Our Ref: DMS#3572031

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Attention of Assistant Director Markets
Economic Regulation Authority
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SUBMISSION RELATED TO DETERMINATION OF ALLOWABLE REVENUE AND FORECAST CAPITAL EXPENDITURE FOR THE IMO AND SYSTEM MANAGEMENT, 2013/14 TO 2015/16 – ISSUES PAPER

Synergy is pleased to offer this submission in response to the Authority's invitation for interested parties to make submissions as part of the public consultation process by which the Authority determines the Allowable Revenue and Forecast Capacity Expenditure for the IMO and System Management over the third review period which covers 2013/14 to 2015/16.

Increased fees for submission period

Synergy notes that both the IMO have System Management have requested real increases in Allowable Revenues and in particular note the latter is seeking a very substantial increase of around 20% per annum over the three year review period.

Synergy understands that a significant portion of these increases, especially in System Management's case, reflect costs incurred in implementing the competitive balancing and load following rule changes and in the case of the IMO partly reflect costs resulting from the implementation of GSI.

Clearly, implementing and operating these major changes imposed a raft of new systems requirements to effect new/high frequency transactions, to provide additional market/reporting information and dictated an increase in FTE positions. However, as the depreciation charges for the new systems pass through the cost base, Synergy would expect minimal real increases costs or even a reduction in subsequent review periods.

Difference in dealing with MREP

Synergy also notes a difference in the approach between the IMO and System Management in respect of one explicitly seeking an allowance to deliver the proposed Market Rules Evolution Program (MREP). While the IMO has not sought any explicit allowance, as a part of its submission, for the

MREP (covered to an extent as part of "business-as-usual") System Management has sought approval of $2.125M in capital for a number of programs that are at best uncertain as to whether and in what depth and complexity they will be progressed.

Synergy submits that careful in-principle consideration should be given to reviewing the merit of a request of this nature (i.e. to create a pool of funds to be expended on items with an undefined scope) and whether in approving such expenditure in advance would be consistent with the approach adopted by a prudent service provider seeking to deliver sustainable services at minimum cost.

Synergy notes that scope exists within current expenditure variance governance mechanisms (i.e. annual fee rate setting and Declared Market Project processes) for either the IMO or System Management to justify significant new expenditures in response to major changes arising from fully scoped and approved market rules and procedures changes. It is also noted that the revenue correction factors would act, albeit in a delayed timeframe, adjusting for this over-return in future years.

Depreciation time frame

Synergy notes a further disparity between the IMO and System Management submissions relating to intangible asset depreciation: the IMO has elected a 5 year write off while System Management has elected a 4 year write off. Given the similar nature of the assets i.e. market related systems, Synergy suggests the ERA consider a common write-off period be adopted, reflecting useful asset life.

Introduction of a WACC

Finally, Synergy notes that System Management has introduced what amounts to a major change in regard to seeking to make a profit through the supply of non-contestable services it is required to provide under the market rules. This is manifest in the application of a post tax WACC methodology to its intangible asset base. In the previous two review periods it was sufficient to include only an interest charge on undepreciated capital expenditures, reflecting a simple cost neutral recovery approach which Synergy notes the IMO continues to apply.

Synergy understands the argument to be that System Management, even though it is ring fenced with a negligible financial risk profile, forms part of Western Power and Western Power demands that all capital expenditures contribute a profit. Reduced to its core, the issue is whether the market rules contemplate that the costs incurred by System Management in providing the required market operation services, as set out in clause 2.23.1, can be extended to include a post tax margin or profit.

In Synergy's view, this is more a philosophical question than it is an economic question. On the one hand, the Australian Energy Market Operator or AEMO operates on cost recovery basis and does not seek to make a profit, while on the other, the example given by System Management, the Single Electricity Market Operator or SEMO of Ireland does. Deciding this issue falls outside of Synergy's remit however it is observed that:

- The determination of the WACC should reflect System Management's distinct risk profile (possibly differs from Western Power's); and
- By allowing System Management to make a profit will marginally increase costs borne by the market for no apparent or observable efficiencies to the market.

Synergy is happy to discuss any or all of the submission with the Authority by contacting either Stephen MacLean: phone 6212 1498, email: stephen.maclean@synergy.net.au or John Rhodes: phone 6212 1138, email john.rhodes@synergy.net.au.

Yours sincerely

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