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# **Electricity Generation and Retail Corporation Regulatory Scheme – Response to 2016 Report to the Minister for Energy on the effectiveness of the Scheme**

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## **Directions Report**

**Public Utilities Office**

**1 June 2019**



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## Abbreviations

Term	Definition
2014 Scheme Review	2014 Report to the Minister for Energy on the Effectiveness of the Electricity Generation and Retail Corporation Regulatory Scheme, Economic Regulation Authority, March 2015
2015 Scheme Review	2015 Report to the Minister for Energy on the Effectiveness of the Electricity Generation and Retail Corporation Regulatory Scheme, Economic Regulation Authority, June 2016
2016 Scheme Review	2016 Report to the Minister for Energy on the Effectiveness of the Electricity Generation and Retail Corporation Regulatory Scheme, Economic Regulation Authority, September 2017
ASX	Australian Stock Exchange
EGRC	Electricity Generation and Retail Corporation
EGRC Regulations	<i>Electricity Corporations (Electricity Generation and Retail Corporation) Regulations 2013</i>
ERA	Economic Regulation Authority
GBU	Generation Business Unit
MIG	Merger Implementation Group
NEM	National Electricity Market
RBU	Retail Business Unit
Scheme	Electricity Generation and Retail Corporation Regulatory Scheme
Segregation and Transfer Pricing Guidelines	<i>Segregation and Transfer Pricing Guidelines 2013</i>
STEM	Short Term Energy Market
SWIS	South West Interconnected System
TAP	Tariff Adjustment Payment
WBU	Wholesale Business Unit
WEM	Wholesale Electricity Market
Wholesale Arrangements	<i>Electricity (Standard Products) Wholesale Arrangements 2014</i>

## Executive summary

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This Directions Report outlines analysis of recommendations made by the Economic Regulation Authority (ERA) in its 2016 Report to the Minister for Energy on the Effectiveness of the Electricity Generation and Retail Corporation (EGRC) Regulatory Scheme (2016 Scheme Review), and details proposed regulatory changes in response to the recommendations.

The EGRC Regulatory Scheme (the Scheme) was introduced in response to the merger of Verve Energy and Synergy on 1 January 2014, and comprises:

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

The EGRC Regulations required Synergy to implement segmented business units with separate financial reporting requirements. The Regulations also prevent Synergy's wholesale business unit from discriminating between the retail business unit and competitors to Synergy when offering a wholesale supply of electricity; and include audit, review and civil penalty provisions.

The Wholesale Arrangements govern the Standard Products Regime, which obliges Synergy to offer various standard wholesale electricity products to market participants at published prices.

The Segregation and Transfer Guidelines set out transfer price requirements for electricity supply trades between Synergy's wholesale and retail business units.

The EGRC Regulations require the ERA to conduct an effectiveness review of the Scheme at least annually. The 2016 Scheme Review is the third such review conducted by the ERA, resulting in the following recommendations:

- The maximum buy-sell spread for Standard Products should be reduced to 10% for a suitable period (i.e. 12 months) to allow assessment of the effect of the change on the level of trade in Standard Products and customised products.
- Synergy should publish its foundation transfer price (the price paid for electricity supplied from Synergy's wholesale business unit to its retail business unit for the purpose of supplying foundation customers) and the method used for calculating this price.<sup>1</sup>
- Synergy should relax its credit requirements for Standard Product transactions, and review and amend the Standard Product specifications.

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<sup>1</sup> Foundation customers are the retail business unit's non-contestable customers (residential and small business customers that use less than 50 megawatt hours (MWh) of electricity per annum) and contestable customers that had agreed to their current retail electricity supply contract with Synergy prior to the merger of Verve Energy and Synergy.

- The Force Majeure clauses in the Wholesale Arrangements should be amended to make them less conservative and symmetric.
- Synergy should produce annual consolidated segmented financial reports, similar to the Consolidated Segmental Statements required of energy companies in the United Kingdom, showing how Synergy's revenues, costs and profits are split across the different business units, and between its contestable and non-contestable customers.<sup>2</sup>

While the Scheme does not have an explicit objective against which the Public Utilities Office could review the ERA recommendations, statements made in the Explanatory Memorandum and Second Reading Speech for the Electricity Corporations Amendment Bill 2013 have informed consideration of the original intent of the Scheme. This is consistent with the approach that the ERA has taken in conducting its Scheme reviews.

The Public Utilities Office agrees with the ERA that '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'.<sup>3</sup>

The Public Utilities Office proposes the implementation of the following regulatory changes in response to the ERA recommendations:

- Amend the Wholesale Arrangements to change the maximum buy-sell spread for Standard Products to 15%, effective from 1 January 2020 until 31 December 2020, to allow for assessment of effects of the change on Standard Product and customised product transactions.
- Amend the EGRC Regulations to require Synergy to publish the foundation transfer price mechanism, as well as any replacements or revisions made to the mechanism.
- Replace the description of the original method for calculating the foundation transfer price in the Segregation and Transfer Pricing Guidelines, with a reference to the current mechanism.

For some of the ERA's recommendations, the Public Utilities Office does not propose any immediate regulatory changes. In particular:

- There does not appear to be sufficient evidence that Synergy's credit requirements for Standard Product transactions are unreasonable, and therefore regulatory amendments to enforce changes to these requirements are not proposed.
- While a more flexible Standard Product offerings may be beneficial, it does not propose any regulatory changes to mandate such offerings, noting that customers are already able to request customised products from Synergy.

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<sup>2</sup> Further information on Consolidated Segmental Statements is available at Appendix 2 of the 2015 Scheme Review, available on the ERA website: <https://www.erawa.com.au/electricity/wholesale-electricity-market/annual-review-of-synergys-regulatory-scheme/review-of-synergys-regulatory-scheme-2015>.

<sup>3</sup> Discussion Paper – 2014 Annual Review of Effectiveness of EGRC Scheme. Available on the ERA website: <https://www.erawa.com.au/electricity/wholesale-electricity-market/annual-review-of-synergys-regulatory-scheme/review-of-synergys-regulatory-scheme-2014>.

- Removing the Specified Plant clause from the Standard Product Force Majeure provisions would be impractical. A better approach would be to monitor the composition of Synergy's generation portfolio going forward to determine the suitability of the list of generation units comprising the Specified Plant.<sup>4</sup>
- The ERA can use its existing powers under section 51 of the *Economic Regulation Authority Act 2003* to access more detailed financial information from Synergy, and supports the ERA exercising these powers without there being a need for any further regulatory changes.

This Directions Report contains an additional proposed regulatory change relating to the frequency of ERA Scheme reviews. The Public Utilities Office considers that an annual review process is too frequent, and proposes to amend the EGRC Regulations to require the ERA to perform its review of the effectiveness of the Scheme once every two years.

