257C0600173BB6/\\$File/Bill40-1SR.pdf](http://www.parliament.wa.gov.au/Parliament/Bills.nsf/34142247BD1BD20948257C0600173BB6/$File/Bill40-1SR.pdf)

<sup>19</sup> Refer to Part 3.

<sup>20</sup> Refer to Regulation 22(a).

On the assumption that the WBU would be unlikely to offer less favourable terms and conditions to the RBU, this requirement should ensure that third parties are treated on a similar basis to the RBU. However, the Scheme does not specify the circumstances the WBU should have regard to or how 'relevance' is to be determined. This is particularly difficult, given that the volume of the RBU's customer load is quite different to that of any other retailer in the market.

The Wholesale Supply Policy implemented by Synergy provides some clarity in this regard,<sup>21</sup> though it still provides Synergy with significant discretion in determining whether one wholesale supply offering is more or less favourable than another.

The ERA considers that, given the level of discretion available to Synergy in determining whether one wholesale supply offering is more or less favourable than another, there is a risk that the current arrangements provide the opportunity for Synergy to treat its competitors less favourably. Further guidance should be set out in the Scheme to reduce the level of discretion available to Synergy.

### *Mechanisms to ensure no discrimination*

Mechanisms within the Scheme to ensure that discrimination does not occur include a compliance regime and Standard Product Arrangements, both of which are discussed further below.

#### *Compliance Regime*

The compliance regime requires the Office of the Auditor General (**OAG**) to conduct annual audits to ensure Synergy has complied with the Scheme. This provides comfort that Synergy has followed the processes set out in the Scheme. However, as noted in Alinta's submission, the current arrangements may result in significant delays between an instance of non-compliance and its identification as part of an annual review, resulting in inappropriate or anomalous behaviour impacting the market and persisting for months before it is discovered.

The ERA considers that, if the current arrangements are to continue, consideration should be given to requiring the OAG to report more frequently, if this could be done cost effectively. This could be further enhanced by requiring Synergy to self-report any serious non-compliance as soon as it becomes aware, similar to the current Electricity Licencing regime.

#### *Standard Product Arrangements*

The Scheme has also included Standard Product Arrangements, which were intended to provide a price discovery mechanism. The maximum Buy/Sell spread is specified in the Scheme and was intended to impose pricing discipline on Synergy.

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<sup>21</sup> Refer to section 6.1 of the Wholesale Supply Policy, which notes that when determining pricing and other terms and conditions for a Request for Quote (RFQ), the WBU must: apply a consistent pricing approach between RFQs of a like or similar nature, including taking into account all relevant circumstances of these RFQs, including but not limited to, volume, period and terms and conditions; take into account relevant internal WBU circumstances including but not limited to, contracted position, plant and fuel availability and available generating capacity; and take into account market conditions or any other conditions considered to be relevant.



The ERA agrees that Standard Products could provide a valuable tool to ensure there is no non-discriminatory behaviour and therefore facilitate competition in the market. However, the current Standard Products appear underutilised.

The Wholesale Advisory Group's (**WAG**) Discussion Paper on Hedge Market Development in the New Zealand electricity market<sup>22</sup> notes that an effective Standard Product market would allow independent generators and retailers to enter the electricity market, and support all generators and retailers in expanding their presence, as they are better able to manage their exposure to electricity price risk. This places important competitive discipline on incumbents, driving innovation and efficiency, and hence lower prices for consumers. Liquidity in contracting helps to provide a robust view of forward prices.<sup>23</sup> High liquidity ensures efficient price discovery and makes it easier to trade at a competitive price.

Concerns have been raised by stakeholders in relation to the type of Standard Products offered, and the take-up to date has been almost non-existent. The number of Standard Product transactions (i.e., eight between 6 August 2014 and 2 December 2014) has been relatively limited and restricted to sell transactions. There have been no transactions since 2 December 2014.<sup>24</sup>

Presentations given by the Merger Implementation Group (**MIG**) note that it selected small contractual volumes of 1 MW, which it considered would lower the effective cost for smaller participants and new entrants. The MIG also intended that the prescribed volume limits would be used to control Synergy's risk exposure and maintain liquidity. Basing the range and quantity of products offered on the requirements of a limited segment of the market (i.e., small retailers), and ensuring Synergy's risk was minimised, has resulted in products that do not meet the general needs of the market. As a result, the Standard Products do not provide any meaningful price discovery.

