Report to the Minister on the Effectiveness of the Electricity Generation and Retail Corporation Regulatory Scheme 2017

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Executive summary

In 2014, the State Government merged Verve Energy and Synergy to create the Electricity Generation and Retail Corporation (EGRC), which trades as Synergy. At the same time, the Government introduced the EGRC regulatory scheme to mitigate the potential for Synergy to misuse its market power.

Each year, the Economic Regulation Authority reviews the effectiveness of the operation of the EGRC scheme and provides the Minister for Energy with a report and recommendations for improvement. This is the ERA's fourth review. This report focusses on the EGRC scheme as at the end of the 2017 calendar year, and provides a priority list of recommendations to improve the effectiveness of the scheme.

Overview of the EGRC scheme

Since the merger, Synergy has maintained ownership or effective control of 80 per cent of generation in the wholesale electricity market. Synergy is also a major electricity retailer. Together, these factors potentially allow Synergy to exploit market power in the wholesale electricity market (WEM) to the detriment of competing electricity generators and retailers and ultimately, electricity consumers.

To sustain private sector participation and competition in the electricity sector, the EGRC regulations place the following obligations on Synergy to limit the potential for misuse of market power, and also to undertake certain actions to enable competition in the wholesale and retail electricity markets.

- Synergy must provide competing retailers and generators with access to contracts for wholesale energy. Retailers seeking to hedge against volatile energy market prices can contract with Synergy for wholesale energy, either through a set of mandated 'standard products' or customised contract arrangements. Standard product prices and anonymised transaction details are published to provide price discovery, transparency, and predictability for short to medium-term electricity contracts.

- Synergy must segment its generation, wholesale trading and retail functions and ring fence its wholesale trading unit when dealing with restricted information on competitors. This seeks to ensure Synergy's business units deal with each other at 'arm's length'. Also, Synergy's wholesale trading business must not discriminate against Synergy's wholesale and retail competitors in contracts for wholesale energy.

- Synergy must prepare and publish separate financial reports for each business unit that are sufficiently transparent to expose any anticompetitive activity, such as operating its retail business at a loss to gain an unfair competitive advantage over other retailers, while the loss is more than offset by greater profits in the wholesale trading unit.

The stated aims and anticipated outcomes for the EGRC scheme were identified at inception. However, the EGRC scheme does not include an objective, or specify any criteria for reviewing its effectiveness. Consequently, the ERA reviews the scheme against the objective to mitigate the potential for Synergy to exploit its market position as a dominant, vertically integrated electricity business, for the purposes of engaging in anticompetitive conduct, to the detriment of competing electricity generation and retail businesses and electricity customers.

In this assessment, the ERA examined the effectiveness of the EGRC scheme from two perspectives.

- A 'top down' review of the wholesale and retail electricity markets to determine if there are any signs that Synergy is exploiting its market power to gain competitive advantage.

- A ‘bottom up’ analysis of each of the main elements of the EGRC scheme to determine if they are operating as intended.

A vertically integrated business participates in upstream and downstream markets. The profit maximising strategy for a vertically integrated business would be to exploit the market that is least competitive. Synergy, as a commercial, vertically integrated entity could be expected to behave in the same way unless it is prevented.

In this case, the downstream retail electricity market is relatively competitive, and the ERA found no strong evidence to suggest that Synergy is exploiting market power to the detriment of its competitors. However, competition in the upstream wholesale market is weak. The ERA is concerned that Synergy’s dominance and the lack of competition in the WEM could enable Synergy to exercise market power and push up wholesale electricity prices. High prices are ultimately passed through to consumers who are charged more for electricity than would be the case in a competitive market.

Synergy is expected to remain dominant in the electricity sector for the foreseeable future. To reduce the risk of customers being charged higher prices for electricity as a result of the use of market power, the existing market power mitigation measures must be reviewed to ensure they are effective in meeting the WEM objectives of encouraging competition and minimising the long-term cost of electricity for consumers.

The ERA will explore wholesale competition in the 2017/18 WEM report, and is also investigating whether Synergy is misusing market power when bidding into the balancing market.

From its bottom-up analysis of individual elements of the EGRC scheme, the ERA has found deficiencies in each of the main elements of the scheme. These deficiencies increase the risk that the EGRC scheme is ineffective in constraining Synergy’s market power when contracting for wholesale supplies.

The ERA’s reasons for these conclusions and recommendations to improve the EGRC scheme are outlined as follows.

The competitiveness of the electricity markets

Contestable retail market

Electricity customers that consume more than 50 megawatt hours annually are contestable, meaning they can choose their electricity retailer. These contestable customers, typically businesses, represent 70 per cent of the retail electricity market by energy volume and comprise approximately 28,000 customers.

Having regard to several indicators together, the contestable retail sector appears competitive and there is no strong evidence to suggest that Synergy is misusing its market power to reduce competition in the contestable retail market.

Five main retailers are actively competing with Synergy for contestable customers. Synergy has lost contestable market share by volume, from [redacted] at WEM commencement in 2006 to [redacted] by the end of 2017.

Wholesale generation market

In contrast to the contestable sector of the retail market, the wholesale electricity market remains highly concentrated with Synergy the dominant generator.

In the wholesale contract market, third parties wishing to hedge against unexpected wholesale market price rises and volatility can contract with Synergy for wholesale electricity supplies. Counterparties rely on the EGRC scheme to place discipline on Synergy so that it does not misuse its market power to overprice wholesale contracts, nor discriminate against competitors on the terms and conditions of a wholesale supply.

It is difficult to determine whether Synergy is exercising market power when contracting for wholesale electricity supplies. Transactional data is limited as there are very few standard product trades and customised product transactions are confidential. There is also considerable variation in the terms and volumes of customised products that makes it hard to compare wholesale contracts to identify possible discrimination.

Following its bottom-up review of the separate elements of the EGRC scheme, the ERA has made five recommendations to amend the scheme. If implemented, these changes will mitigate the risk that Synergy can exploit market power when contracting to supply wholesale electricity to third parties. Retailers will be able to access wholesale supplies at lower prices, hedge against spot market volatility, and lock in stable prices for their customers.

Effectiveness of each element of the EGRC scheme

Standard products regime

Standard products are specified quantities of energy, available for fixed terms that Synergy must offer for sale and purchase. The standard product prices and anonymised transaction details are published.

The regime was established so that third parties can either contract in standard products directly or use the advertised standard product prices as a benchmark to contract with Synergy for wholesale electricity supplies customised to meet their particular needs.

Synergy is constrained from exploiting market power and setting standard product sell prices too high by also being required to publish a price at which it must buy the same standard products if offered by other market participants.

The standard product buy price is set lower than the sell price. The maximum difference between the buy price and the sell price, referred to as the spread, is set in the EGRC scheme. The maximum spread is currently set at 20 per cent. The value of the spread is critical to the effectiveness of the standard product regime because:

- If the spread is too great, Synergy would be able to use its market power to set too high a price for standard products, limiting their usefulness to competing market participants and constraining market competition.
- If the spread is too narrow, and if the balancing price is volatile, this risks the standard product buy price rising above the market price. Synergy would be exposed to the risk of arbitrage trading, and the associated trading losses.

There have been just 53 standard product transactions from the beginning of the regime in 2014 to the end of November 2018. This may be due to a lack of demand for the products and/or, as suggested by some participants in past reviews, because the standard product pricing and terms makes these products unsuitable as hedging tools in the market.

