SUBMISSION TO THE ECONOMIC REGULATION AUTHORITY

Discussion paper: Electricity Generation and Retail Corporation Regulatory Scheme: 2020 Effectiveness Review

28 September 2021

Executive Summary

Matter	Electricity Generation and Retail Corporation Regulatory Scheme: 2020 Effectiveness Review.
Context	Regulation 48(1) of the *Electricity Corporations (Electricity Generation and Retail Corporation) Regulations 2013* (**EGRC regulations**) requires the Economic Regulation Authority (**ERA**) to review the operation of the EGRC scheme for the purpose of assessing its effectiveness at least once in every two years. The ERA must deliver a report to the Minister for Energy (**Minister**) based on the review, not later than two months after the review is completed. In carrying out the review, in addition to compliance with the *Economic Regulation Authority Act 2003* (WA) (**ERA Act**) and the general principles of administrative law, the ERA must have regard to the prevailing circumstances that exist in relation to the operation of the south west interconnected system (**SWIS**). The ERA released its Electricity Generation and Retail Corporation regulatory scheme: 2020 effectiveness review discussion paper (**discussion paper**) on 31 August 2021 inviting public submissions from interested parties on issues that will assist the ERA in undertaking its fifth review.
Scope	The EGRC scheme consists of the: • EGRC regulations; • *Segregation and Transfer Pricing Guidelines 2013* (**segregation and transfer pricing guidelines**); and • *the Electricity (Standard Products) Wholesale Arrangements 2014* (**standard product arrangements**).
Key issues	From Synergy's perspective: 1. The current buy-sell spread of 20 per cent is appropriate and the standard products regime currently meets its stated objectives. 2. Any perceived benefit arising from the implementation of a reduced standard product buy-sell spread is likely to be outweighed by financial, regulatory and operational costs. 3. Any reduction to the maximum standard product buy-sell spread will also create additional risk for Synergy irrespective of how it is implemented. These risks include increased difficulty in managing portfolio risk, potential arbitrage risk and increased forward revenue risk. 4. When assessing the maximum standard product buy-sell spread, the ERA should also consider the potential impact a carbon tax would have on the mechanism. 5. Having regard to the current level of financial audits, EGRC regulation requirements and scrutiny Synergy is subject to as a government trading enterprise, the administrative and cost burden of providing segmented reports outweighs the perceived benefits.

6. A requirement to publish foundation transfer prices would unnecessarily increase regulatory burden without attendant benefit to the market.

7. There is no evidence that the force majeure arrangements applicable to standard products lead to the EGRC scheme being ineffective or negatively impact its efficiency as there has never been a force majeure event applied to the standard products regime.

8. The costs to Synergy of making longer term standard products available to the market will outweigh the benefits.

9. Given the substantial changes occurring in the wholesale electricity market (**WEM**) and the significant enforcement difficulties associated with the existing SRMC/misuse of market power provisions in the WEM Rules, the ERA should consider evaluating the costs/benefits of transitioning from the existing market power mitigation regime to focus on a broader range of inappropriate and inefficient market conduct by *any* market participant.

The above matters are dealt with in more detail in this submission.

Introduction

As in previous years Synergy considers the primary focus of the ERA's current review should be to assess the degree to which the EGRC scheme results in an operational framework that enables Synergy's business units to achieve arm's length dealings in relation to the wholesale supply or acquisition of electricity and wholesale electricity products.

In doing so, the ERA should take a considered view of the regulatory costs and benefits associated with the EGRC regime (including the ERA's review of the effectiveness of that regime) and determine whether the various regulatory arrangements are fair and reasonable to both market participants and Synergy.

1. Maximum buy-sell spread for standard products

1. What benefits do counterparties trading with Synergy anticipate would arise from changing the regulations to include lower maximum spreads for advertised standard products?

Not applicable to Synergy.

2. What costs and benefits does Synergy anticipate if the alternative spreads in section 3.4.3 are implemented?

Under section 3.4.3 of the discussion paper, the ERA has determined that Synergy's maximum buy-sell spread could be reduced from 20 per cent to:

- 10 per cent for quarterly products; and
- 5 per cent for calendar and financial year products,

whilst providing Synergy with a reasonable opportunity of "profiting on a trade".

