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Economic Regulation Authority
PO Box 8469
PERTH BC WA 6849

via email to: records@erawa.com.au

Dear Ms Cusworth

AUSTRALIAN ENERGY MARKET OPERATOR – ALLOWABLE REVENUE AND FORECAST CAPITAL EXPENDITURE 2016/17 TO 2018/19

Synergy welcomes the opportunity to make a submission in response to the Economic Regulation Authority's (**ERA**'s) issues paper on the Australian Energy Market Operator's (**AEMO**'s) fourth allowable revenue and forecast capital expenditure proposal (**proposal**).

Synergy supports reform of the Western Australian (**WA**) electricity market. Synergy supplies energy to more than 1 million residential and commercial customers, and as the state's largest electricity generator and retailer, incurs around 65% of wholesale electricity market (**WEM**) fees. AEMO's entry into WA as the market operator presents an excellent opportunity to promote sustainable long-term energy costs for end users, and has the potential to result in significant efficiencies if the right solution is implemented.

Aligning the WEM with national electricity market (**NEM**) operations presents advantages in terms of achieving economies of scale and scope. Synergy appreciates the economic benefits of consistency and standardisation across the electricity sector, and is optimistic the systems adopted for WA's future energy markets will be efficient and sustainable. However, the unique requirements of the WEM, combined with the range of potential solutions available, means care should be taken to ensure all options are fully considered in relation to maximising benefit, and the most prudent solution is selected for the market as a whole.

With this in mind, Synergy recommends the ERA seeks further evidence from AEMO to fully satisfy itself and market participants that the proposed allowable revenue and capital expenditure, particularly the $36 million proposed for wholesale market reforms is prudent, efficient and represents the lowest sustainable cost option.

While Synergy understands significant capital expenditure is necessary to implement the outcomes of the state government's (**government**) electricity market review (**EMR**), AEMO's proposal does not provide sufficient information to allow Synergy or other market participants to determine whether the expenditure is prudent or efficient, or whether the systems and processes AEMO wishes to adopt are the most appropriate for the WA market.

For example, AEMO's submission does not present a quantitative cost benefit analysis of the proposed market reform solution, nor does the submission provide detail of alternative options considered. Synergy notes that at the time of writing, AEMO's stakeholder engagement program regarding the new WEM and retail market systems proposed for WA is still underway. As a result, Synergy is concerned the forecast capital expenditure and related revenue requirement put forward by AEMO is based on a market reform solution that has not yet been fully considered and tested with the market participants that will be expected to adopt it.

Synergy supports the process the ERA intends to follow (as outlined in its issues paper) to assess AEMO's allowable revenue and capital expenditure, and recommends the ERA places adequate scrutiny on AEMO's proposed market reform solution, particularly the proposal to apply existing NEM systems to the WEM to ensure that the solution will align operation of the WEM with best practice markets while also reducing implementation costs.

While at face-value, depending on the objectives, there is logic in adopting established systems and processes in new jurisdictions, the unique requirements of the WEM means existing NEM systems would likely need to be highly customised for the WA market. Synergy considers further evidence is required to understand whether customising AEMO's existing systems is the most prudent option, or whether adopting new systems (which could potentially be rolled out elsewhere when NEM systems reach end-of-life) may be a more efficient solution for all market participants, including AEMO. AEMO's allowable revenue submission does not appear to contemplate such options, and market participants have not yet had opportunity to participate in market reform workshops with AEMO.

Therefore, Synergy recommends that the ERA critique the assumptions in AEMO's market reform solution and forecast capital expenditure. The ERA may also wish to consider its allowable revenue decision in the context of what is known regarding the nature and timing of EMR reforms.

AEMO's proposal predicates its expenditure on the assumption that the new market will commence on 1 July 2018. It would be prudent for AEMO to articulate the impact on expenditures and revenue in the AR4 period if the new market commencement proceeded at a later date. Synergy considers this information is critical for the ERA to make its determination on appropriate WEM fees.

Notwithstanding the need to request further evidence from AEMO to justify the allowable revenue proposal, Synergy observes that the magnitude of the revenue proposal for the AR4[1] period ($114 million) is significantly higher than that provided for in the current AR3[2] period ($95 million). In particular, total capital expenditure for the AR4 period ($51 million) is almost five times that of the AR3 period.

[1] 2016/17 to 2018/19.
[2] 2013/14 to 2015/16.

