



INDEPENDENT
MARKET
OPERATOR

Wholesale Electricity Market Concept Paper Proposal

Concept Paper Proposal ID: CP_2013_02
Date received: TBA

Concept requested by:

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Address:	Level 17, 197 St Georges Terrace, Perth WA 6000
Date submitted:	TBA
Urgency:	3 (High)
Concept proposal title:	Market Participant Fee - Clarification of GST Treatment
Market Rule(s) affected:	To be determined.

Introduction

The purpose of a Concept Paper Proposal is to foster analysis and discussion of complex issue(s) that can affect the Wholesale Electricity Market (Market), the Market Rules and the Wholesale Market Objectives.

The objectives of the market are:

- (a) to promote the economically efficient, safe and reliable production and supply of electricity and electricity related services in the South West interconnected system;
- (b) to encourage competition among generators and retailers in the South West interconnected system, including by facilitating efficient entry of new competitors;
- (c) to avoid discrimination in that market against particular energy options and technologies, including sustainable energy options and technologies such as those that make use of renewable resources or that reduce overall greenhouse gas emissions;
- (d) to minimise the long-term cost of electricity supplied to customers from the South West interconnected system; and



- (e) to encourage the taking of measures to manage the amount of electricity used and when it is used.

This Concept Paper Proposal can be posted, faxed or emailed to:

Independent Market Operator

Attn: Group Manager, Development and Capacity

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General Information about Concept Paper Proposals

On receipt of this Concept Paper Proposal the Independent Market Operator (IMO) will proceed following these steps:

1. Log the proposal and notify the proposer that it has been received;
2. Assess the concept and consult with the Market Advisory Committee (MAC) for prioritisation against other Rule Participant issues registered; and
3. Work cooperatively with the proposer to develop the full concept paper including:
 - assessment against the Market Objectives; and
 - undertaking a detailed cost benefit analysis related to the identified options.

Details of the Proposed Concept Paper

- 1. Identify the issue(s) with the existing Market and/or its Market Rules that are to be addressed by the proposed concept paper (including any examples):**

Background

From market start, the IMO has been collecting Market Fees, System Operation Fees and Regulator Fees (collectively known as the Market Participant Fees) from Market Participants to recover its own costs, and the costs System Management and the Economic Regulation Authority (ERA), respectively, in performing their functions under the Market Rules.

From market start, all three fees have been invoiced to the Market Participants subject to Goods and Services Tax (GST). The IMO has then passed the fees collected on behalf of ERA and System Management to each entity as received (including GST) and has issued the entities with Recipient Created Tax Invoices which itemised the GST amounts.



The IMO obtained external advice on the GST arrangements for market transactions prior to market start, and a further review was undertaken in 2010 which confirmed the IMO's compliance with GST legislation.

In November 2009 the ERA informed the IMO that they had not been passing on the GST they had been receiving from the IMO to the Australian Taxation Office (ATO), but had been keeping it (as revenue). This resulted in a significant amount of correspondence and discussion between the IMO and the ERA as to the GST classification of the Regulator Fee.

On 21 December 2011, the ERA forwarded to the IMO a copy of a private ruling it had received from the ATO (dated 7 October 2011) in respect of the GST classification of the Regulator Fee, the effect of which was to make the Regulator Fee GST exempt. The IMO received a copy of the ruling from the ERA after the 60 day objection period to the ruling had lapsed.

Conscious of the material impact on WEM settlement, IMO's settlement systems and Market Participants' settlement validation tools, the IMO subsequently lodged its own application for a private ruling which sought to clarify the earlier ruling provided to the ERA.

In September 2012, the ATO issued its private ruling in response to the IMO's private ruling submission, advising that the Regulator Fee passed onto the ERA should have been exempt from GST from market commencement. The ruling also suggested that the Market Fee was exempt from GST from 1 July 2012 following the introduction of new legislation. The ruling did not suggest that the System Operation Fee was also exempt from GST but indicated that System Management should undertake a self-assessment of the GST treatment of this fee in accordance with the new legislation.

GST is still being applied to all transactions under the Market Rules between the IMO and the Market Participants, and between the IMO and System Management. However from June 2012, no GST has been passed on by the IMO to the ERA, the IMO ceased claiming any input tax credits on the Regulator Fees it pays to the ERA and the IMO has continued to remit all amounts of GST collected from the Market Participants in respect of the Regulator Fee to the ATO.

The ATO Ruling

The ATO's key findings were that:

- the Market Fee component of the Market Participant Fee does not constitute a taxable supply under the A New Tax System (Goods and Services Tax) Regulations 1999 (GST Regulations); and
- that the IMO receives the Regulator Fee and System Operation Fee as a collection agent for the ERA and System Management respectively – the ERA and System Management make supplies directly to the Market Participants.

