

# Issues Paper

## Allowable Revenue and Forecast Capital Expenditure for the Independent Market Operator (WEM Functions) 2016/17 – 2018/19

March 2016

Economic Regulation Authority

WESTERN AUSTRALIA

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## Invitation to make submissions

Interested parties are invited to make submissions on the Authority's consultation paper by **4:00 pm (WST) Friday, 29 April 2016** via the submission [portal](#) located on the Authority's website, or:

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### CONFIDENTIALITY

In general, all submissions from interested parties will be treated as being in the public domain and placed on the Authority's website. Where an interested party wishes to make a submission in confidence, it should clearly indicate the parts of the submission for which confidentiality is claimed, and specify in reasonable detail the basis for the claim. Any claim of confidentiality will be considered in accordance with the provisions of 55 of the *Economic Regulation Authority Act 2003*.

The publication of a submission on the Authority's website shall not be taken as indicating that the Authority has knowledge either actual or constructive of the contents of a particular submission and, in particular, whether the submission in whole or part contains information of a confidential nature and no duty of confidence will arise for the Authority.

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# 1 Introduction

## 1.1 Background and Scope of this Issues Paper

The Wholesale Electricity Market (**WEM**) commenced operation in 2006 as part of the Western Australian government's decision to reform its electricity industry. The WEM is governed by the *Wholesale Electricity Market Rules 2015* (**Market Rules**), and its functions include:

- operation of the WEM;
- provision of system planning services;
- administering and determining changes to the regulatory framework governing the operation of the WEM;
- operation of the market Advisory Committee;
- other consultation;
- monitoring and enforcement; and
- other functions under the Market Rules.

Under clauses 2.22.3 and 2.23.3 of the Market Rules, the Economic Regulation Authority (**Authority**) is required to determine allowable revenue and forecast capital expenditure for the Independent Market Operator (**IMO**) for each Review Period. Since the commencement of the WEM in Western Australia in September 2006, the Authority has previously determined allowable revenue for the IMO for three Review Periods.

Allowable revenue is the revenue that may be recovered through fees to meet the costs of the services provided by the IMO to the market. The allowable revenue determined by the Authority forms the basis of annual budgets for the IMO. The budgets must be consistent with the determination of allowable revenue, but include adjustments to account for surpluses or shortfalls in revenues from market fees and system operation fees for the year prior to the budget.

Sub clause 2.22.3(a) of the Market Rules requires the IMO to submit a proposal for its allowable revenue and forecast capital expenditure to the Authority by 30 November of the year prior to the start of the Review Period. On 15 November 2015, the IMO submitted to the Authority a proposal for allowable revenue and forecast capital expenditure for the period from 1 July 2016 to 30 June 2019. This proposal is available on the Authority's [website](#).

Sub clause 2.22.3(b) of the Market Rules requires the Authority, in determining allowable revenue and forecast capital expenditure for the IMO, to undertake a public consultation process which must include publishing an Issues Paper and issuing an invitation for public submissions.

The Authority has prepared this Issues Paper to assist interested parties understanding of the process and making submissions on the IMO's proposal. Interested parties are invited to make submissions on any element of the IMO's proposal.

## 1.2 Transfer of functions to Australian Energy Market Operator

On 30 September 2015, the Minister for Energy announced the transfer of the system management and operation of the Wholesale Energy Market (**WEM**) and Gas Services Information (**GSI**) functions from the IMO to the Australian Energy Market Operator (**AEMO**). This transfer took place on 30 November 2015.

The functions of administering and determining changes to the WEM Rules, and compliance and monitoring, have for now been retained by the IMO and will not be transferred to AEMO. These functions will be reassigned to an alternative agency which has not yet been announced by government.<sup>1</sup>

Due to the timing of this transfer, IMO was unable to incorporate the changes to its functions into its allowable revenue and forecast expenditure proposal. Instead, the IMO has prepared its proposal on a “business as usual” basis.<sup>2</sup> This means that the IMO’s proposal shows what its revenue requirements would be if it were to retain all of its functions.

