

ECONOMIC REGULATION AUTHORITY

Discussion paper: 2014 Annual Report to the Minister for Energy on the effectiveness of the EGRC Regulatory Scheme

22 December 2014



Executive Summary

Matter

The Electricity Generation and Retail Corporation (**EGRC**) is a key stakeholder with respect to the Economic Regulation Authority's (**ERA**) review of the operation of the EGRC regulatory scheme (**scheme**) for the purpose of assessing its effectiveness.

Context

Regulation 48(1) of the *Electricity Corporations (Electricity Generation and Retail Corporation) Regulations 2013* (**regulations**) requires the ERA review the operation of the scheme for the purpose of assessing its effectiveness, at least once each year.

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 and will take into account the views expressed by stakeholders in the preparation of its report to the Minister.

On 10 November 2014 the ERA published a notice inviting public submissions from interested parties on issues that will assist the ERA in undertaking its first review.¹ Further, the ERA has prepared a discussion paper to guide submissions to the review.²

Scope

The scheme consists of the regulations, the *Segregation and Transfer Pricing Guidelines 2013* (**segregation and transfer pricing guidelines**) and the *Electricity (Standard Products) Wholesale Arrangements 2014* (**standard product arrangements**).

Key issues

The key issues from Synergy's perspective are:

- 1** The ERA's role is to assess the degree to which the 'EGRC Regulatory Scheme' results in an effective 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 goods and services related to the wholesale supply or acquisition of electricity.
 - 2** The discussion paper appears unduly focused on Synergy's behaviour in implementing ring fencing arrangements rather than on the outcomes achieved or not achieved by the scheme itself.
 - 3** The ERA's interpretation of the three policy intentions set out in the regulations' Explanatory Memorandum and second reading speech may have the unintended effect of broadening the review's scope and consequently the stakeholder response the ERA may receive.
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¹Notice: <http://www.erawa.com.au/cproot/12996/2/20141110%20Consultation%20Notice%202014%20Annual%20Review%20of%20EGRC%20Regulatory%20Scheme%20Discussion%20Paper.pdf>

²Discussion paper: <http://www.erawa.com.au/cproot/12995/2/20141110%20Discussion%20Paper%202014%20Annual%20Review%20of%20Effectiveness%20of%20EGRC%20Scheme.pdf>

- 4 Based on the proposed scheme assessment criteria for review, there is risk the state government's merger objectives may not adequately be taken into account in terms of Synergy's legitimate business interests to operate efficiently within the confines of the scheme's requirements.
 - 5 The lack of clarity around the precise policy objective for the scheme makes it difficult for the ERA to conduct an effectiveness review (and for stakeholders to comment) as well as impacting Synergy as it has been required to and must continue to implement the obligations under a regulatory scheme which contains no specific and measurable policy goals.
 - 6 The ERA should have regard to the need to promote regulatory outcomes that are in the public interest and meet government policy objectives in carrying out its review function under its own statute and this should be included as part of the scheme's effectiveness assessment criteria.
 - 7 The role of the key management personnel in Synergy should be more clearly defined within the ring-fencing scheme so that the regulations do not unnecessarily interfere with the efficient management of the organisation as a whole.
 - 8 The audit process does not require alignment or integration with the effectiveness review as they are quite rightly distinct processes with different purposes. What should be assessed is whether the audit process, as an aspect of the scheme, is effective in itself as a means for testing compliance – rather than the ERA seeking to review the specific audit process itself and duplicating regulatory effort.
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1. INTRODUCTION

Synergy appreciates this opportunity to provide the following comments on the ERA's review of the scheme's³ effectiveness in the form of a response to its November 2014 discussion paper.

Synergy recognises our shareholder, the Western Australian state government is committed to sustained private sector participation and acknowledges the intent of the scheme is to impose regulatory constraints on the business so that our merged entity structure, which took effect on 1 January 2014, will not unduly preference its retail and generation business units over third party retailers and generators. We also note the state government's intent from merging the former electricity retail corporation with the electricity generation corporation was to address the inefficiencies in the operations of the two entities and realign their incentives so they can operate in the interests of consumers and tax payers.

In that regard, Synergy considers the primary focus of the ERA's review of the effectiveness of the scheme is to assess the degree to which the 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 related goods and services. The ERA needs to consider whether the various regulatory arrangements are fair and reasonable to both market participant and Synergy or in other words needs to achieve the correct balance from the regulatory intervention. That is, in seeking to address inefficiencies in the operations of the two previous entities for the ultimate benefit of consumers,⁴ it is important not to overreach and install a scheme which limits the merged entity's operational efficiencies by diluting economies of scale to the consequent detriment of customers and taxpayers, whilst operating in a transparent and non-discriminatory manner as required under the regulations.