This step increase (especially in capital expenditure) magnifies the need to ensure AEMO's submission represents the lowest sustainable cost option. As discussed, Synergy bears the majority of AEMO's costs, however, Synergy also expects to incur:

- significant costs of its own to implement the required participant-side system and process changes in relation to the WEM reforms;
- increased costs relating to the ERA's new market administration and compliance functions, which have been transferred from the Independent Market Operator;
- electricity retail market operation fees and system establishment and operation costs as an electricity retailer;
- gas services information fees as a gas shipper; and
- gas retail market operation fees and system establishment and operation costs as a gas retailer.

Synergy notes the cost of energy market participation in WA is significant and is increasing. Ultimately, all energy market costs are borne by end use energy customers, therefore Synergy is mindful of the need to ensure essential energy market reforms represent prudent costs and the benefits to consumers outweigh the costs.

The ERA has an obligation under section 26 of the *ERA Act 2003* "to have regard to the need to promote regulatory outcomes that are in the public interest and the long-term interests of consumers in relation to the price, quality and reliability of goods and services…" and an obligation under clause 2.22A.11 of the WEM Rules to take into account "only costs which would be incurred by a prudent service provider…. acting efficiently, seeking to achieve the lowest practicably sustainable cost of delivering [those services]". It is appropriate for the ERA to assess AEMO's proposal in terms of whether the forecast allowable revenue and capital expenditure efficiently and effectively meet these objectives.

To best meet these obligations, Synergy considers the ERA and market participants would benefit from further information from AEMO to support its proposal, and in turn, AEMO requires further information from market participants. Given the limited timeframe for the ERA's determination on AEMO's proposal (until 16 December 2016), and given new information will be available in the coming months (both from AEMO's scheduled market reform stakeholder engagement process and forthcoming government energy policy decisions), the ERA may also wish to consider the possibility of extending the deadline for making its allowable revenue decision to allow all new information to be thoroughly considered.

Attachment 1 to this submission provides further comments in relation to the specific matters raised in the issues paper, to assist the ERA to make its allowable revenue decision.

Synergy confirms that this submission can be made publicly available. Should you require further information regarding any of the comments made in this submission, please contact Mr Simon Thackray, Manager Regulation and Compliance.

Yours sincerely

[redacted]

WILL BARGMANN
GENERAL MANAGER CORPORATE SERVICES

Attachment 1

Synergy comments in response to the ERA's identified issues

Issue 1
Interested parties are invited to make submissions on the key assumptions employed by AEMO in deriving the proposed market operations allowable revenue for 2016/17 - 2018/19

1.1 Efficiencies associated with economies of scale and scope in market operations

It is reasonable to expect the transfer of specific energy functions to AEMO should result in overall cost reductions due to economies of scale and scope. However, AEMO has only identified $2.2 million of efficiencies over the AR4 period, with the primary cost reductions being one-off savings in areas such as depreciation. Cost savings appear only related to the transfer of system operations functions. Savings associated with drawing on national resources and established processes are not identified.

For example, development of the electricity statement of opportunities and gas statement of opportunities, short and medium term forecasting, system and market operations, IT support, stakeholder engagement, corporate services and administrative processes are all duplicated to some extent in the WEM and the NEM. It is not unreasonable to expect that some economies of scope and scale could be achieved.

Synergy notes AEMO has not provided information regarding:

- the change in costs associated with step-changes in business as usual costs;
- the change in costs associated with changes in the scope of market and system operations activities;
- the total of AEMO's corporate overheads and the value attributed to WA functions; or
- the indirect cost allocation methodology that has been used to allocate costs between AEMO's markets and functions.

Synergy acknowledges there may be efficiencies included in AEMO's forecasts that are offset by increases elsewhere. However, further information is required to enable the ERA and market participants to make a fully-informed assessment of AEMO's proposal.

1.2 Comparability of allowable revenue for the AR4 period to previous periods

One of the methodologies the ERA proposes to use to assess AEMO's proposal is to compare business as usual costs to actual costs incurred in the AR3 period. Synergy supports this approach but is concerned there is not enough information provided in AEMO's submission to ensure the costs are comparable.

For example, AEMO's submission contains no information regarding the allocation of indirect costs, capitalisation of staff time against projects, treatment of depreciation, or allocation of shared costs between functions or jurisdictions. The ERA may therefore wish to seek further information from AEMO about these accounting treatments.

1.3 Increase in market operation employee benefits expenses

Page 18 of AEMO's submission states the market operation employee benefits forecast is based on an annual increase of 2.9% in line with the enterprise agreement. It also states there should be further reductions resulting from:

- a reduction of five staff in 2015/16 due to the market administration and compliance functions not being transferred from the Independent Market Operator to AEMO; and
- synergies gained by sharing a single corporate services team across the market and system operations functions.

However, table 8 in AEMO's submission indicates the actual increase in employee benefits for market operations over the period is 15%. It is also unclear where the proposed cost reductions have been captured.

