

# Allowable Revenue Determination – Independent Market Operator

31 March 2010

Economic Regulation Authority

 WESTERN AUSTRALIA

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Economic Regulation Authority  
Perth, Western Australia  
Phone: (08) 9213 1900

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## Contents

<b>Determination</b>	<b>1</b>
<b>Reasons for the Determination</b>	<b>1</b>
Legislative Requirements	1
Proposed Allowable Revenue	4
Approach to Assessment	5
Benchmarking	5
Public Submissions	6
Costs of the First Review Period	6
Costs of the Second Review Period	7
Recurrent Costs	7
Capital Costs	11
Interest Income	13

## List of Tables

Table 1	IMO allowable revenue - 2010/11 to 2012/13 (nominal \$'000)	1
Table 2	IMO proposed allowable revenue - 2010/11 to 2012/13 (nominal \$'000)	4
Table 3	IMO actual costs for the first review period (2007/08 to 2009/10) and proposed allowable revenue for the second review period (2010/11 to 2012/13) (nominal \$'000)	4
Table 4	IMO approved and actual expenditure for the first review period – 2007/08 – 2009/10 (nominal \$'000)	7
Table 5	IMO forecast expenditure on supplies and services – 2010/11 to 2012/13 (nominal \$'000)	10

## Determination

1. On 30 November 2009, the Independent Market Operator (**IMO**) submitted to the Economic Regulation Authority (**Authority**) a proposal for the IMO's allowable revenue (**proposed allowable revenue**) for the period 2010/11 to 2012/13 (**second review period**).<sup>1</sup> The proposed allowable revenue was submitted in accordance with the requirements of clause 2.22.3 of the *Wholesale Electricity Market Rules* (**Market Rules**) under which the Authority is required to periodically determine the allowable revenue of the IMO for periods of three years duration.
2. The IMO's submission is available on the Authority's web site.<sup>2</sup>
3. On 24 December 2009, the Authority issued a notice inviting submissions on the proposed allowable revenue and an issues paper to assist interested parties in understanding and making submissions on the proposal. A single submission was received from Landfill Gas and Power Pty Ltd.
4. In making its determination, the Authority has taken into account the matters set out in clause 2.22.12 of the Market Rules.
5. The Authority has determined that the IMO's allowable revenue for the review period should be the amount proposed by the IMO corrected to take into account an updated value for interest earnings. The values of allowable revenue proposed by the IMO and the values determined by the Authority are shown in Table 1.

**Table 1** IMO allowable revenue - 2010/11 to 2012/13 (nominal \$'000)

	2010/11	2011/12	2012/13
IMO proposed allowable revenue	10,897	11,344	11,729
Authority determined allowable revenue	10,888	11,335	11,720

6. The reasons for this determination are set out below.

## Reasons for the Determination

### Legislative Requirements

7. The IMO was established under regulation 4(1) of the *Electricity Industry (Independent Market Operator) Regulations 2004*.
8. The IMO has functions conferred on it by the *Electricity Industry (Independent Market Operator) Regulations 2004*, the *Electricity Industry (Wholesale Electricity Market) Regulations 2004*, and the Market Rules.

<sup>1</sup> Independent Market Operator, 30 November 2009, ERA Submission Proposal for Allowable Revenue 1 July 2010 to 30 June 2013. The 'first review period' was the three year period 2007/08 to 2009/10 and was the subject of determination of allowable revenue by the Authority in March 2007 (Economic Regulation Authority, 30 March 2007, Allowable Revenue Determination – Independent Market Operator).