There is competition in the contestable retail sector, and Synergy has lost market share. This competition is occurring between retailers that have their own generation and predominantly self-hedge. These retailers will naturally have a lower demand for alternative hedging products and may be driving the low transaction numbers. When these retailers are not perfectly hedged by their own generation they do trade in standard products and account [redacted] out of the 49 standard product transactions to the end of 2017.

Historically, standalone retailers, who arguably have a greater need for access to wholesale supplies and hedging tools, have rarely traded in standard products. To the end of 2017, only [redacted] standard product transactions were with a standalone retailer.

When retailers do not hedge, they may be over-exposed to volatility in wholesale electricity market prices. To provide retail supplies to customers at fixed prices, unhedged retailers will have to either bear the spot market risk or pass this cost through to consumers at increased prices, making the retailer uncompetitive.

The pricing of standard products may contribute to the low number of standard product trades. At the beginning of 2017, Synergy reduced the price of its standard products by roughly $10/MWh. Following this there were 34 transactions (70 per cent of all transactions to the end of 2017). This activity has since lessened and to date in 2018, there have only been four new standard product trades.

The risk of wholesale contracts being overpriced, and the high prices being passed onto consumers, can be addressed by making changes to the standard product regime that would improve access to the standard products without adversely affecting Synergy's legitimate commercial interests. The ERA recommends three changes.

1. The standard product spread should be reduced to 10 per cent.

   – This imposes greater discipline on Synergy's pricing of standard products. The value of 10 per cent is well above the upper end of a range of spreads observed in other jurisdictions that have competitive markets for hedging products. A 10 per cent spread is still conservative and weighted in Synergy's favour such that Synergy is not unduly exposed to commercial risk.

2. Synergy's wholesale credit requirements, established as part of the EGRC scheme, should be relaxed until they are commensurate with the commercial risk of a retailer defaulting on a standard product contract.

   – To trade in wholesale products, retailers must undergo a formal credit assessment at least every 12 months, even though standard product transactions are low volume (1 to 5 MW) and total sale and purchase volumes are capped. These requirements for purchasers of standard products to demonstrate their creditworthiness are unduly onerous.

3. The force majeure suspension clause in standard product contracts should be made less conservative and more symmetrical to recognise the relative risk of non-supply to both parties.

   – The force majeure clause suspends Synergy's obligation to supply the standard product in the event of failure of a particular power plant. The force majeure clause is unduly weighted in Synergy's favour and undermines the use of standard products to hedge. When an outage occurs and supply is suspended, the counter party must access the spot market to meet its supply obligations. At the same time, the spot market will be more volatile as a result of the outage.

Non-discriminatory wholesale trading

The EGRC scheme requires Synergy to not discriminate between its own retail business unit and third parties on the terms and conditions of a wholesale supply of electricity, or take into account the retail arm's financial interests when setting the terms and conditions of supply.

These non-discrimination requirements apply to all the main contractual arrangements, except the 'foundation transfer pricing mechanism'. This governs electricity supplied by the wholesale business unit to the retail business unit for customers that were already contracted to Synergy at the time of the merger. These include residential and small-use business customers, and contestable customers and constitute around one third of the volume supplied by the wholesale business unit to the retail business unit.

By excluding the foundation transfer pricing mechanism from non-discrimination requirements the EGRC scheme creates the opportunity for the wholesale business unit to preference Synergy's retail business when pricing wholesale supplies used to supply foundation customers. This is an unjustified restriction on retail competition. Extending the non-discrimination requirements to all contractual arrangements would provide for all contestable customers to be accessible to all retailers. The ERA recommends:

4. The non-discrimination requirements of the EGRC scheme should be extended to the foundation transfer pricing.

Segregated financial reporting

The EGRC scheme requires Synergy to prepare separate financial statements for each of its segmented business units. The Minister for Energy, in consultation with Synergy Board, is then required to make these reports publically available.

The ERA's 2015 review found that Synergy's segmented financial reports did not separately report results for gas and electricity activities, nor contestable and non-contestable financial results. The reports also varied in the information provided and the time periods covered. The segmented reports are not sufficiently transparent to expose any anticompetitive behaviour such as profit shifting or cross-subsidisation in Synergy's electricity business. The ERA recommends:

5. Synergy should prepare and provide confidential segmented financial reports to the ERA in a format that is sufficiently transparent to identify anticompetitive behaviour. The format of the segmented financial reports should distinguish between revenues, costs and profits for:

    a. gas and electricity activities in each business unit

    b. contestable and non-contestable customers in the retail business unit.

1 Overview of the EGRC scheme

On 1 January 2014, the Government merged its electricity generation and retail businesses, Verve Energy and Synergy, to form the Electricity Generation and Retail Corporation (EGRC), which trades as Synergy.

Recognising that Synergy had control of about three quarters of electricity generation in the Wholesale Electricity Market (WEM) through its own generation plant and through contractual arrangements with third party generators, the Government introduced the EGRC regulatory scheme, comprising:

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

The EGRC scheme imposes requirements on Synergy intended to mitigate the potential for the misuse of market power arising from the merger. An overview of the various elements of the EGRC scheme is set out below.

Business segmentation

Synergy is required to divide its operations into segments: primarily a generation business unit, retail business unit, and wholesale business unit.[1] Synergy is required to prepare separate statements of financial performance for each business unit each quarter, and annually.

Transfer pricing and third party access to wholesale supplies

Synergy must establish transfer pricing arrangements for trading wholesale electricity supplies between its wholesale and retail business units. Transfer pricing arrangements are intended to ensure internal pricing and sales are at arm's length, similar to trading arrangements between independent parties. Transparent transfer pricing arrangements also help to make apparent any anticompetitive profit shifting between segmented business units. Synergy's transfer pricing arrangements are to supply retail customers in two classes:

- Foundation customers - the non-contestable customers (households and small businesses) and contestable customers (medium to large businesses) that were contracted to Synergy[2] or in negotiations to contract with Synergy prior to the merger.[3] The arrangements for supply to foundation customers are set out in the foundation transfer price mechanism.[4]

[1] Synergy also has a shared service operations unit for common services such as finance, human resources and information technology. The EGRC Regulations enable other additional business segment or segments to be established if approved by the Minister for Energy.

[2] At the time, Synergy was independent from Verve Energy and was the Retail Electricity Corporation.

[3] Under the regulations, a foundation customer arrangement is for supply of electricity to the customer at a charge determined in accordance with the *Energy Operators (Electricity Generation and Retail Corporation) (Charges)(By-laws 2006).* A foundation customer arrangement became legally binding on Synergy after the merger if the contestable customer accepted on or before 31 March 2014 (without amendment), an offer for the retail supply of electricity that was made by Synergy to the contestable customer before the merger time.

