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Dear Jenness

DRAFT DECISION – AEMO’S ALLOWABLE REVENUE AND FORECAST CAPITAL EXPENDITURE – REVIEW PERIOD FROM 1 JULY 2019 TO 30 JUNE 2022 – LEGAL REASONING CONCERNS

On 8 May 2019 the Economic Regulation Authority (**ERA**) published its draft decision on AEMO’s Allowable Revenue and Forecast Capital Expenditure for the Review Period from 1 July 2019 to 30 June 2022 under the Wholesale Electricity Market Rules (**WEM Rules**) and the Gas Services Information Rules (**GSI Rules**).¹

The ERA’s draft decision is to approve the following amounts:²

Category		AEMO’s proposal	ERA’s draft decision
WEM Rules	Allowable Revenue	\$98.3 million	\$96.6 million
	Forecast Capital Expenditure	\$77.2 million ³	\$20.8 million
GSI Rules	Allowable Revenue	\$5.9 million	\$5.9 million
	Forecast Capital Expenditure	\$1.3 million ⁴	\$116,000

The ERA has invited interested parties to make submissions on its draft decision. AEMO has made a submission to provide additional information and address matters raised in the ERA’s draft decision.

AEMO appreciates that the ERA has published a draft decision and invited interested parties to make submissions, particularly given these are not WEM Rules requirements. AEMO welcomes these additional steps, as they provide greater transparency in the decision-making process, and allow AEMO and Market Participants to have more input into AEMO’s Allowable Revenue and Forecast Capital Expenditure determination at a time of rapid change in the Western Australian energy sector.

¹ Capitalised terms in this letter have the meaning given in the WEM Rules unless otherwise stated.

² The ERA’s draft decision states that the Allowable Revenue amounts will be adjusted (among other things) by excluding depreciation charges and resource capitalisation charges that relate to unapproved Forecast Capital Expenditure.

³ AEMO’s submission in response to the draft decision revises this amount to \$78.5 million.

⁴ AEMO’s submission in response to the draft decision revises this amount to \$1.2 million.

Purpose of this letter

AEMO has significant concerns regarding the legal reasoning in the ERA's draft decision with respect to Forecast Capital Expenditure under the WEM Rules and the GSI Rules. This letter outlines AEMO's concerns. Given the importance of funding for AEMO's WEM and GSI operations, AEMO requests an opportunity for further engagement before the ERA makes its final determination under the WEM Rules and the GSI Rules on the issues outlined in this letter, and on any other matters concerning the ERA regarding AEMO's Allowable Revenue and Forecast Capital Expenditure.

Summary of AEMO's concerns

AEMO considers that the ERA's draft decision:

- (a) incorrectly interprets and applies clause 2.22A.11(b) of the WEM Rules⁵ (**issue 1**);
- (b) does not give effect to clause 1.20.3 of the WEM Rules (which requires the ERA to determine AEMO's Allowable Revenue and Forecast Capital Expenditure "on the basis that Wholesale Electricity Market and Constrained Network Access Reform will be implemented before 1 October 2022") (**issue 2**); and
- (c) does not give effect to clause 2.22A.2(c)⁶ of the WEM Rules as modified by clause 1.20.5(b) (which requires the ERA to determine AEMO's Forecast Capital Expenditure for a "Review Period" (**issue 3**)).

In AEMO's view, if the ERA were to proceed to make a final determination on the same basis as in its draft decision, then the final determination could potentially be challenged on administrative law grounds.

Preliminary matter – interpreting the WEM Rules

The WA Supreme Court was required to interpret the WEM Rules in *Bluewaters Power 2 Pty Ltd v Australian Energy Market Operator Ltd* [2017] WASC 98. The Court noted that section 123(2) of the Electricity Industry Act 2004 states that the WEM Rules are not "subsidiary legislation" for the purposes of the Interpretation Act 1984. However, despite section 123(2), the Court held that the WEM Rules "should be considered as a species of subordinate or delegated legislation" [at 40]. The Court also held that the WEM Rules "should be interpreted by applying the general rules of statutory construction" [at 40]. The Court referred to the following statutory construction principles at [41] and [42]:

- (a) "[T]he task of statutory construction must begin with a consideration of the text itself. ... The meaning of the text may require consideration of the context, which includes the general purpose and policy of a provision..."⁷

⁵ The corresponding provision is rule 109(3) of the GSI Rules. The analysis and conclusions in this letter with respect to clause 2.22A.11(b) of the WEM Rules also apply to rule 109(3) of the GSI Rules.