<sup>2</sup> See ERA web site, Independent Market Operator - ERA Submission Proposal for Allowable Revenue 1 July 2010 to 30 June 2013, [http://www.era.wa.gov.au/2/272/42/determination\\_o.pm](http://www.era.wa.gov.au/2/272/42/determination_o.pm)

9. Clause 2.1.2 of the Market Rules lists the following functions of the IMO:
- to administer the Market Rules;
  - to operate the reserve capacity mechanism, the short term energy market (**STEM**) and the balancing process;
  - to settle such transactions as is required under the Market Rules;
  - to carry out a long term projected assessment of system adequacy (**PASA**) study and to publish the statement of opportunities report;
  - to administer tender processes for network control services where required by the Market Rules and to enter into network control service contracts;
  - to process applications for participation, and for the registration, de-registration and transfer of facilities;
  - to release information required to be published by the Market Rules;
  - to publish information required to be published by the Market Rules;
  - to develop amendments to the Market Rules and replacements for them;
  - to develop market procedures, and amendments and replacements for them where required by the Market Rules;
  - to make available copies of the Market Rules and market procedures, as are in force at the relevant time;
  - to monitor other rule participants' compliance with the Market Rules, to investigate potential breaches of the Market Rules, and if thought appropriate, initiate enforcement action under the Regulations and the Market Rules;
  - to support the Authority in its market surveillance role, including providing any market related information required by the Authority;
  - to support the Authority in its role of monitoring market effectiveness, including providing any market related information required by the Authority; and
  - to carry out any other functions conferred, and perform any obligations imposed, on it under the Market Rules.
10. Clause 2.22 of the Market Rules requires the Authority to determine amounts of allowable revenue for the IMO to provide services defined in clause 2.22.1 of the Market Rules, being:
- market operation services, including the IMO's operation of the reserve capacity market, short term electricity market and balancing and the IMO's settlement and information release functions;
  - system planning services, including the IMO's performance of the long term PASA and functions under Chapter 5 of the Market Rules; and
  - market administration services, including the IMO's performance of the Market Rule change process, market procedure change process, the operation of the market advisory committee and other consultation, monitoring, enforcement, audit, registration related functions and other functions under the Market Rules.

11. Clause 2.22.3 of the Market Rules establishes the requirements for the Authority's determination of allowable revenue:
  - the IMO must submit a proposal for allowable revenue by 30 November prior to the start of the review period;
  - the Authority must undertake a public consultation process in approving the allowable revenue, which must include publishing an issues paper and issuing an invitation for public submissions; and
  - by 31 March of the year in which the review period commences, the Authority must determine the allowable revenue for the review period.
  
12. Clause 2.22.12 of the Market Rules sets out the following factors that the Authority must take into account in determining amounts of allowable revenue for the IMO:
  - The allowable revenue must be sufficient to cover the forward looking costs of providing the relevant services in accordance with the following principles:
    - i. recurring expenditure requirements and payments are recovered in the year of 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 the IMO 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.
  - The allowable revenue must include only costs that would be incurred by a prudent provider of the services, acting efficiently, seeking to achieve the lowest practically sustainable cost of delivering the services in accordance with the Market Rules, while effectively promoting the Wholesale Market Objectives.
  - Where possible, the Authority should benchmark the allowable revenue against the costs of providing similar services in other jurisdictions.

## Proposed Allowable Revenue

13. The IMO's proposed allowable revenue is shown in Table 2.

**Table 2** IMO proposed allowable revenue - 2010/11 to 2012/13 (nominal \$'000)<sup>3</sup>

	2010/11	2011/12	2012/13
Proposed allowable revenue	10,897	11,344	11,729

14. In its submission to the Authority, the IMO presented its proposed allowable revenue as a sum of cost line items, together with details of actual and projected costs for the first review period of 2007/08 to 2009/10 (Table 3).

**Table 3** IMO actual costs for the first review period (2007/08 to 2009/10) and proposed allowable revenue for the second review period (2010/11 to 2012/13) (nominal \$'000)<sup>4</sup>

Cost item	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
	Actual	Actual	Forecast	Forecast	Forecast	Forecast
Recurrent costs						
Employee benefits	2,772	3,516	3,696	4,013	4,269	4,545
Accommodation	268	290	271	325	396	445
Supplies and services	2,339	4,014	4,947	4,684	4,373	4,456
Capital costs						
Borrowing costs <sup>5</sup>	388	331	88	188	242	262
Depreciation	2,960	3,305	2466	1712	2089	2046
<b>Total costs</b>	<b>8,727</b>	<b>11,456</b>	<b>11,468</b>	<b>10,922</b>	<b>11,369</b>	<b>11,754</b>
Less interest income	-295	-331	-67	-25	-25	-25
<b>Total</b>	<b>8,432</b>	<b>11,125</b>	<b>11,401</b>	<b>10,897</b>	<b>11,344</b>	<b>11,729</b>