Concerns were also raised by Stakeholders in relation to the large size of the buy/sell spread, particularly in comparison to that observed in other markets, in particular the New Zealand ASX, which is around five per cent.<sup>25</sup>

In developed and liquid markets, buy/sell spreads are set by market forces. In the absence of such competition, the Standard Product regime specifies the maximum spread.

There is an optimal spread that would exist in a workably competitive market. A spread that is higher than this enables Synergy to exercise its market power by pricing the standard product such that it sells at a higher price, and/or buys at a lower price than is efficient. The current spread of 20 per cent is significantly higher than those seen in competitive energy markets such as the NEM.

According to presentations made by the MIG, the buy/sell spread for the Standard Product Arrangements was estimated based on the average buy/sell spreads in the STEM (average spread in 2013 of 10 to 40 per cent) and the NEM futures market (March 2014 average peak maturity spread of less than 8 per cent, and an average base maturity spread of less than 2 per cent). Consideration was also given to the anticipated activity within the regime

<sup>22</sup> <https://www.ea.govt.nz/development/work-programme/wholesale/hedge-market-development/consultations/#c14195>

<sup>23</sup> Other benefits may include improved fuel management, plant operating and generation investment decisions; and improved demand side operating and investment decisions.

<sup>24</sup> This date is roughly coincident with the publication on line of Alinta Energy's Exchange for trading in Fixed Forward Standard Products. Information relating to the number and volume of particular transactions on Alinta Energy's Exchange is not publicly available.

<sup>25</sup> [http://www.emi.ea.govt.nz/Datasets/Browse?directory=%2FWeekly\\_electricity\\_hedge\\_contracts\\_reports&parentDirectory=%2FDatasets%2FForward\\_markets](http://www.emi.ea.govt.nz/Datasets/Browse?directory=%2FWeekly_electricity_hedge_contracts_reports&parentDirectory=%2FDatasets%2FForward_markets)

and Synergy's risk exposure. The MIG noted that its decision took into account the fact that less liquid markets tend to have wider buy/sell spreads.

The ERA considers that the decision to select a larger spread appears to have been influenced more by the Government's need to manage Synergy's risk exposure than by the desire to ensure price efficiency. A review is needed to establish the level at which Synergy would be required to price efficiently.

In summary, the ERA considers that an effective Standard Product Arrangement would require:

- a sufficient range and quantity of products. Price discovery can only be achieved if the range of products offered adequately reflects the type of product generally required by retailers; and
- a buy/sell spread sufficiently low to ensure Synergy prices efficiently.

### ***Access to Information***

During the consultation, stakeholders also raised concerns that the ring-fencing arrangements were not strong enough to ensure the RBU does not have access to any information that would provide it with an unfair advantage in winning contracts, thereby reducing competition. These concerns related particularly to fuel information. The ERA considers the ring-fencing arrangements should be reviewed to ensure the retail business does not have access to fuel information, or any other information, that is held by the WBU and that is not available to other retailers.



## Key Findings

Providing a level playing field, with third parties treated on an equal basis to Synergy's retail and generation business units, is key to facilitating competition. A number of improvements are required to ensure this:

- The Scheme currently provides Synergy with significant discretion for determining whether a supply is discriminatory. Further guidance should be set out in the Scheme to remove this discretion.
- Potentially there could be a substantial lag between discriminatory behaviour occurring and it being reported. The collection of information related to annual reviews or audits should occur on a more frequent basis, to monitor performance and compliance. This could be further enhanced by requiring Synergy to self-report any non-compliance, with penalties if it fails to do so, similar to the current Electricity Licencing regime
- The Standard Product Arrangements could provide a useful tool for price discovery and imposing pricing discipline on Synergy. However, the current arrangements appear to have been developed with the risk to Synergy's financial position being the primary consideration. This has resulted in products that are underutilised and unlikely to have resulted in any real pricing discipline being imposed on Synergy. An effective Standard Product Arrangement would require a:
  - Sufficient range and quantity of products. Price discovery can only be achieved if the range of products offered adequately reflects the type of product generally required by retailers; and
  - A buy/sell spread sufficiently low to ensure Synergy prices efficiently.
- The ring-fencing arrangements should be reviewed to ensure the retail business does not have access to fuel information, or any other information, that is held by the WBU and that is not available to other retailers.

