

Allowable Revenue Determination – System Management

30 March 2007

Economic Regulation Authority

 WESTERN AUSTRALIA

A full copy of this document is available from the Economic Regulation Authority web site at www.era.wa.gov.au.

For further information, contact:

Mr Ignatius Chin
Assistant Director, Electricity Market Surveillance
Economic Regulation Authority
Perth, Western Australia
Phone: (08) 9213 1900

© Economic Regulation Authority 2007

The copying of this document in whole or part for non-commercial purposes is permitted provided that appropriate acknowledgment is made of the Economic Regulation Authority and the State of Western Australia. Any other copying of this document is not permitted without the express written consent of the Authority.

Contents

| | |
|-----------------------------------------------|-----------|
| List of Tables | ii |
| Determination | 3 |
| Reasons for the Determination | 4 |
| Legislative Requirements | 6 |
| Public Submissions | 10 |
| Authority's Assessment | 11 |
| System Operating Services | 11 |
| Benchmarking | 14 |
| Ancillary Services | 15 |
| Determination of Margin_Peak, Margin_Off-Peak | 15 |
| Determination of Cost_LRD | 16 |
| Response to Public Submissions | 17 |

List of Tables

| | | |
|---------|--------------------------------------------------------------------------------|----|
| Table 1 | System Management – Allowable Revenue (System Operating Services) | 3 |
| Table 2 | System Management - Allowable Revenue (Ancillary Services) | 3 |
| Table 3 | System Management - Margin_Peak, Margin_Off-Peak and Cost_LRD parameter values | 4 |
| Table 4 | System Management – Allowable Revenue Request | 4 |
| Table 5 | System Management – Expenditure Statement | 4 |
| Table 6 | System Management - Ancillary Service Costs | 5 |
| Table 7 | System Management – Market Establishment Costs (Proposed Recovery) | 11 |
| Table 8 | System Management – Market Establishment Costs (Allowable Recovery) | 12 |

Determination

1. On 30 November 2006, System Management (a segregated unit of Western Power) submitted its proposed forecast expenditure for the period 2007/08 – 2009/10 (**Review Period**) for which System Management seeks to recover revenue.
2. In assessing the Allowable Revenue for System Management, the Economic Regulation Authority (**Authority**) has considered the proposed forecast expenditure submitted by System Management, comments made in submissions to the Authority by interested parties and the work of a consultant (Stamfords Advisors and Consultants) engaged to advise on the application.
3. In undertaking its assessment, the Authority has taken into account the matters set out in section 2.22.12 of the Wholesale Electricity Market Amending Rules (December 2006) (**Market Rules**).
4. The Authority has determined the revenue that can be recovered from Market Participants for the conduct of System Management services (**Allowable Revenue**) for the Review Period as that shown in Table 1 and Table 2 below.

Table 1 System Management – Allowable Revenue (System Operating Services)

| Revenue | 2007/08 | 2008/09 | 2009/10 |
|--------------------------|--------------------|--------------------|--------------------|
| Allowable Revenue | \$4,392,000 | \$4,811,000 | \$5,212,000 |

5. In determining the allowable revenue of Ancillary Service provision, the Authority was also required to take into account the payment structure set out in clause 3.13 of the Market Rules (as shown on Table 2). The Authority has determined that the Ancillary Services Allowable revenue is nil for all financial years during the Review Period as System Management does not receive revenue from the provision of Ancillary Services (see paragraph 79 and following below).

Table 2 System Management - Allowable Revenue (Ancillary Services)

| Ancillary Services | 2007/08 | 2008/09 | 2009/10 |
|---------------------------|------------|------------|------------|
| Load Following | \$0 | \$0 | \$0 |
| Spinning Reserve | \$0 | \$0 | \$0 |
| Load Rejection | \$0 | \$0 | \$0 |
| Dispatch Support | \$0 | \$0 | \$0 |
| System Restart | \$0 | \$0 | \$0 |
| Ancillary Services | \$0 | \$0 | \$0 |

6. The Authority is also required to determine values for the reserve availability margin applying for Peak Trading Intervals (Margin_Peak), the Reserve availability payment margin applying for Off-Peak Trading Intervals (Margin_Off-Peak) and an amount to cover the costs for providing the Load Rejection Reserve, System

Restart and Dispatch Support Ancillary Services (Cost_LRD). The Authority has determined these values as shown in Table 3 below.