The Authority does not consider the ‘business as usual’ approach to be the best way to assess the revenue requirements of IMO functions that have been transferred to AEMO. However, the Authority notes the transfer of the IMO functions to AEMO has occurred since the IMO submitted its proposal to the Authority.

The Authority will assess the proposal on the basis that revenues relating to the WEM function will be allocated to AEMO in respect of the functions transferred to it. This revenue allocated to AEMO will exclude the amounts for the other functions of the IMO, which are to be transferred elsewhere.

The WEM Rules provide for the reassessment of these amounts in the event that revenue recovery or capital expenditure within a review period exceeds the amount approved in the ERA’s final determination by a certain amount.<sup>3</sup>

### Issue 1

Interested parties are invited to make submissions on any matter relevant to the determination of allowable revenue in the context of the transfer of functions from the IMO to AEMO, and to other entities.

<sup>1</sup> There is a possibility that responsibilities to support the rule-making function may be transferred to the ERA. See Public Utilities Office Issues Paper:

[http://www.finance.wa.gov.au/cms/uploadedFiles/Public\\_Utility\\_Office/Electricity\\_Market\\_Review/Position\\_paper-Energy-Market-Operations-and-Processes.pdf](http://www.finance.wa.gov.au/cms/uploadedFiles/Public_Utility_Office/Electricity_Market_Review/Position_paper-Energy-Market-Operations-and-Processes.pdf) page 38. The ERA is not required under the Market rules to make a determination in respect of the functions not transferred to AEMO, nor would it be appropriate.

<sup>2</sup> The IMO has excluded all costings related to the EMR from its allowable revenue and forecast capital expenditure proposal due to the extraordinary nature of the EMR in comparison to its normal business activities, advising that excluding these costs would better facilitate a credible comparison between the current and previous review periods.

<sup>3</sup> Gas Services Information Rules, Division 3, 111.(4) and 111.(5), November 2015.

## 1.3 Requirements of the Wholesale Electricity Market Rules

Clause 2.22.3 of the Market Rules requires the Authority to determine the allowable revenue and forecast capital expenditure for the IMO for the services it provides under the Market Rules. These services are defined in clause 2.22.1 of the Market Rules as:

- market operation services, including the IMO’s operation of the reserve capacity market, short term electricity market and balancing and the IMO’s settlement and information release functions;
- system planning services, including the IMO’s performance of the long term “projected assessment of system adequacy” and functions under Chapter 5 of the Market Rules; and
- market administration services, including the IMO’s performance of the Market Rule change process, Market Procedure change process, the operation of the Market Advisory Committee and other consultation, monitoring, enforcement, audit, registration related functions and other functions under the Market Rules.

The Authority’s determination of Allowable Revenue is one of two external oversight mechanisms provided for in the Market Rules. The Market Rules also require the IMO to prepare an annual budget for the coming financial year and submit it to the Minister for Energy for approval. The budget proposal must be consistent with the Allowable Revenue determined by the Authority for the relevant Review Period.

Factors that the Authority must take into account in determining the allowable revenue and approving the forecast capital expenditure for the IMO are as follows:

- The allowable revenue must be sufficient to cover the forward looking costs of providing the relevant services in accordance with the following principles:
  - i. recurring expenditure requirements and payments are recovered in the year of expenditure;
  - ii. capital expenditures are to be recovered through the depreciation and amortisation of the assets acquired by the capital expenditure in a manner that is consistent with good accounting principles;
  - iii. costs incurred that are related to market establishment, as designated by the Minister, are to be recovered over a period determined by the Minister from “energy market commencement”; and
  - iv. notwithstanding (i), (ii) and (iii), expenditure incurred and depreciation and amortisation charged, in relation to any “declared market project” are to be recovered over the period determined for that declared market project.
  - v. The allowable revenue and forecast capital expenditure must include only those costs that would be incurred by a prudent provider of the services, acting efficiently, seeking to achieve the lowest practically sustainable cost of delivering the services in accordance with the Market Rules, while effectively promoting the wholesale market objectives.
  - vi. Where possible, the Authority should benchmark the allowable revenue and forecast capital expenditure against the costs of providing similar services in other jurisdictions.