⁶ The corresponding provision is rule 108A(1) of the GSI Rules. The analysis and conclusions in this letter with respect to clause 2.22A.2(c) of the WEM Rules also apply to rule 108A(1) of the GSI Rules.

⁷ *Alcan (NT) Alumina Pty Ltd v Commissioner of Territory Revenue* [2009] HCA 41 at [47].

- (b) “[T]he primary object of statutory construction is to construe the relevant provision so that it is consistent with the language and purpose of all the provisions of the statute”.⁸
- (c) “The purpose of legislation must be derived from what the legislation says, and not from any assumption about the desired or desirable reach or operation of the relevant provisions”.⁹

Issue 1 – the ERA’s draft decision incorrectly interprets and applies clause 2.22A.11(b) of the WEM Rules¹⁰

Clause 2.22A.11 of the WEM Rules requires the ERA to take four specified matters “into account” when determining AEMO’s Allowable Revenue and Forecast Capital Expenditure:

- (a) The first matter is that Allowable Revenue must be “sufficient to cover the forward looking costs of providing the services described in clause 2.22A.1¹¹ and performing AEMO’s functions and obligations under the WEM Rules” in accordance with specified accounting principles. One of those principles is that capital expenditure is to be recovered through depreciation and amortisation in a manner that is consistent with generally accepted accounting principles.
- (b) The second matter in clause 2.22A.11(b) of the WEM Rules is that “the Allowable Revenue and Forecast Capital Expenditure must include only costs which would be incurred by a prudent provider of the services described in clause 2.22A.1¹², acting efficiently, seeking to achieve the lowest practicably sustainable cost of delivering the services described in clause 2.22A.1 in accordance with [the WEM Rules], while effectively promoting the Wholesale Market Objectives”.
- (c) The third matter is that the ERA “should” benchmark the Allowable Revenue and Forecast Capital Expenditure against the costs of providing similar services in other jurisdictions “where possible”.
- (d) The fourth matter relates to cost allocation between AEMO’s WEM and non-WEM functions and is not presently relevant.

AEMO considers that the ERA’s draft decision incorrectly interprets and applies clause 2.22A.11(b) of the WEM Rules for two reasons. First, the ERA’s draft decision characterises clause 2.22A.11(b) as a “funding approval requirement”, whereas clause 2.22A.11 only requires the ERA to take the matter specified in clause 2.22A.11(b) and the other three specified matters “into account”. Second, as the following table shows, the ERA’s draft

⁸ *Project Blue Sky Inc v Australian Broadcasting Authority* [1998] HCA 28 at [69].

⁹ *Certain Lloyd’s Underwriters Subscribing to Contract No IH00AAQS v Cross* [2012] HCA 56 at [25]-[26].

¹⁰ The corresponding provision is rule 109(3) of the GSI Rules. The analysis and conclusions in this letter with respect to clause 2.22A.11(b) of the WEM Rules also apply to rule 109(3) of the GSI Rules.

¹¹ The services described in clause 2.22A.1 of the WEM Rules are: market operation services; system planning services; market administration services; and system management services. Clause 1.20.4 of the WEM Rules deems “any activity” performed by AEMO in carrying out its functions of preparing for, and facilitating the implementation of, Wholesale Electricity Market and Constrained Network Access Reform to be “provision of a service described in clause 2.22A.1”.

¹² The services described in clause 2.22A.1 of the WEM Rules are: market operation services; system planning services; market administration services; and system management services. Clause 1.20.4 of the WEM Rules deems “any activity” performed by AEMO in carrying out its functions of preparing for, and facilitating the implementation of, Wholesale Electricity Market and Constrained Network Access Reform to be “provision of a service described in clause 2.22A.1”.

decision incorrectly restates the words “**seeking to achieve** the lowest practicably sustainable cost” as a requirement for proposed expenditure to **be** the lowest practicably sustainable cost:

Page	Wording
Overview (page ii)	“The [ERA] must approve only those costs “which would be incurred by a prudent provider of the services”, acting efficiently and “ seeking to achieve the lowest practicably sustainable costs of delivering the services” ”.
Overview (page iii)	“The ERA must approve funding that meets the approval criteria in the [WEM Rules] and [GSI Rules]; otherwise it breaches its legislative obligations. To be approved, estimates must represent the lowest practicabl[y] sustainable cost of providing the service or function”.
Overview (page iii)	“[T]he ERA is unable to approve funding based on high-level, top-down estimates of costs, where detailed project scopes are still being defined. AEMO expects its cost estimates will change. This suggests current estimated costs cannot be the lowest practicabl[y] sustainable cost[s] and so do not meet the funding approval requirements in the [WEM Rules] and in the [GSI Rules]”.
7	“The [WEM Rules] identify the ERA’s obligations for approving AEMO’s funding. Allowable [R]evenue and [F]orecast [C]apital [E]xpenditure approved by the ERA “must include only costs which would be incurred by a prudent provider of the services”, acting efficiently and “ seeking to achieve the lowest practicably sustainable costs of delivering the services” in accordance with [the WEM Rules] and while effectively promoting the WEM objectives”.
8	“The funding approval requirements in the [WEM Rules] are challenging to apply before alternative delivery options have been analysed and the lowest practicably sustainable cost identified”. However, to fulfil its obligations under [clause 2.22A.11 of the WEM Rules], the ERA must apply the funding approval criteria to AEMO’s AR5 submission”.
9	“Some projects, including the digital roadmap and WEM reform projects, include high level funding estimates as these projects are still in the early stages of development. With such uncertainty, funding estimates for these projects are unlikely to meet the approval criteria of being lowest practicably sustainable cost ”.
19	“The ERA has reviewed AEMO’s standard approach to cost estimation for AR5 and acknowledges the approach is reasonable and that AEMO has demonstrated project governance and accountability for internal funding approvals. However, a reasonable approach to cost estimation is no guarantee that the costs meet the funding approval requirements in the [WEM Rules] and that the estimates provided are the ‘lowest practicably sustainable costs’ of undertaking the functions”.

The ERA’s draft decision specifies the following test for determining whether proposed expenditure is the lowest practicably sustainable cost (at page 7):

To be able to demonstrate lowest practicably sustainable costs and approve AEMO’s funding, the ERA should be able to establish that:

- There is detailed information on the activities to be undertaken by AEMO, including how these activities contribute to the market objectives.

- The cost estimates are provided by robust models and governance mechanisms such that AEMO, market participants and the regulator have confidence in the cost estimates underpinning the submission.
- AEMO has considered different ways of delivering the projects/outcomes and demonstrated that **the preferred option is [the] lowest practicabl[y] sustainable cost**, such as through option analysis and/or cost benefit analysis.

[AEMO's emphasis]

AEMO considers that the ERA's draft decision (by applying this test so as to exclude \$56.4 million of proposed WEM Forecast Capital Expenditure and \$1.2 million of proposed GSI Forecast Capital Expenditure) incorrectly interprets and applies clause 2.22A.11(b) of the WEM Rules and rule 109(3) of the GSI Rules.

AEMO requests that the ERA reconsiders its draft decision to approve:

- \$20.8 million of WEM Forecast Capital Expenditure compared to \$77.2 million proposed (and now \$78.5 million revised); and
- \$113,000 of GSI Forecast Capital Expenditure compared to \$1.3 million proposed (and now \$1.2 million revised).

Issue 2 – the ERA's draft decision does not give effect to clause 1.20.3 of the WEM Rules

Clause 1.20.3 of the WEM Rules relevantly requires the ERA to determine AEMO's Allowable Revenue and Forecast Capital Expenditure "on the basis that Wholesale Electricity Market and Constrained Network Access Reform will be implemented before 1 October 2022". The WEM Rules define "Wholesale Electricity Market and Constrained Network Access Reform" to mean:

any proposed change to the operation of the Wholesale Electricity Market or related network access arrangements, or the regulatory regime applying to the Wholesale Electricity Market (including the Electricity Industry Act, the Regulations and [the WEM Rules]), that has been endorsed by the Minister (whether or not legislation has been made to implement it)".

[AEMO's emphasis].

Reading clause 1.20.3 and the definition together:

- (a) The ERA must determine AEMO's Allowable Revenue and Forecast Capital Expenditure on the basis that Wholesale Electricity Market and Constrained Network Access Reform will be implemented before 1 October 2022.
- (b) "Wholesale Electricity Market and Constrained Network Access Reform" means any proposed change to the operation of the Wholesale Electricity Market (or the regulatory regime applying to it) that has been endorsed by the Minister.
- (c) The Minister's endorsement of a proposed change is determinative. The ERA has no discretion to decide that a proposed change will not be implemented at all, or will be implemented but not before 1 October 2022, on the ground that legislation has not been made or any other ground.