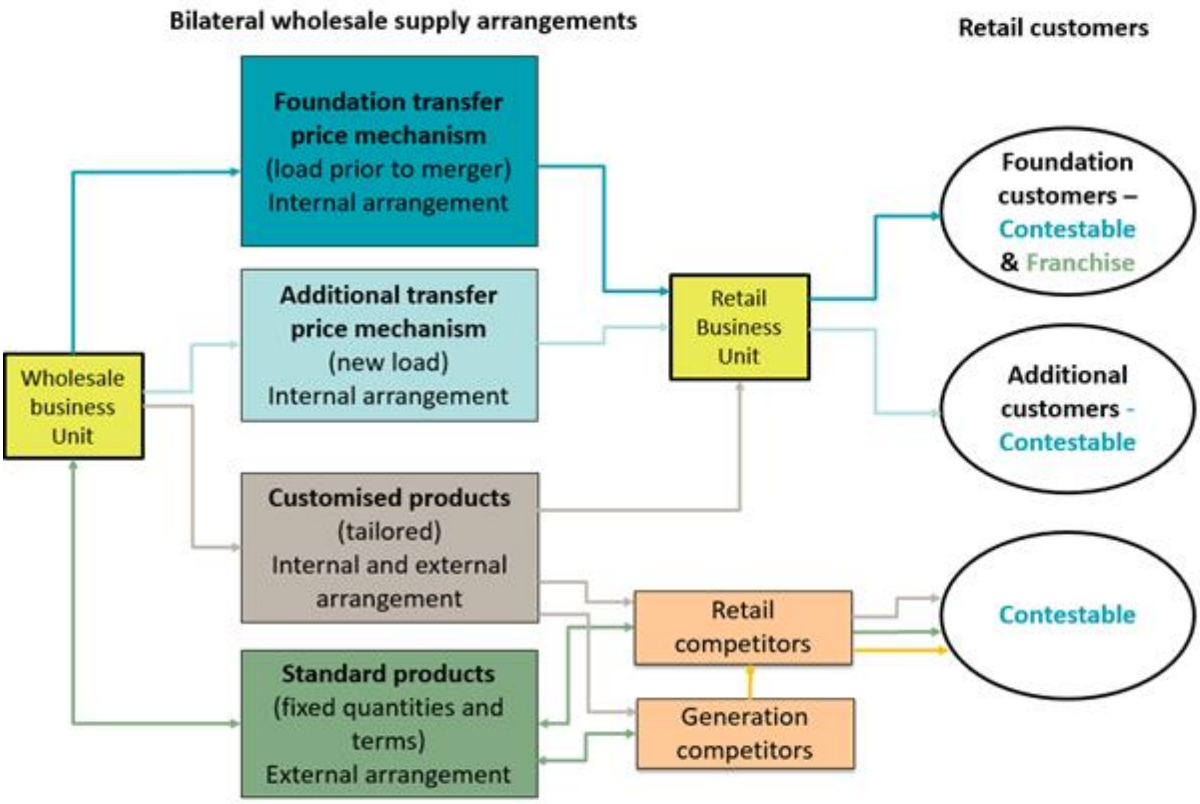
[4] This arrangement is otherwise referred to as the Internal Synergy Wholesale Arrangement.

- Additional customers – that have a new contestable customer arrangement with the retail business unit that became legally binding on Synergy after the merger. The arrangements for supply to new contestable customers are set out in the additional transfer price mechanism.[5]

Third-party retailers and generators can contract for wholesale supplies of electricity from the wholesale business unit through customised or standard products. Customised products are tailored to suit the requirements of the counterparty trading with the wholesale business unit, with terms set out in an Electricity Bilateral Trade Agreement, the appendix of which is specific to the individual customer and transaction. Standard products are fixed quantities of energy that Synergy must advertise for sale and purchase at published prices. The arrangements for trading in standard products are set out in the Bilateral Trade Agreement for Electricity (Standard Products).

The EGRC scheme prohibits the retail business unit from procuring wholesale supplies through the standard product arrangements. However, the retail business unit is able to contract with the wholesale business unit for customised products.

Figure 1: The main contractual arrangements specified in the EGRC scheme



Third-party retailers and generators can also obtain wholesale supplies of electricity from the Short-Term Electricity Market (STEM) and the balancing market. The retail business unit cannot trade directly in the energy markets. However, it can access supply at STEM or balancing market prices through its Supply Balancing Cost Allocation Arrangement with the wholesale business unit, which is the Synergy business unit responsible for trading in the energy market.

5 This arrangement is otherwise referred to as the New Load Wholesale Arrangement

Non-discrimination requirements

Synergy must ensure that a wholesale supply of electricity is not offered to its retail business unit on terms and conditions that are, "having regard to all relevant circumstances", more favourable than those offered to retail or generation competitors.[6] Synergy must also ensure that the financial interests of its retail business unit are not taken into account in determining the terms and conditions on which a wholesale supply of electricity is offered to retail or generation competitors.[7]

The non-discrimination requirements are identified as civil penalty provisions under the EGRC regulations and must be applied in determining the terms and conditions of standard product transactions,[8] additional transfer price mechanisms,[9] and customised product transactions.[10]

Standard products

Synergy must provide specified wholesale energy products for sale and purchase to the WEM. The overarching goals[11] of the standard product regime are to:

- Maintain private sector activity by imposing discipline on Synergy's wholesale pricing.
- Act as a price discovery mechanism, providing transparency and predictability for short to medium dated contracts for market participants.
- Provide a competitive benchmark price to the wholesale supply of electricity on a non-discriminatory basis.
- Provide simple products that are an alternative to customised products, reduce barriers to entry for new retailers, and allow market participants to rebalance their portfolios at the margins.

The standard product arrangements specify the requirements of the standard product regime. Standard products include:

- 'flat' products (at a constant quantity over all times of the day)
- 'peak' products (8:00am to 10:00pm on business days).

Both types of products cover quantities of electricity in increments from 0.5 MWh per trading interval to a minimum aggregate weekly supply of 2.5 MWh per trading interval. Products must be offered for quarterly, calendar and financial year periods. For each product, Synergy must offer to sell 150 MW and purchase 100 MW.

Synergy is constrained from exploiting market power and setting standard product sell prices too high by also being required to publish a price at which it must buy the same standard

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6 See regulation 22(a).

7 See regulation 22(b).

8 See section 5.2(a) of the Electricity (Standard Product) Wholesale Arrangements 2014. http://www.parliament.wa.gov.au/publications/tabledpapers.nsf/displaypaper/3911638a33eff5b6457b2ce248257cf30029ad85/$file/1638.pdf

9 See regulation 9(3) and (4) and Part 3, Division 1 of the regulations. https://www.legislation.wa.gov.au/legislation/statutes.nsf/main_mrtitle_13129_homepage.html

10 Refer to Synergy's Wholesale Electricity Supply Policy, clause 8.2, and Synergy's Wholesale Energy Credit Policy, clause 1(b). https://www.synergy.net.au/About-us/Who-we-are/What-we-do/Wholesale-Business-Unit

11 See Second reading speech, Electricity Corporations Amendment Bill 2013 http://www.parliament.wa.gov.au/Parliament/Bills.nsf/34142247BD1BD20948257C0600173BB6/$File/Bill40-1SR.pdf

products if offered by other market participants. Synergy will avoid additional electricity purchases as is already long in electricity, with more electricity generated or procured than is needed to meet its retail obligations.

The EGRC scheme originally set the spread at a maximum of 25 per cent. On 1 January 2015, the maximum spread was reduced to 20 per cent.

Synergy can update its advertised standard product prices up to a month before the relevant supply period commences. Transaction prices are the published standard product prices on the date of the transaction.

Ring fencing

The EGRC scheme seeks to restrict the flow of sensitive commercial information between business units, so that there is no detriment to competing electricity businesses. The scheme requires restricted information to be ring fenced between business units.