Table 3 System Management - Margin_Peak, Margin_Off-Peak and Cost_LRD parameter values

| Variable | 2007/08 | 2008/09 | 2009/10 |
|-------------------------------|----------|----------|----------|
| Margin_Peak – lower bound | 15% | 15% | 15% |
| Margin_Off-Peak – lower bound | 12% | 12% | 12% |
| Cost_LRD | \$20,833 | \$20,833 | \$20,833 |

Reasons for the Determination

Summary of Application

- System Management's Allowable Revenue application, received 30 November 2006, provides details of the forecast expenditure for the Review Period, for which System Management seeks to recover revenue.
- System Management proposed the Allowable Revenue set out in Table 4 below relating to system operating services.

Table 4 System Management – Allowable Revenue Request

| Amount | 2007/08 | 2008/09 | 2009/10 |
|-------------------|-------------|-------------|-------------|
| Allowable Revenue | \$5,292,000 | \$5,711,000 | \$5,112,000 |

Source: System Management application (30 November 2006), page 4

- In support of its Allowable Revenue application, System Management supplied a proposed expenditure statement for the period, set out in Table 5 below.

Table 5 System Management – Expenditure Statement

| Expenditure | 2007/08 | 2008/09 | 2009/10 |
|--------------------------|--------------------|--------------------|--------------------|
| Labour costs | \$2,890,000 | \$3,063,000 | \$3,247,000 |
| Functional costs | \$350,000 | \$300,000 | \$320,000 |
| Legal costs | \$300,000 | \$330,000 | \$363,000 |
| Self-insurance costs | \$500,000 | \$500,000 | \$500,000 |
| IT costs | \$1,252,000 | \$1,518,000 | \$682,000 |
| Total Expenditure | \$5,292,000 | \$5,711,000 | \$5,112,000 |

Source: System Management application (30 November 2006), page 4

10. System Management also proposed the Allowable Revenue set out in Table 6 below relating to Ancillary Services.

Table 6 System Management - Ancillary Service Costs

| Ancillary Services | 2007/08 | 2008/09 | 2009/10 |
|---------------------------|---------------------|---------------------|---------------------|
| Load Following | \$4,992,000 | \$5,192,000 | \$5,400,000 |
| Spinning Reserve | \$13,000,000 | \$13,520,000 | \$14,061,000 |
| Load Rejection | - | - | - |
| Dispatch Support | - | - | - |
| System Restart | \$250,000 | \$250,000 | \$250,000 |
| Ancillary Services | \$18,242,000 | \$18,962,000 | \$19,711,000 |

Source: System Management application (30 November 2006), page 19

11. System Management separated out the costs associated with the provision of Ancillary Services into five core functions:
- Load Following;
 - Spinning Reserve;
 - Load Rejection;
 - Dispatch Support; and
 - System Restart.
12. In forecasting the budget for each function, System Management used the 2006/07 costs, approved by the Minister for Energy, as a base-line for 2007/08 and then escalated by 4 per cent each year for the period of the review (2008/09 and 2009/10). The approved 2006/07 costs were derived from the report, 'Spinning Reserve Revenue and Cost Streams' prepared by McLennan Magasanik Associates (**MMA**) for the Office of Energy in 2005.
13. Pursuant to clause 2.23.12(a) of the Market Rules, the Allowable Revenue for services (both system operating services and Ancillary Services) must be sufficient to cover the forward looking costs of providing market functions.