## Confidence in the Market

To encourage continued private sector investment, it is critical that existing and potential participants have confidence in the market. Ensuring confidence requires clarity and transparency in the arrangements. There also needs to be confidence that the Scheme will ensure efficient pricing outcomes.

### *Transparency of Regulations*

The Council of Australian Government's (**COAG**) guide to Best Practice Regulation notes that incomplete information is one of the main forms of market failure.<sup>26</sup> COAG's guide to Best Practice Regulation also notes that, where possible, regulations should be drafted in plain language to improve clarity and simplicity, reduce uncertainty, and enable the public to better understand the implications of the regulatory measures.<sup>27</sup>

Transparency is essential for the creation of efficient and competitive wholesale markets, and for restricting the scope for the abuse of market power. Transparency allows for regulatory and public scrutiny that makes it easier to prevent or detect an abuse of market power, and it reduces the perceived risk of an abuse of market power.

The ERA considers that transparency is particularly important in a market that is heavily dominated by a government entity. The ERA considers that the combination of Government conflict, due to it being both owner and policy setter, and the lack of transparency surrounding the merger arrangements, has contributed to scepticism amongst stakeholders about both Synergy's behaviour and the validity of the Scheme.

The ERA considers there is a lack of clarity in the drafting of the EGRC Regulations. The Scheme also permits significant asymmetry in access to information, to Synergy's potential advantage. For example:

- the Scheme requires Synergy to develop written arrangements that set out the terms and conditions that are to apply to wholesale transactions with third parties, but does not oblige it to publish those arrangements, which results in a lack of transparency to others participating in the market; and
- the Credit Policy established by Synergy requires competitors to divulge their commercial positions to Synergy, before they are approved to bilaterally trade with Synergy, and at least every 12 months after that. Thus, unlike others in the market, Synergy has full view of the commercial positions of the majority of the Market Participants.

In markets where one party in a transaction has significantly more information than another, resources may not be allocated efficiently.<sup>28</sup> In such markets, sellers and buyers may be incentivised to conceal information in order to obtain a more favourable price or terms and conditions.

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<sup>26</sup> [https://www.coag.gov.au/sites/default/files/coag\\_documents/COAG\\_best\\_practice\\_guide\\_2007.pdf](https://www.coag.gov.au/sites/default/files/coag_documents/COAG_best_practice_guide_2007.pdf)

<sup>27</sup> [https://www.coag.gov.au/sites/default/files/coag\\_documents/COAG\\_best\\_practice\\_guide\\_2007.pdf](https://www.coag.gov.au/sites/default/files/coag_documents/COAG_best_practice_guide_2007.pdf)

<sup>28</sup> [https://cuttingredtape.gov.au/sites/default/files/documents/australian\\_government\\_guide\\_regulation.pdf](https://cuttingredtape.gov.au/sites/default/files/documents/australian_government_guide_regulation.pdf)

## Transparency and Efficiency of Prices

During the consultation, a number of stakeholders raised concerns in relation to Synergy's retail prices. They are concerned that the RBU is selling energy to its customers below the price it is charged by the WBU. Stakeholders consider Synergy is able to do this because it can use the TAP to subsidise this behaviour.

It is not apparent to the ERA whether or not this is the case, but it is likely that the general lack of transparency in the setting of Synergy's retail tariffs and the TAP has played a significant part in raising such concerns. Retail pricing falls outside the current scope of the Scheme and the ERA notes that the potential for subsidisation existed prior to the merger. However, stakeholders' concerns that subsidisation is occurring appears to have adversely impacted the confidence stakeholders have in the Scheme. Consideration should therefore be given to improving transparency of the retail pricing process and ensuring there is no potential for subsidisation of Synergy's contestable business via the TAP.

The ERA also has concerns in relation to the process for setting prices for Foundation Customers, which may be resulting in inefficient retail tariffs. At the time of the merger, both Verve Energy and Synergy had contracts with third party generators and retailers. Clearly, it was necessary for the merged entity to honour existing arrangements with third parties and these contracts are now managed within the WBU.

