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via email to: publicsubmissions@erawa.com.au

Dear Sara

AUSTRALIAN ENERGY MARKET OPERATOR'S – ALLOWABLE REVENUE AND FORECAST CAPITAL EXPENDITURE PROPOSAL FOR THE PERIOD 1 JULY 2022 TO 30 JUNE 2025

Synergy welcomes the opportunity to make a submission in response to the Economic Regulation Authority's (**ERA**) issues paper on the Australian Energy Market Operator's (**AEMO**) sixth allowable revenue (**AR6**) proposal covering the period from 2022/23 to 2024/25 (**Issues Paper**).

Synergy supplies electricity to more than 1 million residential and commercial customers and, as the state's largest electricity generator and retailer, incurs approximately 45% of the Wholesale Electricity Market (**WEM**) fees.

As Synergy has noted in previous allowable revenue submissions, the ERA is required under section 26 of the *Economic Regulation Authority Act 2003*, amongst other matters, to have regard to:

"(a) 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;

(b) the long-term interests of consumers in relation to the price, quality and reliability of goods and services provided in relevant markets;

(c) the need to encourage investment in relevant markets;

(d) the legitimate business interests of investors and service providers in relevant markets;" …

(g) "the need to promote transparent decision-making processes that involve public consultation."

The ERA also has an obligation under clause 2.22A.5(b) of the WEM Rules to take into account:

> "only costs which would be incurred by a prudent provider of the services provided by AEMO in performing its functions, acting efficiently, to achieve the lowest practicably sustainable cost of performing AEMO's functions, while effectively promoting the Wholesale Market Objectives".

The purpose of this submission is to support the ERA in making its decision on the forecast capital expenditure and allowable revenue proposed by AEMO, by identifying aspects of the proposal that warrant further consideration and require additional supporting information.

General comments

- Synergy supports the WA Government's Energy Transformation Strategy (**ETS**), including WEM reform and delivery of the Distributed Energy Roadmap (**DER**) actions.
- Synergy is keen to see the new market arrangements established by 1 October 2023 and considers investment in the WEM reform program should be prioritised ahead of AEMO's other programs of work, to ensure delivery of a functioning market within specified time frames.
- Synergy appreciates a greater understanding of the scope of the WEM reform program has required AEMO to revise its initial cost estimate. However, the ~$30 million increase in expected costs is a substantial leap and will lead to significant market fee increases over the AR6 to AR8 periods as the capex is recovered. As the largest generation and retail participant in the SWIS, Synergy will pay the majority of these market fee increases, which will ultimately be passed on to electricity customers.
- Synergy accepts market reform comes at a cost, but stresses the need to make certain these revised forecasts represent efficient costs and are supported by robust evidence. Synergy therefore recommends the ERA requires AEMO to provide sufficient evidence to demonstrate to participants that the revised forecast is prudent, efficient, and deliverable.
- In particular, Synergy advocates the ERA to challenge the level of contingency spend included in the WEM reform forecast. More importantly, Synergy requests the ERA (and AEMO) considers the most appropriate method of financial governance to ensure AEMO works within the base cost estimate and only consumes contingency spend where there is a compelling case to do so.
- The revised WEM Reform capex forecast suggests AEMO will spend a similar amount in the next 18 months as it did over the three-year AR5 period. Synergy recommends the ERA scrutinise whether this is deliverable, particularly given the suite of other capex projects proposed for the AR6 period, which may compete for resources.
- A further delay to the commencement of the new market arrangements would not be in the best interest of market participants or end use consumers. Therefore, Synergy recommends that once the ERA has determined what it considers is a prudent and efficient forecast cost to deliver WEM reform, the ERA then considers the deliverability of the works program as a whole, with a view to prioritising WEM reform and deferring less critical work wherever possible.
- Irrespective of the final forecast, Synergy recognises that the upfront cost of market reform was going to be substantial. Synergy therefore recommends the ERA seeks opportunities to soften the price impact for market participants and end consumers. Synergy suggests one avenue the ERA may wish to pursue is whether the depreciation schedule for the new market systems is appropriate. Given the systems put in place by AEMO will likely operate for well over a decade, consideration should be given to recovering costs over the operational life of the assets rather than the notional economic life.