15. The IMO's submission includes a summary description of the forecast costs and their derivation. The IMO separately provided the Authority with four volumes of supporting documentation for the derivation of forecast costs and responses to additional requests for information. This supporting documentation has not been published by the Authority; however it is referred to in this determination where relevant.

<sup>3</sup> Independent Market Operator, 30 November 2009, ERA Submission Proposal for Allowable Revenue 1 July 2010 to 30 June 2013, p.3.

<sup>4</sup> Independent Market Operator, 30 November 2009, ERA Submission Proposal for Allowable Revenue 1 July 2010 to 30 June 2013, p.10.

<sup>5</sup> Borrowing costs here refers to interest cost only, and therefore excludes the principal cost component.



## Approach to Assessment

16. The Authority has assessed the IMO's proposed allowable revenue against the factors set out in clause 2.22.12 of the Market Rules by consideration of a range of matters, including:
- whether the proposed allowable revenue and supporting information provided by the IMO demonstrates a robust and transparent budgeting and capital planning processes;
  - for costs of a recurrent nature, a comparison of forecast costs for the second review period against a benchmark of costs in the first review period; and
  - for costs of a capital nature, assessment of whether supporting information for capital projects is sufficient to demonstrate the expenditures to be consistent with the IMO acting efficiently, seeking to achieve the lowest practically sustainable cost of delivering services, and verification of the calculation of depreciation allowances and borrowing costs from amounts of capital expenditure.

## Benchmarking

17. Sub-clause 2.23.12(c) of the Market Rules requires the Authority, where possible, to benchmark the Allowable Revenue of the IMO against the costs of providing similar services in other jurisdictions. The Authority considers that it is a difficult exercise to undertake such a benchmarking study for the purpose of this review as there are no directly comparable entities to the IMO in terms of scale of operations, structure of the business, and nature of activities.
18. However, the Authority has conducted a high level analysis comparing the combined costs of the IMO and the WEM's system operator – System Management – from the first review period (2007/08 – 2009/10) against the costs for providing services by the National Electricity Market's (**NEM**) market and system operator at that time, the National Electricity Market Management Company Limited (**NEMMCO**).<sup>6</sup> The Authority considers this to be the closest comparator for a benchmarking study.<sup>7</sup> The Authority's analysis provides a general indication that the WEM's combined market and system operator market fee rates (reflecting the combined costs of the IMO and System Management) have been at least twice the amount of the NEMMCO's market fee rates providing similar services during the first review period. The Authority considers that the large disparity is mainly due to the NEM's economies of scale advantage over the WEM.
19. For this review period, the Authority has also conducted a high level analysis on forecast market fee rates to ascertain what the WEM's combined market and system operator market fee rates (reflecting the combined costs of the IMO and

<sup>6</sup> Until 30 June 2009, the NEM's market and system operator functions were provided by the NEMMCO. The NEMMCO's roles and responsibilities were transitioned to the Australian Energy Market Operator (AEMO) on 1 July 2009.

<sup>7</sup> This analysis was conducted by comparing the published market fee rates of the two jurisdictions, that is, the cost for providing services per unit of energy supplied and/or demanded. Calculations for the NEMMCO were based on general revenue to be recovered through market fees and market customer load forecast (as published on the AEMO's web site <http://www.aemo.com.au/registration/fees09-10.html>), whereas calculations for the IMO and System Management were based on their respective revenue requirements to be recovered through market fees and the combined amount of energy supplied and demanded (as published on the IMO's web site [http://www.imowa.com.au/fees\\_charges](http://www.imowa.com.au/fees_charges)).