The ERA may wish to request further information regarding this 15% increase to ensure it is justified and supported by evidence.

1.4 Ongoing impact of the EMR reforms on the allowable revenue

Synergy notes that most of the $15 million of the operating costs associated with the EMR reforms appear to be ongoing. For example, IT licences and operational staff, depreciation, and borrowing costs can reasonably be expected to be recurring (for a limited period), however they are currently implied on page 40 of AEMO's submission as project related one-off costs.

In previous allowable revenue periods, these expenses have been included in business as usual costs. Therefore, to ensure a reasonable comparison between historical and forecast expenditure, Synergy recommends these costs are included in the ERA's assessment of business as usual costs.

Issue 2

Interested parties are invited to make submissions on the key assumptions employed by AEMO in deriving the proposed system management allowable revenue for 2016/17 - 2018/19

2.1 Efficiencies associated with economies of scale and scope in system operations

As previously noted, AEMO should be able to achieve significant economies of scale and scope by combining the system operations and market operations functions, and by finding synergies between WEM and the NEM. The ERA may wish to request further information on potential cost efficiencies associated with the proposed System Management costs.

2.2 Ongoing impact of System Management transfer on the allowable revenue

AEMO has separated its business as usual system operations expenditure from the costs associated with the System Management transfer. In table 15 in AEMO's submission, it has included $5-8 million of recurrent costs in the System Management transfer project to recruit an additional six control room staff. Including these costs in the System Management transfer project may not reflect the ongoing costs associated with system operations. As the AR4 period only includes the 2018/19 year, the true ongoing cost of operating the system under the new arrangements is unclear. Therefore, to ensure a reasonable comparison between historical and forecast expenditure, Synergy recommends these costs are included in the ERA's assessment of System Management business as usual costs.

Issue 3

Interested parties are invited to make submissions on AEMO's forecast capital expenditure for the WEM for 2016/17 - 2018/19

3.1 Increased WEM IT capital expenditure related to WA integration

In table 10, AEMO proposes to spend more than $2 million to upgrade market operations IT infrastructure to align with AEMO's broader IT principles and systems landscape. Though IT systems generally require regular upgrades, the ERA may wish to seek further information on the necessity of this expenditure, as AEMO's submission provides no indication there have been issues with existing systems.

The ERA may also wish to challenge the timing of the IT expenditure, and whether it would be prudent to wait until new market arrangements have been established before undertaking an IT refresh.

3.2 Significant uncertainty related to the implementation of the EMR reforms

AEMO proposes $51 million in capital expenditure, of which $36 million is related to the implementation of the EMR reforms. Though substantial investment is required to develop new market systems, the ERA may wish to consider:

- whether the foundation legislation will be in place to facilitate the development of the new market arrangements in time for a 1 July 2018 commencement;
- there is uncertainty around the design of the new market arrangements, as the detail of the operation of the market continues to be considered by government;
- AEMO has only recently commenced consultation with market participants to work through operational issues and facilitate customisation of AEMO's national systems for the WA market; and
- AEMO's implementation approach is not currently supported by a quantitative cost benefit analysis or risk assessment.

AEMO has not included an explicit contingency in its forecasts associated with the EMR reforms. Synergy acknowledges that the WEM Rules provide for a tolerance of 10-15% before the ERA must reassess the allowable revenue and/or capital expenditure, however, relying on this mechanism rather than calling out an explicit contingency budget may under-state the true cost of the reforms.

Synergy notes AEMO has used a bottom-up approach to determine the cost estimates for the EMR reforms. This may lead to an over-estimation of the program costs as it suggests the program has not been optimised through a top-down review.

3.3 Reduced level of service provision under the new market arrangements

Synergy understands some functionality currently provided by the current systems and services will be lost when AEMO implements the NEM systems in the WEM. For example, AEMO's systems use outdated file transfer protocols, and do not provide data visualisations.

Synergy also understands that unlike the current WEM systems, the AEMO NEM systems do not provide a market participant interface, meaning participants would have to purchase their own.

Given the cost of moving to AEMO's NEM systems, it is reasonable to expect current service levels and functionality should improve (or at least be maintained) rather than decline. The ERA may therefore wish to seek further information on:

- the service levels to be provided by AEMO's proposed market operation systems;
- whether there are plans to improve functionality; and
- whether there will be an additional cost associated with ensuring the AEMO's systems and processes provide a service equal to or greater than the current systems and service provision.

3.4 Timing of the implementation of various aspects of the EMR

AEMO proposes to implement systems and processes currently used in the NEM. Although this approach would seem prudent, Synergy notes many of the NEM systems are reaching end-of-life and will require major upgrades or replacements within the next two to three years. For example, AEMO has already commenced upgrade and replacement of its NEM energy management system.

