

2015 Annual Report to the Minister for Energy on the Effectiveness of the EGRC Regulatory Scheme

Discussion Paper

November 2015

Economic Regulation Authority

WESTERN AUSTRALIA

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Invitation to make submissions

With the merger of Verve Energy and Synergy on 1 January 2014, the Government put in place regulations (**EGRC Regulatory Scheme**) to impose requirements on Synergy, including ring-fencing, business segregation, transfer pricing and non-discriminatory wholesale electricity trading.

The Economic Regulation Authority (ERA) is required to review the operation of the EGRC Regulatory Scheme for the purpose of assessing its effectiveness, at least annually. The ERA must provide a report to the Minister for Energy, including any recommendations it has concerning amendment to the EGRC Regulatory Scheme.

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.

Interested parties are invited to make submissions on the ERA's consultation paper by **4:00 pm (WST) Monday, 21 December 2015** 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

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CONFIDENTIALITY

In general, all submissions from interested parties will be treated as being in the public domain and placed on the 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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1 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.

As recognised by the Government, merging the generation and retail businesses without imposing restrictions potentially provided 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.

Consequently, the *Electricity Corporations (Electricity Generation and Retail Corporation) Regulations 2013* (**EGRC Regulations**) were put in place by the Government to impose requirements on Synergy including ring-fencing, business segregation, transfer pricing and non-discriminatory wholesale electricity trading.

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

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. Submissions from interested parties on issues impacting the effectiveness of the WEM will assist the ERA in preparing its 2015 Report.

The Report will be provided to the Minister following consideration of the submissions received in response to this Discussion Paper and further analysis. The Minister is required to lay the report before each house of Parliament within 21 sitting days after the day on which the Minister receives the report.

1.1 EGRC Regulatory Scheme Overview

The EGRC Regulatory Scheme comprises the following:

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

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

Synergy must not discriminate between the RBU and competitors when offering wholesale supplies, in relation to price and the terms and conditions. It is also required to offer specified standard wholesale products to both buy and sell energy.

The Scheme includes compliance and review provisions. Compliance with the Scheme is monitored by the Auditor General, who is required to conduct annual audits. The Auditor

General assesses whether Synergy has complied with the requirements specified in the EGRC Regulations. Any non-compliance reported by the Auditor General must be investigated by the ERA¹.

The ERA is required to review the operation of the Scheme for the purposes of assessing its effectiveness at least once each year. The EGRC Regulations do not specify any criteria for how this assessment must be made.

A more detailed description of the Scheme is set out in Appendix 1.

1.2 Reporting requirements

In carrying out its 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.

1.3 Summary of the 2014 Report

2014 was the first year of the operations of the merged entity; Synergy. Accordingly, in its first review of the effectiveness of the EGRC Regulations, the ERA focussed on fundamental design issues of the scheme which needed to be addressed as soon as possible to ensure the Scheme was effective.

The ERA considered the lack of a stated objective for the Scheme reduced its effectiveness. Consistent with the Government's stated intentions when introducing the Scheme,² the ERA took the view that the primary purpose of the Scheme was to mitigate the increased potential for exercising market power, which arises due to the merger of Synergy, by ensuring a level playing field for competitors and new entrants, in order to facilitate competition.

The ERA recommended this objective should be made explicit in the Scheme. Without this, the ERA considered there was the potential for other considerations to be given precedence, such as Synergy's financial position, which negates the effectiveness of the Scheme as a market power mitigation measure.

¹ 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.

² The Second Reading Speech for the Electricity Corporations Amendment Bill 2013 in relation to the EGRC Regulations 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".

In addition, the following issues and improvements were identified:

- Include greater prescription in the Scheme to ensure there is no discrimination between the RBU and third parties in relation to price and other terms and conditions;
- Increase the control of information flow to ensure Synergy's retail business only has access to wholesale pricing information available to other retailers;
- Increase the transparency of Synergy's pricing and terms by requiring it to publish all of its relevant policies and procedures; and
- Increase co-ordination between the compliance audits undertaken by the OAG and the operational effectiveness review of the ERA, and introduce requirements for Synergy to self-report any breaches.

Although the ERA considered the Standard Products could provide a useful tool for price discovery and imposing pricing discipline on Synergy, further enhancement is needed to the Standard Products to meet these objectives. The following improvements were suggested:

- expand the range and quantity of standard products; and
- review the spread between the buy and sell prices offered by Synergy.

