

Issues Paper

Allowable Revenue and Forecast Capital Expenditure for the Independent Market Operator (GSI Functions) 2016/17 – 2018/19

March 2016

Economic Regulation Authority

WESTERN AUSTRALIA

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Invitation to make submissions

Interested parties are invited to make submissions on the Authority's Issues Paper by **4:00 pm (WST) Friday, 29 April 2016** via the submission [portal](#) located on the Authority's website, or:

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CONFIDENTIALITY

In general, all submissions from interested parties will be treated as being in the public domain and placed on the Authority's website. Where an interested party wishes to make a submission in confidence, it should clearly indicate the parts of the submission for which confidentiality is claimed, and specify in reasonable detail the basis for the claim. Any claim of confidentiality will be considered in accordance with the provisions of 55 of the *Economic Regulation Authority Act 2003*.

The publication of a submission on the Authority's website shall not be taken as indicating that the Authority has knowledge either actual or constructive of the contents of a particular submission and, in particular, whether the submission in whole or part contains information of a confidential nature and no duty of confidence will arise for the Authority.

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1 Introduction

1.1 Background and Scope of this Issues Paper

Following the gas supply crisis caused by the Varanus Island incident in June 2008, the Gas Supply and Emergency Management Committee recommended the development of two key gas information services for Western Australia, including a Gas Bulletin Board (**GBB**) and a Gas Statement of Opportunities (**GSOO**).

The GBB and the GSOO are established by the *Gas Services Information Act 2012*, the Gas Services Information Regulations 2012 and the Gas Services Information Rules (**GSI Rules**).

Under the *Gas Services Information Act 2012*, the primary purpose of the GBB is to provide a website for the publication of information regarding short or near term natural gas supply, transmission, storage and demand. The GBB is also required to include an emergency management page to assist with the management of supply disruptions.

The purpose of the GSOO, an annual planning document, is to provide a comprehensive medium to long term outlook on natural gas supply, demand, transmission and storage capacity.

The objectives of the GBB and GSOO are to promote the long term interests of consumers of natural gas in relation to:

- the security, reliability and availability of the supply of natural gas in the State;
- the efficient operation and use of natural gas services in the State;
- the efficient investment in natural gas services in the State; and
- the facilitation of competition in the use of natural gas services in the State.

In May 2011, the Independent Market Operator (**IMO**) was appointed to establish and operate the GBB and to prepare and publish the GSOO for the Western Australian natural gas sector. The first GSOO was published on 26 July 2013 and the GBB became operational on 1 August 2013.

Sub clauses 108 and 108A of the Market Rules require the Authority, in determining allowable revenue and forecast capital expenditure for the IMO, to undertake a public consultation process which must include publishing an Issues Paper and issuing an invitation for public submissions.

The Authority has prepared this Issues Paper to assist interested parties in understanding and making submissions on the IMO's proposal. Interested parties are invited to make submissions on any element of the IMO's proposal.

1.2 Transfer of functions to Australian Energy Market Operator

On 30 September 2015, the Minister for Energy announced the transfer of the system management and operation of the Wholesale Energy Market (**WEM**) and Gas Services Information (**GSI**) functions from the IMO to the Australian Energy Market Operator (**AEMO**). This transfer took place on 30 November 2015.

The functions of administering and determining changes to the GSI Rules, and compliance and monitoring, have for now been retained by the IMO and will not be transferred to AEMO. These functions will be reassigned to an alternative agency which has not yet been announced by government.¹

Due to the timing of this transfer, the IMO was unable to incorporate the changes to its functions into its allowable revenue and forecast expenditure proposal. Instead, IMO has prepared its proposal on a “business as usual” basis. This means that the IMO’s proposal shows what its revenue requirements would be if it were to retain all of its functions.

The Authority does not consider the ‘business as usual’ approach to be the best way to assess the revenue requirements of the IMO functions that have been transferred to AEMO. However, the Authority notes the transfer of the IMO functions to AEMO has occurred since the IMO submitted its proposal to the Authority.

The Authority will assess the proposal on the basis that any revenue allocated to the GSI function will be assumed by AEMO for the operation of the GSI functions it now holds. This allocated revenue will necessarily exclude the amounts deemed appropriate for the continued and efficient operation of the other functions of the IMO, including WEM.

The GSI Rules provide for the reassessment of allowable revenue and approved forecast capital expenditure in the event that revenue recovery or capital expenditure within a review period exceeds by a certain proportion the amount approved in the ERA’s final determination for that review period.²

Issue 1

Interested parties are invited to make submissions on any matter relevant to the determination of allowable revenue in the context of the transfer of functions from the IMO to AEMO, and to other entities.

1.3 Rules governing the proposal and determination of Allowable Revenue and Forecast Capital Expenditure

Under clause 108(1) of the GSI Rules, the Economic Regulation Authority (**Authority**) must determine the Allowable Revenue and Forecast Capital Expenditure for the IMO for each Review Period. This review covers the second Review Period, commencing on 1 July 2016 and ending on 30 June 2019.

