alintaenergy

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Economic Regulation Authority
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ALLOWABLE REVENUE AND FORECAST CAPITAL EXPENDITURE 2022-23 TO 2024-25

Alinta Energy has very strong objections to AEMO's proposal, which calls for a 60% ($57 million) increase in AEMO's allowable revenue to a total of $156.2 million and seeks $69.4 million in capex which will need to be recovered over multiple revenue periods, per the 8 significant issues outlined in this submission.

Key drivers of the proposed allowable revenue increase include a 50% ($24.5 million) increase in labour costs, and a 116% ($27.3 million) increase in depreciation, to recover AEMO's proposed capex.

While AEMO attributes a significant portion of this capex ($44.6 million) and increased allowable labour costs (15.4 FTEs) to WEM reform, it claims that it requires $15.4 million capex[1], and an additional 16 FTEs to continue business-as-usual functions.

AEMO is also seeking $9.4 million in capex for DER-related activities, separate from WEM reform.

Overall, Alinta Energy is concerned that AEMO has not substantiated why its call for significantly more revenue and capex is necessary to performing its functions at lowest practicably sustainable cost, per 2.22A.5 of the WEM Rules. If approved, Alinta Energy considers that AEMO's proposal risks:

- Negating the benefits of WEM reform.
- Locking cost increases to customers over the long term without providing commensurate benefits.
- Setting a precedent that will allow AEMO to increase customer costs significantly without the appropriate rationale in future periods.
- Imposing unreasonable costs increases on Market Generators that cannot be recovered in offers.

Alinta Energy's perceived issues in AEMO's AR6 proposal

1. Capex and increased labour costs for WEM reform are not substantiated and may negate the benefits

AEMO is seeking $44.6 million capex and 15.4 FTEs to continue to implement and operationalise

[1] $15.4m for "other capital projects"

WEM reform, bringing it to a total cost of $91.2 million, and increasing the initial estimate for WEM reform by 50%.

Alinta Energy considers that AEMO's proposal does not adequately justify why such a significant investment is required to complete the WEM reforms, nor why AEMO's proposal represents the lowest sustainable cost of implementation.

Alinta Energy also questions how AEMO underestimated the initial costs so dramatically. AEMO states that the 50% revision was due to "more complete scope and information". However, at the time AEMO submitted its AR5 proposal in June 2019, most of the information papers summarising the new market's design had been released; and earlier versions of the reforms had been in train for about two years prior via the *Energy Sector Reforms* in which AEMO was closely involved. Alinta Energy considers that AEMO's earlier estimates would have factored into the decisions to pursue WEM reform and suggests that the reforms would have been significantly re-shaped, if not deferred, had AEMO appraised its costs at ~$90 million from the outset.

Further, Alinta Energy considers that such an increase indicates that AEMO is commissioning new systems and hiring new personnel, rather than leveraging expertise and systems from its NEM operations.

Additionally, Alinta Energy notes that such investments appear disproportionate to the size of the markets they would create and would therefore outweigh the benefits of WEM reform. For example, the key purpose of WEM reform is to create new markets for essential system services, namely Contingency Reserve Raise and Lower – the equivalent to Spinning and Load Rejection Reserve under the current WEM. However, at $91.2m, the amount market participants would pay for the new market would be many times the current cost of these services at ~$15.2 million p.a.[2]

Finally, Alinta Energy notes that AEMO's proposed expenditure on WEM reform would be significantly higher than the major reforms of the past. The IMO spent $10.55 million to implement the Market Evolution Program (MEP) which included the Balancing Market and LFAS markets, and $13.352 million was spent to establish System Management's IT system, SMARTS. This compared to benefits estimated at $7.8 million and $9.6 million per annum.[3]

Alinta Energy doubts whether the new ESS markets can deliver similar ratios of costs to benefits, if AEMO spends many multiples of their current annual value to establish them.

2. Increased costs of BAU activities are not substantiated

AEMO claims that it requires $15.4 million capex, 16 more FTEs and an additional $2.8 million IT costs to continue business-as-usual functions over the AR6 period.

Alinta Energy considers that AEMO's proposal does not substantiate why this significant investment is necessary.

Overall, AEMO states that the FTEs are required to:

- perform "new processes and increased power system modelling required to changing generation mix issues";
- "support functions associated with growth in systems"; and
- support "ongoing market development"

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[2] Ancillary Services Report for the WEM 2021

[3] 2013 Wholesale Electricity Market Report to the Minister for Energy p.28

AEMO states that the $15.4 million capex is required for "lifecycle replacement" of IT systems.

Alinta Energy considers that this rationale is inadequate as AEMO does not state what risks that the additional capex, new "power system modelling" and "growth in systems" would help avoid, nor what benefits they would provide. Alinta Energy suggests that no shareholder or board would sanction such a significant increase in funding based on such a vague business case, and that customers should not be asked to do so either.

Alinta Energy is also concerned about how AEMO estimated its FTE requirement as it involved asking managers for estimates.[4] Alinta Energy considers that managers may have a perverse incentive to overstate their requirements and grow their teams, and limited incentive to minimise their costs.

Additionally, Alinta Energy agrees with the ERA, that increased investment in systems should serve to allay or reduce the need for FTEs. However, AEMO appears to propose the opposite: additional capex to replace systems, and additional FTEs to "support functions associated with growth in systems". This is reiterated in AEMO's *Western Australian labour supporting document* which outlines that the additional personnel is required to manage new settlement and market operations systems.[5] Alinta Energy questions whether AEMO's investment in systems is efficient if it requires significant increases in personnel.