During the review, concerns were raised by stakeholders that Synergy was subsidising its retail contestable business via the Tariff Adjustment Payment (TAP).³ The ERA recommended increasing the transparency of Synergy's retail pricing process to provide confidence to stakeholders that there is no cross subsidisation.

The report was tabled in Parliament by the Minister on 25 June 2015 and is available on the ERA's website.

1.4 Approach and focus for the 2015 review

As the Scheme has now been in operation for nearly two years, significantly more information, including trends in retail market share, is available to the ERA in undertaking its review, so it will be able to undertake a more detailed analysis than was the case in 2014.

As stated in the 2014 Report, the ERA considers that an explicit statement of the objective of the Scheme is necessary to ensure its effectiveness. Specifying an objective against which it can be measured is also necessary for the purposes of assessing how effective the Scheme has been. For the 2015 review, the ERA intends to continue to assess the effectiveness of the Scheme based on the objective developed in last year's report; that is, how effective the Scheme is in mitigating the increased potential for exercising market power, which arises due to the merger of Synergy and Verve, by ensuring a level playing field for competitors and new entrants, in order to facilitate competition.

The ERA will review the framework of the Scheme to assess whether it fully addresses the increased potential for exercising market power which arises due to the merger. This will include revisiting the recommendations the ERA made in its 2014 review and considering them in light of how the Scheme has operated since the last review.

³ The subsidy paid by Government to Synergy due to tariffs for non-contestable customers being below cost reflective levels.

The ERA also intends to undertake further work in relation to assessing the level of competition in the wholesale and retail markets and improvements to the Standard Product arrangements as set out below:

Level of competition in the wholesale and retail markets

There is significant interaction between the wholesale and retail markets, with the effectiveness of competition in either market being impacted by the other. Whilst the Scheme is primarily focussed on ensuring a level playing field in wholesale energy, the interactions between wholesale and retail markets need to be taken into account when assessing how effective the Scheme is. For the 2015 review, the ERA intends to review the current level of competition in both the wholesale and retail markets as part of its assessment of how effective the Scheme has been. This review overlaps with the ERA's requirements under the Wholesale Electricity Market Rules to monitor the effectiveness of the market in meeting the Market Objectives.

Standard Products

Effective competition in the retail market is reliant both on Synergy not discriminating between the RBU and third parties (which the Scheme seeks to ensure) and for those non-discriminatory wholesale prices to be set appropriately. Synergy controls a significant portion of generation in the WEM either through direct ownership or contractual arrangements. The Scheme seeks to address this potential for exercising market power in relation to wholesale prices by requiring Synergy to offer Standard Products and specifying the maximum buy/sell spread. For the 2015 review, the ERA intends to focus on the buy/sell spread and how effective the mechanism is in imposing discipline on Synergy's wholesale pricing.

Each of these is discussed in more detail in the following sections.

2 Framework for an effective EGRC Regulatory Scheme

As outlined above, the ERA considers the objective of the Scheme is to ensure a level playing field for competitors and new entrants and to provide confidence to market participants to encourage participation in the market. The ERA proposes assessing the effectiveness of the Scheme in meeting this objective.

Level Playing Field

In broad terms, the ERA considers achieving a level playing field means:

- third party competitors are able to buy or sell wholesale electricity on the same or similar terms to the RBU or GBU; 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.

As set out in the 2014 report, the ERA has identified a number of specific areas where it considers improvements could be made to ensure a level playing field:

- The Scheme requires the 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.
- As audits are conducted on an annual basis, potentially there could be a substantial lag between discriminatory behaviour occurring and it being reported.
- The ring-fencing arrangements may not be sufficiently robust to ensure the RBU does not have access to any information held by the WBU that is not available to other retailers.
- Stakeholders also raised concerns that Synergy was subsidising its contestable business via the TAP. The potential for cross subsidisation arises as a result of Synergy being the sole supplier for customers using less than 50 megawatt hours per year, and the tariffs for those customers being set (and subsidised) by government.

Confidence to Market Participants

To encourage continued private sector investment, existing and potential participants need to 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. In markets where one party in a transaction has significantly more

information than another, resources may not be allocated efficiently.⁴ In such markets, sellers and buyers may be incentivised to conceal information in order to obtain a more favourable price or terms and conditions.