Synergy has undergone an unprecedented year of change during 2014 commencing with a newly merged structure on 1 January. In addition to bringing together two respective billion dollar businesses we have also been required, consistent with state government requirements, to comply with new laws to constrain our operations and regulatory oversight to monitor our behaviour as follows:

- segregation of business activities, implementation of information technology access controls, training of staff to limit the disclosure of retail and generation restricted information to retail and generation staff respectively, separation of work areas and management roles etc under the regulations;
- complying with segregation and transfer pricing guidelines established by the Minister for Energy as of 1 January 2014 under section 62(1) of the *Electricity Corporations Act 2005 (Act)*;
- establishing standard product arrangements consistent with the Minister for Energy's determination dated 13 May 2014 pursuant to regulation 26(1);
- being subject of an independent financial year audit pursuant to regulation 29;
- being subject of an independent calendar year audit pursuant to regulation 30; and
- being subject of an independent review of the scheme's effectiveness pursuant to regulation 48.

The time and effort required of staff in the organisation to participate in these regulatory processes is substantial. This is time in addition to Synergy's business as usual activities and represents a significant impost on the business to operate optimally.

Given the amount of activity to establish the new business, comply with the new arrangements and the conduct or commence of audits and reviews in less than 12 months from the enactment of the regulations Synergy has had limited time to fully assess the cost and impact on its business of implementing the new arrangements. Consequently, this submission presents our preliminary views on the effectiveness of the scheme to date.

³ The EGRC regulatory scheme includes the regulations, the *Segregation and Transfer Pricing Guidelines 2013 (segregation and transfer pricing guidelines)* and the *Electricity (Standard Products) Wholesale Arrangements 2014 (standard product arrangements)*.

⁴ Dr Mike Nahan, Second Reading Speech, Wednesday 16 October 2013, 3.

2. REQUIREMENTS FOR THE ERA'S ANNUAL REVIEW

Stakeholders are invited to comment on:

Whether the criteria the ERA proposes to use in its assessment of the effectiveness of the operation of the Scheme are appropriate.

What prevailing circumstances or other matters the ERA should take into account when assessing the effectiveness of the operation of the Scheme, and why.

Synergy has a number of concerns relating to the ERA's proposed measure of scheme effectiveness as detailed below.

2.1 Review focus

In Synergy's view, the review appears unduly focused on Synergy's behaviour in implementing ring fencing arrangements rather than on the outcomes achieved or not achieved by the scheme itself. The review should cover whether the policies, documents and arrangements Synergy is required to establish under the scheme are effective to achieve sufficient arm's length dealings in relation to the wholesale supply and acquisition of electricity and wholesale products. That is:

- Does the manner in which the Minister for Energy prescribed standard products and segregation and transfer pricing guidelines work effectively;
- Do the ring fencing arrangements prescribed in the regulations facilitate broader market participation?
- Are the ring-fencing arrangements under the regulations appropriate?
- Has the operation of the scheme over the past year constrained Synergy's potential to exercise market power in the electricity market?
- Has the operation of the scheme over the past year enhanced Synergy's potential to act efficiently which is consistent with the state government's merger objective?

Synergy considers the scope of the ERA's issues paper is focused too heavily on Synergy's performance under the scheme rather than the scheme per se. Synergy considers the above matters should be examined by the ERA rather than examining in detail Synergy's specific implementation of the arrangements in compliance with the regulations.

Synergy's compliance with the regulations is subject to two separate independent audits by the Office of the Auditor General (**OAG**). As the issues paper is currently drafted, the granular approach to the effectiveness review is that there is a degree of duplication with the OAG compliance audits in terms of its compliance focus. Further, we note the ERA has specific statutory powers to investigate Synergy's non-compliance with the regulations under part 5 and these powers are distinct from the ERA's obligation to conduct a review of the EGRC regulatory scheme.

2.2 Mitigating concerns of private-sector market participants

Synergy considers the ERA's interpretation of the three policy intentions set out in the extraneous materials may have the unintended effect of broadening the review's scope and consequently the stakeholder response the ERA may receive. The three intentions the ERA proposes to use to measure the scheme's effectiveness are detailed on pages 5 and 6 of the issues paper and are detailed below:

- 'ensuring the merged entity does not unduly preference its own retail and generation arms over third party retailers and generators;
- providing the private sector with access to electricity on non-discriminatory terms; and
- mitigating the concerns of private-sector market participants.'⁵

⁵ ERA Discussion Paper: 2014 Annual Report to the Minister on the Effectiveness of the EGRC Regulatory Scheme, pp 5-6.