It would appear that energy previously supplied by Verve to Synergy under the Revised Vesting Contract has also continued to be priced on the same basis following the merger. As set out in clause 2.2(e) of the STP Guidelines, the Foundation Transfer Price Mechanism must:

provide for a foundation transfer price for electricity (in \$/MWh) in a Trading Interval which is consistent with the modelled cost of electricity to the Electricity Retail Corporation in that Trading Interval based on—

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.

As noted in its 2011 *Inquiry into Synergy's (Electricity Retail Corporation's) Efficient Costs and Tariffs*,<sup>29</sup> the ERA found that the Revised Vesting Contract was not efficiently procured and raised Synergy's costs above efficient levels.

The ERA considers that a scenario in which the RBU is potentially paying wholesale prices above efficient costs in relation to Foundation Customers could be resulting in the RBU's costs being overstated and the TAP (which is based on the difference between Synergy's costs and the revenue it collects from customers) being higher than it otherwise needs to be.

The ERA notes that the Foundation Transfer Price Mechanism is not due for review until 2017 and recommends the review should be undertaken as soon as possible to ensure the RBU's costs are based on efficient wholesale costs.

<sup>29</sup> Economic Regulation Authority, *Synergy's Costs and Electricity Tariffs Final Report*, 4 July 2012, p. 16. <https://www.erawa.com.au/cproot/10639/2/20120704%20Synergys%20Costs%20and%20Electricity%20Tariffs%20-%20Final%20Report.PDF>

## Key Findings

Transparency is essential for the creation of efficient and competitive wholesale markets.

The ERA considers that amendments are required to improve transparency and require all policies and information required under the Scheme be published.

Stakeholders have raised concerns in relation to Synergy's retail prices. A lack of transparency in the process for setting Synergy's retail tariffs, including the basis of the Tariff Adjustment Payment (**TAP**), has contributed to these concerns.

The Foundation Transfer Price Mechanism should be amended as soon as possible to ensure it is based on efficient costs.

## Appendix 1 Overview of the EGRC Regulatory Scheme

The ERA has drawn from the components of the Scheme, and various other sources (e.g., material provided by Synergy, Synergy's website and Annual Report, and presentations by the MIG), to provide an overview of how the components of the Scheme, and the arrangements implemented by Synergy, operate.

### 1.1 EGRC Regulations

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

#### 1.1.1 Segregation Requirements

##### 1.1.1.1 Division of EGRC Operations into Segments

The EGRC Regulations specifically require that Synergy's operations are divided into segments:

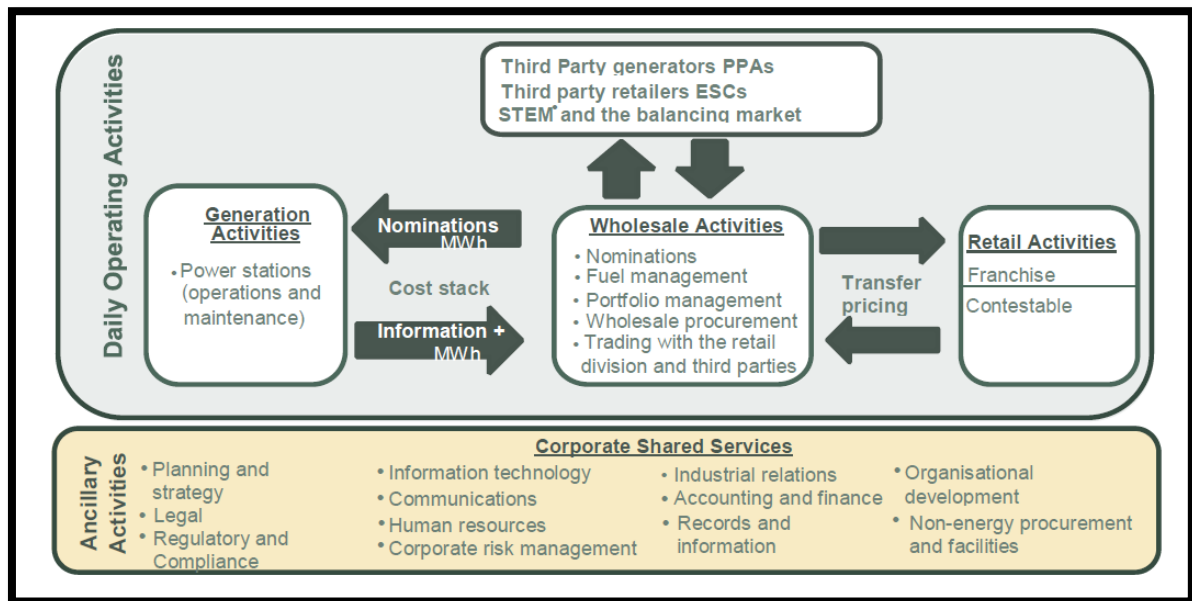
- the Generation Business Unit (**GBU**), comprising operations involving the construction or operation of generating works;
- the Wholesale Business Unit (**WBU**), involving the wholesale acquisition or supply of electricity and the acquisition or supply of wholesale products, including pricing in respect of such acquisition or supply;
- the Retail Business Unit (**RBU**), involving the pricing, sale and marketing of electricity to customers served by the SWIS;<sup>30</sup>
- shared services operations, including operations relating to corporate planning and strategy, organisational development, accounting, financial and legal matters, human resources, information technology support regulatory and compliance matters, communications, billing, and record keeping. It also includes any other operations undertaken in connection with 2 or more business units, excluding generation operations, wholesale operations and retail operations; and
- any additional segment(s) approved by the Minister.