In response to this question two, Synergy submits its estimate of the financial cost that may be imposed should the maximum buy-sell spread be reduced to levels proposed by the ERA under section 3.4.3.

Synergy is currently long on energy. The sum of energy expected to be produced by Synergy's generators plus energy acquired from power purchase agreements is greater than the sum of Synergy's contract demand. To reduce exposure to uncertain and volatile balancing market prices, Synergy enters forward sales contracts with third party retailers or directly with contestable customers through its Retail Business Unit (**RBU**).

Should the propensity of counterparties to sell energy to Synergy increase, Synergy may seek to reduce the price at which it purchases energy to manage exposure to uncertain balancing market prices. Under a reduced buy-sell spread this would also require Synergy to reduce its forward sale price. Given the consistency in Synergy's forward pricing, any decrease to standard product prices would also reduce prices for Wholesale Business Unit (**WBU**) customised products, RBU contestable sales and RBU non-contestable sales.

The magnitude of any reduction to Synergy's prices is uncertain and depends upon the rate at which energy is sold to Synergy. It could range from 0% to 15% (15% being the proposed reduction in the standard product spread for calendar and financial year products). Therefore, Synergy's view is that any benefits arising from the implementation of these alternative spreads will be significantly outweighed by the financial, regulatory and operational burden consequent to the proposal. However, Synergy notes there are additional critical, non-tangible costs that may also be realised, and these additional impacts are described in Synergy's response to question three.

3. What factors should inform the setting of a new maximum spread:

a. the updated Deloitte method (see Appendix 5)

b. the outcomes expected in a competitive market

c. the risk to Synergy of offering standard products

d. benchmarking with other jurisdictions

e. any other factors?

Synergy considers the current buy-sell spread of 20 per cent is appropriate and considers the regime currently meets its stated objectives. That is, the standard products design for published prices, together with completed transactions provides a simple alternative to customised products and tangible evidence for price discovery. Synergy does not consider the success of the standard products regime should be measured solely by their uptake.

Synergy uses the same underlying forward price curve to establish standard product pricing, customised pricing and foundation transfer pricing. Customers currently receive the same price and similar terms irrespective of whether the request for supply is through the standard products regime or through a customised request for pricing. Synergy notes that a reduction in the buy-sell spread cannot lead to more consistent pricing between a standard product and customised requests (as they are currently aligned) but notes that a reduced buy-sell spread may create sufficient incentive for Synergy to take divergent pricing approaches.

When assessing the maximum buy-sell spread, Synergy considers the regime's original objectives should be revisited, as set out in the State Government's "Standard Product Regime – Market Participant Briefing, 9 April 2014". The regime sought to:

- function as a price-discovery mechanism; and
- provide a simple alternative to customised products.

The regime was not intended to create a secondary market, replicate a competitive market or act as a benchmark for a competitive price.

The 'updated Deloitte method' referred to in the discussion paper relies upon the recent accuracy of Synergy's balancing price forecasts to assess WBU's risk of making a profit or loss on a future trade. Synergy understands the period assessed to be 2018 to 2020. Synergy considers that setting the buy-sell spread based on the historic accuracy of Synergy's forecasts is not transparent, forward looking and has the potential to be volatile over time.

The historic measure is inappropriate given imminent, significant changes to the WEM and the SWIS. It is unreasonable to expect Synergy to maintain such tight forecasting accuracy with increasing essential system service requirements, the introduction of facility bidding and constrained network access and changes to the SWIS plant mix (notably the imminent retirement of Muja C).

The ERA's recommendation of a significantly reduced buy-sell spread suffers from small sample bias that leads to the assumption that Synergy's balancing price forecast accuracy will be ongoing. That assumption is neither reasonable nor appropriate.

An unduly tight buy-sell spread will impact Synergy's ability to manage its contract position and portfolio risk, including fuel take or pay contracts. Additionally, it will very likely introduce significant arbitrage risk, potentially facilitating exploitation by sophisticated market participants for their own financial gain without attendant benefits flowing through to customers.