In relation to the first dot point the second reading speech prefaced the statement in the context of the mechanisms and protocols under the regulations applicable to 'some functions within the merged entity'. In other words it is clear from the second reading speech the regulations are to apply to certain functions within EGRC but not the business as a whole. The first dot point above does not convey this important distinction and should be clarified.

With respect to dot points two and three as they appear in context in both the *Electricity Corporations Amendment Bill 2013* second reading speech and explanatory memorandum these relate specifically to the standard product arrangements, not the scheme more broadly.⁶ By inviting stakeholders to comment about whether their concerns have been mitigated more broadly (as is how the final point is framed above), this may detract the focus of submissions and the ERA's review from the intended element of the scheme i.e. the standard product arrangements.

To approach the entire review around 'any' concerns of industry participants is to broaden the focus of the review and invite distraction and focus on self-interested responses, rather than comments for the benefit of the market on whether the desired outcomes in the market have or have not been brought about by the scheme.

2.3 Synergy's legitimate business interests

Based on the proposed scheme assessment criteria there is risk the state government's merger objectives may not adequately be taken into account in terms of Synergy's legitimate business interests to operate efficiently within the confines of the scheme's requirements. It is clear from the following statements within the second reading speech:

'These mechanisms and protocols are designed to ensure that the merged entity will not unduly preference its own retail and generation arms over third party retailers and generators.'

'These customised products will be subject to requirements on the process by which they are offered, ensuring fair and reasonable dealing with wholesale customers',⁷

the state government expects Synergy to act commercially and efficiently in the sale and purchase of wholesale energy within its business whilst acting consistent with the constraints imposed upon it by the regulations. In that regard, Synergy expects the ERA to consider to a certain extent whether it has acted fairly, reasonably and within the spirit of the regulations in relation to its dealings with third party retailers and generators. However, in doing so it is critical the ERA also recognises that 'fair and reasonable' should also apply to Synergy in its own internal dealings provided these are not inconsistent with the regulatory requirements.

2.4 Efficient and effective regulation

The Western Australian Regulatory Gatekeeping Unit's website states⁸:

'The Regulatory Impact Assessment (RIA) program helps agencies to develop efficient and effective regulation that addresses a clear need in the community, and provides assurance to the Government and stakeholders that a proper assessment of options, including consultation with stakeholders has occurred.'

Synergy is not aware of an RIA being undertaken and published for public review. Synergy understands the intent of regulation 48 is for the ERA to review the effectiveness of the overall scheme, that is, whether the regulations, segregation and transfer pricing guidelines and standard product arrangements are achieving the state government's policy objectives. However, as the ERA correctly notes, there are no explicit objectives included in the regulations. The lack of clarity around the precise policy objective for the scheme makes it difficult for the ERA to conduct an effectiveness review (and for stakeholders to comment) as well as impacting

⁶ Dr Mike Nahan, Second Reading Speech, Wednesday 16 October 2013, 3; Explanatory Memorandum, pp 5-6.

⁷ Dr Mike Nahan, Second Reading Speech, Wednesday 16 October 2013, page 3.

⁸ www.finance.wa.gov.au/cms/Economic_Reform/RIA_Process.aspx

EGRC as it has been required to and must continue to implement the obligations under a regulatory scheme which contains no specific and measurable policy goals.

Without clear objectives in the regulations themselves, the ERA has appropriately referred back to the extraneous materials accompanying the *Electricity Corporations Amendment Bill 2013 (Bill)* including the second reading speech and explanatory memorandum to interpret the policy intentions of the scheme.

Consistent with best practice regulation Synergy considers the ERA as part of its effectiveness review should consider whether the regulations are efficient or effective as part of its assessment criteria as inadequate regulatory design can hinder Synergy's ability to operate efficiently. Issues around terminology and interpretation can undermine the effectiveness of the ring-fencing regulations and result in unintended consequences. This matter is detailed further in this submission.

2.5 The public interest

Referring to the Bill's second reading speech, Synergy notes the following which articulates the rationale for the merger:

'The Liberal-National government is re-aggregating Verve and Synergy. Its aim is not to re-establish a government monopoly, but to address the inefficiencies in the operations of the two entities and realign their incentives so they can operate in the interests of consumers and taxpayers.'⁹

This appears to be a clear reference to the importance of the public interest in the outcomes to be achieved by the regulations. Accordingly, with respect to the ERA requirements for this review, Synergy considers the ERA should have regard to the need to promote regulatory outcomes that are in the public interest in carrying out its review function under its own statute¹⁰ and this should be included as part of the scheme's effectiveness assessment criteria in addition to those specified within its issues paper.