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<sup>4</sup> The Force Majeure provisions allow an electricity supplier to be released from its obligations under a Standard Product arrangement if a Force Majeure Event reduces the supplier's aggregate generation capacity from its facilities by at least 20%. The Specified Plant clause also allows Synergy, if it is the supplier, to be released from its obligations under a Standard Product arrangement if any one of its generation units from a list of 'Specified Plant' defined in the Wholesale Arrangements is completely interrupted or curtailed by a Force Majeure Event.

# 1. Introduction

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## 1.1 Background

In late 2013, the *Electricity Corporations Act 2005* was amended to implement the merger of the State owned electricity corporations, Synergy and Verve Energy, which were respectively the largest electricity retail and generation companies operating in the South West Interconnected System (SWIS). The merged entity was named the Electricity Generation and Retail Corporation, and began trading as Synergy on 1 January 2014.

The Electricity Generation and Retail Corporation Regulatory Scheme (the Scheme) was implemented to mitigate the potentially adverse effects of the merger on competition in the Wholesale Electricity Market (WEM). The Scheme consists of:

- the *Electricity Corporations (Electricity Generation and Retail Corporation) Regulations 2013* (EGRC Regulations);
- segregation arrangements approved under regulation 18(1) of the EGRC Regulations, currently these comprise the *Segregation and Transfer Pricing Guidelines 2013* (Segregation and Transfer Pricing Guidelines); and
- wholesale arrangements approved under regulation 26(1) of the EGRC Regulations, currently these comprise the *Electricity (Standard Products) Wholesale Arrangements 2014* (Wholesale Arrangements).

The EGRC Regulations require the operations of Synergy to be divided into discrete business units, with segregation obligations relating to the flow of staff and information between the business units, and transfer pricing provisions governing the transactions between these units. Each business unit is also required to prepare its own separate quarterly financial reports.

The Scheme also requires Synergy to transact in Standard Products, fixed quantities of wholesale electricity that it must offer to sell or purchase at published prices.

The EGRC Regulations mandate oversight of the Scheme by:

- requiring the Auditor General to conduct financial and calendar year audits of Synergy's compliance with various aspects of the Scheme; and
- requiring the Economic Regulation Authority (ERA) to conduct an effectiveness review of the Scheme at least once each year.

To date, the Auditor General has not found Synergy to be non-compliant with any aspect of the Scheme.

The ERA published its first review of the effectiveness of the Scheme (the 2014 Scheme Review) on 25 June 2015. The 2015 Scheme Review was subsequently published on 21 October 2016.



The 2014 and 2015 Scheme Reviews included recommendations for Scheme amendments to improve its effectiveness, including clarifying the objective of the Scheme and financial reporting requirements, strengthening compliance obligations, and tightening the Standard Product pricing requirements. Several market participants also made public submissions to these review processes including their own analyses of the effectiveness of the Scheme.<sup>5</sup>

The ERA published its 2016 Scheme Review on 29 November 2017, including further recommendations relating to financial reporting, transfer pricing and the Standard Products Regime.

## 1.2 Purpose of this report

The purpose of this report is to outline the approach to implement specific recommendations made by the ERA in its 2016 Scheme Review.

This report outlines the major recommendations made by the ERA in its 2016 Review, the Public Utilities Office's analysis of the recommendations, and proposed actions in response to those recommendations.

Similar to the approach adopted by the ERA, the Public Utilities Office has referred to the statements contained within the Explanatory Memorandum and Second Reading Speech for the Electricity Corporations Amendment Bill 2013 to assess whether implementation of the recommendations will be consistent with the original intent of the Scheme.

This paper also includes a proposed extension of the frequency of ERA Scheme reviews to every two years.

## 1.3 Next steps

The Public Utilities Office will seek to implement the changes to the EGRC Scheme proposed in this report as soon as is practicable, and has developed the implementation timeline detailed below in Table 1.1.

**Table 1.1: Implementation schedule for changes to EGRC Scheme**

Milestone	Timing
1. Publication of Directions Report	June 2019
2. Minister for Energy makes required amendments to the Wholesale Arrangements by Ministerial Order Ministerial Order is published in the Government Gazette	July 2019
3. Exposure draft of Amending Regulations to EGRC Regulations and Ministerial Order for amendments to Segregation and Transfer Pricing Guidelines released for consultation	August 2019
4. Amending Regulations and Ministerial Order are published in the Government Gazette	September 2019

<sup>5</sup> ERA Scheme Reviews and public submissions are available on the ERA website: <https://www.erawa.com.au/electricity/wholesale-electricity-market/annual-review-of-synergys-regulatory-scheme>.

## 2. The Electricity Generation and Retail Corporation Regulatory Scheme

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### 2.1 Composition of the EGRC Scheme

The EGRC Scheme comprises three regulatory instruments:

- the EGRC Regulations;
- the Wholesale Arrangements; and
- the Segregation and Transfer Pricing Guidelines.

#### 2.1.1 EGRC Regulations

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

- a Generation Business Unit (GBU);
- a Wholesale Business Unit (WBU);
- a Retail Business Unit (RBU);
- shared services operations; and
- any additional segments approved by the Minister for Energy.

Synergy must prepare:

- a separate quarterly statement of financial performance for each of its business units;
- written arrangements setting out the terms and conditions applying to supply transactions from the WBU to the RBU for the purposes of a retail supply of electricity;
- written policies setting out standard processes to be followed in offering, or responding to requests for, a wholesale supply of electricity from the WBU to the RBU or Synergy's retail or generation competitors; and
- the foundation transfer price mechanism, being the instrument that sets out the means by which the foundation transfer price is calculated. The foundation transfer price is the price paid to the WBU by the RBU for wholesale electricity supplies to service foundation customers, the RBU's non-contestable customers and contestable customers that had agreed to their current retail electricity supply contract with Synergy prior to the merger.<sup>6</sup>

Synergy must not discriminate between the RBU and retail or generation competitors on terms and conditions when offering wholesale supplies, and must not take the financial interests of the RBU into account when determining the terms and conditions for supply offers to its competitors. The EGRC Regulations also contain ring-fencing provisions restricting the flow of information and staff members between Synergy's business units.

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<sup>6</sup> Non-contestable customers are residential and small business customers that use less than 50MWh of electricity per annum. Customers using over 50MWh per annum are contestable, meaning that retailers other than Synergy are able to provide them with a retail supply of electricity.

The EGRC Regulations also contain audit, review and civil penalty provisions to ensure Synergy's compliance with the Scheme.

At the end of each financial year the Auditor General must examine Synergy's compliance with the following:

- Part 2 Divisions 1 and 2 of the EGRC Regulations relating to segmentation of operations and financial administration, and the Segregation and Transfer Pricing Guidelines; and
- Part 3 Division 1 of the EGRC Regulations, relating to wholesaling obligations, including non-discrimination between the RBU and competitors, and the Wholesale Arrangements.