Legislative Requirements

Disaggregation of the Western Australian Electricity Industry

14. The operation and regulation of the Western Australian electricity industry is governed by the *Electricity Industry Act 2004 (Act)*.
15. Pursuant to section 122(1) of the Act, the *Electricity Industry (Wholesale Electricity Market) Regulations 2004 (Regulations)* provide for the establishment of a wholesale electricity market (**Market**) in relation to the wholesale supply of electricity in the South West Interconnected System (**SWIS**).
16. Regulation 5 of the Regulations provides for the establishment of the Market Rules, relating to the Market and to the operation of the SWIS.
17. The Market commenced on 21 September 2006, pursuant to regulation 6(3) of Regulations and clause 1.8.2 of the Market Rules.
18. The objectives of the Market, as stated in clause 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 SWIS;
 - b) to encourage competition among generators and retailers in the SWIS, including by facilitating efficient entry of new competitors;
 - c) to avoid discrimination in the 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 SWIS; and
 - e) to encourage the taking of measures to manage the amount of electricity used and when it is used.

Establishment and Functions of System Management

19. The Regulations provide for the Market Rules to confer on an entity the function of operating the SWIS in a secure and reliable manner (regulation 13(1)).
20. The Market Rules confer this function on the Electricity Networks Corporation trading as Western Power, acting through the segregated business unit known as System Management (clause 2.2.1).
21. Clause 2.2.2 of the Market Rules sets out System Management's other functions in relation to the Market, as follows:
 - a) to procure adequate Ancillary Services where the Electricity Generation Corporation cannot meet the Ancillary Service Requirements;
 - b) to assist the IMO in the processing of applications for participation and for the registration, deregistration and transfer of facilities;

- c) to develop Market Procedures, and amendments and replacements for them, where required by these Market Rules;
- d) to release information required to be released by these Market Rules;
- e) to monitor Rule Participants' compliance with Market Rules relating to dispatch and Power System Security and Power System Reliability; and
- f) to carry out any other functions or responsibilities conferred, and perform any obligations imposed, on it under these Market Rules.

Allowable Revenue

22. In accordance with clause 2.23.3 of the Market Rules, System Management must seek the approval from the Authority of its Allowable Revenue for the Review Period for the services set out in clause 2.23.1, namely:
- a) system operation services, including all of System Management's functions and obligations under these Market Rules except the provision of Ancillary Services; and
 - b) System Management's functions and obligations under these Market Rules in relation to the provision of Ancillary Services (clause 2.23.1).
23. Clause 2.23.12 prescribes the matters that the Authority must take into account when determining the Allowable Revenue. First, clause 2.23.12(a) of the Market Rules states that the Allowable Revenue must be sufficient to cover the forward looking costs of providing System Management's services and performing its functions and obligations under the Market Rules in accordance with the following principles:
- i. recurring expenditure requirements and payments are recovered in the year of the expenditure;
 - ii. capital expenditures are to be recovered through the depreciation and amortisation of the assets acquired by the capital expenditure in a manner that is consistent with generally accepted accounting principles;
 - iii. costs incurred by System Management that are related to market establishment, as designated by the Minister, are to be recovered over a period determined by the Minister from Energy Market Commencement; and
 - iv. notwithstanding paragraphs (i), (ii) and (iii), expenditure incurred, and depreciation and amortisation charged, in relation to any Declared Market Project are to be recovered over the period determined for that Declared Market Project.
24. In making this determination the Authority has considered each of the above items (i. to iv.) separately.
25. Second, clause 2.23.12(b) of the Market Rules states that:
- “the Allowable Revenue must include only costs which would be incurred by a prudent provider of the services described [above] ..., acting efficiently, in accordance with good electricity industry practice, seeking to achieve the lowest practicably sustainable cost of delivering the services described [above] in

accordance with these Market Rules, while effectively promoting the Wholesale Market Objectives.”