The Scheme includes a number of measures in relation to ensuring transparency. These include:

- Requiring Synergy to develop a number of policies and procedures. However, not all of these documents are required to be published.
- Reporting segmented financial information.
 - The Scheme requires Synergy to prepare separate statements of financial performance for each of its segmented business units for inclusion in its Quarterly and Annual Reports. Under the Act, the Minister, in consultation with the EGRC Board, is then required to make these reports publicly available. Potentially, these segmented financial reports could significantly increase the transparency of the Scheme and provide confidence to stakeholders that there is no cross subsidisation and that Synergy is pricing both its wholesale and retail supplies appropriately. The format of the financial statements is not specified in the Scheme, which only requires compliance with AASB 8, which has very broad requirements.
 - The ERA notes Synergy's 2014 and 2015 Annual Reports included a segment reporting note. Whilst the format of the 2015 note provided more detail than was included in the 2014 Annual Report, the level of detail was fairly limited and did not separate the gas business. The current note is prepared on a group basis (i.e. includes subsidiary companies). Providing the segment report on a corporation basis and expanding the detail could potentially increase the usefulness of the information. For example, reporting separately on the contestable and non-contestable retail business potentially could increase confidence that there is no cross subsidisation between these customer groups and provide more confidence that wholesale prices are cost reflective.

In this review, the ERA intends to review how effective the Scheme has been in achieving a level playing field and providing confidence to market participants. The ERA would welcome any information from stakeholders in relation to their practical experience of the Scheme or any suggestions stakeholders may have in relation to improving the Scheme.

⁴ https://cuttingredtape.gov.au/sites/default/files/documents/australian_government_guide_regulation.pdf

3 Assessment of wholesale and retail market competition

The EGRC Scheme has an important role to play in terms of mitigating any market power Synergy may have in relation to wholesale energy and ensuring a level playing field for all retailers. A competitive retail market is dependent on retailers being able to access competitive wholesale energy supplies. In turn, a competitive wholesale energy market is underpinned by retailers seeking wholesale supplies. The effectiveness of competition in either market is impacted by the other.

In Western Australia, the level of competition varies across the retail and wholesale markets. In the case of energy wholesale supplies, Synergy continues to be the largest supplier. As noted in its 2015 Annual Report, Synergy supplied 74 per cent of the total wholesale market, either through its own generation or via long term contracts with other generators.

In the retail market, Synergy's 2015 Annual Report notes it supplied 61 per cent of the total market. This includes both the non-contestable market, of which Synergy has 100 per cent coverage, and the contestable market where its market share in 2012/13 was reported as being around 38 per cent.⁵

Since the WEM commenced in 2006, the retail contestable market has become increasingly competitive with many new retailers, particularly in the last few years, successfully entering the market. Currently customers using less than 50 megawatt hours per year can only be supplied by Synergy. The Government has signalled its intent to introduce full retail contestability in the next few years. This will provide significant opportunity for further increasing the competitiveness of the WEM and retail markets.

The ERA intends to undertake a review of the current level of competition in both the wholesale and retail markets, including changes in market share in the contestable market. This will enable the ERA to more fully assess the effectiveness of the EGRC Regulatory Scheme in mitigating any market power Synergy may have (i.e. both wholesale and retail markets) and, to what extent, if any, additional measures may be required. This review overlaps with the ERA's requirements under the Wholesale Electricity Market Rules to monitor the effectiveness of the market in meeting the Market Objectives.

In undertaking its assessment of the current level of competition in both the retail and wholesale markets, the ERA intends to give consideration to:

- The level of customer activity in the market;
- Barriers to entry – including reviewing the options available to retailers to source wholesale energy, including from the Balancing and STEM markets as well as from the contract market;
- Contract market liquidity;
- The level of rivalry amongst retailers (including discounting and innovation of products offered); and

⁵ Derived from Figure 12, page 24 of http://www.finance.wa.gov.au/cms/uploadedFiles/Public_Utility_Office/Electricity_Market_Review/Electricity-Market-Review-Options-Paper-December-2014.pdf

- Symptoms of any anomalous pricing behaviour (for example, cross subsidisation).

The ERA invites stakeholders to comment on what factors should be considered in its review of retail and wholesale competition and would welcome any information stakeholders may be able to provide.

4 Standard Products

In the WEM, retailers can acquire capacity from the IMO at a fixed price, and wholesale energy can be purchased as required from the Short Term Energy Market (**STEM**) and Balancing Market. Energy prices are limited by a price cap. Nevertheless, retailers are exposed to short term variations in energy prices (up to the level of the price cap) unless they can access longer term contracts. If retailers are not 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 with those who can. It can also be a barrier to entry or expansion in the retail market.

