



SUBMISSION TO THE ECONOMIC REGULATION AUTHORITY

**Discussion paper: 2016 Report to the Minister for Energy on the effectiveness
of the EGRC Regulatory Scheme**

Executive Summary

Matter 2016 report to the Minister for Energy on the effectiveness of the Electricity Generation and Retail Corporation regulatory scheme (**EGRC scheme**) – discussion paper.

Context Regulation 48(1) of the *Electricity Corporations (Electricity Generation and Retail Corporation) Regulations 2013 (regulations)* requires the ERA review the operation of the EGRC 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.

In carrying out the review, in addition to compliance with the *Economic Regulation Authority Act 2002 (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**).

In addition, the ERA has represented to stakeholders that, in accordance with good regulatory practice and the principles of natural justice, it will also take into account stakeholder views expressed in the preparation of its report to the Minister.

The ERA published a notice on 22 May 2017 inviting public submissions from interested parties on issues that will assist the ERA in undertaking its third review of the effectiveness of the EGRC scheme.

Scope The EGRC 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. In conducting the review of the EGRC scheme's effectiveness, the ERA needs to take a considered view as to whether the regulatory costs associated with the EGRC regime (including the ERA's EGRC review and report provided to the Minister) are disproportionate relative to the actual or perceived benefits associated with the EGRC regime. That is, the ERA should undertake a detailed *ex ante* and *ex post* regulatory impact analysis as a part of its review.
2. The ERA should adopt an evidence-based approach when considering stakeholder submissions, particularly regarding Synergy's conduct. Synergy notes that it has, during this and previous reviews, welcomed a similar evidentiary benchmark being applied to its submissions and contentions.
3. The ERA should adopt an evidence-based approach on the need for further EGRC scheme changes prior to requesting stakeholder comment on what form those changes should take.
4. The ERA should have regard to the context in which the prevailing circumstances of the operations of the SWIS takes place. In particular, state government energy policy including generation capacity retirement, full retail contestability and retail tariff reform. Further, the continued high level of retail market competition in the contestable market should be reflected in the ERA's considerations.

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5. The standard product regime meets its high level design objectives including price discovery and is considered to be operating effectively. The standard products regime is not intended to be a benchmark of a competitive price.
 6. Synergy considers there to be no evidence that the current standard products buy/sell spread is inappropriate and/or not supporting the EGRC scheme.

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 needs to 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.

As per past submissions, Synergy recommends the ERA adopts an evidence-based approach to stakeholder submissions whereby market participants should be required to substantiate to the ERA their assertions regarding Synergy's ring fencing conduct. To ensure equal treatment under the regulations, the ERA should also consider exercising its statutory information gathering powers under the ERA Act to obtain such evidence, as per the Authority's current practice with Synergy.

1. SCHEME EFFECTIVENESS

The ERA invites stakeholders to comment on the effectiveness of the scheme in helping or hindering competition in the market, and to provide any evidence that supports their views.

Scheme design: objectives

Synergy considers that the scheme's effectiveness can be improved by the regulations specifying the criteria the ERA must apply or take into account when undertaking its assessment. This will remove the uncertainty to Synergy, ERA and the market around how an effectiveness review is conducted and the matters reviewed therein.

Regulatory impact analysis

In Synergy's view, assessing the effectiveness of the EGRC regime at this stage of its maturity requires the ERA to consider undertaking a detailed *ex post* and *ex ante* regulatory impact analysis to at least:

- map the regulatory costs and benefits that arise in connection with the EGRC regime;
- determine overlaps, dependencies and inconsistencies between the EGRC regime and other state and federal legislation relevant to Synergy including without limitation the *Competition and Consumer Act 2010* (Cth), the *Electricity Industry Act 2004* (WA) and the *Corporations Act 2005* (WA); and
- evaluate whether the regulatory costs and benefits are, when considered in light of their market outcomes:
 - economically efficient;
 - promote the best interests of consumers; and
 - are otherwise fair and reasonable.

The purpose of the ERA's EGRC scheme review, despite the lack of scheme objectives, in Synergy's view is to provide the Minister with statutorily independent advice about whether the EGRC scheme should be amended, continued unchanged or repealed. Synergy therefore encourages the ERA to undertake a detailed regulatory impact analysis as suggested above.