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

A chart was presented by the MIG at a Market Participant and stakeholder briefing session on 5 December 2013. The chart sets out high level details of the new structure, as shown in Figure 1 below.

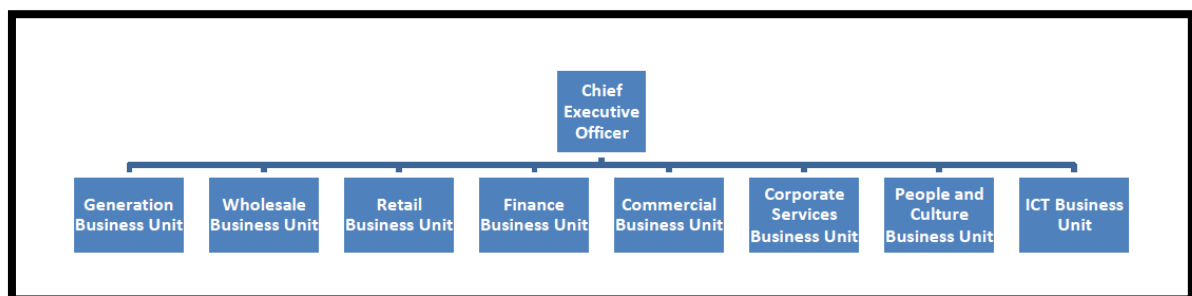
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<sup>30</sup> The SWIS includes the interconnected transmission and distribution systems, generating works and associated works, located in the South West of the State and extending generally between Kalbarri, Albany and Kalgoorlie.



**Figure 1 High Level Details of the New Structure Presented by the MIG**

A model illustrating the new structure (refer to adapted model in Figure 2 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.



**Figure 2 Synergy's New Structure, adapted from Synergy's 2014 Annual Report**

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.

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 WBU 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 WBU, for the procurement of new long-term fuel supply arrangements.

### *1.1.1.2 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 information<sup>31</sup> must not be disclosed to retail staff and generation restricted information<sup>32</sup> 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
- the separation of management roles between the Retail, Wholesale and Generation Business Units.

<sup>31</sup> 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.

<sup>32</sup> 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.



## 1.1.2 Wholesale Trading Requirements

### 1.1.2.1 Supply Arrangements

The EGRC Regulations set out the requirements for the four types of wholesale supply arrangements under the Scheme, involving the WBU, including:

- WBU provides wholesale supply to RBU, for retail supply to Foundation Customers;
- WBU provides wholesale supply to RBU, for retail supply to New Contestable Customers;<sup>33</sup>
- WBU provides wholesale supply of Customised Products to RBU, or other retail competitor or generation competitor; and
- WBU provides wholesale supply of Standard Products to other retail competitor or receives wholesale supply of Standard Products from other generation competitor.