3. The EGRC Regulatory Scheme

EGRC Regulations (see 1.1 of the Discussion Paper)

3.1 Segregation Requirements

Stakeholders are invited to comment on how effective the operation of the Scheme is in mitigating any concerns that stakeholders may have, in terms of:

- *the requirements in relation to segregation and ring-fencing; and*
- *how the requirements have been implemented by Synergy.*

Additionally, stakeholders are invited to comment, to the extent that stakeholders have any knowledge or evidence, on how effective the operation of the Scheme has been in:

- *ensuring Synergy does not unduly preference its own retail and generation arms over third party retailers and generators; and*
- *providing the private sector with access to electricity on non-discriminatory terms.*

The ERA is also interested in any practical experience stakeholders may have of these requirements and Synergy's implementation of them, including in relation to:

- *the complexity and cost of implementing the requirements; and*
- *whether the requirements have increased pressure on Synergy to be efficient.*

Stakeholders may wish to consider the following points when making a submission:

⁹ Dr Mike Nahan, Second Reading Speech, Wednesday 16 October 2013, 3.

¹⁰ *Economic Regulation Authority Act 2003 (WA)*, s26(a).

- *Whether the level of segregation and ring-fencing required by the EGRC Regulations is adequate to ensure the Generation or Retail Business Units do not have an unfair advantage in comparison to their respective competitors.*
- *How effective the controls around access to third party information are in ensuring the Generation or Retail Business Units do not have an unfair advantage in comparison to their respective competitors.*
- *Whether there is sufficient information publicly available to enable stakeholders to fully understand how activities have been segregated.*

Synergy considers there is ambiguity with respect to the application of the ring-fencing requirements to Synergy's key management personnel and this could be clarified to ensure that Synergy is not required to act unnecessarily conservatively in order to avoid breaching the regulations. The role of the key management personnel could be more clearly defined within the ring-fencing scheme so that the regulations do not unnecessarily interfere with the efficient management of the organisation as a whole, resulting in efficiency losses as a result of the re-merger rather than efficiency gains.

3.2 Wholesale Acquisition or supply of electricity

Stakeholders are invited to comment on how effective the operation of the Scheme is in mitigating any concerns that stakeholders may have, in terms of:

- *the requirements in relation to the wholesale supply and acquisition of electricity; and*
- *how the requirements have been implemented by Synergy.*

Additionally, stakeholders are invited to comment, to the extent that stakeholders have any knowledge or evidence, on how effective the operation of the Scheme has been in:

- *ensuring Synergy does not unduly preference its own retail and generation arms over third party retailers and generators; and*
- *providing the private sector with access to electricity on non- discriminatory terms.*

The ERA is also interested in any practical experience Stakeholders may have of these requirements and Synergy's implementation of them, including in relation to:

- *the complexity and cost of implementing the requirements; and*
- *whether the requirements have increased pressure on Synergy to be efficient.*

Stakeholders may wish to consider the following points when making their submission:

Does the Wholesale Electricity Supply Policy ensure a fair and reasonable process for dealing with wholesale customers? If not, why not?

Does the Wholesale Energy Credit Policy ensure a fair and reasonable process for dealing with wholesale customers? If not, why not?

Any evidence that the terms offered in the Wholesale Electricity Supply Policy and/or Wholesale Energy Credit Policy are any less favourable than those offered to Synergy's Retail Business Unit.

Whether the Regulations include adequate controls to ensure that Synergy meets its obligations.

Please refer to our comments in section 2. Additional comments are detailed below.

The request for submissions on how effective the scheme has been in ensuring Synergy does not unduly preference its own retail and generation arms over third party retailers and generators should be limited to submissions related to how the operational framework functions to ensure that Synergy does not unduly preference its own retail and generation arms, rather than whether Synergy has actually provided preference to its retail and generation arms.

3.3 Compliance

Stakeholders are invited to comment on how effective the operation of the compliance requirements of the EGRC Regulations have been, or are likely to be, in mitigating any concerns they may have.