26. The Authority considers the above requirement to be a high threshold for cost-efficient service delivery in the performance of System Management’s prescribed services and functions. This threshold, and in particular the requirement that the Allowable Revenue only include costs incurred by a provider “seeking to achieve the lowest practicably sustainable cost of delivering the services”, forms the basis for this analysis and the Allowable Revenue determination.
27. Third, clause 2.23.12(c) of the Market Rules requires that:

“...where possible, the Economic Regulation Authority should benchmark the Allowable Revenue against the costs of providing similar services in other jurisdictions.”
28. Finally, in determining the allowable revenue of Ancillary Services clause 2.23.12(d) requires the Authority to consider the payment structure set out in clause 3.13 of the Market Rules, which defines the provision of Ancillary Services as:
 - a) Load Following Services, comprising of a capacity payment (the capacity necessary to cover the Ancillary Services Requirement for Load in that month) and an availability payment (as defined under clause 9.9.2(d));
 - b) the amount $Availability_Cost_R(m)$ for Spinning Reserve for each trading month defined under clause 9.9.2 (c); and
 - c) $Cost_LRD$, the monthly amount for Load Rejection Reserve, System Restart and Dispatch Support Services.
29. Clause 2.23.12(d) further requires that the parameters $Margin_Peak$ (m) and $Margin_Off-peak$ (m) and $Cost_LRD$ be calculated as part of the Authority’s determination in respect of Ancillary Services.
30. The Authority notes the difficulties associated with the forecasting of costs, and hence Allowable Revenue, in the Review Period, given the limited historical cost information available due to the recent commencement of the Market. Such issues have been considered in the determination of Allowable Revenue. It is evident that the second review period will provide an opportunity for comparison with the first three years of Market operation and, accordingly, an enhanced capacity to assess the efficiency of System Management’s service provision.

Determination Process

31. The determination process is set out in clause 2.23.3 of the Market Rules, as follows:
 - a) System Management must submit a proposal for its Allowable Revenue for the period 2007/08 to 2009/10 by 30 November 2006;
 - b) the Authority must undertake a public consultation process in approving the Allowable Revenue for System Management for the Review Period, which must include publishing an issues paper and issuing an invitation for public submissions; and

- c) the Authority must determine the Allowable Revenue of System Management for the Review Period, for each of the services described in clause 2.23.1 of the Market Rules, by 31 March 2007.
- 32. System Management submitted its proposal for Allowable Revenue on 30 November 2006.
- 33. The Authority undertook a public consultation process as required, including publishing an issues paper and issuing an invitation for public submissions on 21 December 2006.
- 34. The Authority engaged consultants to provide advice on System Management's application and its compliance and conformance with the relevant provisions in the Market Rules.
- 35. The consultants also provided advice with respect to the efficiency of System Management as compared to other like organisations via a benchmarking process.
- 36. The Authority makes this determination pursuant to, and in satisfaction of, the requirement for the Authority to determine the Allowable Revenue of System Management for the Review Period, as stated in clause 2.23.3(c) of the Market Rules reproduced in paragraph 31 above.

Public Submissions

37. In accordance with clause 2.23.3(b), the Authority undertook a public consultation process as required, including publishing an issues paper on 21 December 2007 and issuing an invitation for public submissions.
38. Public submissions in respect of the determination of System Management's Allowable Revenue were received from:
 - a) Alinta Sales Pty Ltd (**Alinta**); and
 - b) the Electricity Retail Corporation trading as Synergy (**Synergy**).
39. Alinta's submission identified the following issues for the Authority's consideration with respect to System Management's application for system operating services revenue:
 - a) Alinta noted the increased forecast employment cost escalation applied to System Management's application (6 per cent annual growth) as opposed to the IMO's application (4 per cent annual growth). Alinta suggested a similar growth be expected for both System Management and the IMO.
 - b) Alinta suggested the annual escalation in legal costs, of 10 per cent, is excessive in respect of CPI movement.
 - c) Alinta queried the nature of the self-insurance costs included in System Management's application.
 - d) Alinta recommended that the Authority consider an economic incentive scheme for System Management to promote operational efficiency.
40. Alinta's submission also questioned the assumption of 4 per cent annual escalation of 2006/07 Ancillary Services costs approved by the Minister, in System Management's application (31 January 2007). In particular, Alinta queried whether the 4 per cent is linked to a CPI forecast or is driven by other factors.
41. Synergy's submission noted the risks and uncertainty associated with the first Review Period but raised no specific issues for consideration by the Authority.
42. The issues identified in the above public submissions have been considered in this decision.