System Management) may be. The forecast market fee rates for this review period were calculated with the allowable revenue determined by the Authority<sup>8</sup> and projected market forecast load<sup>9</sup> for the review period. For the first review period, the IMO's and System Management's average combined market fee rate was 42 cents per MWh. For this review period the Authority projects that the average combined market fee rate to be 49 cents per MWh. If this projected average combined market fee rate was realised for this review period, this would represent an increase of 17 per cent in the average market fee rate over the first review period.

20. The Authority will explore the extent to which it can draw on appropriate data, and other possible means to undertake benchmarking study to a sufficient level of depth and rigour in future review periods.

## Public Submissions

21. In accordance with clause 2.22.3(b) of the Market Rules, the Authority undertook public consultation on the IMO's proposed allowable revenue, including publishing an issues paper on 24 December 2009 and issuing an invitation for public submissions. The closing date for public submissions was 27 January 2010.
22. A submission was received from Landfill Gas and Power Pty Ltd.
23. Landfill Gas and Power Pty Ltd indicates support for the IMO's assumptions and forecasts costs and for capital expenditure to upgrade the Wholesale Electricity Market System (**WEMS**) to improve service levels for market participants. The submission also notes that implementation of recommendations from the Oates Review will place an additional burden on the IMO during the second review period.<sup>10</sup>

## Costs of the First Review Period

24. A key issue for the Authority to consider is the extent to which costs for the first review period can be used as a base for determining allowable revenue for the second review period.
25. A comparison of allowable revenue and actual costs for the first review period is shown in Table 4.

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<sup>8</sup> See ERA web site, Determination of the IMO and System Management Allowable Revenue and Ancillary Service Parameters, [http://www.erawa.com.au/2/272/42/determination\\_o.pm](http://www.erawa.com.au/2/272/42/determination_o.pm)

<sup>9</sup> The projected market supply and demand load was calculated using forecasts of energy sent-out for the SWIS, which was obtained from the IMO's 2009 Statement of Opportunities Report. See IMO web site, [http://www.imowa.com.au/f176.17993/2009\\_SOO\\_Final\\_v0.2.pdf](http://www.imowa.com.au/f176.17993/2009_SOO_Final_v0.2.pdf), (p.50).

<sup>10</sup> The Oates Review is a government review of Verve Energy's financial situation and outlook. This review recommends options for the reform of the structure of the market and government owned entities that service the South West Interconnected System. The review can be found at [http://www.energy.wa.gov.au/cproot/1571/14895/Verve\\_Energy\\_Review\\_Final\\_Report\\_August\\_2009.pdf](http://www.energy.wa.gov.au/cproot/1571/14895/Verve_Energy_Review_Final_Report_August_2009.pdf). Implementation of the Oates Review's recommendations commenced early in 2010 and was still in progress at the time of the publication of this determination.

**Table 4** IMO approved and actual expenditure for the first review period – 2007/08 – 2009/10 (nominal \$'000)<sup>11</sup>

Expenditure	Approved	Actual
<b>Recurrent costs</b>		
Employee benefits	10,008	9,984
Accommodation	820	829
Supplies and services	10,720	11,300
<b>Capital costs</b>		
Borrowing costs	996	807
Depreciation	7,173	8,731
<b>Total costs</b>	<b>29,717</b>	<b>31,651</b>
Less interest income	-49	-693
<b>Total</b>	<b>29,668</b>	<b>30,958</b>

26. Actual costs for the first review period are projected to exceed the amount of allowable revenue for that period by approximately \$1.3 million (4.3 per cent). The differences that arise are primarily related to greater costs incurred in 'supplies and services' (\$580,000 over the amount allowed for in allowable revenue) and depreciation allowances (\$1,018,000 over the amount allowed for in allowable revenue) - although these amounts are partly offset by lower borrowing costs and greater interest income.
27. Taking into account that the IMO was a relatively new organisation at the commencement of the first review period with consequent uncertainty in activities and costs, the Authority does not consider the difference between allowable revenue and actual costs to be material. The Authority considers that the similarity of actual costs and allowable revenue for the first review period is evidence of sound budgeting processes and cost control within the IMO, and actual costs for the first review period constitute an appropriate base for the determination of allowable revenue for the second review period.