Following from the above, the IMO does not make a credible acquisition from the ERA when it pays the ERA the amount referred to as the Regulator Fee and therefore is acting only as an agent on behalf of the ERA in respect to the recovery of Regulator Fee amounts.

The ERA's own private ruling found that the Regulator Fee was exempt from GST under Division 81 of the GST Act.

A consequence of the ATO's ruling on the IMO is that:

- The IMO is not entitled to invoice Market Participants directly, in its own name, for the Regulator Fee and the System Operation Fee, as it has done since market start.
- The IMO was not entitled to claim GST credits for any period in relation to payments to the ERA for the amount referred to as the Regulator Fee and must recover and pay the ATO the value of these credits to account for the ATO's shortfall from October 2008 (in line with ATO recovery time frames).
- The Regulator Fee and the Market Fee are exempt from GST. It is likely that the System Operator Fee will also be exempt from GST following self-assessment under the new GST provisions.

While the IMO does not agree with the private ruling, it has accepted it. The IMO is now engaged with the ATO and the following points reflect discussions to date:

- The ATO has indicated that it has no intention of unwinding transactions historically between the IMO and the Market Participants and between the IMO and System Management which have been incorrectly treated as taxable and/or GST incorrectly levied by the IMO.
- The IMO will recover the incorrectly claimed GST credits in respect to payments to the ERA in the first year of its next Revenue Period (2013/14). This cost was included as a one off item in the IMO's Allowable Revenue Submission submitted to the ERA for approval and published on 20 December 2012. The total cost to be recovered is \$543,480 which includes \$43,929 of interest¹.
- The ATO agreed that the IMO will not be subject to any penalty.
- Since June 2012, the IMO has ceased claiming any input tax credits on the Regulator Fees it pays to the ERA. However, the IMO continues to remit all amounts of GST collected from the Market Participants in respect of the Regulator Fee to the ATO.
- Consistent with the indication not to unwind any historical transactions, the ATO has also indicated that it does not intend to unwind any transactions relating to the Regulator Fees that Market Participants continue to pay to the IMO and the associated input tax credits being claimed.

¹ Independent Market Operator - Proposal for Allowable Revenue and Forecast Capital Expenditure – 1 July 2013 to 30 June 2016, page 29, available at: http://www.erawa.com.au/cproot/11033/2/20121220%20-%20IMO%20Proposal%20for%20Allowable%20Revenue%20and%20Forecast%20Capital%20Expenditure_1%20July%202013%20to%2030%20June%202016.pdf

The IMO, in order to give effect to the findings of the ATO in the ruling, must change the GST treatment of the Market Participant Fees charged to Market Participants and the way these fees are invoiced.

The IMO is currently working with the ATO to establish a timeframe within which these changes will be implemented. Given the rule, procedure and systems changes involved, the IMO has suggested that a 1 January 2014 start date would be feasible (this time frame is also designed to enable adequate time for the full implications on Market Participants to be assessed and any consequential system changes to be effected). This matter is currently the subject of dialogue between the IMO and the ATO.

Implications of the Ruling

The ruling has several practical consequences for the IMO and Market Participants:

- The IMO's market settlement systems which were designed to add GST to all payments including the Regulator Fee, Market Fee, and the System Operation Fee (pending self-assessment by System Management) need to be adjusted to reflect the ruling.
- The IMO's invoicing and clearing procedures need to be reviewed to reflect the ruling.
- Market Participants will no longer be charged GST on the Regulator Fee, Market Fee, or the System Operation Fee (pending self-assessment by System Management) or be able to claim input credits for these fees going forward.
- The Credit Limits for Market Participants may marginally reduce over time and the procedures and calculation may require review.
- Market Participants' settlement verification tools and systems which interface directly with the IMO's systems may require adjustments.

The ruling has highlighted an issue in the Market Rules that means that the IMO would no longer be able to 'bundle' all market fees in the manner it currently does. The ruling also highlights a more fundamental issue regarding who the principal agent is for all transactions in the SWIS.

2. Outline the overall objective of the Concept Paper Proposal:

The objective of this Concept Paper is twofold. The first objective is to make Market Participants aware of the issue. The second objective is to provide information on the implications and possible solutions so that participants may consider and provide feedback on possible concerns and changes required as a result of the rulings.

3. Identify any reasonably practicable options for achieving the objective:

The removal of GST from fees within the settlement system processes does not, in itself, represent a significant change to the market. However, the finding that the IMO recovers the two fees as a collection agent on behalf of the ERA and System Management poses a wider issue.