Synergy does not expect that a reduction in the buy-sell spread will create or encourage a thriving secondary contract market amongst wholesale participants. Rather it expects Synergy's position as a wholesale contract counterparty would likely increase.

WEM prices are currently well below the average cost of many existing thermal generators and depression of forward contract prices will increase the propensity for independent power producer (**IPP**) and Synergy thermal generator loss with attendant impacts on IPP viability and State finances.

If the ERA adopts the 'updated Deloitte method', the ERA should provide market guidance regarding how future buy-sell spread assessments will occur to ensure the process is methodological and not subjective.

4. How could a new maximum standard product spread by implemented to both minimise any additional risk to Synergy and increase the effectiveness of the standard products regime? This could be phasing in a lower spread over several years or reducing the minimum volumes of standard products available for the first year of a lower spread. For example lowering the total standard product volume for sale (150MW to 100MW). Can stakeholders suggest alternative options?

Synergy considers the current maximum standard product spread is reasonable and appropriate. Any reduction will create additional risk for Synergy irrespective of how it is implemented. As discussed under Synergy's response to questions three and five, these risks include, but are not limited to:

- increased Synergy forward revenue risk;
- reduced Synergy ability to appropriately price generator and wholesale market risks;
- diminished Synergy ability to manage its contract position and portfolio risks;
- heightened arbitrage risk from potential exploitation by sophisticated market participants; and
- a carbon tax which could further reduce the buy-sell spread below appropriate levels.

Synergy also notes its generation market share is declining and Synergy expects this trend to continue. As Synergy's supply position reduces, particularly with the retirement of Muja C and major power purchase agreements rolling off in the mid to late 2020s, the appropriateness of the required standard product offer volumes should be revisited.

5. Are there any other factors the ERA should consider regarding the maximum standard product spread?

When assessing the maximum standard product spread, the ERA should assess and advise on the potential impact of a carbon tax given increasing requirements to decarbonise stationary electricity generation. The below worked examples highlight how a carbon tax could lower the buy-sell spread below desired levels.

The worked examples are based on a balancing price of $40 / MWh and a carbon price of $50 per tonne. Assuming an emission intensity of 0.6 tonnes carbon per MWh, the equivalent carbon price is $30 / MWh.

Example One: Existing maximum buy-sell spread of 20%

Sell price: $40 / MWh
Buy price: $32 / MWh

Add Carbon
Sell price (with Carbon): $70 / MWh
Buy Price (with Carbon): $62 / MWh

In example one, the effective buy-sell spread becomes $8 / $70 = 11.4%

Example Two: Prescribed maximum buy-sell spread reduced to 5%

Sell price: $40 / MWh
Buy price: $38 / MWh

Add Carbon
Sell price (with Carbon): $70 / MWh
Buy price (with Carbon): $68 / MWh

In example two, the effective buy-sell spread becomes $2 / $70 = 2.9%

In example two, a 0.04 under-forecast of carbon intensity multiplied by the $50 carbon price would equal $2 / MWh, equivalent to the total allowable spread.

2. Other elements of the EGRC scheme

6. If Synergy were obliged to publish more detailed periodic financial reports, including separate financial results for its contestable and non-contestable customers, and gas and electricity:

a. How would market participants use this information?

b. Would having the information improve the effectiveness of the EGRC scheme? If so, how?

Synergy has previously commented on the merits of segmented reporting in its 4 July 2017 EGRC submission to ERA[1]. Since that submission, Synergy has been the subject of three further financial year audits by the Office of the Auditor General (**OAG**) in accordance with Part 4 of the EGRC regulations, with no adverse audit opinion findings. Synergy notes that the OAG opinions are publicly available and the ERA exercises its statutory powers to request further detail from Synergy on OAG matters the subject of the EGRC regulations as a standard practice. Further, if the OAG forms an opinion Synergy has not complied with one or more provisions of the EGRC regulations, the ERA has the function to investigate the matter.

