

The background of the lower half of the page is a photograph of a wind farm and power lines, overlaid with a semi-transparent blue filter. On the left, several large white wind turbines are visible, their blades extending outwards. On the right, a tall metal lattice tower for power lines stands prominently, with other similar towers receding into the distance. The overall scene is set in a hilly, open landscape under a clear sky.

Independent Market Operator

**Rule Change Notice
Title: Reassessment of
Allowable Revenue during a
Review Period**

Ref: RC_2011_02

Standard Rule Change Process

Date: 14 March 2011

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Independent Market Operator

Level 3, Governor Stirling Tower
197 St George's Terrace, Perth WA 6000
PO Box 7096, Cloisters Square, Perth WA 6850
Tel. (08) 9254 4300
Fax. (08) 9254 4399
Email: imo@imowa.com.au
Website: www.imowa.com.au



1. THE RULE CHANGE PROPOSAL

1.1. The Submission

On 10 March 2011 the Economic Regulation Authority (ERA) submitted a Rule Change Proposal regarding amendments to clauses 2.22.8, 2.22.13 and 2.23.8 and new clauses 2.22.15 and 2.23.13 of the Wholesale Electricity Market Rules (Market Rules).

This Rule Change Notice is published according to clause 2.5.7 of the Market Rules, which requires the Independent Market Operator (IMO) to publish a notice within 7 Business Days of receiving a Rule Change Proposal.

1.1.1 Submission details

Name:	Chris Brown
Phone:	08 9213 1992
Fax:	08 9213 1999
Email:	chris.brown@erawa.com.au
Organisation:	Economic Regulation Authority
Address:	Level 6, Governor Stirling Tower, 197 St Georges Terrace
Date submitted:	10 March 2011
Urgency:	2-medium
Change Proposal title:	Reassessment of Allowable Revenue during a Review Period
Market Rules affected:	Clauses 2.22.8, 2.22.13, 2.22.15 (new), 2.23.8 and 2.23.13 (new)

1.2. Details of the Proposal

In its Rule Change Proposal, the ERA notes three concerns over the operation of clauses 2.22.8, 2.22.13 and 2.23.8 of the Market Rules, which provide for a reassessment of Allowable Revenue for the IMO and System Management during a Review Period where an amount of un-forecast expenditure is proposed to be incurred.

Firstly, in their current form, the way in which clauses 2.22.8, 2.22.13 and 2.23.8 of the Market Rules apply to proposed capital expenditures of the IMO and System Management can result in inconsistencies, depending on the timing of the expenditure and the period over which the cost is to be depreciated or amortised, in:

- whether a project of a given total cost meets the criteria for a Declared Market Project (clause 2.22.13); and
- whether a reassessment of approved Allowable Revenue by the ERA is triggered.

As a result of these inconsistencies, capital expenditures made by the IMO and System Management that involve material increases in the market fees¹ charged to Market Participants may or may not be subject to review by the ERA.

¹ Market fees in this context can include IMO "Market Fees" (IMO) and/or System Management "System Operation Fees".

Secondly, the ERA considers that the existing threshold value of incremental revenue that acts as a trigger for the declaration of a Declared Market Project (under 2.22.13) and the reassessment of approved Allowable Revenue (under 2.22.8 and 2.23.8) is too high. This creates the potential for material increases in fees to occur without review by the ERA of whether the additional expenditure meets the criteria specified in clauses 2.22.12(b) or 2.23.12(b) of the Market Rules.

Thirdly, the Market Rules do not allow for the IMO or System Management to request that the ERA review a budget proposal that does not automatically trigger such a review under clauses 2.22.8, 2.22.13 and 2.23.8. As a result no mechanism is currently available to resolve uncertainty over whether the budget proposal satisfies the criteria in clause 2.22.12(b) or 2.23.12(b), and there is a risk that the ERA may not approve the associated Allowable Revenue for the next Review Period.

The purpose and operation of the Market Rules for which changes are being proposed

The ERA notes that under the Market Rules, the IMO and System Management submit proposed expenses for the forthcoming three-year Review Period, including capital expenditures, for the purposes of allowing the ERA to determine their respective approved Allowable Revenue. Allowable Revenue is recovered from Market Participants through Market Fees (IMO) or System Operation Fees (System Management).

The Market Rules recognise that budget proposals involving expenditure that was not anticipated by the IMO or System Management at the time that proposed expenses were submitted to the ERA as part of the Revenue Determination process may need to be incurred during a Review Period.