Finally, Alinta Energy considers that AEMO's proposal to increase its FTE count to support market development may be unnecessary noting that AEMO's responsibilities in this regard have not changed since the last period. Alinta Energy would have expected that these functions could be performed by staff no longer required to perform the market development aspects of WEM reform, as this phase of the project concludes.

3. Costs per FTE exceed market rates

AEMO's proposal states that $24.5 million additional spending on labour is required to support 31.4 FTEs.

Alinta Energy considers that this indicates AEMO is paying significantly above market rate for FTEs, at ~$260,000 per employee, per annum.

Given this cost per employee, Alinta Energy strongly questions how AEMO has estimated these additional labour costs and whether it has benchmarked the costs of these new positions.

4. Depreciation appears to be applied over an unreasonably short period

Alinta Energy considers that it is difficult to discern whether AEMO is recovering its capex via depreciation consistently with "acceptable accounting principles" per 2.22A.5 of the WEM Rules because the proposal does not outline what assets will be depreciated, and over what useful life – only the total depreciation per annum.

However, based on the shape of depreciation over AR5, and the proposed depreciation over AR6, it appears AEMO is depreciating most of the value of its assets over an unreasonably short period.

For example, most of the capex from AA5 is depreciated within 5 years, with only $3.8 million remaining of the $61.8 million AR5 capex in 2025, three years after the AR5 period. Additionally, that AEMO plans to depreciate $31.8 million of the $69.4 million requested capex during AR6

[4] Western Australian labour supporting document p.5.

[5] This paper also states that 4 new FTEs are required in the capacity team, for functions that only performed annually, at certain times of the year.

indicates a similarly short useful life.

Given this, Alinta Energy recommends that the ERA verify that AEMO is depreciating the assets funded with capex over a reasonable period.

If the depreciation period is unreasonably short, Alinta Energy would suggest that this undermines the case for investment as it implies a very short useful period. It would also be inconsistent with "acceptable accounting principles" per 2.22A.5.

5. $9.4m on DER activities is disproportionate to the potential benefits and any benefits will be limited to Synergy, undermining competition

Alinta Energy considers that AEMO's proposal to spend $9.4 milliom for DER projects, and largely on "Project Symphony" would be inconsistent with 2.22A.5 and the WEM objectives because these costs are unlikely to be offset by commensurate benefits and would exacerbate current cross subsidies, undermining efficiency and resulting in net costs to consumers.

Given that rooftop solar PV owners are already heavily subsidised (via non-cost-reflective network tariffs, buyback schemes, and franchise variable tariff rates), Alinta Energy questions whether they will have an incentive to participate in the market and offer services, unless they are given further cross-subsidies.

Additionally, Alinta Energy considers that any benefits of Project Symphony would be limited to Synergy, noting that most DER owners are Synergy franchise customers, and that other WEM participants are not involved in Project Symphony. Alinta Energy suggests that AEMO's proposal to invest heavily in this project therefore undermines the WEM objective to promote competition.

6. $3.6m of DER costs would be unrelated to the DER Roadmap and AEMO's functions

The Issues Paper states that "more than a third ($3.6 million) of AEMO's cost estimate to fund its DER capital expenditure program ($9.4 million) is not directly related to AEMO's obligations arising from the DER roadmap." Rather they are "driven by market need".

Given this, Alinta Energy contests whether this spending is necessary to AEMO's functions under the WEM Rules.

Alinta Energy also doubts whether this investment would be prudent, efficient and reduce costs to customers over longer term per 2.22A.5 because:

- AEMO does not attempt to forecast any quantitative benefits of this capex.
- AEMO's AR6 proposal indicates that investment in systems and new functionality tends to 'snowball' and result in AEMO requesting increased revenue in future periods to replace or upgrade systems and hire FTEs to support them.
- These costs would be paid by all customers, even though rooftop solar PV owners cause the current issues faced.

7. Proposed contingency may be misallocated again

AEMO proposes contingency of $11.4 million for AR6 considering that this would avoid it "making substantially costly in-period adjustments to the forecast, through in-period submissions".

While Alinta Energy perceives the potential value in AEMO's logic to minimise the regulatory burden, the ERA's findings indicate that AEMO may not use the contingency for this intended purpose; and may spend it regardless of whether it is required.

The ERA found that:

- typically, AEMO's spend falls below its estimates; and
- the approved project contingency for AR5 was used against projects other than what it was approved for.[6]

Given these findings, and that the ERA have no oversight over how contingency is spent once approved, Alinta Energy cannot support allowing AEMO another contingency. Instead, Alinta Energy recommends that AEMO be required to make an in-period submission should it consider it requires additional revenue per 2.22.5A.

8. Borrowing costs are unclear

Alinta Energy considers that AEMO's proposal does not provide adequate information on its borrowing costs.

It is not possible to discern whether AEMO;
- is borrowing at reasonable costs
- is managing its debt levels prudently
- will have increases in borrowings in the future
- has over-recovered its borrowing costs in the past, noting that the absence of borrowing costs previously indicates that AEMO had sufficient cash to cover its previous capex spending and would not require further depreciation of AR5 capex in the current period.

Conclusion

Alinta Energy perceives numerous issues in AEMO's AR6 proposal. If these issues outlined above are not addressed, Alinta Energy has material concerns that AEMO's AR6 proposal would:

- overstate the revenue AEMO required to perform its functions at the lowest sustainable costs;
- negate the benefits of WEM reform; and
- significantly inflate the costs to customers over the long term.

Thank you for your consideration of Alinta Energy's submission.

Yours sincerely

[redacted]

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[6] Australian Energy Market Operator's allowable revenue and forecast capital expenditure proposal for the period 1 July 2022 to 30 June 2025 Issues paper p22