Authority's Assessment

43. The Authority had regard to the report prepared by the consultant, Stamfords Advisors and Consultants, that reviewed System Management's application and conducted an extensive analysis of the information provided.
44. The full consultant's recommendations can be found in Stamford's report entitled 'Assessment of Allowable Revenue – System Management' and is available on the Authority's [web site](#).
45. The Authority also had regard to issues raised in public submissions and the matters specified in the Market Rules.
46. The Authority's reasoning focuses on those aspects of System Management's application where the approach taken is considered to be inconsistent with the requirements of the Market Rules. Each of these matters is addressed below.

System Operating Services

Market Establishment Recovery

47. System Management's application states that it incurred costs of \$2.5 million related to market establishment ('Phase 1 capital recovery').
48. System Management stated that in 2006/07, a depreciation expense of \$500,000 was incurred in relation to Phase 1 capital recovery. System Management's proposed recovery of the remaining establishment costs (\$2,000,000), as contained in its application, are set out in Table 7 below.

Table 7 System Management – Market Establishment Costs (Proposed Recovery)

| Expenditure | 2007/08 | 2008/09 | 2009/10 |
|--------------------------|-------------|-------------|---------|
| Phase 1 capital recovery | \$1,000,000 | \$1,000,000 | - |

Source: System Management application (30 November 2006), page 12

49. In approving System Management's 2006/07 budget, the Minister for Energy, consistent with clause 2.23.12(a)(iii), approved the \$2.5 million Phase 1 costs as costs related to market establishment and determined that they be recovered over a period of five years.
50. Notwithstanding the determination by the Minister pursuant to clause 2.23.12(a)(iii), System Management now seeks to recover such costs over a 2.5 year period. System Management's application states that this is consistent with clause 2.23.12(a)(ii), which states that capital expenditure is to be recovered through depreciation and amortisation in a manner consistent with generally accepted accounting principles.

51. While clause 2.23.12(a)(ii) makes provision for capital expenditure to be recovered through depreciation and amortisation in a manner consistent with generally accepted accounting principles, this clause does not provide for System Management to deviate from a Ministerial decision on this aspect of expenditure. Nor for the Authority to review or amend previous decisions of the Minister. Pursuant to clause 2.23.12(a)(iii), the expenditure in question has been determined by the Minister to be recovered over a 5 year period.
52. In accordance with the Minister's determination, Stamfords recommended that the market establishment costs to be recovered over the Review Period be as set out in Table 8 below.

Table 8 System Management – Market Establishment Costs (Allowable Recovery)

| Expenditure | 2007/08 | 2008/09 | 2009/10 |
|--------------------------|-----------|-----------|-----------|
| Phase 1 capital recovery | \$500,000 | \$500,000 | \$500,000 |

53. The Authority agrees that these costs have been designated as market establishment costs by the Minister, who has also determined that such costs are to be recovered over a 5 year period. Accordingly, the Authority accepts the consultant's recommendation that the recovery of market establishment costs be decreased from \$1.0 million in 2007/08 and 2008/09 to \$0.5 million in each of 2007/08, 2008/09 and 2009/10. This change will be reflected in the allowable revenue proposed by System Management for its System Operating Services.