Synergy must ensure that retail restricted information is not disclosed to retail staff and generation restricted information is not disclosed to generation staff. Restricted information is that which relates to a generator or retail competitor and is obtained by Synergy staff in conducting business within the unit. The information might be expected to materially and adversely affect the commercial interests of the competitor if disclosed.

Controls must be in place to limit access to information technology systems containing restricted information, and Synergy must implement training to ensure that staff receiving, or with access to, restricted information understand their obligations. Wholesale staff that have access to restricted information must occupy work areas that are separate from retail and generation staff. Staff in management roles in a particular business unit, except for shared services, must not have management responsibility for the other specified business units.

Compliance

The Office of the Auditor General monitors compliance with the EGRC scheme and conducts a financial year audit of the segmentation of Synergy's operations, financial administration, segregation arrangements, and wholesaling obligations and arrangements. The Office of the Auditor General must also conduct a calendar year audit covering disclosure of restricted information and the requirements for information technology controls, training, separate work areas and separation of management roles.

The Office of Auditor General must give the Minister, the Synergy board and the ERA a report on each audit that includes its opinion and details of any deficiency, failure or shortcoming by Synergy in meeting the requirements of the EGRC Regulations. The report must be tabled in Parliament within 21 sitting days. The ERA must investigate any instances of non-compliance reported by the Office of Auditor General and may impose civil penalties.

Notably, for the purposes of the current review, the monitoring and auditing by the Office of the Auditor General addresses matters of compliance by Synergy with the specific administrative and procedural requirements of the EGRC scheme, not whether the scheme is effective.

2 ERA's review function

The EGRC regulations require the ERA to conduct a review of the effectiveness of the operation of the EGRC scheme at least annually. The EGRC scheme itself does not contain an explicit statement of its objective, or provide criteria for reviewing its effectiveness.

The broad aim of the EGRC scheme is to 'sustain private sector participation' in the market.[12] This supports the WEM objectives of ensuring the continued development of competition and minimising the long-term cost of electricity to consumers.[13]

Without explicit criteria for reviewing the effectiveness of the EGRC scheme, the ERA has interpreted its role and conducts its review assuming:

> The objective of the EGRC scheme is to mitigate the potential for Synergy to exploit its market position as a dominant, vertically integrated electricity business, for the purposes of engaging in anticompetitive conduct, to the detriment of competing electricity generation and retail businesses and electricity customers.

The ERA conducted a 'top down' review to look at the extent of competition in the wholesale and retail markets. The ERA also undertook 'bottom up' analysis of each of the main elements of the EGRC scheme to determine if the elements are operating as intended.

In conducting the review the ERA drew from the competition analyses, data provided by Synergy, stakeholder responses to discussion papers and workshops, confidential interviews, and experience and evidence from other jurisdictions.

This report focusses on the critical issues with the EGRC scheme at the end of the 2017 calendar year, and provides a priority list of recommendations to improve the effectiveness of the scheme.

In previous reports the ERA has identified other considerations for improving the EGRC scheme. These observations and recommendations remain, and should be considered in conjunction with the priority recommendations in this 2017 EGRC report.

The ERA will continue to monitor the scheme and may escalate some of these other recommendations to priority recommendations in the future.

12 Electricity Corporations Amendment Bill 2013, second reading speech http://www.parliament.wa.gov.au/Parliament/Bills.nsf/34142247BD1BD20948257C0600173BB6/$File/Bill40-1SR.pdf

13 See Market Rule 1.2, p.26, for WEM objectives. https://www.erawa.com.au/cproot/14681/2/Wholesale%20Electricity%20Market%20Rules_10.12.16.pdf

3. Competition analysis

The ERA has assessed the state of competition in the South West Interconnected System by examining some indicators of competition in the retail[14] and wholesale supply markets.

Synergy's retail sales have decreased each year since 2007. Only Synergy can retail to residential and small business customers, and the installation of rooftop photovoltaics by some of these customers may have contributed to the declining sales in this sector.

3.1 Contestable retail sector

Electricity customers that consume more than 50 megawatt hours annually are contestable. The measures of retail competition examined by the ERA indicate that the contestable market is competitive.

Five main retailers are competing with Synergy. Synergy's contestable market share, measured by energy consumption, has declined over time, from [redacted] at WEM commencement in 2006 to [redacted] by the end of 2017. The private sector has continued to participate in the wholesale and retail electricity markets since implementation of the EGRC scheme.

It is not sufficient to demonstrate that some competition is occurring to conclude that the EGRC scheme is operating effectively. Any assessment of market competition must be objective and requires context. The competitiveness of the contestable retail sector should be considered in light of the following observations:

- The rate of decline in Synergy's market share following the introduction of the EGRC scheme is similar to the general trend observed from market commencement.
- The level of concentration in the contestable retail market, measured using the Herfindahl-Hirschman Index, did not reduce in the past year. It remains on the border between being classified as moderately concentrated and un-concentrated.[15]
- There has been no increase in small retailer market share nor in the number of small retailers participating in the market.[16]

3.2 Wholesale electricity market

The wholesale electricity market remains highly concentrated. Three generators produce 90 per cent of electricity in the market. Although Synergy's generation output has decreased

[14] Measures of retail competition analysed by the ERA were the Herfindahl-Hirschman Index of market concentration, contestable market share based on consumption, contestable market sales by volume, customer transfer and churn rates, hedging activity, and changes in Synergy's average energy price by contestable and non-contestable sector. The ERA did not examine retailer price, cost or margin outcomes or customer experiences and satisfaction with these outcomes.

[15] The higher the Herfindahl-Hirschman Index, the higher the degree of market concentration. Markets with an index below 1,500 are considered to be un-concentrated, while markets with an index of between 1,500 and 2,500 are considered to be moderately concentrated. Markets with an index above 2,500 are considered to be highly concentrated. In 2017, the index has remained at around 1,500.

[16] Growth in the contestable market has slowed from an annual average of 4.9 per cent between 2007 and 2017 to 1.9 per cent over the last five years. Growth has come from contestable market participants, called direct purchasers, who are purchasing wholesale electricity for their own consumption and not using a retailer. Small retailers' market share has remained static at around 2 per cent by volume over the past two years.

since the merger, its dominance in the market remains high, with ownership or control of around 80 per cent of generation. Synergy set prices in 81 per cent of intervals in the balancing market in 2017.

Synergy's dominance in the market and its vertically integrated structure may also provide an opportunity for Synergy to exercise market power and increase wholesale electricity prices and profit in this sector, while being unconcerned about a loss of retail market share.[17]

In the STEM and balancing markets, all generators, including Synergy, must comply with the WEM Rules. These rules govern how generators participate and price their offers into the market. The ERA is currently undertaking a separate investigation into Synergy's bidding behaviour in the balancing market.[18]

Third parties wishing to access wholesale electricity and hedge against unexpected wholesale market price rises and volatility can contract with Synergy for wholesale electricity supplies. Counterparties rely on the EGRC scheme to place discipline on Synergy so that it does not misuse its market power to overprice wholesale contracts, nor discriminate against competitors on the terms and conditions of a wholesale supply.