Two provisions in the Market Rules can be used to recover such expenditures through the fees payable by Market Participants.

- Clauses 2.22.7 and 2.23.7 require the IMO or System Management to increase (decrease) revenue from Market Fees or System Operation Fees in the current year's budget when their expenditure in the previous Financial Year was greater than (less than) revenue in that year.
- Clauses 2.22.8 and 2.23.8 provide for the ERA to reassess Allowable Revenue if, taking into account adjustments under 2.22.7 or 2.23.7, revenue recovery for the whole of the Review Period is likely to be greater than 15 per cent of approved Allowable Revenue for the Review Period.

Clauses 2.22.8 and 2.23.8 ensure that expenditure proposals involving a significant departure from approved Allowable Revenue for the Review Period, or a series of expenditure proposals that in aggregate constitute a significant departure from approved Allowable Revenue, are subject to appropriate scrutiny by the ERA. Expenditure proposals are approved only when the ERA considers that the underlying expenditures meet the criteria specified in clauses 2.22.12(b) or 2.23.12(b).

Clause 2.22.13 provides for the IMO to determine that particular capital projects are Declared Market Projects. A Declared Market Project must involve:



- a major change to a function of the IMO or System Management under these Market Rules; or
- a major change to any of the computer software or systems that the IMO or System Management uses in the performance of any of its functions under these Market Rules; and
- an estimated cost to implement the changes would cause either the IMO's budget or System Management's budgets during the current Review Period to exceed their respective approved Allowable Revenue by greater than 15 per cent.

Clause 2.22.14 requires the IMO to receive ERA approval for the incremental Allowable Revenue associated with a Declared Market Project prior to commencing that project.

The ERA notes that Declared Market Projects represent significant changes to the operation of the IMO or System Management in the Wholesale Electricity Market (WEM), with potential consequences for Market Participants that include the additional fees required to recover the cost of the project, adjustment costs and changes to the competitiveness of the WEM. It is therefore appropriate that the ERA considers the merits of a Declared Market Project, applying the criteria specified in clauses 2.22.12(b) or 2.23.12(b).²

Issue 1 - Inconsistencies in the treatment of capital expenditures

The ERA is concerned that, under the current Market Rules, a budget proposal involving capital expenditure that will result in the IMO or System Management recovering Allowable Revenue in excess of 15 percent of approved Allowable Revenue for the current Review Period may or may not trigger an assessment of that expenditure by the ERA depending on the timing of the expenditure and the period over which the expenditure is to be depreciated or amortised. These two dependencies are illustrated in Table 1 and Table 2, respectively.

Table 1 illustrates how, for the same capital project, the year in which the project occurs can determine the outcome of the threshold test under either clauses 2.22.8 (for the IMO) or 2.23.8 (for System Management) of the Market Rules.

² Clause 2.22.12(b) states "the [IMO] Allowable Revenue must include only costs which would be incurred by a prudent provider of the services described in clause 2.22.1, acting efficiently, seeking to achieve the lowest practicably sustainable cost of delivering the services described in clause 2.22.1 in accordance with these Market Rules, while effectively promoting the Wholesale Market Objectives.". Clause 2.23.12(b) states "the [System Management] Allowable Revenue must include only costs which would be incurred by a prudent provider of the services described in clause 2.23.1, acting efficiently, in accordance with good electricity industry practice, seeking to achieve the lowest practicably sustainable cost of delivering the services described in clause 2.23.1 in accordance with these Market Rules, while effectively promoting the Wholesale Market Objectives..."



Table 1. Impact of a capital expenditure – expenditure in different years of a Review Period

	<i>Current Review Period</i>				<i>Next Review Period</i>			
	Year 1 \$m	Year 2 \$m	Year 3 \$m	Total \$m	Year 1 \$m	Year 2 \$m	Year 3 \$m	Total \$m
Approved Allowable Revenue	25	25	25	75	25	25	25	75
Capital project – incremental revenue								
Scenario 1	5	5	5	15				
Scenario 2		5	5	10	5			5

The ERA notes that under scenario one, the capital project has a cost (expressed as three years of amortisation allowances) of \$15 million, equivalent to 20 percent of previously approved Allowable Revenue for the current Review Period of \$75 million. The project cost is written off by depreciation over three years.³ The depreciation allowances are recovered through an increase in revenue generated by fees of \$15 million levied on Market Participants over the current Review Period. As revenue raised over the current Review Period is now expected to be greater than 15 percent of approved Allowable Revenue, a review of the proposed expenditure by the ERA is triggered (under clauses 2.22.8 or 2.23.8, or under 2.22.14 if the project meets the necessary criteria for a Declared Market Project under 2.22.13).