## Costs of the Second Review Period

### Recurrent Costs

#### Employee Benefit Costs

28. The IMO's forecast of employee benefit costs provides for increases in costs over cost levels of 2009/10 with an 8.5 per cent increase in 2010/11, an additional 6.4 per cent in 2011/12 and an additional 6.5 per cent in 2012/13. These cost increases are attributed to:
- an increase in staff numbers by 1.4 full-time equivalent positions;
  - a step increase in remuneration to levels consistent with 'market levels'; and

<sup>11</sup> Independent Market Operator, 30 November 2009, ERA Submission Proposal for Allowable Revenue 1 July 2010 to 30 June 2013, p.6. Actual values include projected actual costs for 2009/10.

- an underlying escalation in rates of remuneration over the second review period.
29. The additional staff positions comprise a 'reception and corporate support officer' and a part-time 'communications manager'. Supporting information provided by the IMO included detailed business cases for the additional staff positions which have been approved by the IMO Board on the basis that:
- an identifiable business need exists for the positions; and
  - the additional positions are a more cost effective approach to staffing than maintaining a current dependence on temporary staff resources secured from employment agencies.<sup>12</sup>
30. The Authority has reviewed the business cases for the additional staff positions and accepts that these business cases adequately justify the additional positions and associated costs of employee benefits.
31. The step increases in remuneration are based on salary ranges recommended by a remuneration consultant to set remuneration levels to the upper quartile of remuneration levels evident from salary benchmarks for organisations of similar revenue and industry sector, and within the range of salary levels evident from salary survey data from other Australian energy market operators and Western Australian electricity Market Participants.<sup>13</sup> The Authority has reviewed the report of the remuneration consultant and considers this report to comprise an independent and rigorous review of remuneration levels.
32. The Authority has considered whether setting remuneration levels at the upper quartile of remuneration levels in salary benchmarks is consistent with the requirement under the Market Rules that the allowable revenue include only costs consistent with the lowest practicably sustainable cost of delivering the IMO's services. The Authority observes that the current remuneration practices of the IMO do not reflect standard industry practices of including short-term incentive schemes and, reflecting this, higher base salaries may be appropriate.
33. Taking these matters into account, the Authority considers that the IMO has adequately justified the increases in employee benefit costs to allow for salary levels to increase to market levels.
34. Underlying escalation rates in remuneration - included by the IMO in the forecast of employee benefit costs - are 5 per cent for 2010/11, 5 per cent for 2011/12 and 7 per cent for 2012/13. These were the rates recommended by the IMO's remuneration consultant.<sup>14</sup>
35. The Authority observes that the underlying escalation rates in employee benefit costs are broadly consistent with labour cost forecasts for the electricity, gas and

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<sup>12</sup> Independent Market Operator, Meeting No 56, Meeting of the Board of Directors ERA Allowable Revenue Submission 2010/11 – 2012/13, Board Decision Item 2 – Additional Staffing Positions.

<sup>13</sup> Independent Market Operator, 30 November 2009, ERA Submission Proposal for Allowable Revenue 1 July 2010 to 30 June 2013, p.11; Gerard Daniels, November 2009, Commercial in Confidence Independent Market Operator Remuneration Review Revised Report.

<sup>14</sup> Independent Market Operator, 30 November 2009, ERA Submission Proposal for Allowable Revenue 1 July 2010 to 30 June 2013, p.12; Gerard Daniels, November 2009, Commercial in Confidence Independent Market Operator Remuneration Review Revised Report (IMO supporting documents, volume 1.

water sectors used by the Australian Energy Regulator in recent determinations (of 4.4 per cent in 2010/11, 6.0 per cent in 2011/12 and 6.0 per cent in 2012/13).<sup>15</sup>

36. On the above basis, the Authority considers that the IMO's forecast costs of employee benefits for the second review period are consistent with the IMO acting efficiently, seeking to achieve the lowest practically sustainable cost of delivering services.