At the end of each calendar year the Auditor General must examine Synergy's compliance with Part 2 Division 3 of the EGRC Regulations, relating to ring-fencing requirements for Synergy's business units.

If the Auditor General finds that Synergy has not complied with one or more provisions of the Scheme, the ERA must investigate the matter. If the ERA finds that Synergy has contravened a civil penalty provision defined in the EGRC Regulations, it may impose a civil penalty on Synergy up to a maximum amount of \$100,000, plus an additional daily amount of \$20,000 until the contravention is rectified.

The EGRC Regulations also require the ERA to carry out an effectiveness review of the Scheme at least once each year.

### 2.1.2 Wholesale Arrangements

The Wholesale Arrangements constituted under the EGRC Regulations govern the parameters of the Standard Product Regime.

Standard Products are fixed quantities of wholesale electricity that Synergy must advertise for sale and purchase at published prices. Synergy may also choose to transact in customised products tailored to the individual needs of its counterparties. Third parties are able to purchase both Standard Products and customised products from the WBU. The RBU may purchase customised products from the WBU, but is prohibited from procuring Standard Products.

The Wholesale Arrangements set out the following parameters for Standard Products:

- Standard Products are available in one megawatt (MW) increments, with up to 0.5 MWh per half-hour Trading Interval;
- Standard Products can be purchased for quarterly, calendar year and financial year supply periods;
- Synergy must offer both Flat and Peak Standard Products;<sup>7</sup>
  - For each Standard Product offered Synergy must offer to buy at least 100MW and sell at least 150MW.
- Synergy must offer to buy and sell at least 5MW of Standard Products per week.

<sup>7</sup> Flat products are available for every Trading Interval in the supply period, whereas Peak products are available from 8.00 am to 10.00 pm on business days.

The Wholesale Arrangements limit the maximum buy-sell spread for Standard Products to 20%, meaning that the price at which Synergy offers to buy a particular Standard Product cannot be more than 20% lower than the price at which it offers to sell that product. Synergy must publish its Standard Product prices on a website.<sup>8</sup>

The Wholesale Arrangements also include Force Majeure provisions allowing the seller of wholesale electricity in a Standard Product arrangement to be suspended from its obligations under the arrangement if part of its generation portfolio is curtailed by a Force Majeure Event.<sup>9</sup>

### 2.1.3 Segregation and Transfer Pricing Guidelines

The Segregation and Transfer Pricing Guidelines set out the requirements applicable to:

- the original foundation transfer price mechanism, which set out the means by which the original foundation transfer price was calculated and established the terms and conditions for wholesale electricity supplies from the WBU to the RBU to supply foundation customers; and
- the additional transfer price mechanism, which applies to wholesale electricity supplies from the WBU to the RBU to supply new customers after the merger, and prohibits the RBU from supplying electricity to the WBU.

The original foundation transfer price mechanism as set out in the EGRC Regulations expired on 30 June 2017, with a replacement foundation transfer price mechanism taking effect on 1 July 2017. The Segregation and Transfer Pricing Guidelines have not been updated to provide information on the replacement foundation transfer price mechanism.

The Segregation and Transfer Pricing Guidelines also impose load forecasting obligations on the RBU, and allocate costs to the WBU and RBU in respect of any variances between the RBU forecast and actual load in a Trading Interval.

## 2.2 Intent of the Scheme

### 2.2.1 Scheme objective

The EGRC Regulations do not contain an explicit objective for the Scheme. The ERA, Synergy and other market participants have advocated for a specific policy objective to be added to the Scheme.

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<sup>8</sup> Synergy's Standard Products information and prices are available at <http://wholesale.synergy.net.au/SitePages/Standard%20Products.aspx>.

<sup>9</sup> The Wholesale Arrangements define a Force Majeure Event as being, in relation to a person who is a party to a Standard Product Agreement, 'any event or circumstance or combination of events and circumstances the cause of which is beyond the reasonable control of the person and which by the exercise of due diligence the person is not reasonably able to prevent or overcome, other than the person's lack of, or inability or unwillingness to reasonably use funds'.

The ERA identified the lack of a Scheme objective as a concern in its 2014 Scheme Review, stating:

*‘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.’<sup>10</sup>*

Synergy’s submission to the 2014 Review stated:

*‘The lack of clarity around the precise policy objective for the Scheme makes it difficult for the ERA to conduct an effectiveness review (and for stakeholders to comment) as well as impacting EGRC as it has been required to and must continue to implement the obligations under a regulatory scheme which contains no specific and measurable policy goals.’<sup>11</sup>*

Synergy also considers that a Scheme objective should include provisions requiring the Scheme to be repealed, in the situation where the reduction in Synergy’s market share means the Scheme is no longer required given the level of electricity market competition.

In conducting its reviews of the Scheme effectiveness, the ERA used the Explanatory Memorandum and Second Reading Speech for the Electricity Corporations Amendment Bill 2013, in relation to discussion of the proposed EGRC Regulations, as a basis for interpretation of the intent of the Scheme.<sup>12</sup>

## 2.2.2 Explanatory memorandum and second reading speech

The Public Utilities Office considers the following excerpts from the Second Reading speech to the Electricity Corporations Amendment Bill 2013 as providing sufficient guidance on the original intent of the Scheme:

*‘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.’*

<sup>10</sup> ERA, 2014 Scheme Review, March 2015, p. 2. Available on the ERA website: <https://www.erawa.com.au/electricity/wholesale-electricity-market/annual-review-of-synergys-regulatory-scheme/review-of-synergys-regulatory-scheme-2014>.

<sup>11</sup> Synergy, Public Submission – EGRC Regulatory Scheme – Synergy, 22 December 2014, p. 6-7. Available on the ERA website: <https://www.erawa.com.au/electricity/wholesale-electricity-market/annual-review-of-synergys-regulatory-scheme/review-of-synergys-regulatory-scheme-2014>.

<sup>12</sup> The Explanatory Memorandum and Second Reading Speech for the Electricity Corporations Amendment Bill 2013 are available on the Parliament of Western Australia website: <http://www.parliament.wa.gov.au/parliament/bills.nsf/BillProgressPopup?openForm&ParentUNID=34142247BD1BD20948257C0600173BB6>.

*The amended Act will allow regulations to be made to segregate certain functions within the merged entity. Under these regulations some functions within the merged entity will be subject to ring-fencing, a transfer pricing mechanism, and protocols governing the flow of sensitive information. These mechanisms and protocols will be designed to ensure that the merged entity will not unduly preference its own retail and generation arms over third party retailers and generators. This will increase pressure on the merged entity to be efficient, reducing upward pressure on electricity prices.’<sup>13</sup>*

The Government recognised the merged entity would be dominant in the WEM and that regulatory constraints would need to be imposed to limit any potential market power of the merged entity to encourage competition. In particular, there was the potential for the merged entity to preference its own retail and generation units over third-party retailers and generators; and that measures would be required to ensure Synergy’s interaction with all market participants, including interactions between its own business units, would occur on a non-discriminatory basis.