Under scenario two, the project is undertaken in the second year of the current Review Period but is otherwise identical to the project in scenario one. As the additional revenue that will be raised in the current review period is expected to be less than 15 percent of approved Allowable Revenue, the Market Rules do not trigger a review of the proposed expenditure by the ERA.

The ERA's view is that this outcome is an anomaly and that the year of the Review Period in which a capital expenditure is incurred should have no bearing on whether expenditure triggers a reassessment of Allowable Revenue by the ERA.

As part of the Allowable Revenue determination for the next Review Period, the ERA will review the proposed depreciation allowance in the first year of that triennium and could elect not to approve this expense. However, this would not be a satisfactory outcome as, if the cost were determined to not satisfy the criteria of the Market Rules, a substantial part of the cost would already have been met by Market Participants through market Fees.

Table 2 shows how the length of time over which a capital expenditure is depreciated, or in the case of an intangible asset, amortised, can partly determine the outcome of the threshold test.

³ The IMO's and System Management's capital projects predominantly consist of systems enhancements and computer equipment for which a three-year depreciation schedule is consistent with generally accepted accounting standards.



Table 2. Impact of a capital expenditure – different depreciation/amortisation periods

	<i>Current Review Period</i>				<i>Next Review Period</i>			
	Year 1 \$m	Year 2 \$m	Year 3 \$m	Total \$m	Year 1 \$m	Year 2 \$m	Year 3 \$m	Total \$m
Approved Allowable Revenue	25	25	25	75	25	25	25	75
Capital project – incremental revenue								
Scenario 1	5	5	5	15				
Scenario 2	3	3	3	9	3	3		6

The ERA notes that under scenario two, the capital expenditure is depreciated over five years, rather than the three years under scenario one. The longer time period under scenario two would be appropriate under the Market Rules as long as it is consistent with generally accepted accounting principles for the depreciation or amortisation of the type of asset being acquired.⁴

The capital expenditures under both scenarios are of the same amount. However, the longer time period for depreciation under scenario two means that the additional revenue required during the current Review Period is equivalent to only 12 per cent of approved Allowable Revenue. A reassessment of Allowable Revenue by the ERA, or an assessment of the project by the ERA under the rules for Declared Market Projects would not be triggered under this scenario.

The ERA seeks to address these inconsistencies in the treatment of capital expenditures through redrafting clauses 2.22.8, 2.22.13 and 2.23.8 of the Market Rules.

The ERA states that in seeking to rectify these inconsistencies in clauses 2.22.8 (for the IMO) and 2.23.8 (for System Management) of the Market Rules, it has sought to preserve the primary intent of these clauses. In particular, the ERA has sought to ensure that the redrafted clauses will continue to trigger a reassessment of Allowable Revenue when:

- a single budget proposal will result in revenue exceeding the threshold in the Market Rules; or
- the combined revenue associated with more than one budget proposal exceeds the threshold in the Market Rules.

To achieve this outcome, the proposed changes to the relevant clauses differentiate between the concepts of capital expenditure and recurring expenditure. In the interest of consistency the ERA has also applied these concepts in the proposed redrafting of clause 2.22.13 of the Market Rules (i.e. regarding the IMO proposing a Declared Market Project).

⁴ As required under clauses 2.22.12 (a) ii. and 2.23.12 (a) ii of the Market Rules.

The ERA notes that a capital expenditure refers to expenditure where the benefits are spread across several accounting periods such as the acquisition of new assets and improvements or extensions to existing assets. This term capital expenditure appears in clauses 2.22.12(a)(ii) and 2.23.12(a)(ii) of the Market Rules.

Recurring expenditure consists of expenditure incurred in only one accounting period where the benefit of that expenditure is enjoyed only in that period. It includes depreciation and amortisation expenses that recoup capital expenditures made in previous periods. Recurring expenditure is analogous to the concept of “recurring expenditure requirements and payments” in clauses 2.22.12(a)(i) and 2.23.12(a)(i) of the Market Rules.

The proposed revised clauses 2.22.8 and 2.23.8 of the Market Rules have been drafted to ensure that it is the capital expenditure that is taken into account in the threshold test, rather than the resulting depreciation (or amortisation) expenses. This eliminates any influence of the timing of the capital expenditure within a Review Period or the time over which that expenditure is depreciated or amortised.