### *Accommodation Costs*

37. The relative minor variation between approved and actual accommodation costs during the first Review Period shown in Table 4 suggests that these costs are relatively predictable and stable. These characteristics reflect that the IMO's office accommodation and car parking facilities are provided under contracts with fixed annual increments in costs.
38. The State Government lease over the IMO's existing premises will expire on 30 June 2012 and will not be renewed. Accommodation costs for the IMO for 2012/13 are therefore estimates which reflect advice from the Department of Treasury and Finance (**DTF**) on future rental costs.<sup>16</sup> The increase in accommodation costs in 2012/13 also reflects a 20 per cent increase in the amount of leased office space to accommodate planned growth in full-time equivalent positions and provide room for contractors and consultants as required.<sup>17</sup>
39. Taking into account that estimates of accommodation costs for 2010/11 and 2011/12 are based on existing contracts and that the estimate of costs for 2012/13 is based on independent advice, the Authority considers that the IMO's forecasts for accommodation costs for the second review period are consistent with the IMO acting efficiently, seeking to achieve the lowest practically sustainable cost of delivering services.

### *Supplies and Services*

40. The IMO provided supporting documentation to the Authority which details forecast costs of supplies and services at a highly disaggregated level. These costs are summarised in Table 5.

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<sup>15</sup> Econotech, 25 March 2009, Updated labour cost growth forecasts.

<sup>16</sup> IMO supporting documents, volume 2, p.9.

<sup>17</sup> IMO supporting documents, volume 1, p.6.

**Table 5** IMO forecast expenditure on supplies and services – 2010/11 to 2012/13 (nominal \$'000)<sup>18</sup>

Expenditure	2010/11	2011/12	2012/13
IT Support	2,091	2,140	2,160
Corporate Support	1,745	1,433	1,518
Market Operations	88	39	40
Market Administration	463	469	460
Systems Planning	297	292	278
<b>Total</b>	<b>4,684</b>	<b>4,373</b>	<b>4,456</b>

41. The total costs for supplies and services are forecast to be approximately constant in nominal terms over the three years of the second review period, and lower than the value of costs of supply and services projected for 2009/10 (\$4,947,000).
42. The supporting documentation provided by the IMO includes budget papers that set out the derivation of cost forecasts for individual cost items, comprising mainly a justified derivation of a base level of costs for either 2008/09 or 2010/11, taking into account actual or projected costs for these years corrected for abnormal items, and application of cost escalation rates for subsequent years.<sup>19</sup>
43. The cost escalation rates applied by the IMO are generally values of the state final demand deflator provided by the DTF (2.25 per cent in 2010/11, and 2.5 per cent per annum in both 2011/12 and 2012/13).<sup>20</sup> The Authority observes that these escalation rates are consistent with CPI forecasts of the Reserve Bank of Australia of 2.25 per cent to the end of 2010, increasing to 2.5 per cent by 2012.<sup>21</sup> On this basis, the Authority considers the escalation rates applied by the IMO to be reasonable.
44. Other escalation rates have been applied to some items of supplies and services, including:
- audit fees (escalation rate of 3 per cent per annum applied on the basis of advice from the DTF); and
  - activities related to specific requirements under the Markets Rules, including activities of compliance, investigations and participant dispute resolution, for which budget allowances are constant annual amounts without escalation factors applied.<sup>22</sup>
45. Certain items of supplies and services are supported by additional documentation, including:
- internal audit costs, supported by a strategic internal audit plan of the IMO;

<sup>18</sup> Independent Market Operator, 30 November 2009, ERA Submission Proposal for Allowable Revenue 1 July 2010 to 30 June 2013, p.13.

<sup>19</sup> IMO supporting documents, volume 2.

<sup>20</sup> The estimated growth in the SFD deflator is 2.25 per cent in 2010/11 and 2.5 per cent per annum in 2011/12 and 2012/13.

<sup>21</sup> Reserve Bank of Australia, November 2009, Statement on Monetary Policy.