*‘The amended Act will also contain the regulation-making power to allow the Minister for Energy to approve arrangements for wholesale trading of electricity by the merged entity. It is intended that this power will be used to oblige the merged entity to offer a range of standard wholesale electricity products on a non-discriminatory basis across the merged entity’s own retail business unit and other wholesale electricity customers.*

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

*The merged entity will also be free to offer customised electricity products in response to requests from market customers, as Verve Energy currently does. These customised products will be subject to requirements on the process by which they are offered, ensuring fair and reasonable dealing with wholesale customers.’<sup>14</sup>*

Recognising there was a high likelihood that market participants would have limited alternatives to transacting with the merged entity in the WEM, the Government introduced Standard Products to ensure that market participants would have access to wholesale supply products with non-discriminatory pricing compared with equivalent products traded between Synergy’s wholesale and retail business units. The Public Utilities Office considers the underlying goal of this measure to be the promotion of a competitive market, with a level playing field for all participants.

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<sup>13</sup> Second Reading Speech for the Electricity Corporations Amendment Bill 2013, 19 November 2013, p. 1.

<sup>14</sup> Second Reading Speech for the Electricity Corporations Amendment Bill 2013, 19 November 2013, p. 2.

The Standard Product Regime was designed by the Merger Implementation Group (MIG), which had been formed by the Government to provide governance and oversight of the merger.<sup>15</sup> The MIG considered that primary objectives of the Standard Product Regime were to:

- Function as a price-discovery mechanism to provide greater transparency and predictability for short to medium-term energy contracts.
- Provide a simple alternative to customised products by:
  - facilitating new market entrants with simple products and lower barriers to entry; and
  - enabling market participants to rebalance their portfolios (at the margins) with simple products.

The MIG did not intend for the Standard Product Regime to operate as a market.

Considering this information, the Public Utilities Office agrees with the ERA position that ‘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’.<sup>16</sup>

The Public Utilities Office notes that requirements such as segregation, ring-fencing and transfer pricing are designed to limit the ability for Synergy’s potential market power to undermine competition, and the Standard Product Regime is designed to promote greater access to the WEM and provide a price-discovery mechanism for market participants.

The Public Utilities Office therefore considers the ERA’s approach in utilising the Explanatory Memorandum and Second Reading Speech to guide its assessment of the effectiveness of the Scheme to be appropriate. The statements made by the then Minister for Energy on the intent of the Scheme provide sufficient information and a public reference for stakeholders as to the policy objective of the Scheme. The Public Utilities Office therefore does not consider there is an evident need for a specific Scheme objective.

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<sup>15</sup> The MIG consisted of Mr Peter Oates (Chair); Mr David Hunt; and Dr Ray Challen, Deputy Director General of the Public Utilities Office; and utilised Public Utilities Office staff to form a project team.

<sup>16</sup> ERA, 2014 Scheme Review, March 2015, p. 1.



### 3. 2016 Scheme Review recommendations and implementation actions

#### 3.1 2016 Scheme Review recommendations

The ERA Report on the 2016 Scheme Review included a summary of the recommendations to improve the effectiveness of the Scheme as shown below:<sup>17</sup>

**Table 3.1: Summary of the ERA 2016 Scheme Review recommendations and their intended outcomes**

Recommendation	Intended result
Set a narrower (10%) maximum spread between the buy and sell price for Standard Products.	Places discipline on Synergy to set efficient prices in the bilateral contract market.
Require that Synergy publish its foundation transfer price and the method it uses for calculating this price.	Provides transparency and allows for scrutiny of bilateral contract prices.
Relax the Standard Product credit requirements.	Improve retailers' opportunities for contracting and provides a liquid Standard Product market, encouraging new entry and greater retail competition.
Review and amend the Standard Product specifications.	
Amend the Force Majeure clauses in the Standard Product arrangements to make them less conservative and symmetric.	Limited impact on Synergy given its large portfolio. Standard Products are able to be used for risk management by market participants with substantially smaller generation capacity.
Synergy to produce annual consolidated segmented financial reports. Information to be treated as commercial in confidence.	Ensures transparency of how Synergy's revenues, costs and profits are split across Synergy's different electricity segments. Addresses concerns of market participants about the potential for cross-subsidisation and adverse effects on competition in the retail market.

The Public Utilities Office has analysed the recommended measures to determine appropriate actions to address each issue identified as impacting effectiveness of the Scheme. This included consideration of whether meeting the intended outcome for each recommendation would require regulatory changes, and if so, the most appropriate form of these changes.

The Public Utilities Office has also taken into account the potential effects on Synergy and other market participants in the WEM of any measures implemented, as well as the relative simplicity and practicality of any proposed actions.

<sup>17</sup> ERA, 2016 Scheme Review, November 2017, Table 1. Summary of main findings, the ERA's recommendations and their intended outcomes.



## 3.2 Analysis

### 3.2.1 Reduction in the buy-sell spread for Standard Products

Although Synergy sets the prices for its Standard Products, the Scheme imposes a constraint specifying the allowable difference between the prices for buying and selling these products. The spread is currently set at 20%, meaning that the price at which Synergy offers to buy a particular Standard Product (buy price) cannot be more than 20% lower than the price at which it offers to sell that product (sell price). The Scheme thus imposes pricing discipline on Synergy, as any increase it makes to the price at which it sells Standard Products will increase the minimum price at which it may be compelled to purchase Standard Products.

The Standard Products are intended to serve as a price-discovery mechanism. Setting the buy-sell spread at an appropriate level should ensure that Standard Products are priced efficiently. If the spread is too wide, there is the possibility that Synergy may be pricing Standard Products above their efficient level.

If Standard Products are priced efficiently, then the customised products Synergy transacts in with other market participants should also be priced efficiently, due to the non-discrimination requirements in the EGRC Regulations. Setting the buy-sell spread at an appropriate level can therefore provide market benefits by placing discipline on Synergy to price its wholesale products efficiently.

The ERA recommended that the maximum buy-sell spread for Standard Products be set to 10% for a suitable period (i.e. 12 months), providing sufficient time for the ERA to review the effects of any changes. Reducing the maximum buy-sell spread would require amendments to the Wholesale Arrangements.

The ERA engaged Deloitte Access Economics (Deloitte) to determine a methodology to estimate the appropriate spread for Standard Products for its 2015 Scheme Review. Deloitte considered that to fulfil the objectives of the Standard Products Regime, the buy-sell spread should reflect the spread that would prevail in the WEM if Standard Products were offered competitively. Various methods for determining such a spread were considered, including:

- Setting the spread with reference to volatility in the Short Term Energy Market (STEM). This would represent the risk that the WBU incurs by offering spreads in an illiquid market where it cannot balance the sale of an electricity future by purchasing a corresponding future.
- Setting the spread with reference to the spread for the National Electricity Market (NEM) electricity futures listed on the Australian Stock Exchange (ASX), as a representation of spreads in a competitive and liquid market.
- Setting the spread with reference to the maximum spreads for market makers (parties who increase liquidity by buying and selling products, and profit from the spread) in the New Zealand electricity futures market that are traded on the ASX. Market makers perform a similar function to the WBU in offering Standard Products, although the WBU is exposed to relatively more risk due to its long position on energy.