## 2 Independent Market Operator Proposal

### 2.1 Allocation of Costs across the IMO's Electricity and Gas Functions

In August 2013, the IMO's functions were expanded to include activities related to Gas Services Information (**GSI**).

The IMO has two key areas of function, including:

- the IMO's electricity functions set out in the WEM Rules; and
- the IMO's GSI services function set out in the Gas Services Information Rules (**GSI Rules**).

When the IMO received the GSI function to administer in 2013, it integrated its functions under the GSI Rules into its existing teams to enable it to achieve operational efficiencies that would not have been achieved if the functions were operated separately. Accordingly, many of the IMO's resources (including staff, administrative support, office accommodation, and other corporate and management support) are shared across both functions. Where resources are shared across functions, the IMO has developed a cost allocation methodology.

#### Issue 2

Interested parties are invited to make submissions on the allocation of costs by the IMO to allocate resources across its GSI and WEM functions.

### 2.2 Proposed WEM Allowable Revenue and Forecast Capital Expenditure 2016/17 – 2018/19

The IMO's proposed WEM allowable revenue and forecast capital expenditure for the July 2016 to July 2019 review period are outlined in Table 1 below.

**Table 1 Proposed WEM Allowable Revenue and Forecast Capital Expenditure for the Fourth Review Period**

\$'000 (nominal)	2016/17	2017/18	2018/19	Total
Allowable Revenue	17,570	16,216	17,001	50,787
Forecast Capital Expenditure	4,383	4,740	4,659	13,782

The IMO has noted that its submission has been made on the following basis:

- the submission may be subject to review after the transfer of a number of the IMO's functions to AEMO, pending the finalisation of funding arrangements; and
- the business requirements of Electricity Market Participants and other stakeholders have an influence on the IMO's workload and subsequent expenditure.

## 2.3 Allowable Revenue

The IMO's proposal provides information on its proposed Allowable Revenue for each year of the fourth Review Period as set out in the cost categories in Table 2 below.

**Table 2 Proposed WEM Allowable Revenue for the Fourth Review Period**

\$'000 (nominal)	2016/17	2017/18	2018/19	Total
Employee Benefits Expense	6,551	6,678	6,875	20,103
Accommodation	774	808	844	2,427
Supplies and Services	5,087	5,156	5,404	15,648
Borrowing Costs	360	349	363	1,073
Depreciation	4,851	3,277	3,567	11,696
Total Expenditure	17,623	16,269	17,054	50,946
Interest Revenue	-53	-53	-53	-159
<b>Allowable Revenue</b>	<b>17,570</b>	<b>16,216</b>	<b>17,001</b>	<b>50,788</b>

Clause 2.22.3 of the Market Rules requires the IMO to seek approval of its allowable revenue for each of the three WEM services that it provides, as defined under clause 2.22.1 of the Market Rules. The IMO has provided a breakdown of the proposed allowable revenue for each function as set out in Table 3 below.

**Table 3 Proposed Allowable Revenue associated with each WEM service**

\$'000 (nominal)	2016/17	2017/18	2018/19	Total
Market Operations	10,713	9,364	9,928	30,004
System Planning	2,459	2,415	2,430	7,303
Market Administration	4,399	4,438	4,643	13,480
<b>Allowable Revenue</b>	<b>17,570</b>	<b>16,216</b>	<b>17,001</b>	<b>50,788</b>

The key assumptions employed by the IMO in the derivation of its proposed Allowable Revenue for the fourth Review Period are provided in Table 4 below.