To avoid double counting in the application of the threshold test, the redrafted rules exclude any depreciation or amortisation expenses that will be incurred during the Review Period. These redrafted clauses of the Market Rules also seek to ensure that decisions to capitalise or not capitalise particular expenditures associated with a project cannot influence whether a reassessment of Allowable Revenue is triggered.

The ERA considers that the proposed treatment of capital expenditure partly reflects the arrangements set out in clause 6A.7.1 of the National Electricity Rules for the reopening of a revenue determination for the capital expenditure of a transmission network service provider. Among other requirements, this clause includes a threshold test that “the total of the un-forecast capital expenditure required in the regulatory control period must exceed five per cent of the value of the regulatory asset base of the transmission network service provider in the first year of the relevant regulatory control period”.

Issue 2 - The level of the threshold exceeds the appropriate level for the triggering of a reassessment of Allowable Revenue by the ERA.

In the ERA’s opinion, the 15 percent threshold specified in clauses 2.22.8, 2.22.13 and 2.23.8 prevents the appropriate degree of scrutiny of proposed changes to the IMO’s and System Management’s costs within a Review Period. Given the current level of the threshold, Market Participants could not be confident that material increases in the market fees they are required to pay reflect costs that meet the principles outlined in clauses 2.22.12(b) and 2.23.12(b) of the Market Rules.

Table 3 shows the dollar value of the 15 percent threshold under the approved Allowable Revenue for the IMO and System Management for the first and second Review Periods.



Table 3. IMO and System Management Allowable Revenue and reassessment threshold triggers

		<i>IMO</i>		<i>System Management</i>	
		1 st Review Period	2 nd Review Period	1 st Review Period	2 nd Review Period
		\$m	\$m	\$m	\$m
Approved Revenue	Allowable Revenue	29.7	33.9	14.4	21.2
15 per cent threshold		4.5	5.1	2.2	3.2

The ERA observes that the IMO and System Management were able to manage the variation between actual and approved expenditure to within five percent of approved Allowable Revenue in the first Review Period. This is in spite of the uncertainty in projected costs submitted to the ERA as part of the assessment of Allowable Revenue for the First Review Period.

The ERA accepts that the appropriate level of the threshold is largely a matter of judgement as to the necessary balance between:

- providing the IMO and System Management with the flexibility to respond to changing circumstances (e.g. cost increases or need for additional expenditure) during a Review Period; and
- providing for accountability of the IMO and System Management to ensure that Allowable Revenue includes only those costs that would be incurred by a prudent provider acting efficiently, seeking to achieve the lowest practicably sustainable cost of delivering the required services, while effectively promoting the wholesale market objectives.

The ERA proposes that the threshold increase in revenue for a Review Period should be reduced to ten percent of approved Allowable Revenue for the Review Period. However, the ERA also considers that the views of stakeholders should be sought as to the appropriate level as part of the rule change process.

Issue 3 - The need for a rule providing for a power to request the ERA to review a budget proposal for capital expenditure

The ERA considers that the assessment of proposed capital expenditure against the provisions of clauses 2.22.12(b) and 2.23.12(b) often involves an element of judgement. As a result, in circumstances where the Market Rules do not create the requirement for the ERA to assess a proposed capital expenditure, the IMO or System Management may elect to delay a project due to the risk that the ERA may not approve the Allowable Revenue recovering depreciation or amortisation expenses in the next Review Period. Capital projects that are consistent with the attainment of the Market Objectives may be delayed as a result.

The ERA considers that the inclusion of a clause in the Market Rules allowing the IMO or System Management to request that the ERA review a proposed capital project has a precedent. Section 80 of Part 9 of the National Gas Rules provides for the Australian Energy Regulator to make an advance determination with regard to future capital expenditure at the request of a service provider.



1.3. The Proposal and the Wholesale Market Objectives

The ERA's view is that the proposed rule changes will:

- promote the economically efficient production and supply of electricity and electricity related services in the South West interconnected system (Wholesale Market Objective (a)), by helping to ensure that proposed significant capital expenditures of the IMO and System Management during a Review Period are assessed by the ERA in the same manner as capital expenditures that are part of proposed costs for the three-yearly Allowable Revenue Determination; and
- contribute to the minimisation of the long-term cost of electricity supplied to consumers from the South West interconnected system (Wholesale Market Objective (d)), by increasing the level of scrutiny of costs incurred by the IMO and System Management that are ultimately passed on to consumers by Market Participants.