Need for change in view of legislative developments

The ERA considers its task in undertaking this review is to assess how effective the EGRC regime is in mitigating the increased potential for exercising market power, which arose due to the merger of Synergy and Verve Energy in January 2014. Given this, Synergy considers that a detailed regulatory impact analysis of the kind described above would demonstrate that relaxation to the EGRC regime could be justified in accordance with good regulatory practice in the event that an "effects test" of the kind described in the *Competition and Consumer Amendment (Misuse of Market Power) Bill 2016* (Cth) is introduced to section 46 of the *Competition*

and Consumer Act 2010 (Cth). Further attention should be paid to other developments in relevant laws and regulation, including in relation to competition law, wholesale electricity market regulation and the state government's energy policy objectives and direction.

Level playing field

Further, if the ERA considers that the EGRC regime's policy objective is to ensure a level playing field for competitors and new entrants, in order to facilitate competition, Synergy considers that the concept of a level playing field should apply equally to Synergy.¹

Synergy is obliged under its enabling legislation to act commercially and efficiently in the sale and purchase of wholesale energy within its business, whilst acting consistent with the constraints imposed by the regulations and in compliance with its other legal and regulatory obligations. The EGRC scheme is not designed to ensure private participant's interests are promoted, particularly to the detriment of Synergy's own commercial interests.

Although the EGRC scheme was intended to provide for a level playing field, Synergy seeks to bring to the ERA's attention, as a government trading enterprise, it is subject to a significant amount of regulation which does not apply to its competitor including without limitation in the retail market:

- obligations to offer to supply small use contestable customers;
- regulated tariffs, fees and charges;
- concessions administration;
- renewable energy buyback scheme regulation; and
- electricity supplier of last resort.

Retail and wholesale competition

Since the merger in January 2014, competition in the contestable electricity market has continued to be very active, in terms of churn and contracting. When assessing SWIS competition the ERA should take into account:

- retail market definition and associated customer segments i.e. large use contestable customers, small use contestable customers, residential and business franchise customers;
- the number of customers churning between retailers;
- why customers churn (price, service, debt avoidance etc);
- demand and supply;
- new retail entry models such as solar power producer agreement providers which do not require a retail licence;
- the number of existing retail licence holders;
- why so many retailers chose to supply only customers who consume more than 160MWh per annum;
- Synergy's regulated tariffs, fees and charges;
- level of contract and price disclosure and discovery; and
- the status and timing of EMR initiatives including full retail contestability, metering contestability and retail tariff reform.

¹ "2016 Report to the Minister for Energy on the Effectiveness of the Electricity Generation and Retail Corporation Regulatory Scheme – Discussion paper" May 2017" page 4.

2. PARTICIPANT AFFILIATIONS

The ERA welcomes feedback from stakeholders on their experience of the scheme and how:

- **participant affiliations in the market have affected them; and**
- **the design of the scheme could be changed to provide increased transparency without compromising commercial confidentiality.**

Synergy considers that there is no justification for expanding the EGRC scheme to include "participant affiliations" nor Synergy's gas business, which operates in a highly competitive market.

The ERA states in its discussion paper "a key question is whether the incumbent generator is sufficiently independent from its generation affiliates so that regulators and third parties can be reasonably confident that the incumbent and its affiliates act individually, particularly in bidding"².

Synergy submits its balancing merit order for the balancing portfolio ahead of the time in each trading day that other market participants submit their bids to AEMO. Synergy's current practice is to submit price quantity pairs that are equal to the short run marginal cost of generation for the balancing portfolio.

Given the aforementioned context, Synergy suggests that the ERA should clarify:

- the basis on which the ERA considers the matter requires review i.e. what *actual* market power concerns is the ERA seeking to address; and
- why after three years of scheme operation the ERA consider this to now be an issue?

The ERA also proposes that concerns about how company revenues, costs and profits may be split across different parts of each businesses could be dealt with by imposing an obligation to publicly report separate financial results annually for generation and for domestic and non-domestic electricity and gas supply. The ERA notes Ofgem considers the publication of these consolidated segmental statements is important for consumer confidence and for facilitating new entry (and thereby competition) through informed decision making.