The Minister has endorsed proposed changes to the Wholesale Electricity Market (including the regulatory regime applying to it) in a letter to AEMO dated 13 March 2019. AEMO has provided a copy of the Minister's letter to the ERA in Appendix A1 of its Allowable Revenue and Forecast Capital Expenditure proposal. The Minister's letter relevantly states:

For the purposes of [clause 1.20 of the WEM Rules] and the description of "Wholesale Electricity Market and Constrained Network Access Reform", the following changes to the operation of the Wholesale Electricity Market (including relevant changes to the Wholesale Electricity Market legislative regime) are endorsed.

Clause 1.20.3 therefore requires the ERA to determine AEMO's Allowable Revenue and Forecast Capital Expenditure on the basis that all of the proposed changes that have been endorsed will be implemented before 1 October 2022.

The ERA's draft decision states (at page 21):

The Minister for Energy has endorsed the WEM reform program, and the date for the new market design remains unchanged at 1 October 2022. This provides **some certainty that the WEM reform project will continue as planned through AR5**. AEMO has also provided additional detail on tranches 1 and 2 WEM reform activities in the first year of AR5, and how these activities have been costed. The ERA is comfortable that the activities are well scoped, cost estimates are prudent and contribute to a clear deliverable by mid-2020. The draft decision is to approve all of the funding for the first year of the WEM reform project, excluding contingency.

...

The draft decision is to not approve forecast capital expenditure required in later years, over and above the forecast costs for the core WEM reform team. There is insufficient information available on these costs for the ERA to establish that they meet the funding requirements in the WEM rules. This is not a criticism of AEMO's approach, but rather acknowledgement that **it is too early in the WEM reform process for AEMO to estimate costs** that meet the funding approval requirements.

[AEMO's emphasis]

The ERA's draft decision states (at page 7) that the "funding approval requirement" in clause 2.22A.11(b) applies to AEMO's functions of preparing for, and facilitating the implementation of, Wholesale Electricity Market and Constrained Network Access Reform under clause 1.20. On that basis the ERA's draft decision proceeds to assess whether AEMO's proposed WEM reform project expenditure is the lowest practicably sustainable cost. The ERA's draft decision is to approve \$13.8 million of proposed WEM reform project expenditure compared to \$51.2 million proposed.

AEMO considers that the ERA's draft decision does not give effect to clause 1.20.3 of the WEM Rules for two reasons.

First, the ERA's draft decision states that the Minister's endorsement of proposed changes provides "some certainty that the WEM reform project will continue as planned". The words "some certainty" imply a level of confidence that is less than absolute certainty. The words are inconsistent with the requirement in clause 1.20.3 for the ERA to assume that the

proposed changes “will be implemented”.¹³

Second, the ERA’s draft decision states that it is “too early in the WEM reform process for AEMO to estimate costs” that will meet the funding approval requirement. This statement does not account for the context of clause 1.20.3 and how it applies to Wholesale Electricity Market and Constrained Network Access Reform.

The WEM reform process is inherently uncertain. There is a degree of uncertainty as to how and when a proposed change will be implemented. It is possible, for example, that the Minister may endorse a proposed change to the operation of the Wholesale Electricity Market and request that other parties (such as AEMO and the Energy Transformation Implementation Unit¹⁴) carry out the necessary policy analysis and operational work to implement the proposed change.

In AEMO’s view, having regard to this context, it is not necessary for the WEM reform process to advance to a point where there is drafting to implement the necessary changes. Similarly, in AEMO’s view, it is not necessary for AEMO to provide finalised project scopes and bottom-up cost estimates. Project scopes and cost estimates will inevitably evolve as the WEM reform process continues to advance. AEMO has publicly committed to apply its well-established and proven capital project governance procedures throughout the Review Period and, at all times, will seek to achieve the lowest practicably sustainable cost of delivering the services described in clause 2.22A.1.

AEMO requests that the ERA reconsiders its draft decision on the basis that it has not given effect to clause 1.20.3 of the WEM Rules.

Issue 3 – the ERA’s draft decision does not give effect to clause 2.22A.2(c) of the WEM Rules¹⁵ as modified by clause 1.20.5(b)

Clause 2.22A.2 states:

For the **Review Period**, AEMO must seek the approval of its Allowable Revenue and Forecast Capital Expenditure from the Economic Regulation Authority for each of the services described in clause 2.22A.1 in accordance with the following—

- (a) by 30 November of the year prior to the start of **the Review Period**, AEMO must submit a proposal for its Allowable Revenue and Forecast Capital Expenditure over **the Review Period**;
- (b) the Economic Regulation Authority must undertake a public consultation process in approving AEMO’s Allowable Revenue and Forecast Capital Expenditure for a **Review Period**, which must include publishing an issues paper and issuing an invitation for public submissions; and
- (c) by 31 March of the year in which **the Review Period** commences, the