There is a lack of clarity in the Market Rules as to the IMO's role as a clearing house for the market because the role of principal / agent in all electricity trades is not articulated.

IMO acts as principal

The WEM was established on the basis of the IMO acting as the principal in all physical trades and transactions made under the Market Rules. The IMO has developed its operations, settlement processes and systems and invoicing procedures in accordance with this understanding. As such, the IMO could propose changes to the Market Rules that would clarify the IMO's position as the principal in all such transactions in the market.

The principal role, which is common in energy markets around the world², essentially involves the IMO taking delivery (at least for an instant) of all electricity generated and subsequently consumed in the market. The introduction of the Balancing Market has resulted in 100% of the electricity generated being traded and scheduled through the IMO's market systems. While the IMO is yet to explore the full risks associated with taking on the principal role for all physical trades and transactions, it would appear to be a natural progression given the nature of the Balancing Market and the role of the IMO intended role as the market operator and clearing house for all physical electricity trades in the SWIS.

A consequence of the IMO being the principal is that all services provided in relation to the electricity would be being provided to the owner of the 'pool' of electricity (that is, to the IMO directly).

The IMO has completed a preliminary assessment of the settlement system, invoicing and clearing changes required if it were to act as principal to all physical trades. This clarification and the removal of GST from the Market Fee, Regulator Fee, and the System Operation Fee (pending self-assessment) is unlikely to require any substantial changes to the IMO's current operations, settlement and invoicing systems and procedures. It would also allow the IMO to continue bundling all market fees as currently occurs and for Market Participants to continue settling these amounts as per the current processes.

A Rule Change Proposal would be required to clarify the IMO's role as the central clearing house for the market, thereby removing the risk of additional settlement systems and clearing processes needing to be developed for payments made under the Market Rules.

IMO acts as agent

The IMO also considered an alternative option where it acts explicitly as an agent for the ERA and System Management in collecting the Regulator Fee and System Operation Fee from the Market Participants. This option involves several uncertainties besides the lack of clarity as to

² Including the National Electricity Market in eastern Australia.

who in the market is the principal for physical market transactions. The IMO also found that the practicalities, complexity of implementation, and significant additional costs for this option would not be consistent with the Wholesale Market Objectives.

The factors considered in regards to this option are outlined below.

Continuing to use the IMO's current systems and processes poses an issue if the IMO is to act as an agent. While the ATO found that the IMO collected the Regulator Fee and System Operation Fee as a collection agent for the ERA and System Management, the ATO did not go as far as to recognise an agency agreement, either express or implied, between any of the parties. As a result, the IMO is not able to issue tax invoices to the Market Participants in respect of the Regulator and System Operation Fees. Agency agreements could be entered into between the IMO and ERA and between the IMO and System Management to ensure the IMO could issue valid invoices in respect of these amounts.

Alternatively, given that the ruling found that the ERA and System Management are making supplies to the Market Participants directly, the ERA and / or System Management could create or alter their own settlement and clearing processes, prudential standards and/or monitoring systems in respect of these amounts and invoice Market Participants directly.

The IMO notes that the cost to the market of both or either of the ERA and System Management establishing their own settlement and related processes could be substantial and would add a level of complexity to the market which was not intended in the original design of the institutions. It is also unlikely that these changes could be implemented within the timeframe being negotiated with the ATO. Further, this would also require that the IMO adjust the current settlement, invoicing, and prudential processes to reflect the changed circumstances.

The prudential measures for each of the fees would also need to be reviewed. As the Regulator Fee and the System Operation Fee do not represent amounts owed to the IMO, these amounts may no longer be covered by the Credit Limit provisions in the current Market Rules. Further investigation of this issue would need to be undertaken to determine whether the ERA and System Management would be covered by the prudential security held by the IMO in the event of Market Participant default.

In both cases, a wider review of the settlement and prudential rules would be required. The Market Rules were not drafted with the IMO as the collection agent as a frame of reference and, should an agency relationship be expressed between the parties, the Market Rules may not retain the interpretation that was intended by the drafters. Similarly, the Market Rules were not drafted with the intention of the ERA and System Management invoicing Market Participants directly and such a change would depart from their existing and intended roles.

The uncertainties with this option create additional risks for the IMO, ERA, System Management and the Market Participants. Additional costs of either option would be borne by the Market Participants.

Recommendation

The IMO proposes to progress the first option – to amend the Market Rules to make it explicit that the IMO is the principle in all physical market trades and transactions, including in relation

to services provided by the ERA and System Management.

This option:

- is consistent with the Wholesale Market Objectives;
 - best reflects the existing design intention for the WEM, as well as the understanding of the IMO and Market Participants; and
 - is likely to require more minimal changes to the existing settlement and prudential processes.
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