Synergy uses its forecast view of energy market prices, or forward price curve, to calculate standard product sell prices. Since 1 July 2017, Synergy has also used its forward price curve as the basis for calculating foundation transfer prices.[19]

Given the non-discrimination requirements in the EGRC scheme, the same forward price curve now underlies the calculation of standard product prices, additional transfer prices and customised product prices. Therefore, if Synergy is able to misuse its market power when pricing standard products, this could also influence the majority of other wholesale contract prices.

It could be argued that if Synergy is overpricing wholesale contracts then, because of the non-discrimination requirements in the EGRC scheme, the retail business unit will also 'overpay' for wholesale supplies. This is because the scheme requires Synergy to:

- Establish transfer pricing arrangements for trade between its wholesale and retail business units to ensure internal pricing and sales are at arm's length and similar to trading arrangements between independent parties.
- Ensure that a wholesale supply of electricity is not offered to its retail business unit on terms and conditions that are more favourable than the terms on which a wholesale supply of electricity is offered to retail competitors or generation competitors.[20]

[17] See page 7 of the Parliamentary transcript from the Assembly Estimates Committee meeting held on 19 September 2017. Regardless of the retail business unit reporting a loss of $273 million, by combining the wholesale and retail business units' financial results, Synergy made an overall profit, an outcome that was a function of the internal transfer price. http://www.parliament.wa.gov.au/hansard/hansard.nsf/0/0c4ff5c8fe13b7c1482581ae00222869/$FILE/A40+S1+20170919+p78b-86a.pdf

[18] See https://www.erawa.com.au/electricity/wholesale-electricity-market/market-behaviour-investigations/2017-investigation-into-synergys-pricing-behaviour .

[19] When the EGRC scheme commenced, the transfer price of electricity supplied by Synergy's wholesale business unit to its retail business unit was based on contracts and budgets from prior to the merger. Six months prior to 30 June 2017, Synergy was required to prepare a replacement foundation transfer price mechanism, and give it to the Minister. On 1 July 2017, this replacement mechanism came into force for a period of three years, or for a longer period if approved in writing by the Minister.

[20] See regulation 22(a).

Even if the retail business unit has a reduced profit, or incurs losses through competition in the contestable market, overall Synergy will still profit. This is because Synergy's profit is independent of the retail business unit's wholesale supply costs. The retail business unit's reduced profit will be offset by gains by the wholesale business unit from the price mark-up. The wholesale business unit will also collect a price mark-up from the third party generators and retailers contracting for supply with Synergy. This is demonstrated by the example in the box below.

The requirements for transfer pricing and for Synergy to set non-discriminatory wholesale prices do not eliminate the opportunity for Synergy to mark-up wholesale prices higher than it could in a competitive market.

If Synergy marks up its wholesale prices, there is no effect of this mark-up on Synergy's overall profit from supplying to its own retail business unit at the marked-up price. Adding the wholesale and retail business units' profits cancels out the quantity bought by the retail business unit at the marked-up wholesale price.

Therefore, Synergy's profit is determined by the quantities sold to third party generators and retailers at the marked-up price, combined with the quantity sold by the retail business unit at its retail price, minus Synergy's wholesale costs. A simple mathematical explanation of how this is possible is provided below:

$$\begin{aligned} Wholesale\ profit = {} & (Retail\ quantity\ bought\ \times\ wholesale\ price) + (third\ party\ quantities \\ & \times\ wholesale\ price) - wholesale\ cost \end{aligned}$$

$$Retail\ profit = (Retail\ quantity\ sold\ \times\ Retail\ price) - (Retail\ quantity\ bought\ \times\ wholesale\ price)$$

$$Synergy\ profit = Wholesale\ business\ unit\ profit + Retail\ Business\ Unit\ profit$$

$$\begin{aligned} Synergy\ profit = {} & (\cancel{RBU\ quantity\ bought\ \times\ wholesale\ price}) \\ & + (third\ party\ quantities\ \times\ wholesale\ price) - wholesale\ cost \\ & + (Retail\ quantity\ sold\ \times\ Retail\ price) - (\cancel{RBU\ quantity\ bought} \\ & \cancel{\times\ wholesale\ price}) \end{aligned}$$

$$\begin{aligned} Synergy\ profit = {} & (third\ party\ quantities\ \times\ wholesale\ price) - wholesale\ cost \\ & + (Retail\ quantity\ sold\ \times\ Retail\ price) \end{aligned}$$

Synergy's profit is therefore not dependent on the retail business unit's wholesale supply costs.

Thus, if Synergy is misusing its market power to inflate wholesale contract prices, the wholesale supply arm of Synergy's business could earn economic rent. Where consumer demand is insensitive to changes in price, consumers will pay for the inefficient pricing in the long term.

The ERA's priority recommendation to increase the transparency of Synergy's segmented financial reporting (refer to chapter 4.4) will help to determine if Synergy is engaging in this behaviour. More detailed financial reporting will make transparent any anticompetitive activity such as profit shifting or cross-subsidisation in Synergy's electricity businesses.

In its 2018 Retail Pricing Inquiry report, the Australian Competition and Consumer Commission (ACCC) considered vertical integration in the National Electricity Market (NEM) and commented:

> "Vertical integration in the NEM is likely to have reduced market liquidity as more generation capacity is tied up with retail businesses and reserved to manage risk

> internally. The big three retailers have acquired the majority of the NEM's thermal generation capacity, which are natural suppliers of many fundamental hedging products. Without sufficient competitive pressure in wholesale and retail markets these vertically integrated players may have the ability and incentive to withhold contracts from rival retailers, or to discriminate against them regarding price.
>
> …The analysis of vertically integrated business shows that they are able to allocate profit between their retail and wholesale arms. It is important to keep this in mind when assessing the retail margins or profitability of the retail business by itself. An apparently uncompetitive retail business may in fact be connected to a very profitable wholesale operation."

The ACCC is reporting every six months on the supply of retail and wholesale electricity in the NEM until 2025. The ERA will continue to monitor the ACCC's reports and conclusions.

3.3 Effectiveness of individual elements of the EGRC scheme

The ERA has considered individual elements of the EGRC scheme to determine whether or not the EGRC scheme is enabling private sector participation and competition. There are some elements of the EGRC scheme that appear to achieve the intended outcomes, such as restrictions on the flow of competitors' sensitive information between business units through staff movements.[21]

There is scope to improve other elements of the EGRC scheme to encourage effective competition. The ERA has presented its recommendations for improvement to the EGRC scheme in order of priority in chapter 4.

Recommendations for improving the EGRC scheme that the ERA has identified in previous reviews remain relevant. The ERA will continue to monitor the scheme and may escalate some of these to priority recommendations in the future.

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21 The ERA examined the restrictions on information transfer via staff movements and found that few staff movements have occurred at Synergy at the managerial level and that Synergy has processes in place to ensure that transferring staff do not share restricted information.

4. Priority recommendations to improve effectiveness of the EGRC scheme

This chapter identifies which elements of the EGRC scheme should be changed, as a priority, to improve its overall effectiveness and encourage competition in the wholesale and retail electricity markets.

4.1 Reduce the standard product spread

If Synergy is able to misuse market power when setting standard product prices, this could limit the extent to which other retailers are able to use standard products to easily access wholesale supplies and hedge against volatility in the electricity spot markets.