[1] Refer https://www.erawa.com.au/cproot/18052/2/Synergy%20-%20public%20submission%20-%202016%20EGRC%20Discussion%20paper.pdf.

Given regard to the current level of financial audits, EGRC regulation requirements and scrutiny Synergy is subject to as a government trading enterprise, Synergy considers the administrative and cost burden of providing segmented reports outweighs the perceived benefits in relation to increased public transparency.

7. If Synergy was obliged to publish its foundation transfer price, how would participants use this information and would having the information improve the effectiveness of the EGRC scheme?

In 2017, the ERA recommended Synergy should publish its foundation transfer price and the method it uses to calculate this price to ensure transparency of the ring-fencing arrangements. However, the State Government disagreed with the ERA's recommendation to publish Synergy's foundation transfer price, stating that "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"[2].

Synergy supports the State Government's views and notes that enforcing the publication of the foundation transfer price would not facilitate the effectiveness of the EGRC scheme and instead, be inconsistent with the Scheme.

Further, at any point in time, Synergy uses the same underlying forward price curve to establish standard product pricing, customised pricing and foundation transfer pricing. The RBU currently receives the same price for foundation customers and contestable customers and this pricing is mirrored to the market in Synergy's pricing of standard products and customised WBU pricing to third parties.

Given the consistency in Synergy's pricing approach, Synergy considers that a requirement to publish foundation transfer prices would unnecessarily increase regulatory burden through compliance with publication requirements without attendant benefit to the market.

8. Do market participants see benefits in extending the non-discrimination requirements to the foundation transfer price mechanism? If so, please describe the expected benefits.

The ERA notes the EGRC regulations do not prohibit Synergy from providing discounts to foundation customers, enabling Synergy to maintain its retail customer base whilst reducing the ability of third-party retailers to compete for foundation customers. To mitigate this concern, the ERA has revisited its previous recommendation to extend non-discrimination requirements to the foundation transfer pricing mechanism.

These non-discrimination requirements are in place to ensure internal pricing and sales are at arm's length, similar to trading arrangements between independent parties. Nonetheless, it is evident that Synergy's pricing approach is non-discriminatory as it adopts a consistent pricing approach across the foundation transfer price mechanism and mechanisms subject to non-discrimination requirements, including standard product pricing and customised pricing.

Synergy publishes its Foundation Transfer Price Mechanism to the market, as required by the ERGC regulations. Given the transparency already provided to all market participants, Synergy does not believe that additional regulatory requirements are useful or warranted.

[2] Public Utilities Office, 2019, Electricity Generation and Retail Corporation Regulatory Scheme – Response to 2016 Report to the Minister for Energy on the effectiveness of the Scheme, p. vi, (online).

9. The ERA would like to understand if market participants are choosing not to enter into standard product contracts because of the associated credit requirements. If so, how do participants suggest Synergy's standard product credit requirements should be altered?

10. Although Synergy has never used the force majeure clause to suspend its obligations under a standard product transaction, is the existence of the clause still a concern for participants?

11. If the force majeure clause were to be amended, what changes would participants recommend and why? Is the list of generation units still suitable? If not, then why not?

The following provided in response to questions 9, 10 and 11.

The ERA's discussion paper states that in submissions to previous EGRC reviews market participants have indicated that the credit requirements and force majeure provisions in standard product terms and conditions were the main barriers to trade in standard products. The ERA has reiterated earlier views that force majeure provisions in Synergy's standard product contracts should be less conservative and credit requirements should be relaxed to lower barriers for market participants to trade in standard products.

Synergy's credit requirements are developed in accordance with the EGRC regulations. Under regulation 23(1) Synergy is required to prepare and maintain a written policy setting out standard processes to be followed in offering a wholesale supply of electricity to its retail business unit, a retail competitor or a generation competitor, including processes for:

(a) assessing the ability of the retail business unit, retail competitor or generation competitor to make payments for the wholesale supply of electricity; and

(b) determining the terms and conditions on which the wholesale supply of electricity is to be offered, taking into account that assessed ability.

