
Wholesale Electricity Market Rule Change Proposal Form

Change Proposal No: RC_2011_02
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Change requested by:

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Date submitted:	10 March 2011
Urgency:	2-medium
Change Proposal title:	Reassessment of Allowable Revenue during a Review Period
Market Rule(s) affected:	Clauses 2.22.8, 2.22.13, 2.22.15 (new), 2.23.8 and 2.23.13 (new)

Introduction

Market Rule 2.5.1 of the Wholesale Electricity Market Rules provides that any person (including the IMO) may make a Rule Change Proposal by completing a Rule Change Proposal Form that must be submitted to the Independent Market Operator.

This Change Proposal can be posted, faxed or emailed to:

Independent Market Operator

Attn: Manager Market Development and System Capacity

PO Box 7096

Cloisters Square, Perth, WA 6850

Fax: (08) 9254 4339

Email: market.development@imowa.com.au

The Independent Market Operator will assess the proposal and, within 5 Business Days of receiving this Rule Change Proposal form, will notify you whether the Rule Change Proposal will be further progressed.

In order for the proposal to be progressed, all fields below must be completed and the change proposal must explain how it will enable the Market Rules to better contribute to the achievement of the wholesale electricity market objectives. The objectives of the market 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.

Details of the proposed Market Rule Change

1. Describe the concern with the existing Market Rules that is to be addressed by the proposed Market Rule change:

The Economic Regulation Authority (**ERA**) has three concerns over the operation of clauses 2.22.8, 2.22.13 and 2.23.8 of the *Wholesale Electricity Market Rules* (**Market Rules**), which provide for a reassessment of Allowable Revenue for the Independent Market Operator (**IMO**) and System Management during a Review Period where an amount of un-forecast expenditure is proposed to be incurred.

First, 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.

Secondly, 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

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

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

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.

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 per cent 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.

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	Year 2	Year 3	Total	Year 1	Year 2	Year 3	Total
	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$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

Under scenario one, the capital project has a cost (expressed as three years of amortisation allowances) of \$15 million, equivalent to 20 per cent 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

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..."

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.

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 per cent 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 per cent 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.

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

	<i>Current Review Period</i>				<i>Next Review Period</i>			
	Year 1	Year 2	Year 3	Total	Year 1	Year 2	Year 3	Total
	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$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

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.

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

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.

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, the ERA 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).

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 requirements 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 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 per cent 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 per cent 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 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 per cent 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 per cent 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 inclusion of a clause in the Market Rules allowing the IMO or System Management to request that the ERA review a proposed capita 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.

2. Explain the reason for the degree of urgency:

The proposed rule changes are considered to be of a moderate level of urgency given that the issues with the existing rules prompting these changes do not put at risk the safe, effective and reliable operation of the WEM. The proposed rule changes cannot reasonably be considered to be of a high level of urgency for this reason.

However, proposals for previously un-forecast capital expenditure may result in either the IMO or System Management incurring depreciation and/or amortisation expenses over a period of time that exceed 15 per cent of allowable revenue in the Review Period in which the capital item is purchased could occur at any time during the current Review Period. In the absence of the proposed rule changes the costs of these capital expenditures may be recovered from Market Participants without the appropriate scrutiny of expenditure by the ERA. The ERA's view is that the potential for this to occur means that the proposed rule changes should not be considered to be of a low level of urgency.

3. Provide any proposed specific changes to particular Rules: (for clarity, please use the current wording of the Rules and place a ~~strikethrough~~ where words are deleted and underline words added)

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 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.

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 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,

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).
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4. Describe how the proposed Market Rule change would allow the Market Rules to better address the Wholesale Market Objectives:

The objectives of the market defined in section 1.2.1 of the Market Rules 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 consumers 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.

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 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.
- contribute to the minimisation of the long-term cost of electricity supplied to consumers from the SWIS 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.

5. Provide any identifiable costs and benefits of the change:

The ERA notes that the costs and benefits of the changes being proposed are difficult to quantify.

The only direct cost resulting from these changes are the costs associated with the preparation of a proposal by the IMO or System Management and the ERA's assessment of those proposals.

In practice, the information that the ERA requires to make an assessment of a proposed expenditure is the same information that should be prepared to inform Board or senior management consideration of such proposals. On this basis, we would not anticipate that the

proposed rule changes would add materially to the costs incurred by the IMO or System Management.

Overall, we consider that the additional direct costs would be no more than a few tens of thousands of dollars for the most complex capital expenditure proposals. The bulk of these costs would be incurred by the ERA.