#### Internal Synergy Wholesale Arrangement

In relation to the first dot point above, the EGRC Regulations require that Synergy has a written arrangement in place, before any supply transaction is entered into between the WBU and the RBU, for a retail supply of electricity to a customer otherwise than under a new contestable customer arrangement. This written arrangement must state that the transfer price under this arrangement is the foundation transfer price i.e., the price determined for that supply in accordance with the Foundation Transfer Price Mechanism<sup>34</sup>.

To address this requirement, Synergy has implemented the Internal Synergy Wholesale Arrangement (**ISWA**). This arrangement is made 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 regulation 9(1) and (2) of the EGRC Regulations. Section 2 of the STP Guidelines also applies, with prices determined in accordance with clause 2.2(e) and energy forecasting and nominations made in accordance with 5.1(3) and 5.1(4).

#### New Load Wholesale Arrangement

Similarly, in relation to the second dot point above, 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

<sup>33</sup> A new contestable customer arrangement is an arrangement between Synergy and a contestable customer that imposes a legal obligation on the EGRC to supply electricity to the contestable customer on a retail basis and becomes legally binding on Synergy after the merger time.

<sup>34</sup> According to the MIG, the foundation transfer pricing mechanism covers franchise tariffs, contestable tariffs, and existing contestable contracts up to their expiry (including contracts signed prior to 1 January 2014, where supply had commenced; contracts signed prior to 1 January 2014, where supply had not yet commenced; formal contract offers made by Synergy prior to 1 January 2014, which the customer accepted prior to 1 April 2014; and any contractual options contained within the aforementioned agreements). [http://www.finance.wa.gov.au/cms/uploadedFiles/Public\\_Utility\\_Office/Synergy\\_and\\_Verve\\_Energy\\_Merger/Market-participants-and-stakeholder-briefing-session-December-2013.pdf](http://www.finance.wa.gov.au/cms/uploadedFiles/Public_Utility_Office/Synergy_and_Verve_Energy_Merger/Market-participants-and-stakeholder-briefing-session-December-2013.pdf)



price (i.e., referred to as an 'Additional Transfer Price Mechanism' under the STP Guidelines).

To address this requirement, Synergy has implemented the New Load Wholesale Arrangement (**NLWA**). This arrangement is produced in accordance with regulations 9(3) and 9(4) of the EGRC Regulations, and section 4 of the STP Guidelines.

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

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

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

The Master Bilateral Trade Agreement addresses regulation 9(6) and is used in the RFQ process for trading in customised products, including the bilateral trade of electricity, Capacity Credits and Contracts for Differences.

The Bilateral Trade Agreement (Standard Products) provides for trading in Standard Products, and addresses requirements in the *Electricity (Standard Products) Wholesale Arrangements 2014* and regulation 9(6). The Bilateral Trade Agreement (Standard Products) is publicly available from Synergy's website.<sup>35</sup>

#### **1.1.2.2 Wholesaling Obligations**

The EGRC Regulations prohibit Synergy from:

- discriminating between its RBU and competitors when offering wholesale supplies; and
- from taking into account the financial interests of the RBU in determining the terms and conditions on which a wholesale supply of electricity is offered to retail or generation competitors.<sup>36</sup>

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 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.

<sup>35</sup> <http://wholesale.synergy.net.au/Documents/EGRC%20Standard%20Product%20Agreement.pdf>

<sup>36</sup> 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.

Synergy has published a Wholesale Electricity Supply Policy<sup>37</sup> and a Wholesale Energy Credit Policy.<sup>38</sup>

Together, the two policies:

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

### 1.1.2.3 Synergy Wholesale Electricity Supply Policy

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

### 1.1.2.4 Synergy Wholesale Energy Credit Policy

Synergy's Wholesale Energy Credit Policy was also implemented to meet the requirements of Regulation 23, and sets out the credit processes to be followed for Wholesale Energy Trading Activities with Approved Counterparties, including activities between the WBU and the RBU).