The spreads observed in the other jurisdictions with more liquid wholesale markets were considerably narrower than the implied spread calculated from STEM volatility.

Deloitte did not consider it prudent to immediately adopt benchmark spreads from other jurisdictions. A wider spread would be required for the Standard Products Regime to compensate Synergy for the risk that it would be unable to close out its position in an illiquid market. Therefore, Deloitte recommended setting the spread with reference to volatility in the STEM, with the spread being progressively reduced if liquidity were to increase in the Standard Products market.

To calculate the level of the implied spread with reference to STEM volatility, Deloitte analysed STEM data from the beginning of 2011 to the end of 2015, making a high level adjustment to account for the effect of the carbon pricing arrangements where applicable. Deloitte considered that setting the spread to one standard deviation, representing a 69% chance that Synergy would profit from a given trade, would be prudent, given that a trader in a competitive market would expect a greater than 50% chance of making a profit on any single trade.

Deloitte calculated the implied spread for quarterly products, by comparing the average STEM prices for the first quarter of each year in the sample to one another, and then the average STEM prices for the second quarter of each year, and so on. The implied spreads for quarterly Standard Products calculated by Deloitte are provided in Table 3.2 below:

**Table 3.2: Implied spreads for Standard Products using volatility approach to allow Synergy an approximately 69% chance of making a profit on any given transaction (Deloitte)**

Quarterly products	Implied spread – 1 standard deviation	
	Flat	Peak
Quarter 1	6.2%	8.3%
Quarter 2	14.1%	12.4%
Quarter 3	14.9%	15.6%
Quarter 4	7.0%	9.7%
<b>Average</b>	<b>10.6%</b>	<b>11.5%</b>

Source: 2015 Scheme Review, Appendix 6, Deloitte Access Economics: Standard Products Spread Review, Table 15 Implied spreads for Standard Products.

The ERA agreed that using a standard deviation of one, thus providing Synergy with a 69% chance of profiting from any single trade, would result in a reasonable balance between managing Synergy's risk and achieving efficient pricing outcomes. It conducted its own analysis of STEM prices, using the period from the beginning of July 2014 to the end of March 2016. This period was chosen due to the consistency of market conditions, as the carbon tax repeal and Verve Energy-Synergy merger had both already occurred.

The ERA's analysis did not calculate individual spreads for quarterly products, as for Deloitte's analysis, but rather a single implied spread based on the volatility in the quarterly average STEM price for each quarter in the time period. The results of the ERA's analysis are provided in Table 3.3 below:

**Table 3.3: ERA analysis of average STEM prices**

Quarter	Average STEM Price (Peak) \$/MWh	Average STEM Price (Flat) \$/MWh
2014 Q3	55.44	46.79
2014 Q4	45.31	37.87
2015 Q1	50.06	40.38
2015 Q2	46.32	35.72
2015 Q3	50.41	40.06
2015 Q4	58.05	47.88
2016 Q1	54.99	44.90
<b>STEM Price Average</b>	<b>51.51</b>	<b>41.95</b>
<b>STEM Price Standard Deviation</b>	<b>4.81</b>	<b>4.63</b>
<b>Spread based on 1 Standard Deviation</b>	<b>9%</b>	<b>10%</b>

Source: 2015 Scheme Review, Standard Products, Setting the spread.

The ERA acknowledged that its estimate was based on a limited set of data points.

The Public Utilities Office considers Deloitte's method of calculating the implied buy-sell spread for quarterly products to be prudent, and agrees with the ERA that it is sensible to evaluate STEM volatility in the post-merger, post-carbon tax market environment. Additionally, in the time since the publication of the 2015 Scheme Review, sufficient STEM data has become available to conduct an analysis using four years of data under the same post-merger, post-carbon tax market conditions.

The Public Utilities Office has replicated the analyses by Deloitte and the ERA, for the period from 1 July 2014 to 30 June 2018, in the tables below:

**Table 3.4: Implied spreads for Standard Products using volatility approach to allow Synergy an approximately 69% chance of making a profit on any given transaction (1 July 2014 – 30 June 2018)**

Quarterly products	Implied spread – 1 standard deviation	
	Flat	Peak
Quarter 1	12.8%	11.9%
Quarter 2	16.6%	15.2%
Quarter 3	16.5%	16.5%
Quarter 4	14.3%	13.8%
<b>Average</b>	<b>15.0%</b>	<b>14.4%</b>

**Table 3.5: Analysis of average STEM prices (1 July 2014 – 30 June 2018)**

Quarter	Average STEM Price (Peak) \$/MWh	Average STEM Price (Flat) \$/MWh
2014 Q3	\$55.44	\$46.79
2014 Q4	\$45.31	\$37.87
2015 Q1	\$50.06	\$40.38
2015 Q2	\$46.32	\$35.72
2015 Q3	\$50.41	\$40.07
2015 Q4	\$58.05	\$47.88
2016 Q1	\$54.99	\$44.90
2016 Q2	\$66.03	\$53.57
2016 Q3	\$70.01	\$55.55
2016 Q4	\$54.79	\$46.30
2017 Q1	\$67.37	\$55.38
2017 Q2	\$66.47	\$53.78
2017 Q3	\$73.74	\$60.63
2017 Q4	\$65.24	\$55.41
2018 Q1	\$57.27	\$45.13
2018 Q2	\$55.50	\$45.69
<b>STEM Price Average</b>	<b>\$58.56</b>	<b>\$47.82</b>
<b>STEM Price Standard Deviation</b>	<b>\$8.62</b>	<b>\$7.26</b>
<b>Spread based on 1 Standard Deviation</b>	<b>13.7%</b>	<b>14.1%</b>

STEM volatility has increased in the time since Deloitte and the ERA conducted their analyses for the 2015 Scheme Review. The data from 1 July 2014 to 30 June 2018 indicates that the level of the buy-sell spread required to set the spread to one standard deviation is around 15%, rather than 10%. The Public Utilities Office considers that, given application of the method outlined by Deloitte and the ERA to the available STEM data for the post-merger, post-carbon tax period, it is now appropriate to set the buy-sell spread for Standard Products to 15%.