Additionally, stakeholders are invited to comment, to the extent that stakeholders have any knowledge or evidence, on how effective the operation of the Scheme has been in:

- ensuring Synergy does not unduly preference its own retail and generation arms over third party retailers and generators; and*
- providing the private sector with access to electricity on non- discriminatory terms.*

The ERA is also interested in any practical experience stakeholders may have of these requirements and Synergy's implementation of them, including in relation to:

- the complexity and cost of implementing the requirements; and*
- whether the requirements have increased pressure on Synergy to be efficient.*

Stakeholders may wish to consider the following points when making a submission:

- Whether the compliance requirements are sufficient to ensure Synergy is held accountable to its obligations under the EGRC Regulations.*
- Whether the audit process could be better aligned and integrated with the review of the effectiveness of the operation of the Scheme.*
- Whether the penalty provisions are suitable for discouraging Synergy from engaging in discriminatory behaviour.*

Please refer to our comments in section 2. Additional comments are detailed below.

(a) Whether the penalty provisions are suitable for discouraging Synergy from engaging in discriminatory behaviour

Notwithstanding the civil penalty provisions, Synergy strives for a culture of regulatory compliance across the organisation. From a compliance perspective we have an ongoing organisational requirement to comply with all scheme regulatory requirements and not just the civil penalty provisions. The reality for Synergy is irrespective of whether we breach a civil penalty provision or not, there will be consequences to Synergy for breaching the regulations.

(b) Whether the audit process could be better aligned and integrated with the review of the effectiveness of the operation of the Scheme

Synergy refers to its comments above as to the potential for duplication with the OAG process with the current approach of the ERA in reviewing effectiveness. Such regulatory duplication is not desirable and is avoidable if the ERA focuses on the effectiveness of the scheme itself rather than analysing in detail Synergy's implementation – which is the function of the OAG's process. In this way, the audit process does not require alignment or integration with the effectiveness review as they are quite rightly distinct processes with different purposes. Further we note under the regulations the ERA is provided with specific investigation powers under part 5 in relation to any non-compliance by Synergy with one or more provisions of the scheme.

What should be assessed is whether the audit process, as an aspect of the scheme, is effective in itself as a means for testing compliance – rather than the ERA seeking to review the specific audit process itself and duplicating regulatory effort.

Segregation and Transfer Pricing Guidelines (see 1.2 of the Discussion Paper)

Stakeholders are invited to comment on how effective the operation of the requirements of the Segregation and Transfer Pricing Guidelines have been in mitigating any concerns they may have.

Also, to the extent that they have any knowledge or evidence, how effective the operation of the Scheme has been in:

- ensuring Synergy does not unduly preference its own retail and generation arms over third party retailers and generators; and*
- providing the private sector with access to electricity on non- discriminatory terms.*

The ERA is also interested in any practical experience stakeholders may have of these requirements and Synergy's implementation of them, including in relation to:

- the complexity and cost of implementing the requirements; and*
- whether the requirements have increased pressure on Synergy to be efficient.*

Stakeholders may wish to consider the following points when making a submission:

- Whether the Guidelines include sufficient requirements to provide transparency around the transfer pricing process.*
- Whether the information required to be published by Synergy is sufficient to demonstrate compliance with its obligations.*

Please refer to our comments in section 2.

Standard Product Arrangements (see 1.3 of the Discussion Paper)

Use of Standard Products in Other Markets

Stakeholders are invited to comment on how effective the operation of the requirements of the Standard Product Arrangements has been in mitigating any concerns they may have. Also, to the extent that they have any knowledge or evidence, how effective the operation of the Scheme has been in:

- ensuring Synergy does not unduly preference its own retail and generation arms over third party retailers and generators; and*
- providing the private sector with access to electricity on non- discriminatory terms.*

The ERA is also interested in any practical experience stakeholders may have of these requirements and Synergy's implementation of them, including in relation to:

- the complexity and cost of implementing the requirements; and*
- whether the requirements have increased pressure on Synergy to be efficient.*

Stakeholders may wish to consider the following points when making a submission:

- How effective the Standard Products are in imposing discipline on Synergy's wholesale pricing?*
- To what extent the Standard Products have provided a competitive benchmark price to the wholesale supply of electricity on a non-discriminatory basis?*
- To what extent the Standard Products have provided an alternative to customised products?*
- Whether the Standard Products have reduced barriers to entry for new entrant retailers and allowed Market Participants to rebalance their portfolios.*
- Whether the type of products and minimum volumes specified in the Standard Products Arrangements are appropriate and useful.*

- *The level of the spread between Buy and Sell and whether it has been effective in underpinning price efficiency.*
- *Are fair and reasonable procedures employed in the operation of the Standard Product Regime? If not, which procedures require amendment and why?*
- *What improvements, if any, could be made to the Standard Product Regime?*

Please refer to our comments in section 2.