Pursuant to clause 109(3) of the GSI Rules, the Authority’s determination must ensure that the Allowable Revenue and Forecast Capital Expenditure includes only those costs that

¹ There is a possibility that responsibilities to support the rule-making function may be transferred to the ERA. See Public Utilities Office Issues Paper: http://www.finance.wa.gov.au/cms/uploadedFiles/Public_Utility_Office/Electricity_Market_Review/Position_paper-Energy-Market-Operations-and-Processes.pdf page 38. The ERA is not required under the Market rules to make a determination in respect of the functions not transferred to AEMO, nor would it be appropriate.

² Gas Services Information Rules, Division 3, 111.(4) and 111.(5), November 2015.

would be incurred by a prudent provider of the relevant services, acting efficiently and seeking to achieve the lowest practicably sustainable cost of delivering those services.

Under clause 108(2) of the GSI Rules, the IMO is required to submit the Allowable Revenue and Forecast Capital Expenditure proposal to the Authority by 30 November of the year prior to the start of the review period. The IMO submitted this proposal to the Authority on 15 November 2015. This proposal is available on the Authority's [website](#).

The GSI Rules were amended in November 2015 to include transitional provisions for the transfer of the GSI functions from the IMO to AEMO.

Under Part 2, Schedule 3 of the Transitional Rules:

- 1) For the review period from 1 July 2016 to 1 July 2019:
 - (a) the proposal for Allowable Revenue and Forecast Capital Expenditure submitted by the IMO prior to the AEMO Transition Date is deemed to have been submitted jointly by the IMO and AEMO; and
 - b) the ERA is not required to determine each of the IMO's and AEMO's Allowable Revenue and Forecast Capital Expenditure for that Review Period until 30 June 2016.
- 2) From the AEMO Transition Date until the date AEMO publishes the AEMO Budget under subrule 111A(1):
 - (a) AEMO is to deemed to have prepared and adopted for the purposes of the Rules the IMO's current Approved Annual Revenue as at the AEMO Transition Date; and
 - (b) the operation of rule 117 and subrule 118A is modified as follows:
 - (i) AEMO will not be required to separately itemise amounts in a GSI Invoice under subrule 117(1)(b) or subrule 117(3)(b); and
 - (ii) AEMO must pay a share of the payments received for GSI Fees to the IMO commensurate with the IMO's budgeted costs of the IMO GSI Services

In determining the Allowable Revenue and Forecast Capital Expenditure for the IMO, under clause 108(3) of the GSI Rules, the Authority is required to undertake a public consultation process, which includes publishing an Issues Paper and issuing an invitation for public submissions.

The Authority has prepared this Issues Paper to assist interested parties in understanding the IMO's proposal and the Authority's approach and process, and in making submissions on these matters.

This Issues Paper addresses the following matters:

- The requirements of the GSI Rules for the determination of the IMO's Allowable Revenue and Forecast Capital Expenditure;
- Summary information on the proposal submitted by the IMO; and
- The process to be followed by the Authority in making the determination on the GSI Allowable Revenue and Forecast Capital Expenditure.

1.4 Requirements of the Gas Services Information Rules

Under clause 108(1) of the GSI Rules, the Authority is required to determine the Allowable Revenue and Forecast Capital Expenditure for the IMO for each Review Period, for the GSI services that they provide.

The GSI services required of the IMO are presented in clause 107 of the GSI Rules. These services are:

- to establish, operate and maintain the GBB;
- to register or deregister Registered Participants and Registered Facilities and to grant Exemptions;
- to prepare and publish the GSOO;
- to make Amending Rules and Procedures, including the initial Rules made by the Minister under regulation 6 of the GSI Regulations;
- to facilitate the processes of the Gas Advisory Board;
- to monitor compliance and investigate breaches or possible breaches of the Rules or the Procedures;
- to take enforcement action under the GSI Regulations;
- to manage information gathering and disclosure functions under the GSI Regulations and the Rules; and
- services deriving from the exercise of any other functions conferred on the IMO under the *Gas Services Information Act 2012*, the Gas Services Information Regulations 2012 or the GSI Rules.

The matters for consideration by the Authority in determining the GSI Allowable Revenue and Forecast Capital Expenditure are presented in clause 109 of the GSI Rules and are as follows:

- The Allowable Revenue must be sufficient to cover the forward looking costs of providing the GSI Services in accordance with the following principles:
 - a) recurring expenditure requirements and payments are recovered in the year of the expenditure;
 - b) capital expenditures are to be recovered through the depreciation and amortisation of the assets acquired by the capital expenditures in a manner that is consistent with generally accepted accounting principles; and
 - c) despite sub-rules (a) and (b), expenditure incurred, and depreciation and amortisation charged, in relation to any GSI Project are to be recovered over the period determined for that GSI Project.
- The Allowable Revenue and Forecast Capital Expenditure must include only costs which would be incurred by a prudent provider of the GSI Services, acting efficiently, seeking to achieve the lowest practicably sustainable cost of delivering those services in accordance with the Rules, while effectively promoting the GSI Objectives.
- Where possible, the ERA should benchmark the Allowable Revenue and Forecast Capital Expenditure against the costs of providing similar services in other jurisdictions.