**Table 4 Key assumptions applied in the derivation of Allowable Revenue for the Fourth Review Period**

Cost or calculation parameter	Key Assumption
Escalation Rate for Annual Indexation Costs	Indexation cost based on Department of Treasury advice of 2.50 per cent across the Review Period. IMO has excluded costs covered by fixed price contracts from this indexation.
Employee Benefits Expenses <sup>4</sup>	<p>The IMO currently has 45.7 FTE approved positions, which incorporate gas related functions as well as electricity related responsibilities. IMO has proposed 40 FTE for WEM related responsibilities over the fourth review period.</p> <p>Increases in salary costs are based on staff performance. Annual salary increases of 2.90 per cent have been budgeted for each year of the review period in line with the AEMO Enterprise Agreement.</p>
Supplies and Services	<p>The IMO relies strongly on the outsourcing of specialist services for the provision of its internal business needs.</p> <p>Operations and Technology Costs incorporate the maintenance and support of the Wholesale Electricity Market System (WEMS) and Settlements, datacentre hosting and specialist support, high speed fibre links, IT desktop and infrastructure support, as well as the costs of telecommunications and internet access. Costs budgeted for Operations and Technology are impacted by:</p> <ul style="list-style-type: none"> <li>the replacement of overseas third parties with local agencies for the provision of support to its settlements and metering systems;</li> <li>additional desktop support and software licences resulting from an increase in the number of applications being used across the business; and</li> <li>projected movement in international exchange rates.</li> </ul> <p>Development and Capacity costs fluctuate on the basis of cyclical reviews which are required under the Market Rules, and include the external costs of supporting rule changes.</p> <p>Legal and Compliance costs include an incremental compliance audit for each year of the review period.</p>
Accommodation	IMO's submission was prepared under the assumption that it would remain in its current premises over the fourth review period. <sup>5</sup>
Depreciation	<p>Depreciation is determined by the expected written down value of assets as of 30 June 2016, as well as depreciation that flows from assets purchased over the course of the review period.</p> <p>The depreciation model is based on a five year schedule for computer software and a three year schedule for computer hardware to reflect its current useful life.</p>
Borrowing Costs	IMO have taken the existing loan facilities and projected capital expenditure requirements of its fourth IT Roadmap into consideration when arriving at its projected borrowing costs. Future loan facilities are based on projected interest rates provided by Western Australian Treasury Corporation (WATC).

### Issue 3

Interested parties are invited to make submissions on the key assumptions employed by the IMO in deriving its proposed WEM Allowable Revenue for the fourth Review Period 2016/17 - 2018/19.

## 2.4 Forecast Capital Expenditure

The IMO's proposal for forecast capital expenditure over the fourth review period includes a key strategic IT planning document.<sup>6</sup> This document is used by the IMO to ensure that the planning, delivery, management and use of its IT systems optimally support its business requirements.

This is the fourth technology roadmap that the IMO has developed to meet the requirements of its operation and support of the WEM. It reflects a requirement to evolve the technology used by the IMO, especially with regard to the reduction of Legacy System Risk, streamlining the Oracle licencing and potentially investigating alternative databases, and migration to datacentres with better service levels and reliability.

A summary of the capital requirements used in deriving the IMO's proposed WEM Forecast Capital Expenditure for the initial Review Period is presented in Table 5 below.

**Table 5 Forecast Capital Expenditure for the Fourth Review Period**

\$'000 (nominal)	2016/17	2017/18	2018/19	Total
WEMS	1,951	3,074	2,797	7,822
WEMS – Metering and Settlements	565	164	486	1,215
Market Transparency	368	377	386	1,131
Infrastructure Market Systems	1,253	1,099	832	3,184
Corporate Support	246	26	158	430
<b>Total</b>	<b>4,383</b>	<b>4,740</b>	<b>4,659</b>	<b>13,782</b>

<sup>4</sup> Employee benefits expenses include such things as salaries, superannuation, payroll tax, fringe benefits tax and other staffing costs.