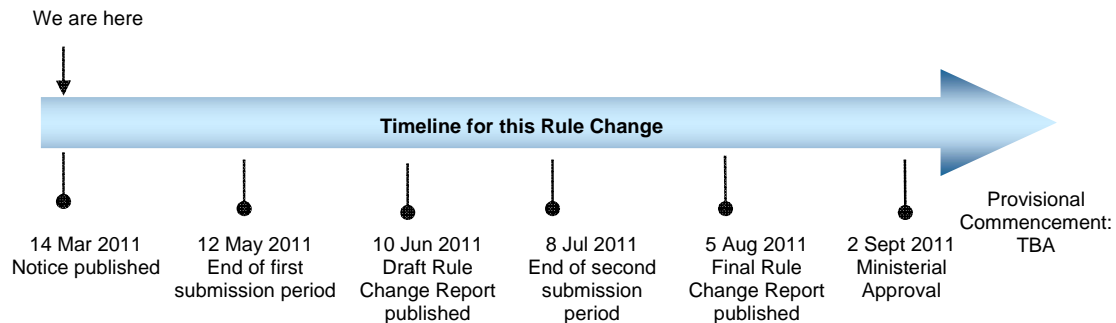
The ERA is of the view that the proposed changes will not reduce the extent to which the Market Rules address the other objectives of the WEM.

2. WHETHER THE PROPOSAL WILL BE PROGRESSED FURTHER

The IMO has decided to proceed with this proposal on the basis that Market Participants should be given an opportunity to provide submissions as part of the rule change process.

This Rule Change Proposal will be processed using the Standard Rule Change Process, described in section 2.7 of the Market Rules.

The projected timelines for processing this proposal are:



Please note that the time for the first submission period has been extended beyond the usual 30 Business Days to better align operational considerations over the Easter/Anzac Day holiday period, as published in the extension notice on 14 March 2011. All other dates have been adjusted accordingly.



3. CALL FOR SUBMISSIONS

The IMO is seeking submissions regarding this proposal. The submission period is 30 Business Days from the publication date of this Rule Change Notice. Submissions must be delivered to the IMO by 5:00pm on **Thursday 12 May 2011**.

The IMO prefers to receive submissions by email to market.development@imowa.com.au using the submission form available on the IMO website: <http://www.imowa.com.au/rule-changes>.

Submissions may also be sent to the IMO by fax or post, addressed to:

Independent Market Operator
Attn: General Manager, Development
PO Box 7096
Cloisters Square, Perth, WA 6850
Fax: (08) 9254 4399

4. PROPOSED AMENDING RULES

ERA proposes the following amendments to the Market Rules (~~deleted text~~, added text):

- 2.22.8. Where, taking into account any adjustment under clause 2.22.7, the budget proposal is likely to:
- (a) result in revenue recovery, over the relevant ~~current~~ Review Period, more than 45% at least 10% greater than the Allowable Revenue determined by the Economic Regulation Authority; or
 - (b) result in a sum of capital expenditures and recurring expenditures such that if:
 - i. depreciation and amortisation expenses in the current Review Period recovering the capital expenditures are subtracted from recurring expenditures; and
 - ii. the capital expenditures were to be fully recovered in the current Review Period;then revenue recovery would be at least 10% greater than the Allowable Revenue determined by the Economic Regulation Authority.

the IMO must apply to the Economic Regulation Authority to reassess the Allowable Revenue. The IMO must endeavour to make such an application in sufficient time to allow its budget proposal to be approved under clause 2.22.9 before the commencement of the Financial Year to which it relates. The Economic Regulation Authority may amend a determination under clause 2.22.3(c) if the IMO makes an

application under this clause 2.22.8. Clause 2.22.3(b) applies in the case of an application under this clause 2.22.8.

...

2.22.13. Subject to clause 2.22.14, the IMO may declare a project to be a Declared Market Project if:

- (a) the project involves:
 - i. a major change to a function of the IMO or System Management under these Market Rules; or
 - ii. a major change to any of the computer software or systems that the IMO or System Management uses in the performance of any of its functions under these Market Rules; and

(b) the IMO estimates ~~that the cost~~ a sum of capital expenditures and recurring expenditures required by the IMO or System Management to implement the changes such that if:

- i. depreciation and amortisation expenses in the current Review Period recovering the capital expenditures of the Declared Market Project are subtracted from recurring expenditures; and
- ii. the capital expenditures of the Declared Market Project were to be fully recovered in the current Review Period;

would cause either the IMO's budget or System Management's budgets during the current Review period to exceed their respective approved Allowable Revenue by ~~more than 15%~~ at least 10%.