<sup>22</sup> IMO supporting documents, volumes 2 and 3.

- operation audit costs, supported by a proposal and quotation from an external provider; and
  - technical studies on matters including the rate of return for the purposes of determining the Market Reserve Capacity Price each year and demand forecasts, supported by proposals and quotations from external providers.<sup>23</sup>
46. The Authority is satisfied that the forecast costs for supplies and services are consistent with the IMO acting efficiently, seeking to achieve the lowest practically sustainable cost of delivering services, taking into account:
- forecast costs over the second review period being maintained at approximately constant levels in nominal terms, and being less than projected costs for 2009/10;
  - documentary evidence that demonstrates a rigorous budgeting process; and
  - reasonable escalation rates for recurrent costs based on advice from the DTF.

### Capital Costs

47. Depreciation and borrowing costs in the IMO's proposed allowable revenue for the second review period include:
- amounts arising from capital projects planned for the second review period; and
  - amounts arising from actual and planned capital expenditures in the first review period that are carried over into the second review period according to depreciation schedules.

### Capital Projects for the Second Review Period

48. The Authority has assessed the IMO's proposed depreciation and borrowing costs by first considering whether the capital projects planned for the second review period represent expenditures that are consistent with the IMO acting efficiently, seeking to achieve the lowest practically sustainable cost of delivering services, and secondly verifying the calculation of amounts of depreciation and borrowing costs.
49. The IMO presented a 'Strategic Asset Plan' for the Minister for Energy's consideration and approval on an annual basis. The Strategic Asset Plan is supported by a 'Systems Development Roadmap', which provides a detailed business case underpinning the IMO's planned capital expenditure on market systems and infrastructure for the period 2009/10 to 2012/13.
50. The IMO has provided the Authority with copies of the Strategic Asset Plan, Systems Development Roadmap and the Minister for Energy's approval of the Strategic Asset Plan, all dated October 2009.<sup>24</sup>
51. Depreciation and borrowing costs in the IMO's proposed allowable revenue for the second review period include amounts in respect of three capital projects identified in its Strategic Asset Plan and Systems Development Roadmap. These projects are:

<sup>23</sup> IMO supporting documents, volumes 2 and 3.

<sup>24</sup> IMO supporting documents, volume 1.

- upgrading of the WEMS (\$5.05 million), which includes as a priority an upgrading of the web-based interface used by Market Participants and allows deferral of the replacement of the WEMS by two years until 2013/14 (with this replacement having been previously indicated in the 2009 Strategic Asset Plan to commence in 2011/12);<sup>25</sup>
  - corporate applications (\$565,000), which includes upgrading of the 'standard operating environment' and other software supporting the IMO's operations; and
  - office refurbishment (\$812,000) associated with a change of office location following expiry of the Western Australian Government's lease on the IMO's existing premises.
52. The Authority is satisfied that the Strategic Asset Plan and Systems Development Roadmap sufficiently demonstrate a rigorous capital planning process in decisions for upgrading of the WEMS and for corporate software applications and that the forecast costs are consistent with the IMO acting efficiently, seeking to achieve the lowest practically sustainable cost of delivering services.
53. The IMO has provided additional information to indicate that the forecast costs of office refurbishment comprise an estimate of costs provided by the Department of Housing and Works. Taking into account that this is an independent estimate of costs, the Authority is satisfied that the forecast cost of office refurbishment is consistent with the IMO acting efficiently, seeking to achieve the lowest practically sustainable cost of delivering services.

### *Depreciation Allowances*

54. The Authority has reviewed the IMO's proposed depreciation costs over the second review period by:
- establishing the accounting procedures applied by the IMO to different asset classes to derive depreciation allowances and considering whether these procedures accord with generally accepted accounting principles; and
  - performing a check of the IMO's calculation of depreciation amounts.
55. The Authority has verified that the accounting procedures applied by the IMO in derivation of depreciation allowances are consistent with accepted accounting procedures, in particular:
- a capitalisation threshold of \$5,000 applied to determine whether an asset is expensed or capitalised is consistent with Western Australian Government accounting guidelines;<sup>26</sup>
  - depreciation of WEMS software over three years and non-WEMS software over five years is consistent with Western Australian Government accounting guidelines;<sup>27</sup> and
  - the period of depreciation for property, plant and equipment:

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<sup>25</sup> The IMO's System Roadmap identifies the discrete projects associated with the upgrading of WEMS in 2009/10 and the second review period. The Authority has confirmed that costs associated with these projects have been correctly allocated across these years.