A buy-sell spread of 15% will allow Synergy the following probabilities of making a profit on any given Standard Product transaction, according to Deloitte's methodology:

**Table 3.6: Probability of Synergy profiting on a Standard Product transaction with 15% buy-sell spread (using Deloitte’s methodology)**

Quarterly products	Probability of Synergy profit on any given Standard Product transaction	
	Flat	Peak
Quarter 1	72%	74%
Quarter 2	67%	69%
Quarter 3	67%	67%
Quarter 4	70%	71%

The Public Utilities Office has discussed the prospect of a reduced buy-sell spread with Synergy. Synergy has stated its opposition to any reduction to the existing buy-sell spread, contending that it may lead to perverse market outcomes and that Synergy would likely incur a financial loss. Synergy already has a long position on energy, and a reduction in the buy-sell spread would increase the risk of the business purchasing additional energy and exacerbating its risk position.

Synergy considers that there is no evidence that the current maximum buy-sell spread is inappropriate. Given historic volatility in the Balancing Market, Synergy considers it to be unreasonable to expect the business to forecast future market prices within tight boundaries. Synergy also considers that a lower buy-sell spread would transfer risk from other market participants to Synergy, increasing the likelihood of speculation and risk-taking amongst other WEM participants.

While the Public Utilities Office acknowledges Synergy’s position on this matter, it considers there is a need to gather sufficient evidence to determine whether a reduced maximum buy-sell spread will encourage greater Standard Product transactions, noting that a reduced maximum buy-sell spread of 15% will still allow Synergy a reasonable probability of making a profit on Standard Product transactions.

The ERA recommended that a new buy-sell spread remain in place for 12 months, so that it may observe any resultant changes in the frequency of Standard Product transactions. The Public Utilities Office agrees that such a timeframe is appropriate, and therefore proposes to amend the Wholesale Arrangements so that the maximum buy-sell spread for Standard Products is changed to 15% for a period of 12 months.

If the changes to the ERA’s Scheme review cycle proposed in chapter 4 of this report are implemented, the next Scheme Review after the review being completed in 2019 (the 2020 Scheme Review) will commence in 2021, with a final report being delivered in the second half of 2021. The Public Utilities Office considers that implementing the revised buy-sell spread from 1 January 2020, for a period of 12 months, will allow time for observation of the effects of the reduced spread, helping inform future recommendations on an appropriate level at which the maximum buy-sell spread should be set going forward.

**Proposed Action:**

Amend the Wholesale Arrangements to change the maximum buy-sell spread for Standard Products to 15%, effective from 1 January 2020 until 31 December 2020.

### 3.2.2 Synergy to publish the foundation transfer price and the method

The EGRC Regulations require Synergy to prepare a foundation transfer price mechanism, which establishes a method for calculating the foundation transfer price, being the price that the RBU pays the WBU for electricity supplied to foundation customers.<sup>18</sup> Synergy is required to periodically replace the foundation transfer price mechanism, and may also revise the foundation transfer price mechanism to comply with an applicable provision<sup>19</sup> or make a change of a minor or technical nature. Any replacement or revision of the foundation transfer price mechanism must be given to the Minister for Energy.

The requirements applicable to the original foundation transfer price mechanism, which remained in force until 30 June 2017, are contained in the Segregation and Transfer Pricing Guidelines. Since 1 July 2017, the terms and conditions applying to the retail supply of electricity to foundation customers have been governed by a replacement foundation transfer price mechanism. Synergy provided the Minister for Energy with a copy of the replacement mechanism in accordance with the EGRC Regulations.

The replacement foundation transfer price mechanism was not required to be published. The Segregation and Transfer Pricing Guidelines state that “additional guidelines will be made by the Minister under section 62(1) of the Act at a later time, to apply to any replacement foundation transfer price mechanism”. To date, no such additional guidelines have been made.

The Segregation and Transfer Pricing Guidelines state that the foundation transfer price must be consistent with the modelled cost of electricity to the Electricity Retail Corporation based on:

- existing contracts for the acquisition of electricity by the Electricity Retail 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>18</sup> Foundation customers are the RBU's non-contestable customers (residential and small business customers that use less than 50MWh of electricity per annum) and contestable customers that had agreed to their current retail electricity supply contract with Synergy prior to the merger of Verve Energy and Synergy.

<sup>19</sup> An applicable provision is a provision of another written law, segregation arrangements, or market rules made under the *Electricity Industry Act 2004* Part 9, that is expressed to apply to the foundation transfer price mechanism.

The replacement foundation transfer price mechanism, however derives the transfer price from Synergy's energy forward curve of market prices.<sup>20</sup> There is therefore a risk that market participants are making decisions based on the outdated information provided in the Segregation and Transfer Pricing Guidelines.

The ERA recommended that Synergy publish the foundation transfer price and the method it uses for calculating this price. In addition to the outdated information contained in the Segregation and Transfer Pricing Guidelines, the ERA considers that there may also be a lag between changes being made to the foundation transfer price mechanism and the ERA or Auditor General applying regulatory scrutiny to these changes as part of scheduled review and audit processes.

The Public Utilities Office agrees that the method used to calculate the foundation transfer price should be published, to ensure that publicly available information about Synergy's internal pricing is current and timely regulatory scrutiny of any changes made. However, the Public Utilities Office considers that the foundation transfer price itself should not be published as it contains commercial-in-confidence information.

The Public Utilities Office notes that the Second Reading Speech for the Electricity Corporations Amendment Bill 2013 states: 'In order to ensure transparency of the ring-fencing arrangements, the outcome of compliance and audit reports will be made publicly available. The high-level transfer pricing mechanism will likely also be made publicly available, although not the transfer price itself'. The publication of the replacement foundation transfer price mechanism, but not the foundation transfer price itself, would therefore be consistent with the original intent of the Scheme.

The Public Utilities Office proposes to amend the EGRC Regulations to require Synergy to publish on its website the most recent version of the foundation transfer price mechanism any time it is revised or replaced. The Public Utilities Office also proposes to amend the Segregation and Transfer Pricing Guidelines to remove the description of the previous method for calculating the foundation transfer price.

Synergy considered that the ERA's recommendation is not reasonable because:

- it requires Synergy to reveal commercial-in-confidence information;
- concerns relating to the foundation transfer price mechanism should be evidence based; and
- commercial arrangements between the RBU and WBU that are not contrary to the EGRC Regulations should not be made publicly available, as this will detrimentally affect Synergy's legitimate business interests.

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<sup>20</sup> The prices for Standard Products are based on the same forward curve, and therefore the proposed reduction in the buy-sell spread for Standard Products should also lead to a reduction in the foundation transfer price.



The Public Utilities Office does not agree that publication of the method used to determine the foundation transfer price would be detrimental to Synergy's legitimate business interests, provided it does not reveal the foundation transfer price itself or the forward energy curve used to calculate it.

**Proposed Action:**

Amend the EGRC Regulations to require Synergy to publish on its website the foundation transfer price mechanism, as well as any replacements or revisions made to the mechanism.

Replace the description of the original method for calculating the foundation transfer price in the Segregation and Transfer Pricing Guidelines with a reference to the current mechanism.