Provisional Estimates

54. System Management has made provision for, and sought to recover a number of items that are regarded as estimated expenditure for items that are not currently being incurred or incurred to the same extent forecast.
55. The provision for such expenditure items was considered by Stamfords to be appropriate as it allows the organisation to provide for its market functions.
56. It is anticipated that if actual expenditure on these items does not equal the amount forecast, or they do not recur, an impact on Allowable Revenue should be evidenced.
57. The Minister is required to approve the relevant budget for the System Management in accordance with clause 2.23.9 of the Market Rules.
58. Therefore, if the Minister approves a budget for System Management that includes expenditure being less than the Allowable Revenue determined by the Authority, a surplus will occur for the relevant year.
59. Clause 2.23.7 of the Market Rules states that any underspending from Allowable Revenue will be carried over and an equivalent reduction in Allowable Revenue for the following year will occur.
60. On this basis, Stamfords has recommended that the Authority should, as part of its determination, recommend that an assessment be made of the utilisation of the estimated expenditure amounts when the Minister (with the advice from the IMO)

considers the approval of the 2008/09 and 2009/10 budgets for System Management. If the analysis determines that the estimated amounts are not being fully utilised, the Minister should consider whether the total budget should be reduced by the provisional amounts not utilised. This would then make a corresponding adjustment to the Allowable Revenue in accordance with clause 2.23.7.

61. This recommendation by the consultant is due to the newness of the operating environment and the lack of historic information available to enable a better assessment of likely expenditure. Future determinations will have the benefit of historic financial performance that can be taken into account in the assessment of such costs.
62. The Authority notes that the inclusion of provisional estimates in allowable revenue is not necessarily inappropriate given the newness of the market.
63. The Authority notes that it is not empowered by the Market Rules to place conditions on its approval of Allowable Revenue. However, the Authority recommends that, as part of his role in approving the yearly budgets derived from approved Allowable Revenue, the Minister scrutinise such expenditure to ensure that actual expenditure on these items is prudent and, if the estimated amounts are not being utilised, that the total System Management budget be reduced by the amounts not utilised, and the Allowable Revenue be adjusted accordingly in accordance with clause 2.23.7 of the Market Rules.

Self-Insurance Costs

64. System Management provided in its application for Allowable Revenue a provision for self-insurance of \$500,000 per annum.
65. As part of Western Power, System Management advised in documentation provided to the consultant on 15 March 2007, that:
 - a) Western Power networks business is currently reviewing its risk profile to ensure that any new risks introduced with disaggregation and the commencement of the market are identified and assessed.
 - b) Western Power plans to determine whether any new risks require insurance coverage and whether these risks can be covered by the expansion of an existing policy or will require a new, separate policy.
 - c) Western Power is assessing the cost/benefit of insuring new risks and is endeavouring to determine whether self-insurance is a more cost effective approach with catastrophic cover for significant unforeseen events.
66. System Management is subject to a prescribed civil monetary liability maximum for claims associated with acts or omission as defined in Regulation 52(2) of the *Electricity Industry (Wholesale Electricity Market Regulations) 2004*. The prescribed maximum is capped at \$100,000 per instance and \$10 million for every 12 month period.
67. Stamfords recommended that the selection of an amount for self-insurance is an arbitrary figure and recommends that System Management engage consultants to conduct an actuarial review of the potential loss and then consider the appropriateness of self-insurance versus third party insurance.

68. The Authority concurs with the approach of System Management in attempting to seek an appropriate insurance premium for the exposure.
69. The Authority notes Stamford's assessment and has determined that Allowable Revenue for System Operating Services should be decreased in respect to self-insurance costs by \$400,000 for each year of the Review Period.
70. The Authority's analysis has concluded that \$100,000 per annum is an adequate self-insurance provision. This amount is based on the following considerations:
 - a) an analysis of the legal exposure and claims faced by NEMMCO as stated in its Annual Report for the years ended 30 June 2004, 30 June 2005 and 30 June 2006;
 - b) System Management's experience thus far in operation of the Market, noting, that in six months of operation there have been no claims; and
 - c) the uncertain nature of such provisions, particularly in the first Review Period, and the complexities of obtaining insurance for such activities.
71. The Authority considers that if legal claims contribute to the Allowable Revenue being less than actual expenditure, the excess costs will be able to be considered as an adjustment to the pre-existing Allowable Revenue determination for the following year in accordance with clause 2.23.7 of the Market Rules.
72. The Authority does not support Stamford's recommendation that an actuarial review be conducted. In the Authority's view, it is unnecessary. Further, in subsequent review periods, with the benefit of historical data, the appropriate cost of insurance should be readily ascertainable.