¹³ We note (by way of comparison) that between 2016 and 2018 the ERA was required to determine AEMO’s Allowable Revenue and Forecast Capital Expenditure for “all or part of the Review Period from 1 July 2016 to 1 July 2019” on the basis that “Wholesale Electricity Market Reform includes the full implementation of the reform package set out in the Wholesale Energy and Ancillary Service Report before 1 July 2020”.¹³ No legislation was made for the reform package set out in that report. Nevertheless, under clause 1.20.3 as then in force, the ERA was required to assume that it would be fully implemented.

¹⁴ <https://www.mediastatements.wa.gov.au/Pages/McGowan/2019/05/McGowan-Government-creates-Energy-Transformation-Taskforce.aspx>.

¹⁵ The corresponding provision is rule 108A(1) of the GSI Rules. The analysis and conclusions in this letter with respect to clause 2.22A.2(c) of the WEM Rules also apply to rule 108A(1) of the GSI Rules.

Economic Regulation Authority must determine AEMO's Allowable Revenue and approve the Forecast Capital Expenditure of AEMO for **the Review Period** for each of the services described in clause 2.22A.1.

[AEMO's emphasis]

Clause 1.20.5 of the WEM Rules states:

For the Review Period from 1 July 2019 to 1 July 2022—

- (a) AEMO is not required to submit its proposal for Allowable Revenue and Forecast Capital Expenditure for **that Review Period** until 15 March 2019; and
- (b) the Economic Regulation Authority is not required to determine AEMO's Allowable Revenue and Forecast Capital Expenditure for **that Review Period** until 14 June 2019.

[AEMO's emphasis]

AEMO considers that the ERA's draft decision does not give effect to clause 2.22A.2(c) of the WEM Rules as modified by clause 1.20.5(b).

The ERA's draft decision is to use a "staged funding approach" to determine AEMO's WEM Forecast Capital Expenditure for the Review Period from 1 July 2019 to 30 June 2022. The staged funding approach would apply to WEM reform project expenditure in years 2 and 3 of the Review Period:

Page	Wording
iii	"AEMO will need to request additional funding for the second and third years of the WEM project, once it has a set of clear business requirements and market rules against which to design, cost, procure and implement new IT and business systems".
19	"Application of the funding requirements is challenging for AEMO's two large-scale, early stage projects, where scope and delivery are still uncertain, particularly in the later years of AR5. Therefore, for the draft decision, the ERA has considered staged funding approval for these projects".
21	"The draft decision is to approve all of the funding for the first year of the WEM reform project, excluding contingency. ... AEMO will need to provide a revised funding proposal for the last two years of AR5, where most expenditure is for the implementation of the new systems. The ERA recommends AEMO does not make a further funding proposal until more certainty on WEM reforms is available".

Clause 2.22A.2 of the WEM Rules specifies a process and timeframes for determining AEMO's Allowable Revenue and Forecast Capital Expenditure for a Review Period. The process starts with AEMO's proposal and ends with the ERA's determination. The timeframes begin and end before the start of the Review Period. Clause 1.20.5 (which commenced on 29 June 2018) specifies the same process with respect to the Review Period from 1 July 2019 to 30 June 2022, but with modified timeframes. The modified timeframes also begin and end before the start of the Review Period.

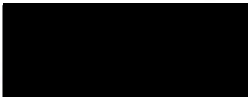
In AEMO's view, clause 2.22A.2(c) of the WEM Rules (as modified by clause 1.20.5(b)) requires the ERA to determine AEMO's WEM Forecast Capital Expenditure for the full Review Period, and does not permit a staged funding approach. We acknowledge that

AEMO expressed a different view in its Allowable Revenue and Forecast Capital Expenditure proposal. AEMO's current view is based on a legal review of the WEM Rules. In addition, as noted in AEMO's submission in response to the ERA's draft decision, a staged funding approach would not achieve the lowest practicably sustainable cost of delivering the services described in clause 2.22A.1 during the Review Period.

Next steps

AEMO requests an opportunity for further engagement to resolve these concerns before the ERA make its final determination under the WEM Rules and the GSI Rules. Again, AEMO appreciates that the ERA has provided greater transparency in the decision-making process, as this provides an opportunity for issues such as those outlined in this letter to be considered and addressed before the ERA makes its final determination.

Yours sincerely



Cameron Parrotte
Executive General Manager – Western Australia

