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Economic Regulation Authority
PO Box 8469
PERTH BC WA 6849

via email to: publicsubmissions@erawa.com.au

Dear Ms Cusworth

ALLOWABLE REVENUE AND FORECAST CAPITAL EXPENDITURE PROPOSAL FOR THE AUSTRALIAN ENERGY MARKET OPERATOR

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

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.

Overarching comments

The ERA, under section 26 of the *Economic Regulation Authority Act 2003 (Act)*, is:

"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..."

Further the ERA has 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]"

The purpose of this submission is to assist the ERA to make an informed decision on whether the forecast allowable revenue and capital expenditure detailed in the proposal meet these requirements.

Implementation of capacity mechanism reforms

Synergy supports reform of the Western Australian (WA) electricity market to facilitate a sustainable energy industry.

It is important to note that more than \$2.5 million of the proposed \$3.6 million capital expenditure for RCM3 will already have been incurred by June 2017. While there is no ex-post capital expenditure adjustment available under the WEM rules, Synergy recommends the ERA tests the prudence and efficiency of expenditure already incurred and uses this assessment to inform whether the outstanding forecast expenditure is likely to be efficient for example, the reasonableness of the RCM3 consultancy costs.

Additional costs associated with the establishment of a new data centre

Synergy supports AEMO's migration to a single location as it makes economic sense to centralise AEMO's functions and Synergy appreciates the importance of ensuring IT infrastructure and systems are robust.

Synergy understands when AEMO accepted responsibility for market operations in WA in November 2015 it upgraded the communications infrastructure at its current location to conform to AEMO's higher IT specifications. Synergy notes the proposal will have the effect of AEMO's communications infrastructure being upgraded in two Perth CBD locations within two years, an expenditure matter the ERA may wish to consider. Further the ERA should consider whether AEMO's recovery of the residual value of the already-installed assets and its treatment of accelerated depreciation is reasonable.

Synergy recommends the ERA review whether there is an overlap of the expenditure proposed in AEMO's February 2017 submission and that already approved in December 2016. Synergy notes the ERA approved \$2.3 million in transfer costs (supplies and services capital expenditure), which the ERA described as including the following:

"Redundant communications links are required between the new AEMO Perth Office, Western Power and the two Perth data centres to support ongoing utilisation of Western Power operational systems by AEMO for management of the southwest-interconnected system. These links are also required for the transfer of operational SCADA controls after the introduction of new market structures in 2018 and will be re-purposed."¹

The ERA's technical advisors, Geoff Brown and Associates (**GBA**), further breaks down the transfer costs and indicates that forecasts include \$1.61 million to *"provide for the leased data links that are required to connect the new control room within the Perth CBD to the outside world"*². GBA continues to say:

"We are not able to comment on the reasonableness or otherwise of any of these costs, although we accept that expenditure is required in all cases..... We note however that there is an increase of 18% between 2017-18 and 2018-19 in the nominal cost of operating each of the data links. This is much higher than the assumed escalation factor of 2.5%."³

¹ Page 20, *Final Determination on Allowable Revenue and Forecast Capital Expenditure for the Australian Energy Market Operator 2016/17 – 2018-19*, 16 December 2016, available at: <https://www.erawa.com.au/cproot/14691/2/Final%20Determination%20-%20AEMO%20Allowable%20Revenue%202016-2019.pdf>.

² Page 3, *Review of AEMO Allowable Revenue and Capital Expenditure Requirements for WEM Operations 2016-19 Technical Advisor's Report*, 8 December 2016, available at: <https://www.erawa.com.au/cproot/14690/2/Consultant%20Report%20-%20Geoff%20Brown%20and%20Associates.PDF>.

³ Page 13, *Review of AEMO Allowable Revenue and Capital Expenditure Requirements for WEM Operations 2016-19 Technical Advisor's Report*, 8 December 2016, available at: <https://www.erawa.com.au/cproot/14690/2/Consultant%20Report%20-%20Geoff%20Brown%20and%20Associates.PDF>.

The ERA has taken the advice of its technical advisors and in its 16 December 2016 Final Determination states:

*"The determination values are based on 2015/16 actual expenditure with the corporate recovery for AEMO's board, plus the addition of one-off items for telecommunications identified by AEMO."*⁴

Therefore, the ERA may wish to seek further information from AEMO to clarify what expenditure has already been incurred, and what is required above and beyond the \$1.61 million already approved. The ERA may also wish to consider AEMO's statement in its proposed \$2.2 million communication links solution is *"more expensive than other options"*⁵, and seek further detail on the other options that AEMO considered and why those options were not pursued.

Percentage of overhead/indirect costs capitalised

Synergy notes the overhead/indirect costs proposed to be capitalised by AEMO seem high, particularly when compared with other regulated businesses. The majority of regulated businesses capitalise 10-15% of indirect costs.⁶ AEMO appears to have capitalised around 20% or \$1.9 million of program costs. Synergy recommends the ERA should assess whether 20% capitalisation is prudent and efficient under the circumstances. In that regard, the ERA may wish to:

- consider which of AEMO's costs are incremental, and which costs are simply AEMO's internal fixed costs that are being allocated to WA (i.e. staff with BAU roles that are not being replaced) and would otherwise be allocated to other jurisdictions; and
- benchmark these indirect costs against those of other businesses.