Benchmarking

73. A benchmarking analysis was undertaken by the consultant, which involved identifying entities that exist in other jurisdictions performing similar services to System Management, as identified in clause 2.23.1 of the Market Rules.
74. Under clause 2.23.12(c) of the Market Rules, the Authority is required to benchmark System Management's Allowable Revenue, where possible, against the costs of providing similar services in other jurisdictions.
75. The organisations and their jurisdictions utilised in the benchmarking analysis were:
 - a) National Electricity Market Management Company (**NEMMCO**) (Australia);
 - b) Power System Operator (**PSO**) (Singapore); and
 - c) Independent Electricity System Operator Canada (**IESO**) (Canada).
76. Through the benchmarking process, it is evident that no other market is identical to the Western Australian Market. It is therefore extremely difficult to draw accurate comparisons between the Market and other jurisdictions. However, the analysis provided an understanding of the comparable services offered in other jurisdictions and a measure as to the efficiency of the services provided by System Management under the Market Rules.

77. The results of the consultant's analysis determined that the cost of providing like services in other jurisdictions were not materially different from System Management's cost structure in support of its Allowable Revenue application.
78. The Authority agrees, that subject to the reservations relating to some specific areas assessed in the determination, the benchmarking assessment by Stamfords suggests that, broadly speaking, the cost of providing like services in other jurisdictions is not materially different to those proposed by System Management.

Ancillary Services

Ancillary Services Allowable Revenue

79. System Management's application states that the Ancillary Service Allowable Revenue which is sought to be recovered for Load Following, Spinning Reserve and System Restart services, is based on modelling provided in a report prepared by McLennan Magasanik Associates for the Office of Energy in 2005 ('Spinning Reserve Revenue and Cost Streams') (**MMA Report**).
80. The Authority notes that:
 - a) settlement mechanisms exist in the Market Rules, in clauses 3.13, 3.14, 3.22 and 9.9, for payments and recovery of Ancillary Services costs in the Wholesale Electricity Market; and
 - b) the settlement operation of Ancillary Services is performed by the IMO; and
 - c) System Management's involvement in the settlement processes is confined to providing settlement information to the IMO.
81. The Authority therefore notes that System Management does not receive revenue from Ancillary Service payments. That is, System Management neither makes payments nor recovers payments as part of the settlement process for the provision of Ancillary Services. Therefore, System Management is not financially involved in the settlement process of Ancillary Services and accordingly, does not require Allowable Revenue from the provision of Ancillary Services.
82. The Authority is also mindful that to the extent that circumstances change in relation to System Management's obligations with respect to the provision of Ancillary Services, the Market Rules provide a mechanism for the System Management to apply to the Authority to reassess its Allowable Revenue.
83. The Authority therefore determines that the Ancillary Services Allowable Revenue for System Management, pursuant to clause 2.23.1(b) of the Market Rules is nil for each financial year during the Review Period.

Margin_Peak and Margin_Off-Peak

84. System Management has not proposed any values for the parameters Margin_Peak and Margin_Off-Peak.
85. The Authority notes that the current values for Margin_Peak and Margin_Off-Peak, pursuant to clause 3.13.3(a) of the Market Rules, are 15% and 12% respectively.
86. In assessing these values, the Authority has noted that:

- a) it has not received submissions or indications from interested parties of any reason to alter the margins that the Electricity Generation Corporation (**Verve**) could reasonably have been expected to earn on energy sales foregone due to the supply of spinning reserve (clauses 2.23.12(d)(i)(1) and 2.23.12(d)(ii)(1) of the Market Rules);
 - b) the Authority has no evidence that suggests that there have been changes which require revision of the values of loss in efficiency of Verve's Registered Facilities if and when they are scheduled by System Management to provide the spinning reserve (clauses 2.23.12(d)(i)(2) and 2.23.12(d)(ii)(2) of the Market Rules); and
 - c) the current major provider of the ancillary services, Verve, has not indicated to the Authority that the current values of Margin_Peak and Margin_Off-Peak are inadequate.
87. On this basis, the Authority determined that the current values of Margin_Peak and Margin_Off-Peak are adequate and should not be changed.
88. The Authority notes that the Wholesale Electricity Market is relatively new. The Authority is concerned about introducing unnecessary elements of uncertainty and instability before the Market matures. Accordingly, the Authority has reservations about introducing dramatic changes to the Market unless there are compelling reasons to do so. The Authority is not aware of any reasons or basis for introducing changes during this Review Period and has not received submissions informing it of such reasons.

Cost_LRD

89. The Authority notes that System Management has proposed, for all financial years during the Review Period:
- a) the System Restart service cost of \$250,000 per annum;
 - b) the Load Rejection service cost of \$0 per annum; and
 - c) the Dispatch Support Service cost of \$0 per annum.
90. The Authority accepts that these proposed costs are likely to reflect the System Restart, Load Rejection and Dispatch Support services requirements in the Wholesale Electricity Market and they will be settled by the IMO via the market settlement mechanisms provided in the Market Rules.
91. The Authority notes that the above costs may be incurred by market participants but, as discussed in paragraph 81, System Management is not a beneficiary of the payment of these costs.
92. Accordingly, given the proposed costs for System Restart, Load Rejection and Dispatch Support services discussed above, pursuant to clause 2.23.12(d)(iii) of the Market Rules, for the purpose of clause 3.13.1(c) of the Market Rules, the Authority determines that the Cost_LRD for each month during the Review Period to be \$20,833 per month.

Response to Public Submissions

93. The public submissions received made comments in a number of specific areas not elsewhere covered in this determination. Specific concerns raised in the submissions are addressed below. However, the Authority considered all of the submissions received together with the advice of the consultants in making this determination.
94. Alinta noted the increased forecast employment cost escalation applied to System Management's application (6 per cent annual growth) as opposed to the IMO's application (4 per cent annual growth). Alinta suggested that employment cost escalation for System Management and the IMO would be expected to be similar. However, the Authority considers that the proposed employment cost escalation proposed by System Management is consistent with evidence of specific industry cost increases supplied in System Management's application.
95. Alinta suggested that the annual escalation in legal costs, of 10 per cent, is excessive in respect of CPI movement. The Authority considered that the proposed legal cost escalation can be managed under the provisions of clause 2.23.7 of the Market Rules which provides for the carry forward of surpluses and shortfalls on a year to year basis.
96. Alinta recommended that the Authority consider an economic incentive scheme in the Allowable Determination that would provide System Management with a financial incentive for achieving operational efficiencies. However, there is no scope within the Market Rules for the Authority to include a performance based structure in the Allowable Revenue determination.
97. Alinta questioned the assumption of 4 per cent annual escalation of 2006/07 Ancillary Services costs approved by the Minister, in System Management's application (31 January 2007). In particular, Alinta queried whether the 4 per cent is linked to a CPI forecast or is driven by other factors. The Authority considered that this issue is no longer relevant given that the Ancillary Services Allowable Revenues for each financial year within the Review Period are determined to be nil.
98. Alinta submitted that it welcomes an opportunity to comment on any finding that the Authority's consultant presents. However, due to time limitation, the lack of such a provision in the Market Rules and confidentiality issues, the Authority regrets that it has not been able to undertake further consultation.
99. Alinta has submitted to the Authority that System Management costs should not also be recovered as 'network cost' through Western Power's Access Arrangement. The Authority advises that care has been exercised to exclude network cost from being recovered under this determination process.
100. The Authority notes that System Management provided a response to Alinta's submission. The Authority advises that this response has been published on the Authority's [web site](#) and was considered in its Allowable Revenue determination process.