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

### 1.1.2.5 Synergy Wholesale Trading Policy

Synergy has also developed a Wholesale Trading Policy that is not required under the EGRC Regulations. This policy is a self-regulatory mechanism that all personnel involved in Wholesale Trading Activities have been required to comply with from 1 January 2014. The Policy is intended to establish effective and appropriate mechanisms for the governance of Wholesale Trading Activities through the definition of roles and operating procedures, including approval of specified trading commodities and instruments and delegated financial authority. The policy does not apply to energy trading between the WBU

<sup>37</sup> [http://www.synergy.net.au/docs/VMI\\_EGRCWholesaleElectricitySupplyPolicy.pdf](http://www.synergy.net.au/docs/VMI_EGRCWholesaleElectricitySupplyPolicy.pdf)

<sup>38</sup> [http://www.synergy.net.au/docs/VMI\\_EGRCWholesaleEnergyCreditPolicy.pdf](http://www.synergy.net.au/docs/VMI_EGRCWholesaleEnergyCreditPolicy.pdf)

and the GBU and is not binding on any subsidiary of Synergy, nor any other entity in which Synergy holds an interest.

The Trading and Risk Management Committee (TRMC) must provide positive confirmation of compliance with this policy to the Audit and Risk Management Committee (ARMC), on at least a quarterly basis.

#### 1.1.2.6 Synergy Ring Fencing Policy

The ERA notes, from its review of Synergy's Wholesale Energy Credit Policy, that Synergy has also voluntarily developed an internal Ring Fencing Policy.<sup>39</sup>

### 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:

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

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

The Auditor General must then give a copy of the reports to both the board of the EGRC and to the ERA, as soon as practicable after the report is given to the Minister. The Auditor General's reports are required to be tabled 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.

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;

<sup>39</sup> Synergy's Wholesale Energy Credit Policy, section 1.2 notes that the Credit Policy "should be read with the Wholesale Electricity Supply, Ring Fencing and Wholesale Trading Policies."

- 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.<sup>40</sup>

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 the current report.

## 1.2 STP Guidelines

As noted above, the EGRC Regulations require:

- Preparation by Synergy of the Foundation Transfer Price Mechanism (i.e., the instrument by which the Foundation Transfer Price is determined), and revisions to, or replacement of the Foundation Transfer Price Mechanism. This instrument must be given to the Minister (at which time it comes into force) and remains in force until 30 June 2017 or a later day approved in writing by the Minister.
- Preparation by Synergy of the Additional Transfer Price Mechanisms (i.e., the mechanism 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 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.<sup>41</sup> Among other things, the

<sup>40</sup> That is, they are returned to Treasury and not retained by the ERA.

<sup>41</sup> 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>

STP Guidelines set out the requirements applicable to the Foundation Transfer Price Mechanism and the Additional Transfer Price Mechanisms.

The Foundation Transfer Price Mechanism determines the transfer price for the wholesale supply of electricity by the WBU to the RBU, for the purposes of a retail supply of electricity to a Foundation Customer. Under the Guidelines, the Foundation Transfer Price Mechanism must:

- establish terms and conditions to apply to supply transactions for the purposes of retail supply of the foundation load;<sup>42</sup>
- 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 only supply electricity to the RBU 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 2017;<sup>43</sup> and
- a procedure to apply in wholesale force majeure events.

In relation to the Additional Price Mechanism, the STP Guidelines require the RBU to establish a procedure for making nominations in respect of each Trading Interval and prohibit the RBU from supplying electricity to the WBU.

The STP Guidelines also include requirements in respect to 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.

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

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

<sup>42</sup> In respect of a period, the foundation load is the aggregate quantity of electricity in MWh consumed during that period by the Foundation Customers.

<sup>43</sup> 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](http://www.treasury.wa.gov.au/cms/uploadedFiles/Treasury/State_finances/2013_14_midyear_review.pdf)

## 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.

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, Synergy must publish and update, on a monthly basis, information on price trends for Transactions in Standard Products.

Synergy is also required to develop and publish details of its procedures for entering into a Standard Product Agreement with an Approved Counterparty. A number of publicly available procedures have been produced by Synergy to address this requirement,<sup>44</sup> 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;<sup>45</sup>
- 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.

Details of the Standard Products offered by Synergy and any transactions entered into can be found on its website.<sup>46</sup>

<sup>44</sup> Refer to the Standard Product Homepage for access to these procedures:  
<http://wholesale.synergy.net.au/SitePages/Home.aspx>

<sup>45</sup> 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>

<sup>46</sup> <http://wholesale.synergy.net.au/SitePages/Home.aspx>