- Further, Synergy requests the ERA seeks clarity on the ongoing operating costs of the new market, and the prudence of establishing permanent resources – and therefore recurrent costs – to support a new market in its early stages. AEMO refers to AR6 as a 'bedding-in' period, therefore it may be more prudent to utilise flexible resourcing arrangements during such a period of uncertainty.
- In addition to WEM Reform, Synergy recommends the ERA focuses on:
  - the prudence of the IT program of works given competing priorities;
  - cost allocation between AEMO's WEM and the National Electricity Market (**NEM**) operations to ensure against double recovery;
  - whether proposed cyber security costs are efficient and risk commensurate, and the basis for these costs;
  - the impact of depreciation on WEM fees;
  - increasing labour costs not directly associated with market operation (IT, reserve capacity power system and market planning); and
  - achieving a reasonable transition path for market fee increases through AR6 and beyond.
- Synergy supports the ERA continuing with its approach to stage the approval of uncertain projects throughout the AR6 period. Synergy considers this achieves an appropriate balance between the accuracy of project costs and the forecast revenue requirement, market transparency, and the certainty and consistency of market fees.

Synergy recommends the ERA consider a requirement for AEMO to publish, prior to the draft AR6 decision, a transparent regulated revenue model for AR6, equivalent to that provided by Western Power to support its fifth access arrangement proposal. This would be consistent the requirement for transparent decision making under section 26(g) of the *Economic Regulation Authority Act 2003.*

Synergy's comments on specific elements of AEMO's proposal

Forecast capex

Synergy notes the overall capex forecast is high and while it doesn't directly result in a one-to-one revenue increase in the AR6 forecast, it will significantly affect AEMO's revenue requirement and therefore market fees through AR6 to the AR8 period. For this reason, Synergy supports AEMO's proposal to exclude from the AR6 forecast less certain projects like five-minute settlement, participation of DER aggregation and participation in ETS Stage 2 projects until they are better understood and/or required by policy and substantiated by an out of period funding request. Synergy considers there to be more scope for projects to be deferred and potentially excluded from the AR6 forecast altogether.

Synergy recommends the ERA and AEMO consider any opportunity to defer capital projects, with the exception of WEM Reform. A good example of where this could be considered prudent is in relation to:

- the additional DER projects (those not specified as DER Roadmap actions); and
- discretionary IT projects, including moving systems to the cloud and enhanced cyber security.

Synergy supports the ERA's preference to have these projects justified and costed at a later stage and only added to allowable revenue at the point where AEMO can demonstrate they meet the requirements of the WEM Rules.

In particular, Synergy questions whether the cyber security costs are sufficiently justified. The costs appear to be significant and perhaps overstated given the risk being addressed in the WEM. This is also an area where Synergy recommends scrutiny of the allocation of AEMO's costs between the WEM and the NEM operations. Synergy considers the likelihood and impact of a cyber event in the NEM is significantly higher than the WEM and would like to see AEMO considering this factor and other relevant factors in the allocation of various project costs.

Synergy recommends the ERA pays closely scrutinise the amount of contingency included in AEMO's forecast. While AEMO highlights that there is no incentive for it to over forecast as it is a not-for-profit, there is also no incentive for AEMO to stretch itself to deliver projects at a lower cost to market participants and end consumers.

AEMO in its role to maintain system security is appropriately conservative. However, Synergy considers it reasonable to assume the AR6 proposal is similarly conservative. The issue with this is, unlike a commercial organisation there is also no incentive for AEMO not to spend up to, and potentially over its budget.

Synergy therefore recommends the ERA considers the appropriateness of contingency amounts applied to each project forecast and where this is high, seek further information from AEMO. Where appropriate justification is not provided, Synergy recommends the project is disallowed, with the intent of AEMO requesting revenue for the project through market fees only upon presentation of a fully formed business case to the ERA.

Forecast operating costs

Synergy is surprised by the significant increase in operating expenditure proposed by AEMO. Synergy appreciates AEMO is best placed to estimate the level of effort required under the new market arrangements, but considers there is greater opportunity to achieve economies of scale and scope within the overall business than has been put forward in the AR6 proposal.

Synergy considers that while the bottom-up build of resource requirements AEMO has developed is a reasonable approach by which to develop the initial labour costs forecast, it must be balanced by a robust top-down challenge, ideally with rigorous efficiency targets applied to it. While Synergy recognises AEMO has applied a degree of internal challenge, Synergy considers the 5% reduction to the bottom-up labour forecast applied by AEMO is too conservative. Given the degree of uncertainty on how much effort the new market will require, coupled with the flexibility available to AEMO in terms of resourcing options and expenditure overrun allowances, Synergy considers there is further scope for stronger efficiency targets.

