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SUBMISSION

Determination of Allowable Revenue and Forecast Capital Expenditure for the Independent Market Operator and System Management

Background: WA IPA

The WA Independent Power Association (WA IPA) welcomes the opportunity to make a submission to the Economic Regulation Authority (ERA) on the proposals for Allowable Revenue and Forecast Capital Expenditure from the Independent Market Operator (IMO) and System Management under the Wholesale Market Rules (Market Rules).

The WA IPA consists of seven member companies operating in the Western Electricity Market (WEM). WA IPA was established in 2012 to represent the interests of non-government owned power companies, and particularly to foster private investment in the market and promote competition, consistent with the original aims of the electricity market reforms in this State.

All member companies hold either retail and/or generation licences, so are active market participants.

Electricity Reform Objectives

One of the key objectives of electricity reform was to open up the market for private investment and use competition as a driving force putting downward pressure on prices.

The WA market was designed to take into account WA's isolated grid and framed around a bilateral contract structure, with a small volume Short Term Energy Market (STEM).

Given the relatively small size of the market and a key objective of reform being to keep downward pressure on electricity prices, it is important that the costs of running the market are kept as low as possible.

General Comments

As the Issues Paper points out: "Allowable Revenue and Forecast Capital Expenditure 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”.

WA IPA also notes that “where possible the Authority should benchmark the Allowable Revenue and Forecast Capital Expenditure against costs of providing similar services in other jurisdictions”.

Despite the Issues Paper saying that the Authority considers it is not practical to undertake such a benchmarking study, the WA IPA believes that it is important to understand the market cost of electricity traded in WA on a comparable basis with other jurisdictions. Such an exercise would not be difficult and could be done on a tracking basis at least to see how WA compares from year to year, going back to the start of the market, rather than just as a one-off review.

Both IMO and System Management’s proposals amount to significant increases in costs. IMO is requesting a 19% increase in Allowable Revenue compared to the second Review Period and System Management an 80% increase for the same period. Capital expenditure has increased substantially for both bodies over the third Review Period. At a time when other costs of producing electricity are rising, mainly from increased fuel and network costs, as identified by the Frontier Economics study commissioned by the WA IPA, it is difficult to see how these increased market costs can be absorbed by market participants without getting passed on to consumers.

IMO’s Proposal

For IMO’s proposal, it is up to the ERA to determine if those costs would be incurred by “a prudent provider of services, acting efficiently...” and it is difficult to see how such a judgement can be made without some sort of benchmarking study.

WA IPA notes the main factors involved in IMO’s proposed increases include higher depreciation and amortisation costs resulting from considerable capital expenditure in the second review period; increased employee benefit expense; significant increases in accommodation costs, and recovery of GST incorrectly raised by IMO.

While the assumptions underlying these increases are outlined in IMO’s proposal, there is no analysis of whether they are justified on the basis of the operator “acting efficiently”. In other words, while each of the expenditures is explained, there is little understanding of how the expenditure contributes to the performance of IMO in delivering the services efficiently at the “lowest practically sustainable cost”.

In terms of proposed capital expenditure, WA IPA notes that the costs are essentially for IT systems under IMO’s “IT Roadmap 2013 – 2016”. This new expenditure is not a significant proportion of the overall costs, but it does build on significant investment in previous periods.

System Management’s Proposal

As noted above, System Management is proposing an 80% increase in required revenue for the new period, compared to the AR2 period.

System Management's proposal is based on the "building block methodology", which as the Issues Paper notes, is markedly different to the approach used previously by System Management and by the ERA. The Issues Paper notes: "It is not immediately apparent to the Authority why System Management has altered its methodology for the determination of its Allowable Revenue". Neither is it apparent to the WA IPA.

Another significant departure from previous proposals from System Management is the claim this time for compensation for tax equivalent payments or return on capital. It is not readily apparent why this has now been added, except that System Management is seeking to put in place a more comprehensive revenue model using the building block approach.

The Issues Paper also notes that the proposed weighted average cost of capital of 6.66% is markedly different to that used recently by the ERA in assessing Western Power's Access Arrangement (3.60%). The WA IPA assumes that the ERA would have a view as to the appropriate WACC for System Management, but there does not seem to be a good argument as to why it should differ from that applied to Western Power as a whole.

Forecast capital expenditure of \$5.271 million is for three main categories:

- Consolidating support for the Market Evolution Program (MEP)
- Improving internal processes and systems
- Supporting market development

This is a smaller amount than was expended in previous periods, but as with IMO, it does build on significant investment already made.

Summary

The WA IPA understands that both IMO and System Management are improving the range of services to the market, especially through the Market Evolution Program, and hopefully, the effectiveness and responsiveness of their operations.

However, it needs to be remembered that this is still a relatively small market and the costs of running these organisations will ultimately get passed through to the consumer. The two market bodies constitute natural monopolies, and ERA should treat their revenue and capital expenditure proposals as it would treat other natural monopolies, that is through determining the lowest practical sustainable cost of supplying the services offered.