<sup>5</sup> The rental rate for the IMO premises (which has an area of 857 m<sup>2</sup>) commenced at \$660/m<sup>2</sup> in 2012, with annual increases of 4 per cent each October built into the current 10 year lease agreement (this includes an option for IMO to exit the lease after 5 years).

<sup>6</sup> Independent Market Operator, *Appendix 2 - Fourth IT Roadmap*, 8 September 2015.

## Issue 4

Interested parties are invited to make submissions on the capital expenditure proposed by the IMO over the fourth review period.

### 3 Process to be followed by the Authority

The Authority considers that it is appropriate to review IMO's proposal in light of the transfer of its WEM functions to AEMO. The Authority will therefore conduct an analysis of the IMO's projected revenue and capital expenditure on the basis of cost per function, as well as cost per FTE, and allocate revenue to the functions to be transferred to AEMO and exclude functions to be assigned to an alternative government agency (the rule change, compliance and monitoring functions). The Authority also intends to compare the IMO's projected revenue with costs incurred by the IMO during the previous review period.

The Authority considers that as AEMO is well established in the Eastern States, it would be appropriate to benchmark the IMO's actual and projected costs for providing WEM services against the actual and projected costs incurred by AEMO for the provision of similar services in the Eastern States, provided relevant information can be obtained.

The Authority will test with AEMO whether reliable cost indicators are available for the provision of these services in parts of the interconnected National Electricity Market (**NEM**). The Authority may also benchmark costs against similar functions in the Northern Territory and New Zealand Markets.

The Authority notes that the West Australian Electricity Market is unique in its size and isolation, and will take into account that efficiencies of scale that might apply to the operation of the National Energy Market (**NEM**) services in the Eastern States may not be applicable in Western Australia. The Authority also notes that bespoke software and system architecture is and has been required by AEMO and the IMO respectively to manage its data and services, and will take this into account.

The Authority also intends to benchmark the IMO's proposal against both the projected and actual corporate costs of a comparably sized organisation, such as the ERA.

The process that the Authority intends to apply in its determination is to:

- Assess the proposal against likely changes to the revenue requirements associated with the provision of the WEM services as a result of the transfer of these functions from the IMO to AEMO.
- Determine the likely differences in revenue requirements as a result of the compliance monitoring and enforcement, and rule change functions being separated from other WEM functions, which have been transferred to AEMO.
- Assess the proposal against benchmarks of the actual costs in the period 2013-2016 of parallel services provided by the IMO in the provision of both GSI and WEM related services where possible.

- Benchmark the costs of WEMS against similar services provided by AEMO in the Eastern States, where possible.<sup>7</sup>
- Seek further supporting information for the proposed Allowable Revenue and Forecast Capital Expenditure sufficient to demonstrate that it is consistent with costs that would be incurred by a prudent provider of services, acting efficiently and seeking to achieve the lowest sustainable cost of delivering these services in Western Australia.
- Identify and assess whether recurring expenditure requirements and payments are recovered in the year of the expenditure.
- Identify and assess differences in costs that are reflective of “trend changes”, due to cost drivers such as an increasing scale of operations and inflation of unit costs.
- Identify changes in costs that are reflective of changes in the nature of activities being undertaken or changes in the manner in which activities are undertaken (such as transfers of certain activities from being undertaken in-house to being undertaken by contractors).
- Assess whether amounts of depreciation and amortisation included in the Allowable Revenue have been appropriately determined from Capital Expenditure.
- Assess capital expenditure amounts deferred as a result of the Energy Market Review, and the planning for transfer of responsibilities, and compare the proposal for capital expenditures with capital values associated with the provision of these services in other jurisdictions by AEMO.

## Issue 5

Interested parties are invited to make submissions on the process that the Authority intends to follow in assessing the IMO’s allowable revenue and forecast capital expenditure.

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<sup>7</sup> The Authority notes that in some instances it may not be practical to undertake such benchmarking as there are no directly comparable entities to the IMO in other jurisdictions in terms of scale of operation, structure of the business and nature of activities.