Future market reform

Synergy supports in principle the components of AEMO's proposal that are already enacted in the WEM rules and are therefore subject to less regulatory uncertainty than other components of AEMO's forecast expenditure.

The ERA should consider certainty of market design when assessing whether any expenditure relating to market reforms that has not already been implemented should proceed or whether further clarity from the state government on market design is required to assess the proposal prior to expenditure being incurred. For example, Synergy queries whether it is prudent to incur expenditure on a new energy management system and forecast tools until there is a complete understanding of the future design of the energy market as this could result in systems ultimately not being fit-for-purpose.

⁴ Page 16, *Final Determination on Allowable Revenue and Forecast Capital Expenditure for the Australian Energy Market Operator 2016/17 – 2018-19*, 16 December 2016, available at: <https://www.erawa.com.au/cproot/14691/2/Final%20Determination%20-%20AEMO%20Allowable%20Revenue%202016-2019.pdf>.

⁵ Page 13, *2016-19 Allowable Revenue and Forecast Capital Expenditure Submission to Economic Regulation Authority, AEMO*, 17 February 2017, available at:

<https://www.erawa.com.au/cproot/17238/2/AEMO%20Allowable%20revenue%20attachment%202%20AEMO%20Proposal.PDF>.

⁶ In its draft determination for ATCO Gas Australia, the ERA referred to the AER's recently approved 15% for SP Ausnet, 13% for Envestra Victoria and 5% for Multinet Victoria, stating that "...and overhead allocation of 15 per cent would be more in line with industry practice". Page 120, *Draft Decision on Proposed Revisions to the Access Arrangement for the Mid-West and South-West Gas Distribution System*, 14 October 2014, available at: <https://www.erawa.com.au/gas/gas-access/mid-west-and-south-west-gas-distribution-systems/access-arrangements/access-arrangement-for-period-2014-2019/decisions-and-proposals>.

Further, given AEMO has indicated it will submit a further allowable revenue adjustment in the third or fourth quarter of 2017 "*once clarification has been obtained about the underpinning market reform legislation (expected after the WA State Election)*"⁷, the ERA should satisfy itself it can make an informed decision on reform-related expenditure in the absence of this clarification.

Synergy notes the proposed \$0.498 million of revenue and \$1.75 million in forecast capital expenditure associated with the development of a new energy management system and forecasting tools. While a new energy management system and forecasting tools may be required in the near future, Synergy considers at least in the short-to-medium term, AEMO continuing to share Western Power's SCADA and energy management systems could be considered by the ERA as an interim step to incurring the expenditure until there is certainty of market design.

Treatment of incurred expenditure if the market reform program is not completed

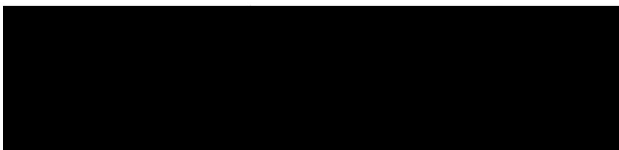
In its consultation paper, the ERA highlights AEMO will have already incurred 65% of forecast capital expenditure (\$7.54 million) and expect to have collected 40% of the proposed adjusted allowable revenue (\$1.1 million) by 30 June 2017. The ERA will therefore need to decide whether the expenditure already incurred:

- meets the requirements of the WEM rules, in particular in relation to preparing for the EMR;
- is prudent given the circumstances at the time; and
- efficiently minimises costs.

In addition to this, and perhaps more importantly, Synergy notes the treatment of costs as either capital or operating expenditure is dependent on whether these costs result in an asset for regulatory purposes. For example, it would not be appropriate to capitalise planning and development costs if the market reforms are changed such that no asset is required⁸. In the event expenditure already incurred is capitalised then the ERA should be satisfied as to the basis of the costs being capitalised and whether the market should bear this cost and any impact on market fees (of which Synergy's customers will pay 65%).

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



WILL BARGMANN
GENERAL MANAGER CORPORATE SERVICES

⁷ Page 3, 2016-19 Allowable Revenue and Forecast Capital Expenditure Submission to Economic Regulation Authority, AEMO, 17 February 2017, available at:

<https://www.erawa.com.au/cproot/17238/2/AEMO%20Allowable%20revenue%20attachment%202%20AEMO%20Proposal.PDF>.

⁸ For example, in Western Power's third access arrangement process the ERA disallowed \$4.5 million of early strategic planning costs for transmission projects which ultimately did not go ahead. These costs were therefore expensed rather than capitalised. Page 143, *Final Decision on Proposed Revisions to the Access Arrangement for the Western Power Network*, 5 September 2012, available at:

<http://www.erawa.com.au/cproot/10737/2/20120905%20-%20D94955%20-%20Final%20Decision%20on%20Proposed%20Revisions%20to%20the%20Access%20Arrangement%20for%20the%20Western%20Power%20Network%20-%20Published%20Version.pdf>.