When retailers are unable, or unwilling, to hedge they may be over-exposed to volatility in wholesale electricity market prices, and this may undermine competition in the retail market. To provide retail supplies to customers at fixed prices, unhedged retailers will have to either bear the spot market risk themselves or pass this cost through to consumers at increased prices, making the retailer uncompetitive. Currently, 8 to 9 per cent of the contestable retail sector is unhedged and without self-generation or bilateral contracts with generators (including contracts with Synergy). The ERA is investigating whether this level of exposure presents a risk to the stability of the contestable retail market.

As noted in chapter 3, there is competition in the contestable retail sector, and Synergy has lost market share. However, this competition is occurring between retailers that have their own generation and predominantly self-hedge. These retailers will have a lower demand for alternative hedging products.

Standalone retailers, who arguably would have greater demand for hedge products, have rarely traded in standard products. There have been 53 standard product transactions to the end of November 2018 as shown in Table 1 below. Of these, [redacted] with standalone retailers.

Table 1: Standard product transactions

Date range	Number of standard product transactions		Notes
	BUY	SELL	
Aug to Dec 2014	-	8	All trades were with [redacted]
During 2015	5	1	All trades were with [redacted]. While the buy price was suitable for some sellers, the sell price may have been too high for those wanting to purchase standard products.
During 2016	-	1	The trade was with [redacted]. In the latter half of 2016, pricing in the STEM and balancing market was volatile.
During 2017	-	34	At the start of 2017, volatility in the market had reduced somewhat but was still high. Synergy reduced its standard product buy and sell prices by roughly $10/MWh. The 34 transactions were with a [redacted]
By end Nov 2018	-	4	Detailed information on these trades is not available.
Total	**5**	**48**	**53 standard product transactions in total**

Source: ERA analysis of Synergy data

The low number of standard product trades indicates there is either a lack of demand for the products, or as indicated by feedback from some market participants, the standard products are not useful to procure a wholesale supply or as a tool to hedge against volatility in the spot market.

In its submission to the 2017 discussion paper, Kleenheat considered that the standard product regime was ineffective as a price discovery tool, given the excessive buy-sell spread, and as a competitively priced option for procuring wholesale energy.[22] Kleenheat drew attention to the negligible growth of small retailers, which it considered could be attributed to the price-driven aspects of the regime. While recognising the increased number of transactions, Kleenheat argued that prices were set too high to offer a reasonable hedge for the electricity portfolio of a retailer.

Synergy considered that there was no evidence that the current standard products buy sell spread was inappropriate, or was not supporting the EGRC scheme, especially given there was a substantial increase in the standard product deals in the second part of 2017 and in 2018.

4.1.1 How the standard product spread constrains market power

Synergy is constrained from exploiting market power and setting standard product sell prices too high by also being required to publish a price at which it must buy the same standard products if offered by other market participants. Synergy will avoid purchasing additional electricity as it is already has more than enough from existing generation output and contracts to meet its regulatory obligations.

The standard product buy price is set lower than the sell price. The maximum difference between the buy price and the sell price, referred to as the spread, is set in the EGRC scheme. The maximum spread is currently set at 20 per cent.

If the spread between the buy and the sell prices in the standard product regime is set narrow enough, it places discipline on Synergy's sell prices for bilateral contracts. The buy price anchors the sell price, through the spread. For example if Synergy raises its standard product sell price, it must also raise its buy price to maintain the maximum spread.[23]

If the spread is too narrow, and the standard product sell price is set high enough that the standard product buy price is above the expected price in the energy market, and a counterparty wishes to enter into a standard product buy transaction, Synergy will be obliged to purchase the energy at a price higher than STEM and balancing market prices.

If the standard product maximum buy-sell spread is too wide, Synergy can misuse market power and set standard product sell prices and bilateral contract prices too high. Synergy is dominant in the wholesale market and other retailers have few options other than to source their wholesale energy supplies from Synergy.

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22 In its submission to the 2017 discussion paper, Kleenheat recommends that the ERA investigate if the pricing of Synergy products includes an excessive risk premium and/or margin, particularly in future years. Kleenheat considered that this would include investigating the non-price terms and conditions (including force majeure) attached to retail offers. The ERA examined this in its 2016 review.

23 This is illustrated in the stylised diagram in Figure 2 of the ERA's review of the 2016 calendar year, which shows the relationship between buy, sell and expected market prices. See page 12 https://www.erawa.com.au/cproot/18474/2/2016%20EGRC%20Report%20to%20the%20Minister.pdf

If there is no risk that Synergy will be obliged to purchase energy, the buy price is not an effective anchor for the sell price. The standard product regime is not achieving one of its overarching goals to impose discipline on Synergy's wholesale pricing.[24]

4.1.2 An appropriate spread

As part of its 2015 review, the ERA engaged Deloitte Access Economics to provide advice on a suitable method for estimating the maximum spread. Deloitte considered that the standard products were an alternative to purchasing electricity in the STEM and avoiding the associated price uncertainty. Deloitte developed a method for calculating the maximum spread by estimating STEM market volatility, and allowing a 69 per cent chance that Synergy would make a profit on standard product trades.

The ERA employed this method along with information from other markets[25] to recommend a maximum spread of 10 per cent. The ERA recommended that consideration also be given to the use of varied spreads, with smaller spreads employed for more frequently traded products and wider spreads employed for illiquid products that have longer term uncertain forecasts. [26]

In its 2016 submission, Synergy stated that it was highly unreasonable to suggest Synergy could forecast a spot price two years out with an accuracy of +/- 5 per cent.[27] Synergy stated that the forecast for standard product prices was made quarterly on a two-year ahead basis, which made it difficult to form accurate estimations of future prices. It noted that the future price forecasts were highly affected by variability in the forecasts of temperature-dependent load. It therefore suggested that a 10 per cent spread between the buy and the sell prices was not a viable option.

Synergy sets prices for standard products based on a forward energy curve representing its expectation of future energy market prices. The uncertainty about future energy market prices is captured in the product price that is offered to the market in the form of a risk premium that adjusts the expected energy curve. This risk premium[28] is included regardless of whether the market is liquid or illiquid and irrespective of the term, including for two-year forward products.

Changes to the wholesale arrangements can be made relatively quickly, as they do not require changes to the legislation but can be made by the Minister through tabling in Parliament and publication in the Gazette.

The maximum standard product spread is important to increasing the pressure on Synergy to be disciplined in pricing its bilateral contracts and reducing upward pressure on electricity prices. There is minimal risk to Synergy and changes to the spread can be undertaken easily by Ministerial decision.

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24 Refer back to the overarching goals of the Standard Product regime in chapter 1, page 3.

25 Spreads in other markets typically vary between 2 and 8 per cent.

26 The Energy Security Board has released a consultation paper on market making requirements in the NEM, requesting feedback on the parameters for the Market Liquidity Obligation in the National Energy Guarantee and the market making obligation in South Australia. The consultation paper cites spreads of 1.6 to 2.4 per cent in the NEM and $1 or $2/MWh or 2 per cent in Singapore. The Energy Security Board questions whether a 5 per cent spread is appropriate or a tighter spread could be justified. See http://www.coagenergycouncil.gov.au/sites/prod.energycouncil/files/publications/documents/Market%20Making%20Requirements%20in%20the%20NEM%20Consultation%20Paper.pdf

27 Consistent with the use of a ten per cent spread. See item 2 in Synergy's 2016 EGRC review submission.

28 The risk premium may be fixed or increasing over time.

Recommendation 1

The standard product spread should be reduced to 10 per cent. This imposes greater discipline on Synergy's pricing of standard products.