The relevant obligation applies under condition 19A of the Standard Conditions of Electricity Supply Licence granted under the *Electricity Act 1989*, which imposes a set of financial information reporting and information retention conditions on "relevant licensees" being licensees that:

- supply or it and any of its "affiliates" jointly supply:
 - electricity to more than 250,000 domestic customers; or
 - gas to more than 250,000 domestic customers; or
 - electricity to more than 250,000 non-domestic customers; or
 - gas to more than 250,000 non-domestic customers, respectively; and
 -
- it or any of its affiliates is a holder of an electricity generation licence granted or treated as granted under section 6(1)(a) of the Act.

Synergy has two main concerns with respect to the ERA floating these financial information reporting and information retention conditions in the context of the EGRC review.

First, it should be noted that one of the policy drivers associated with the introduction of the financial information reporting obligation and similar provisions stemming from the Energy Supply Probe of October

² Op cit page 7.

2008 was a perception that retail competition was not giving rise to the benefits that regulators, economists, policy makers and more importantly consumers had expected of it. Specifically, retail consumers had incurred significant increases in prices and churn rates were much lower than anticipated, resulting in the continued dominance of incumbent suppliers.

The context of the SWIS is fundamentally different. Synergy maintains a monopoly with respect to consumers that use up to 50MWh per annum but in the contestable market, competition is fierce with Synergy's market share is radically lower than the 87% market share of the GB's six large suppliers.³

Second, were it implemented fairly in line with the GB market design, this proposal would be unduly onerous on all parties caught by the provisions. The financial reporting licence condition applies to all retailers that meet the definition of "relevant licensee" and meeting that definition is contingent upon customer numbers and holding a generation licence. Were the condition to apply in the SWIS without proportionate amendment to the threshold customer numbers, Alinta and Synergy would be caught by the definition and would have to comply with the licence condition.

If the customer thresholds were adjusted to SWIS market size, then the condition would apply to electricity and gas retailers of quite modest size. To give a sense of comparable market size, according to Ofgem, the GB market has around 28 million domestic electricity and 21 million domestic gas customers, accounting for 36% of electricity and 61% of gas consumption respectively.⁴ The SWIS has around one million domestic customers for electricity and Western Australia has something in the order of 740,000 customers for gas.

Synergy also considers the ERA in conducting its effectiveness review should take into account existing arrangements that already provide safeguards against discriminatory, unfair or anti-competitive behaviour such as *Competition and Consumer Act 2010* (Cth). To the extent that applicable laws provide sufficient protection against market power misuse there should be no need for further EGRC regulatory intervention. Further in the event applicable laws relating to market power are enhanced then the EGRC scheme should be reviewed to remove any regulatory duplication. The ERA has successfully adopted this approach previously in relation to the *Code of Conduct for the Supply of Electricity to Small Use Customers 2016* which resulted in reduced retailer regulatory burden with no commensurate loss of customer protection to small use customers.

The ERA welcomes stakeholder feedback on their experience of the scheme's compliance monitoring regime and the submission handling and outcomes of any complaints made regarding the scheme.

The ERA is interested to know whether stakeholders would support the development of an independent formal complaints process? what form this should take and what improvements this would bring to the effectiveness of the scheme?

Synergy is in a continual state of audit or review scrutiny throughout the course of a year. The regulations have been in existence since 1 January 2014. Under the regulations, Synergy is subject to two audits by the Office of Auditor General (**OAG**) and an effectiveness review by the ERA every year. Further, if the OAG forms an opinion Synergy has not complied with one or more provisions of the regulations, the Authority has the function to investigate the matter.

The ERA has expressed the view the OAG should undertake more frequent compliance reviews. Synergy has responded to the EGRC scheme compliance requirements seriously and responsibly. Synergy considers the current level of audit and review is bordering on excessive and more frequent reviews will result in a regulatory burden that is inconsistent with good regulatory practice or good public policy. Standard regulatory practice is to incentivise market participants to attain good compliance behaviour by extending the regulatory audit or review periods and conversely addressing poor compliance by increasing audit and review frequency.