Standard Products enable 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. Liquidity in contracting helps to provide a robust view of forward prices.⁶ High liquidity ensures efficient price discovery and makes it easier to trade at a competitive price.

The Scheme includes requirements for Synergy to offer defined Standard Products and specifies the maximum Buy/Sell spread. In addition to providing retailers with a simple mechanism for procuring wholesale energy, the Standard Product Arrangements included in the Scheme were intended to provide a price discovery mechanism in relation to customised products. Specifying the maximum buy/sell spread in the Scheme was intended to impose pricing discipline on Synergy.

The ERA agrees that Standard Products could provide a valuable tool for price discovery and efficient wholesale pricing in relation to Synergy. Trading in the Standard Products has been limited with only 14 transactions since the market commenced in July 2014. This may either indicate retailers have been able to source their energy requirements through customised products or, alternatively, that the Standard Products offered are not working effectively.

As set out in its 2014 report, the ERA considers an effective Standard Product Arrangement would require:

- Sufficient range and quantity of products; and
- Setting the maximum range between the price Synergy buys and sells energy for (i.e. the buy/sell spread) at a level that facilitates price discovery and ensures Synergy prices efficiently. There is an optimal spread that would exist in a workably competitive market. Any spread that is higher than this optimal level could potentially enable Synergy to price the standard products such that it sells at a higher price, and/or buys at a lower price than is efficient. Alternatively, a spread lower than this optimal level could lead to Synergy pricing below the efficient level and effectively subsidising other retailers.

In this review, the ERA intends to focus on the buy/sell spread. As noted above, specifying the maximum buy/sell spread in the Scheme was intended to impose pricing discipline on Synergy. Ensuring the spread is set at an optimal level ensures Synergy is not able to exercise market power when setting either the buy or sell price. The ERA will seek to develop an appropriate methodology for determining the buy/sell spread. It will also give further consideration to, assuming an appropriate spread is set, how effective the Standard Products can be in terms of mitigating any market power Synergy may have in relation to

⁶ Other benefits may include improved fuel management, plant operating and generation investment decisions; and improved demand side operating and investment decisions.

pricing wholesale energy, or whether additional measures are needed to ensure Synergy prices its wholesale energy appropriately.

The ERA would welcome any information from stakeholders in relation to their practical experience of the Standard Products or any suggestions stakeholders may have in relation to improving the Standard Products, particularly in relation to the buy/sell spread.

Appendix 1 Overview of the EGRC Regulatory Scheme

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;⁷
- 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.

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

⁷ 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.

⁸ 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.

⁹ Generation Restricted Information is defined as information relating to a generation competitor that is obtained by or provided to wholesale staff in the course of the conduct of the wholesale business and might

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

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;¹⁰
- 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 Mechanism¹¹.

To address this requirement, Synergy has implemented the Internal Synergy Wholesale Arrangement (**ISWA**). This arrangement is made in accordance with regulation 11 of the

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

¹⁰ 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.

¹¹ 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_Merg/Market-participants-and-stakeholder-briefing-session-December-2013.pdf

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 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.¹²

1.1.2.2 Wholesaling Obligations

The EGRC Regulations prohibit Synergy from:

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

¹² <http://wholesale.synergy.net.au/Documents/EGRC%20Standard%20Product%20Agreement.pdf>

- 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.¹³

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.

Synergy has published a Wholesale Electricity Supply Policy¹⁴ and a Wholesale Energy Credit Policy.¹⁵

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

¹³ 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.

¹⁴ http://www.synergy.net.au/docs/VMI_EGRCWholesaleElectricitySupplyPolicy.pdf

¹⁵ http://www.synergy.net.au/docs/VMI_EGRCWholesaleEnergyCreditPolicy.pdf

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 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.¹⁶

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

¹⁶ 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."

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;
- 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.¹⁷

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.

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

¹⁷ That is, they are returned to Treasury and not retained by the ERA.

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.¹⁸ Among other things, the 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;¹⁹
- 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;²⁰ 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.

¹⁸ 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>

¹⁹ In respect of a period, the foundation load is the aggregate quantity of electricity in MWh consumed during that period by the Foundation Customers.

²⁰ 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

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.

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,²¹ 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;²²

²¹ Refer to the Standard Product Homepage for access to these procedures:
<http://wholesale.synergy.net.au/SitePages/Home.aspx>

²² 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.

Details of the Standard Products offered by Synergy and any transactions entered into can be found on its website.²³

²³ <http://wholesale.synergy.net.au/SitePages/Home.aspx>