The value of 10 per cent is well above the upper end of a range of spreads observed in other jurisdictions that have competitive markets for hedging products and does not unduly expose Synergy to commercial risk.

4.2 Improve standard product arrangements

This requirement for non-preferential conduct by Synergy safeguards the ability of the private sector to compete in the market. Given the possibility of continued volatility in the energy markets in the future, barriers to transacting in standard products will need to be resolved relatively quickly.

In submissions to previous EGRC reviews, market participant have claimed that, apart from price, the credit requirements and force majeure provisions were the main barriers to trade in standard products. If standard product terms are a barrier, there is little opportunity for independent retailers to procure wholesale supplies and source hedge contracts, which can reduce competition.

The effect of the credit requirements on limiting trade in standard products has been identified in public submissions to the ERA's consultation process in each EGRC review since the EGRC scheme was introduced. To trade in standard products, a participant must first become an approved counterparty to Synergy, which requires the participant to provide its last two audited financial year statements. Synergy's Wholesale Energy Credit Policy then requires that a formal credit assessment is performed for every new counterparty. Synergy can also conduct a formal credit assessment at least every 12 months, and may conduct credit assessments at its discretion where there are indications of a change in a counterparty's financial health.

Synergy considered that the standard product credit requirements do not prevent customers from purchasing standard products. Synergy noted that the credit requirements are a function of board-approved policies and are intended to protect Synergy from the risk of counterparty default.

While [redacted] has since contracted with Synergy for standard products, [redacted] have entered into these contracts.[29] Only [redacted] contracted for customised products, which are also subject to the same credit requirements. The credit requirements may still be a barrier to entry for these participants. With few opportunities for contracting, small retailers may choose not to compete for new business, thereby limiting competition in the retail market.[30]

Concern about the asymmetry in standard product force majeure provisions was again raised by stakeholders at the ERA's 2017 EGRC workshop. When Synergy is the seller in a standard product transaction, interruption to supply from any one of a list of generating units triggers the force majeure clause, and suspension of Synergy's obligations. This may reduce the use of standard products as a risk management tool.

29 There are eight other small retailers registered as market customers in the SWIS.

30 See page 100: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/284390/cc3_revised.pdf

In support of this, Kleenheat noted that when the higher standard product price may well be justified, the wholesale supply may not be available due to the force majeure clauses. Kleenheat considered that the force majeure clauses needed to be amended to “prevent Synergy unduly enacting such clauses without due regard for the materiality of the resultant higher price due to the force majeure event”.[31]

The individual contribution of each specified plant to the aggregate generation capacity of Synergy ranges between 2 per cent and 9 per cent of the total capacity credits owned or controlled by Synergy, as shown in Table 2.

Table 2: Plant specified for the Standard Product Arrangements and their contribution to Synergy’s total capacity portfolio

Specified plant	Capacity credit (MW)*	Percentage of Synergy’s capacity portfolio (%)
SWCJV_WORSLEY_COGEN_COG1**	107	3
MUJA_G5	195	6
MUJA_G6	193	5
MUJA_G7	211	6
MUJA_G8	211	6
COLLIE_G1	317	9
COCKBURN_CCG1	232	7
BW1_BLUEWATERS_G2	217	6
BW2_BLUEWATERS_G1	217	6
PPP_KCP_EG1	80	2
NEWGEN_KWINANA_CCG	320	9
Non-specified plants (owned or controlled by Synergy)***	1,223	35

Source: ERA analysis of Synergy data.

*Note: *Approved capacity credit (2017-18). **Worsley Cogeneration plant was deregistered on 2 March 2017. **Non-specified plant are facilities registered to Synergy that are not specified in clause 10.1(c)(2) of the Bilateral Trade Agreement for Electricity (Standard Products).*

*Given the size of Synergy’s generation portfolio, the clause allowing for suspension of supply following an outage of just one generating unit appears to be excessive and disproportionate to the risk faced by Synergy from such an event. The suspension clause also transfers any risk that Synergy holds in transacting in standard products back to the counterparty, which may have contracted to cover the risk of high prices that can occur due to outages.

Nevertheless, changes in the number of sell transactions occurred in 2017 without changes to the product specifications, credit requirements, or force majeure provisions. When questioned on how the ongoing criticism of the standard product regime could be reconciled with the increased transacting in standard products, participants in the ERA’s stakeholder workshop considered that it was attributable to volatility in the energy markets.

31 See: https://www.erawa.com.au/cproot/18923/2/PubSub%20-%20EGRC%20Review%202017%20-%20Kleenheat.pdf

Analysis of the timing of the transactions, and the state of volatility in the markets during 2017, supports this explanation. In the first half of 2018 standard product prices have remained the same as in 2017 but prices and volatility in the energy markets have reduced and there were only two standard product sell transactions, each of which was for a 1 MW flat quarterly product in March.

Feedback from retailers in response to the discussion paper for the 2017 review continued to raise the same concerns about the standard products.[32] Given that only [redacted] usually trade in standard products, these criticisms warrant further consideration.

Access to wholesale supplies is important to ensuring the participation of private sector generation and retail competitors in the market. Access to hedge products enables retailers to hedge against volatility in the electricity spot market. By removing two more potential barriers to trading in standard products, these products will be available on reasonable terms. The ERA makes two recommendations.

Recommendation 2

Synergy's wholesale credit requirements established as part of the EGRC scheme should be relaxed until they are commensurate with the commercial risk of counterparty default.

Recommendation 3

The force majeure suspension clause in standard product contracts should be made less conservative and more symmetrical to recognise the relative risk of non-supply to both parties.

4.3 Non-discrimination requirements to apply to all contractual arrangements

All of the main contractual arrangements under the EGRC scheme employ the same energy forward curve as the basis for calculating contract prices. However, only the foundation transfer price mechanism is not subject to the non-discrimination requirements in the EGRC scheme.

The non-discrimination requirements were not relevant to the original foundation transfer price mechanism, as the original focus of this mechanism was on setting a price for electricity supplied by the wholesale business unit to the retail business unit for customers who were already contracted to Synergy at the time of the merger.

With the introduction of the replacement foundation transfer price mechanism in 2017, the focus of this mechanism on historical contracts and budgets was removed. Both the foundation and additional transfer prices are for supply by the wholesale business unit to the retail business unit for the wholesale supply of electricity to meet contestable customer load, although the foundation transfer price mechanism also sets the price for the non-contestable customers.

32 Such as Kleenheat and Perth Energy.

With no requirement for Synergy to consider the non-discrimination requirements in setting the terms and conditions of the foundation transfer price mechanism, the EGRC scheme provides an opportunity for the wholesale business unit to discount prices for the retail business unit's contestable foundation customers. Such behaviour would maintain Synergy's retail customer base, and it would also reduce the ability of third party retailers to compete for foundation customers, which constitute a significant portion of the volumes supplied by the wholesale business unit to the retail business unit (roughly one-third).

Recommendation 4

The non-discrimination requirements of the EGRC scheme should be extended to the foundation transfer pricing mechanism.

4.3.1 Staff movement between business units remains unconstrained

Stakeholder feedback through interviews and submissions has raised concerns that the ring fencing arrangements were being breached by staff movements.[33]

Few staff movements have occurred at Synergy at the managerial level and Synergy has processes in place to ensure that transferring staff do not share restricted information.