### 3.2.3 Standard Product credit requirements and specifications

To trade in Standard Products, a market participant must first become an approved counterparty to Synergy. In the 2016 Scheme Review the ERA indicated that to become an approved counterparty, a market participant must satisfy criteria including the provision of its last two audited financial year statements to Synergy. Synergy's Wholesale Energy Credit Policy<sup>21</sup> generally requires new approved counterparties to undergo an independent credit assessment upon approval, and then again at least every 12 months thereafter. The Public Utilities Office has clarified with Synergy that financial statements are only required for the purpose of credit checks.

The ERA considers that these requirements may be disproportionate to the type of product that is contracted under a Standard Product arrangement, and has recommended that Synergy relax its credit requirements so that they are proportionate to the exposure of the business to the risk of counterparty default under the Standard Product Regime.

Synergy has recently completed a review of its Wholesale Energy Credit Policy and elected to not make any substantive changes to the policy in response to the ERA's recommendation.

Synergy considers that its credit requirements are a function of board approved policies and are intended to protect the business from the risk of counterparty default. In its submission to the 2017 Scheme Review, Synergy noted that it did not consider that its credit requirements prevented customers from purchasing Standard Products, particularly given the significant increase in Standard Product transactions in the latter part of 2017 and in 2018.

In discussions with the Public Utilities Office, Synergy has emphasised that becoming an approved counterparty does not always require the provision of a market participant's last two audited financial year statements. For example, there is no requirement to do so if:

- the proposed counterparty is publicly listed;
- Synergy requests an independent assessment from a credit agency; or
- the proposed counterparty elects to pre-pay rather than seek credit from Synergy.

<sup>21</sup> The Wholesale Energy Credit Policy is available on the Synergy website: [https://www.synergy.net.au/About-us/Who-we-are/What-we-do/Wholesale-Business-Unit?tid=Whatwedo:help\\_advice:WholesaleBusinessUnit](https://www.synergy.net.au/About-us/Who-we-are/What-we-do/Wholesale-Business-Unit?tid=Whatwedo:help_advice:WholesaleBusinessUnit).



The Public Utilities Office understands that Synergy's standard practice is to utilise an independent rating agency to undertake credit assessments on its behalf where the proposed counterparty's financial information is not publicly available. The credit assessment process often requires various documents from the proposed counterparty, including two years of audited financial statements. Synergy does not have any input into the type of information required by the independent rating agency in performing its credit assessment.

The requirement of a credit rating to assess credit worthiness is in line with industry practice. Synergy's policies appear to be consistent with those of large vertically-integrated gentailers (electricity retailers that also own generation assets) in the NEM that also have board approved policies to manage risk. For example, AGL's Risk Management Policy<sup>22</sup> states that the AGL Board is responsible for approving and monitoring the implementation of policies governing AGL's systems of internal compliance, risk management and control. AGL attach trade limits to counterparties to manage its credit risk.

In a submission to the Australian Securities and Investments Commission in 2013, Alinta Energy wrote that it 'has credit support arrangements in place with entities it trades with taking into account those entities credit ratings...amongst other risk management arrangements prevalent in this sector'. It also wrote that energy market entities 'have well developed and sophisticated risk management expertise underpinned by continued market participation'.<sup>23</sup>

The specific policies of these companies relating to their credit requirements for counterparties in wholesale electricity transactions are not publicly available (unlike Synergy's wholesale credit policy, which is required to be published under the EGRC Regulations). The Public Utilities Office was therefore unable to compare the companies' specific credit requirements to those of Synergy.

The Public Utilities Office considers that Synergy's Wholesale Energy Credit Policy is properly targeted, with criteria indicating that credit ratings are only required when net exposure is likely to exceed \$100,000 at any point in time.

Given the information available, the Public Utilities Office does not consider that there is sufficient evidence that Synergy's credit requirements for Standard Product transactions are unreasonable. Accordingly no regulatory amendments to enforce changes to Synergy's credit requirements are proposed.

The ERA has also recommended that Synergy reviews and amends the standard product specifications. The ERA has suggested that, in order to provide more desirable products and increase participation in the Standard Product Regime, consideration could be given to ideas such as offering off-peak products, providing differing volumes and term lengths, and providing flexible commencement dates.

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<sup>22</sup> AGL's Risk Management Policy is available on the AGL website: <https://www.agl.com.au/about-agl/who-we-are/our-company/corporate-governance>.

<sup>23</sup> Alinta Energy submission to the Australian Securities and Investments Commission, Derivative Transaction Reporting – Consultation Paper 205, 1 May 2013. Available on the Australian Securities & Investments Commission website: <https://download.asic.gov.au/media/1335542/cp205-submission-AlintaEnergy.pdf>.

The Public Utilities Office considers that more flexible product offerings may provide market benefits, but does not propose any regulatory changes to mandate such offerings. The Public Utilities Office will monitor the effect of the decreased buy-sell spread to assess whether participation in the Standard Products Regime increases.

The Public Utilities Office also notes that the Standard Products are intended to be simple products, and that counterparties are able to request customised products from Synergy if desired.

### 3.2.4 Standard Product Force Majeure clauses

The Wholesale Arrangements allow for Standard Products to include terms and conditions that relieve Synergy and its counterparty from the performance of their respective obligations under a Standard Product (SP) agreement, if such performance is ‘hindered, delayed, prevented or otherwise affected by the occurrence of a Force Majeure Event’. A Force Majeure Event is defined in the Wholesale Arrangements as follows:

***Force Majeure Event*** means, in relation to a person who is a party to an SP agreement, any event or circumstance or combination of events and circumstances the cause of which is beyond the reasonable control of the person and which by the exercise of due diligence the person is not reasonably able to prevent or overcome, other than the person’s lack of, or inability or unwillingness to reasonably use funds.

In Synergy’s Bilateral Trade Agreement for Electricity (Standard Products), a Force Majeure Event is further defined to include occurrences such as acts of God, industrial action, terrorism, malicious damage and the failure of a supplier of the seller to provide fuel, materials, equipment or services.<sup>24</sup>

The Standard Product supplier is deemed to be ‘hindered, delayed, prevented or otherwise affected by the occurrence of a Force Majeure Event’ if either:

- the electricity that can be generated or supplied by the supplier’s facilities is reduced by at least 20% in aggregate due to a Force Majeure Event; or
- if the supplier is Synergy, electricity supply from any one of a list of ‘Specified Plant’ ceases or is completely curtailed or completely interrupted due to a Force Majeure Event.

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<sup>24</sup> The Bilateral Trade Agreement for Electricity (Standard Products) is available on the Synergy website: <http://wholesale.synergy.net.au/Documents/EGRC%20Standard%20Product%20Agreement.pdf>.