As part of their role in managing all risks associated with Synergy's operations, Synergy's Board of Directors are required to review and approve Synergy's credit requirements. In so doing, the directors must ensure that Synergy acts in accordance with prudent commercial principles (section 61(1)(a) *Electricity Corporations Act 2005*).

The Minister also has oversight of Synergy's credit policy through the requirement in regulation 23(5) of the EGRC Regulations for Synergy to give a copy of the policy and any revision of the policy to the Minister. Synergy is also required to publish this policy, a copy of which is publicly available on Synergy's standard products website.

Force majeure clauses are standard and widely adopted contractual terms in almost all commercial transactions, including wholesale energy arrangements. Synergy is exposed to upstream force majeure clauses and generator availability risk and it is appropriate and prudent to reflect these risks in downstream sale contracts. Any change to force majeure provisions potentially increases risk to Synergy and therefore may warrant an increase in the buy-sell spread. A combined tightening of force majeure provisions and reduction in the buy-sell spread may create legitimate risk which Synergy is not able to adequately pass through via contract pricing.

There is no evidence the force majeure clauses applicable to standard products lead to the EGRC scheme being ineffective. There is also no evidence the clauses are not reasonable practice in the wholesale supply of energy. Synergy submits that the requirements are commercially reasonable.

In the absence of appropriate credit requirements or contractual relief during force majeure events, the prudent commercial practice would be to adjust wholesale risk premiums cognisant of the additional risk borne by Synergy.

12. What specifications would market participants find useful in a new standard product?

Not applicable to Synergy.

13. The ERA is interested in hearing from Synergy if there are any costs and benefits to Synergy of making longer term standard products available?

In its 2016 review, the ERA noted that standard products with different specifications, including different contract terms, may better meet the diverse needs of WEM participants. However, it is noted in the discussion paper that "the State Government decided to not make any regulatory changes to standard product offerings as market participants can request customised products from Synergy when the standard products do not meet their requirements".

Synergy agrees with the State Government's position and considers customised products a more appropriate avenue for market participants to obtain specialised offerings.

Synergy further considers its costs of making longer term standard products available outweigh the ERA's perceived benefits. The WEM is experiencing rapid and accelerating change and will continue to do so in future years. Synergy notes that its generation market share is declining and expects this trend to continue with the retirement of Muja C and major power purchase agreements ending in the mid to late 2020s.

In addition to risks stemming from a declining supply position, offering long term contracts increases Synergy's risk due to unknown costs in outer periods including:

- exposure to unknown fuel costs through contractual price re-sets;
- exposure to unknown gas transport costs;
- unforeseen generator outages; and
- increased reliance on fast and flexible gas turbines during peak periods to offset baseload energy displaced by DER and large-scale renewables.

14. What aspect of the new Commonwealth legislation or lessons from the ACCC inquiry need to be considered in the ERA's report to the Minister?

In view of the substantial changes in the WEM and the significant enforcement difficulties associated with the existing SRMC/misuse of market power provisions in the WEM Rules, the ERA may consider it appropriate to evaluate the costs/benefits of transitioning from the existing market power mitigation regime to focus on a broader range of inappropriate and inefficient market conduct by *any* market participant. In particular, the Amendment[3] targets conduct such as withholding hedge contracts for the purpose of substantially lessening competition and generators manipulating the spot/balancing market.

Consequently, the ERA may seek to investigate whether there has been anti-competitive and inefficient conduct in the balancing market, such as withholding supply and rebidding strategies, such as shadow pricing. The ERA may also consider the extent to which such strategies may be adversely affecting market

[3] The Treasury Laws Amendment (Prohibiting Energy Market Misconduct) Act 2019 (Cth), amended the Competition and Consumer Act 2010 (Cth) and these amendments took effect on 10 June 2020.

prices and whether application of the Amendment provisions would be likely to decrease the incidence of such conduct.

In relation to retail conduct, Synergy notes it is subject to regulated residential and small business retail tariffs, fees and charges that are reviewed by Government annually, including supply chain costs. In addition, Synergy has retail obligations to offer to supply small use customers at standard prices. Synergy is the only retailer within the SWIS subject to such retail regulatory oversight.