<sup>26</sup> Treasurer's Instruction TI 1101 requires Western Australian government agencies to apply this standard threshold.

<sup>27</sup> Department of Treasury and Finance, AASB 138 Intangible Assets, Accounting Policy Guideline 2, p.8.



- furniture and equipment, 5 years;
  - computer equipment, 3 years; and
  - leasehold improvements, 10 years (or remaining term of lease, if less).
56. The Authority has checked the IMO's calculation of depreciation amounts and verified that the amounts are correct.

### *Borrowing Costs*

57. The IMO partially finances capital costs by advances of funds from the Western Australian Treasury Corporation (**WATC**). These advances are repaid together with an amount of interest.
58. Projected borrowing costs over the second review period were calculated on existing funding facilities provided by the WATC, projected capital expenditure and advice on funding rates provided to the IMO by the WATC.
59. The IMO has forecast borrowing costs of \$188,000 in 2010/11, \$242,000 in 2011/12 and \$262,000 in 2012/13.
60. The Authority examined the alignment between the IMO's planned capital expenditure and the planned drawing down of debt over the second review period. The Authority also notes that the IMO provided the WATC's calculations of borrowing costs, by month, based on the IMO's existing debt and planned draw downs.
61. The Authority considers that the IMO's borrowing costs are consistent with the financing behaviour that would be expected from a prudent provider of the services seeking to achieve the lowest practically sustainable cost of delivering the services in accordance with the Market Rules.

### *Interest Income*

62. The IMO has deducted from forecast costs an amount of forecast revenue from interest on cash deposits.
63. The IMO's submission projected interest income over the second review period of \$25,000 per annum, calculated on the basis of expected cash holdings and interest rates in effect in September 2009.<sup>28</sup> Forecast interest income of \$25,000 in each year of the second review period was based on projections of average cash deposits of \$916,000 and an interest rate of 2.85 per cent.
64. The amount of interest income forecast for the second review period is substantially less than actual interest income for the first review period (\$295,000 in 2007/08 and \$331,000 in 2008/09) and the projected amount of \$67,000 in 2009/10. The lower expected interest income is mainly due to lower projected cash balances over the second review period when compared to the first review period. Higher cash balances in the first period were the result of:
- higher levels of electricity generation and consumption than forecast at the time of the Authority's first allowable revenue determination that boosted revenue through the market fees mechanism; and

<sup>28</sup> System Management, e-mail correspondence 28 January 2010.

- lower than expected expenditure due to the uncertainty inherent in the initial budgeting for activities, given there was little effective precedent on which to draw.
65. Subsequent to submission of its proposed allowable revenue, the IMO has advised the Authority that the interest rate it earns on deposits has increased since September 2009 and is expected to be 3.75 per cent.<sup>29</sup> Accordingly, the Authority has applied an interest rate of 3.75 per cent to the IMO's expected cash holding to determine interest income of \$34,000 per annum for the second review period. The Authority has amended the proposed allowable revenue to reflect this revised value.
66. The Authority considers that once projected interest income is adjusted for current interest rates, projected interest income is consistent with the cash management policy that would be expected from a prudent provider of the services seeking to achieve the lowest practically sustainable cost of delivering the services in accordance with the Market Rules.

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<sup>29</sup> This rate of interest is consistent with rates offered by the major banks on business on-line saver accounts as of 24 February 2010 (Commonwealth Bank – 3.75 per cent, National Australia Bank – 3.75 per cent, Westpac – 3.8 per cent and ANZ – 4 per cent.