The list of Specified Plant is detailed in Table 3.7 below:

**Table 3.7: Specified Plant defined in the Wholesale Arrangements**

Facility	2018-19 Capacity Credits (MW)	Percentage of Capacity Credits owned or controlled by Synergy (%)
SWCJV_WORSLEY_COGEN_COG1	0	0
MUJA_G5	195	6
MUJA_G6	193	6
MUJA_G7	211	6
MUJA_G8	211	6
COLLIE_G1	317.2	9
COCKBURN_CCG1	240	7
BW1_BLUEWATERS_G2	217	6
BW2_BLUEWATERS_G1	217	6
PPP_KCP_EG1	80.4	2
NEWGEN_KWINANA_CCG	327.8	10

Worsley Cogeneration (SWCJV\_WORSLEY\_COGEN\_COG1) was deregistered on 2 March 2017.

The Specified Plant clause was included in the Wholesale Arrangements because it was considered highly unlikely that a Force Majeure Event could disrupt 20% of Synergy's generation capacity (637MW at the time of the merger), as that would either require such an event to completely curtail Muja C and Muja D simultaneously, or to simultaneously disrupt generating units in multiple geographical locations. The Specified Plant clause was thus included to cover Synergy if a Force Majeure Event were to cause the total curtailment of one of its baseload generating units.

In the 2016 Scheme Review the ERA has referenced stakeholder feedback indicating that the Force Majeure provisions may discourage small existing or new entrant retailers from using Standard Products as a hedging tool, as the high electricity prices triggered by an outage caused by a Force Majeure Event would be one of the outcomes the retailer would be hedging against.

The ERA also considers that the Specified Plant clause, allowing Synergy to potentially use the Force Majeure provisions with an outage impacting only as much as 2% of its capacity portfolio, is too conservative in reducing the exposure of the business to Force Majeure Events, and skewed to the advantage of Synergy.

The ERA recommended that the Force Majeure clauses in the Wholesale Arrangements be amended to make them less conservative and symmetric.

The Public Utilities Office notes that Force Majeure Events by definition occur rarely, and the majority of the wholesale supply price rises that retailers would be hedging against do not occur due to Force Majeure Events. To date, Synergy has not used the Force Majeure provisions to relieve its obligations under any Standard Product contract.

If the Specified Plant clause was removed to make the Force Majeure provisions symmetric, only allowing the seller in a Standard Product transaction to suspend its obligations if a Force Majeure Event disrupted 20% of its aggregate generation capacity, then the Force Majeure provisions would provide negligible coverage to Synergy. This is because of the low likelihood of either a Force Majeure Event completely curtailing Muja C and Muja D simultaneously, or Force Majeure Events simultaneously disrupting generating units in multiple geographical locations. If the percentage of generation required to be affected was reduced from 20% there is the risk of smaller generators being able to use the Force Majeure provisions when there is an outage of a relatively trivial amount of energy.

The Public Utilities Office therefore considers that removing the Specified Plant clause would be impractical.

The Public Utilities Office notes that Worsley Cogeneration has been deregistered, and Synergy's generation portfolio may be subject to further closures due to the ageing profile of the fleet. Synergy's baseload generating units would in that scenario become more necessary to ensure the business could honour its supply commitments. The Public Utilities Office therefore intends to monitor the composition of Synergy's generating portfolio going forward, and will not take any immediate action to amend the list of Specified Plant in the Wholesale Arrangements.

### **3.2.5 Consolidated financial reporting**

Retail customers in the SWIS are classed as being either contestable or non-contestable. Customers that use less than 50MWh of electricity per annum are non-contestable, meaning that they are required to be supplied by Synergy on regulated retail tariffs. Customers that use more than 50MWh of electricity per annum are contestable, and may choose any electricity retailer, including Synergy.

The revenue Synergy receives from some of the regulated retail electricity tariffs paid by its non-contestable customers is not high enough to recover the costs incurred in making supplies to these customers. The difference between Synergy's supply costs and revenue for electricity supplied to non-contestable customers has previously been subsidised by the State Government through the Tariff Adjustment Payment (TAP).

The EGRC Regulations require Synergy to prepare separate quarterly statements of financial performance for each of its segmented business units. These reports are required to be made public, providing transparency. Synergy's segmented financial reports do not separate financial results for contestable and non-contestable customers, or gas and electricity operations.

The ERA has noted that the financial reports for different business units have varied in the level of information and time periods covered, limiting its ability to scrutinise each business unit's electricity related activities.

The ERA notes that other retailers, including Alinta Energy, Amarda Energy, Community Energy and ERM Power have previously raised concerns that Synergy's contestable business could be subsidised by pass-through of TAP related revenues from Synergy's non-contestable business, potentially allowing Synergy to offer contestable customers lower retail prices than its competitors.<sup>25</sup>

The ERA has therefore recommended that Synergy provide segmented financial reports to ensure transparency regarding how its revenues, costs and profits are split across Synergy's different electricity business segments.

The Public Utilities Office notes that there is no evidence that Synergy has engaged in any anti-competitive behaviour or misconduct. However, the Public Utilities Office agrees that the current structure of Synergy's financial reports may undermine the ERA's ability to investigate any concerns raised by other retailers, thereby undermining industry confidence.

Section 51 of the *Economic Regulation Authority Act 2003* states:

*'If the Authority has reason to believe that a person has information or a document that may assist the Authority in the performance of its functions, the Authority may require the person to give the Authority the information or a copy of the document.'*

The Public Utilities Office considers that the ERA can use its existing powers under section 51 of the *Economic Regulation Authority Act 2003* to access the desired segmented financial information from Synergy, and supports the ERA exercising these powers under the existing regulatory framework to perform regulatory scrutiny and provide assurances to the industry regarding any anti-competitive behaviour. Given the ERA's existing powers, the Public Utilities Office does not consider there is a need to pursue any regulatory changes to obligate Synergy to publish segmented financial reports.

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<sup>25</sup> ERA Scheme Reviews and public submissions are available on the ERA website: <https://www.erawa.com.au/electricity/wholesale-electricity-market/annual-review-of-synergys-regulatory-scheme>.

## 4. Frequency of Scheme reviews

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The EGRC Regulations require the ERA to carry out a review of the Scheme at least once each year for the purpose of assessing its effectiveness. The Scheme reviews take several months to complete and require a substantial resource commitment from the ERA and from stakeholders providing input to these review processes.

The 2016 Scheme Review is the ERA's third review to assess the effectiveness of the EGRC Scheme, and reiterates recommendations made in previous reviews.

The Public Utilities Office considers that the frequency of Scheme reviews should allow adequate time for the implementation of specific recommendations and observation of the effects of these actions.

The Public Utilities Office therefore proposes to amend the EGRC Regulations to change the frequency of the ERA's Scheme reviews to once every two years.

**Proposed Action:**

Amend the EGRC Regulations to require the ERA to carry out a review of the EGRC Scheme at least once every two years for the purpose of assessing its effectiveness.