Synergy appreciates the ERA cannot be expected to have a better understanding of the impact of the new market arrangements on AEMO's operations than AEMO has. Synergy therefore recommends the ERA avoids challenging the labour bottom-up build at a granular level. Instead, Synergy suggests the ERA looks at alternative options at its disposal such as applying a top-down efficiency mechanism that sets a target operating cost benchmark. An efficiency dividend of 5-10% (on AEMO's proposed forecast) may be appropriate.

Synergy appreciates there will need to be a resourcing uplift during AEMO's new market bedding in period, but considers this should be temporary in nature. As the bedding in period carries over into the AR7 period, Synergy recommends the ERA considers the temporary nature of these positions to drive long-term efficiencies and whether outsourcing is a cost effective and viable alternative to insourcing. Although temporary staff may be more expensive in the short term, it avoids establishing long term recurrent costs and annual adjustments associated with permanent staff. Given the current uncertainty surrounding the new market and broader energy transformation, it may be prudent to avoid establishing long-lasting resource costs where practicable.

AEMO appears to have considered changes in labour capitalisation treatment from operating to capital expenditure, but Synergy questions whether AEMO has considered the shift back from capital to operating expenditure. Synergy would expect a similar sized reversion of capitalised labour, but cannot see this occurring within the period in AEMO's proposal. Synergy recommends the ERA considers whether the continuation of capitalised resources should continue beyond the commissioning of the various systems, or whether these resources can be redeployed back into the business, thereby offsetting the labour uplift in the later years of AR6 and into AR7.

Cost allocation between AEMO markets

One of the key policy decisions made in relation to WEM reform was to adopt systems and processes from the NEM to reduce the cost of developing, operating and reforming the new market. With this in mind, Synergy requests the ERA considers whether AEMO's proposal takes account of the economies of scale and scope that would be expected with AEMO operating common markets in the NEM and WEM.

Moreover, Synergy suggests the ERA considers whether AEMO's shared costs, such as IT costs are arrived at on a reasonable, justified and consistent basis.

Depreciation and amortisation

Synergy notes almost half of the increase in allowable revenue is due to capital projects from the AR5 period. Synergy considers these projects as critical to deliver the reforms necessary for the WA energy industry. However, Synergy highlights the impact on market fees is significant (with a ~60% uplift). Synergy recommends the ERA considers whether there are any alternatives that smooth the impact profile of this and any future major periods of reform.

For example, Synergy considers there could be scope to extend the economic life of IT assets beyond five years. Both the WEM and NEM dispatch engines for example have had useful lives of over ten years. The extension of the economic lives of these systems would smooth the impact of depreciation and amortisation over three allowable revenue periods, and improve 'beneficiary pays' outcomes of the new market arrangements.

Synergy recommends the ERA considers alternative options to achieve this more equitable cost recovery approach, including but not limited to:

- extending regulatory asset lives commensurate with actual asset lives; and
- an alternative depreciation methodology such as an annuity approach.

Synergy considers this would be in the long term interests of consumers and better address the market objectives.

Market fees

AEMO's proposal will result in significantly increased WEM fees. The overall cost and fee impact associated with implementing the new market arrangements makes it absolutely paramount to ensure those market participants who will ultimately benefit from the new regime equitably pay. Synergy recommends the ERA considers the impact of each element of AEMO's proposal on the overall transition path for WEM fees, and consider future allowable revenue periods to ensure there is no inter-generational wealth transfer.

Synergy expects the ERA will provide significant top-down scrutiny of AEMO's proposal to ensure only those projects that can be considered prudent, and only those costs that can be considered efficient are approved, in line with the requirements of the WEM Rules. However, Synergy also expects the ERA and Coordinator of Energy to provide fee estimates that reflect the individual cost of operations for both entities. This should ensure the transfer of rule development functions from the ERA to the Coordinator of Energy does not increase the overall WEM fees.

Synergy appreciates part of ETS Stage 2 includes a review of the market fee allocation method, and commends EPWA for seeking to improve both the equitability and price incentives related to those fees. Synergy considers it important to ensure those benefitting from the market appropriately contribute to its ongoing operation, maintenance and development.

Synergy confirms that this submission can be made public. Should you require further information regarding any of the comments made in this submission, please contact me.

Yours sincerely

[redacted]

SIMON THACKRAY
MANAGER REGULATION AND COMPLIANCE