There are no provisions within the EGRC scheme to constrain the movement of staff, who have access to restricted information, from employment by one business unit to employment by another business unit. The EGRC scheme does not specify how staff transfers should be managed by Synergy, which has the discretion to establish and amend its own procedures at any time to ensure compliance with the EGRC scheme.

In its submission to the 2017 discussion paper, Synergy noted the benefits of staff transfers to assist employees to develop career paths and said it had implemented various controls to minimise any risks. Synergy considered that there was no evidence to suggest that the ring fencing guidelines required amendment to address concern about staff movements.

The ERA requested information from Synergy on staff transfers to determine the frequency of transfers and how Synergy ensures compliance with the EGRC scheme. Four internal staff movements occurred between business units and twelve secondments occurred over the 2016 to 2018 period, these are shown in Table 3 below.

[33] For example, in its submission to the 2017 discussion paper, Perth Energy stated that the ring fencing arrangements appear to have been breached by staff movements. https://www.erawa.com.au/cproot/18924/2/PubSub%20-%20EGRC%20Review%202017%20-%20Perth%20Energy.pdf

Table 3: Staff movements between Synergy business units

Staff movement	Wholesale	Retail	Generation
Transfers	-1	+1	
	+1	-1	
	+2		-2
Secondments	-4	+4	
	+3		-3
	-2		+2
	+1		-1
	+2		-2

Source: ERA analysis of Synergy data.

Synergy ensured that the ring fencing requirements, in particular the constraints in sharing restricted information, were set out in the terms and conditions of the agreement for each transfer. For example, at the beginning and end of a secondment, staff are provided with refresher training how to treat restricted information, and the staff member must be removed from group emails relating to their secondment.

An agreement by a manager not to share restricted information about a competitor with other employees within a business unit is not a guarantee that the manager will not consider their own knowledge of restricted information when making decisions for the business unit to which they have transferred. Nonetheless, to date there have been few staff movements at the managerial level, and Synergy has worked to ensure that transferring staff were aware of and have complied with the requirements of the EGRC scheme.

Excluding individuals from moving between roles within Synergy for set periods is impractical in a small electricity sector such as that in Western Australia where the pool of experienced electricity professionals is limited. The ERA has not made any recommendations on staff movements between business units.

4.4 Segmented financial reporting

Financial reports are produced using standard accounting practices. There is no requirement for Synergy to produce financial reports that separate the costs of its different activities within particular business units. This can create uncertainty among other market participants about the effectiveness of the EGRC scheme in maintaining competition in the retail market.

As noted in chapter 3.2, Synergy's overall profit is independent of the retail business units' wholesale supply costs. If Synergy uses market power to increase its wholesale prices, there is no effect of this mark-up on Synergy's overall profit from supplying to its own retail business unit at the marked-up price. Adding the wholesale and retail business units' profits cancels out the quantity bought by the retail business unit at the marked-up wholesale price.

The segmented financial reports as currently produced do not provide the information necessary for the ERA to determine if Synergy is profit shifting from its retail business unit to its wholesale business unit for anticompetitive purposes.

4.4.1 Current requirements for segmented financial reporting

The EGRC scheme requires Synergy to prepare separate statements of financial performance for each of its segmented business units. Under the Act, the Minister, in consultation with the Synergy board, is then required to publish these reports.[34]

The ERA's 2015 review found that Synergy's financial reports did not separate gas and electricity or contestable and non-contestable financial results. The reports varied in the information provided and the time periods covered. This limits the ability to scrutinise the revenues, costs and profits of each business unit's electricity activities and leads to concern among other market participants about the possibility of cross-subsidisation and adverse effects on competition in the retail market.

At present, there is nothing in the EGRC scheme requiring separation of Synergy's financial reporting on its gas or electricity activities, or contestable and non-contestable sectors within the retail business unit. No guidelines exist requiring Synergy to produce accounts in a certain way so that they can be regulated to address these concerns.

In previous reviews, the ERA recommended that Synergy be required to provide consolidated segmental financial statements; similar to those required of gentailers in the United Kingdom wholesale electricity market. This would ensure that financial reports are prepared on a consistent basis and provide sufficient information about transfer pricing. It would also allow for scrutiny of Synergy's revenues, costs and profits to remove any concerns about profit shifting between business units to the detriment of competition.

Kleenheat and Perth Energy supported the ERA's recommendations. Kleenheat recommended increased granularity in Synergy's financial reporting to provide transparency to Synergy's gas and electricity results in segmented reporting, and profit performance in the contestable and non-contestable electricity segments. Perth Energy considered that without more granular reporting, other market participants could not be assured Synergy's activities were consistent with the EGRC scheme's requirements.

Synergy argued that the administrative and cost burden of providing segmented reports outweighed the benefits of public transparency. Synergy had two main concerns with the ERA's past recommendation to provide consolidated segmental statements.

- Synergy noted that one of the policy drivers behind the introduction of the financial information reporting obligations in the United Kingdom was a perception that retail competition was not giving rise to the benefits expected. There, retail consumers had incurred significant increases in prices, and churn rates were much lower than anticipated, resulting in the continued dominance of incumbent suppliers. Synergy noted that the context in the South West Interconnected System was fundamentally different. It considered that competition in the contestable market is fierce and that Synergy's market share is lower than the 87 per cent market share of the United Kingdom's six large suppliers.
- Synergy considered that if the requirement for the provision of consolidated segmental reports was implemented as in the United Kingdom market design, this proposal would be unduly onerous on all other parties caught by the provisions, such as Alinta.

[34] See https://www.synergy.net.au/About-us/News-and-announcements/Regulatory-Reports for Synergy's quarterly financial reports and https://www.synergy.net.au/About-us/News-and-announcements/Annual-reports?tid=News-and-announcements:side_nav:Annual reports for its annual reports.

Synergy is the dominant supplier in the wholesale market and is the largest participant in the contestable retail market. The EGRC scheme only applies to Synergy and so the ERA does not envisage a requirement for Alinta to also provide consolidated financial reports.

The ERA is required to review the effectiveness of the operation of the EGRC scheme as it exists. There is no specified requirement for the ERA to perform a financial audit function involving the regulation of accounts to ensure that the accurate ring fencing of costs is occurring. Making changes to the segmented financial reporting requirements in the scheme would enable the ERA to determine if Synergy is profit shifting from its retail business unit to its wholesale business unit for anticompetitive purposes.

Recommendation 5

Synergy should prepare and provide confidential segmented financial reports to the ERA in a format that is sufficiently transparent to identify anticompetitive behaviour. The format of the segmented financial reports should distinguish between revenues, costs and profits for:

- gas and electricity activities in each business unit
- contestable and non-contestable customers in the retail business unit.

Appendix 1 Abbreviations

EGRC	Electricity Generation and Retail Corporation
ERA	Economic Regulation Authority
WEM	Wholesale Electricity Market
GBU	Generation Business Unit
RBU	Retail Business Unit
WBU	Wholesale Business Unit
STEM	Short-term Electricity Market
SWIS	South West Interconnected System
MW	Megawatt
MWh	Megawatt hours
ACCC	Australian Competition and Consumer Commission
LNG	Liquefied Natural Gas
NEM	National Electricity Market