There is concern that the timing of AEMO's implementation will result in WEM participants adopting systems that will need to be upgraded shortly after the new market commences. Synergy considers AEMO should look at options to defer implementation to ensure the WEM adopts the newest version of NEM systems, or whether the WEM could be used as an early adopter of proposed NEM system upgrades. It is also feasible that an off-the-shelf market solution may be more appropriate for the WEM than adopting the NEM systems.

The ERA may wish to request further information from AEMO on deferment and/or alternative market solutions and the options AEMO considered when developing the proposed approach and associated expenditure forecast.

Issue 4

Interested parties are invited to make submissions on the key assumptions employed by AEMO in deriving the proposed GSI allowable revenue and forecast capital expenditure for 2016/17 - 2018/19

4.1 Accommodation

As part of the EMR program of work, AEMO took responsibility for the WEM operations functions from the IMO, and system operations functions from Western Power System Management. Currently, the system operations control centre is in East Perth, and the market operations centre is in the Perth CBD. AEMO plans to move all of its WA staff into a single Perth CBD location in September 2017 and has therefore included $4 million in capital expenditure in its proposal to do so. AEMO proposes to recover $200,000 of this $4 million from GSI participants.

While there are benefits associated with co-locating AEMO's staff, the ERA may wish to seek further information on whether it is appropriate to allocate any of these costs to GSI participants. The key driver of the staff relocation is the need to move electricity operations staff to the CBD. Synergy considers relocation costs should be wholly allocated to WEM market participants.

4.2 Increased GSI IT capital expenditure related to WA integration

AEMO proposes to spend $0.5 million in the architectural alignment of GSI IT infrastructure. The ERA may wish to seek further information on the necessity of this expenditure, as AEMO's submission provides no indication that there have been issues with existing systems.

4.3 Increased GSI business as usual capital expenditure

AEMO proposes to increase GSI business as usual forecast capital expenditure between 2017/18 and 2018/19 from $90,000 to $202,000. However, AEMO does not attribute this increase to any specific project or service requirement.

The ERA may wish to request AEMO provides evidence to justify the GSI cost increase.

Issue 5
Interested parties are invited to make submissions on the process that the Authority intends to follow in assessing the AEMO's allowable revenue and forecast capital expenditure

5.1 Request for additional information in support of AEMO's proposal

Synergy supports the ERA's proposed approach to reviewing AEMO's proposal. In particular, Synergy recommends the ERA:

- conducts benchmarking against AEMO's other market operations costs, and the costs of similar market operators such as those in Singapore and New Zealand;
- assesses the Western Power contract for efficiency given its ability to exert market power in negotiations with AEMO;
- identifies and assesses step-changes in functional requirements and associated expenditure, including those where functions have not transferred to AEMO, where AEMO proposes to reduce its service offerings, and trend-changes in relation to cost-drivers;
- tests assumptions relating to EMR reforms, and system management transfer; specifically to assess whether the implementation timing is prudent and the costs represent the lowest sustainable option;
- considers underlying accounting treatments and whether they have been applied correctly; and
- seeks technical advice where required to assist in its review.

5.2 Timing of the ERA's allowable revenue determination

Synergy recognises the ERA has limited time to make a determination on AEMO's proposal (until 16 December). Synergy is concerned the time limitations on the process will not allow the ERA to fully assess AEMO's proposal, or for AEMO to produce additional evidence if it is requested by the ERA.

Therefore, the ERA may wish to consider whether it needs further time to make a decision on the proposal beyond 16 December 2016. Deferring the ERA's decision may have merit given the number of key EMR reform decisions that are still pending, and the fact that new and valuable information from AEMO's market reform stakeholder engagement program will soon be available.

Further detailed consideration of the allowable revenue submission over an extended timeframe would:

- allow AEMO's proposed wholesale and retail market solutions to be based on feedback from the market participants that will be using them;
- ensure the AEMO's forecast can be appropriately critiqued and justified;
- enable market participants to be ready, willing and able to use the new systems;
- enable the ERA to make a fully-informed determination;
- minimise cost impact on end use energy customers, ensuring AEMO's investment is prudent, sustainable and represents the lowest cost option; and
- allow decisions around energy market investment to be made in the context of important political and legislative decisions.

Synergy considers the benefits of the ERA taking time to ensure AEMO's proposal is prudent, efficient and represents the lowest sustainable cost option, outweigh the potential costs of delaying the revenue determination.

Deferring the revenue determination to early 2017 should not adversely affect implementation of new market arrangements, as the WEM fees currently being collected for 2016/17 should adequately cover the planned project management and stakeholder consultation required in the short-term.