³ Ofgem *Retail Energy Markets in 2016* (https://www.ofgem.gov.uk/system/files/docs/2016/08/retail_energy_markets_in_2016.pdf) at 11.

⁴ Ofgem *Retail Energy Markets in 2016*, at 10.

In contrast, despite a lack of supporting evidence the ERA is seeking to increase the frequency of OAG audits. Synergy questions whether the ERA in considering the recommendation gave due regard to the matters specified section 26 of the ERA Act in the performance of its functions which includes the “the legitimate business interests of investors and service providers in relevant markets”.

Consistent with the above, Synergy also sees no need and no possible justification for an independent formal complaints process on EGRC matters. Such a mechanism creates a risk of frequent and spurious complaints. The ERA’s annual effectiveness review is an adequate forum for stakeholders to substantiate their concerns. Further, we note despite no formal complaints process, stakeholders are free to engage with the Minister, ERA or the Public Utilities Office at any point in time (and have done so in the past).

In putting forward the proposal the ERA also appears not to have adequately taken into account existing mechanisms that already provide safeguards against discriminatory, unfair or anti-competitive conduct specifically the *Competition and Consumer Act 2010* (Cth).

The ERA welcomes any information from stakeholders on their experience of the standard product arrangements. For example, the ERA invites responses to the following questions:

- **have the overarching goals of the standard product arrangements described by the Merger Implementation Group been met? If not, why not?**
- **why do market participants choose to use standard products?**
- **why do market participants choose not to use standard products?**
- **are the standard product regime’s design specifications (e.g. volume, term, spread, lead time) appropriate? If not, why not?**
- **what alternatives to the use of standard products are available?**
- **how can the standard product arrangements be improved?**

The EGRC discussion paper suggests a reduction of the spread between the buy and the sell price for standard products to 10 percent.

Page 13 of the discussion paper also refers to the pattern for the standard product pricing over 2016 was substantially different to the one in 2015. It is stated that “standard product sell prices should include the expected spot price and a premium for contracting to remove spot price risk, and should thus be higher than the prices in the STEM and balancing markets.”

Synergy also brings to the ERA’s attention the forecast for the standard product prices is made quarterly on a two-year ahead basis, which makes it difficult to form accurate estimations of the future pricing. Standard product sell prices tend to fluctuate due to volatility in the forecast and the market dynamics and, therefore, cannot always be higher than the prices in the STEM and balancing markets. The future price forecasts are highly impacted by temperature dependent load forecast variability. It is highly unreasonable to suggest that Synergy is capable of forecasting a spot price two years out with an accuracy of + or – 5%. Therefore, suggested 10 percent spread between the buy and the sell price is not a viable option.

It is stated in the Appendix 2 of the discussion paper that a 20 percent spread between standard product buy and sell prices is significantly higher than observed in other competitive markets. Synergy notes the Wholesale Electricity Market is significantly different from other competitive markets and therefore cannot be equally compared with.

Other matters

Synergy's business impact and cost

Synergy recognises the EGRC scheme design intent is to facilitate the transition to a more competitive market via regulatory constraints so Synergy does not unduly preference its retail and generation business units over third party retailers and generators, specifically in the provision and use of sensitive information.

A regulatory impact assessment of the kind referred to earlier in this submission is necessary to determine the regulatory costs, their impact on Synergy and the state budget, more generally. However, in Synergy's view the EGRC scheme has resulted in a loss of economic efficiency and substantial regulatory costs within the business arising from the separation of interrelated activities, direct compliance and administrative costs. These range from physical separation of the wholesale business unit, restriction on the sharing of information, knowledge and expertise, additional IT control costs, significant ring fencing training monitoring, the two annual OAG audits and the cost and time of responding to the ERA's statutory information requests. Synergy considers any review of the EGRC scheme should include in a detailed *ex ante* and *ex post* regulatory impact assessment.

Ministerial report

Synergy sees value in introducing a public review period for the draft EGRC regulatory review report to the Minister for Energy as this will create opportunity to address matters raised in the review and provide evidence to support certain claims. This will also improve the quality and accuracy of the report submitted to the Minister.

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