...

2.22.15 During a Review Period, the IMO may seek the approval of an adjustment of its approved Allowable Revenue for that Review Period from the Economic Regulation Authority for each of the services described in clause 2.22.1 in accordance with the following:

- (a) the Economic Regulation Authority may, on application by the IMO under clause 2.22.15, make a determination to the effect that, if capital expenditure is made in accordance with a proposal made by the IMO and specified in the determination, then approved Allowable Revenue for the relevant Review Period is increased by an amount equal to the associated depreciation or amortisation expenses over the Review Period;
- (b) any proposal under clause 2.22.15 must include only costs which would be incurred by a prudent provider of the services described in clause 2.22.1, acting efficiently, seeking to achieve the lowest practicably sustainable cost of



delivering the services described in clause 2.22.1 in accordance with these Market Rules, while effectively promoting the Wholesale Market Objectives;

- (c) the Economic Regulation Authority may, but is not required to, engage in public consultation before making a determination under clause 2.22.15; and
- (d) a determination under clause 2.22.15 is binding on the Economic Regulation Authority, but a decision not to make such a determination creates no presumption that future expenditure will not meet the relevant criteria under clause 2.22.15(b).

...

2.23.8. Where, taking into account any adjustment under clause 2.23.7, the budget proposal is likely to:

- (a) result in revenue recovery, over the relevant Review Period, more than 15% at least 10% greater than the Allowable Revenue determined by the Economic Regulation Authority; or
- (b) result in a sum of capital expenditures and recurring expenditures such that if:
 - i. depreciation and amortisation expenses in the current Review Period recovering the capital expenditures are subtracted from recurring expenditures; and
 - ii. the capital expenditures were to be fully recovered in the current Review Period;

then revenue recovery would be at least 10% greater than the Allowable Revenue determined by the Economic Regulation Authority.

System Management must apply to the Economic Regulation Authority to reassess the Allowable Revenue. System Management must endeavour to make such an application in sufficient time to meet its obligation under clause 2.23.9. The Economic Regulation Authority may amend a determination under clause 2.23.3(c) if System Management makes an application under this clause 2.23.8. Clause 2.23.3(b) applies in the case of an application under this clause 2.23.8.

...

2.23.13 During a Review Period, System Management may seek the approval of an adjustment of its approved Allowable Revenue for that Review Period from the Economic Regulation Authority for each of the services described in clause 2.23.1 in accordance with the following:

- (a) the Economic Regulation Authority may, on application by System Management under clause 2.23.13, make a determination to the effect that, if capital expenditure is made in accordance with a proposal made by System



Management and specified in the determination, then approved Allowable Revenue for the relevant Review Period is increased by an amount equal to the associated depreciation or amortisation expenses over the Review Period;

- (b) any proposal under clause 2.23.13 must include only costs which would be incurred by a prudent provider of the services described in clause 2.23.1, acting efficiently, in accordance with good electricity industry practice, seeking to achieve the lowest practicably sustainable cost of delivering the services described in clause 2.23.1 in accordance with these Market Rules, while effectively promoting the Wholesale Market Objectives;
- (c) the Economic Regulation Authority may, but is not required to, engage in public consultation before making a determination under clause 2.22.13; and
- (d) a determination under clause 2.23.13 is binding on the Economic Regulation Authority, but a decision not to make such a determination creates no presumption that future expenditure will not meet the relevant criteria under clause 2.23.13(b).

5. ABOUT RULE CHANGE PROPOSALS

Any person (including the IMO) may make a Rule Change Proposal by completing a Rule Change Proposal Form and submitting this to the IMO (Clause 2.5.1 of the Market Rules).

The IMO will assess the proposal and, within 5 Business Days of receiving the proposal form, will notify the proponent whether the proposal will be progressed further.

In order for the proposal to be progressed the change proposal must explain how it will enable the Market Rules to better contribute to the achievement of the Wholesale Market Objectives. The market objectives 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.



A Rule Change Proposal can be processed using a Standard Rule Change Process or a Fast Track Rule Change Process. The standard process involves a combined 10 weeks public submission period, while the fast track process involves the IMO consulting with Rule Participants who either advise the IMO that they wish to be consulted or the IMO considers have an interest in the change.