2 Independent Market Operator Proposal

2.1 Allocation of Costs across the IMO's Electricity and Gas Functions

In August 2013, the IMO's functions were expanded to include activities related to Gas Services Information (**GSI**).

The IMO has two key areas of function, including:

- the IMO's electricity functions set out in the WEM Rules; and
- the IMO's GSI services function set out in the GSI Rules.

The IMO has integrated its functions under the GSI Rules into its existing teams to enable it to achieve operational efficiencies that would not be achieved if the functions were operated separately. Accordingly, many of the IMO's resources (including staff, administrative support, office accommodation, and other corporate and management support) are shared across both functions. Where resources are shared across functions, the IMO has developed a cost allocation methodology.

Issue 2

Interested parties are invited to make submissions on the allocation of costs by the IMO to allocate resources across its GSI and WEM functions.

2.2 Proposed GSI Allowable Revenue and Forecast Capital Expenditure 2016/17 – 2018/19

The IMO's proposed GSI allowable revenue and forecast capital expenditure for the second review period are outlined in Table 1 below.

Table 1 Proposed GSI Allowable Revenue and Forecast Capital Expenditure for the Second Review Period

\$'000 (nominal)	2016/17	2017/18	2018/19	Total
Allowable Revenue	2,362	2,454	2,053	6,869
Forecast Capital Expenditure	214	189	211	614

The IMO has noted that its submission has been made on the following basis:

- the submission may be subject to review after the transfer of a number of the IMO's functions to AEMO, pending the finalisation of funding arrangements; and
- the business requirements of Gas Market Participants and other stakeholders have an influence on the IMO's workload and subsequent expenditure.

2.3 Allowable Revenue

The IMO's proposal provides information on its proposed Allowable Revenue for each year of the second review period as set out in the cost categories in Table 2 below.

Table 2 Proposed GSI Allowable Revenue for the Second Review Period

\$'000 (nominal)	2016/17	2017/18	2018/19	Total
Employee Benefits Expense	946	972	994	2912
Accommodation	101	106	110	317
Supplies and Services	637	672	682	1,991
Borrowing Costs	60	45	21	126
Depreciation	618	659	246	1,522
Total Expenditure	2,362	2,454	2,053	6,869
Interest Revenue	-	-	-	-
Allowable Revenue	2,362	2,454	2,053	6,869

The key assumptions employed in the derivation of the proposed Allowable Revenue for the second review period are provided in Table 3 below.

Table 3 Key assumptions applied in the derivation of proposed allowable revenue for the second review period

Cost or calculation parameter	Key Assumption
Escalation Rate for Annual Indexation Costs	Indexation cost based on Department of Treasury advice of 2.50 per cent across the Review Period.
Employee Benefits Expenses ³	The IMO currently has 45.7 FTE approved positions, which incorporate gas related functions as well as electricity related responsibilities. IMO has proposed 5.7 FTE for GSI related responsibilities over the second review period, which represents 12.1 per cent of the IMO's total approved FTE. The Authority's allowable revenue determination for the initial review period included approval for 5.5 FTE out of a total of 43 FTE across all of the IMO's functions. The IMO considers that the overall increase in FTE is largely responsible for its proposed 0.2 FTE increase over the second review period. Increases in salary costs are based on staff performance and are in line with Department of Treasury advice, which recommends a budget for annual salary increases of 2.50 per cent each year.
Supplies and Services	The IMO relies strongly on the outsourcing of specialist services for the provision of its internal business needs. Development and Capacity costs are the costs associated with specialist forecasting services. ⁴ Development and Capacity costs are expected to total \$0.634 million during the second review period. These costs fluctuate on the basis of the cyclical reviews that are required under the Market Rules, and include external costs of supporting Rule Changes determined by the Market Advisory Committee. Operations and Technology costs are the highest cost category, totalling \$.724 million in the second review period. ⁵ The costs associated with this category were impacted by additional desktop support built into the Review Period expenditure, and additional software licence costs.
Accommodation	IMO's submission was prepared under the assumption that it would remain in its current premises over the second review period. ⁶
Depreciation	The depreciation model is based on a five year schedule for computer software and a three year schedule for computer hardware to reflect its current useful life.
Borrowing Costs	IMO has taken the existing loan facilities and projected capital expenditure requirements of its fourth IT Roadmap into consideration when arriving at its projected borrowing costs.

³ Employee benefits expenses include such things as salaries, superannuation, payroll tax, fringe benefits tax and other staffing costs.

⁴ For example, for the annual GSOO, administering the Gas Advisory Board meetings, and administering any changes to the GSI Rules

⁵ Operations and Technology costs include those associated with the maintenance and support for the GBB system, datacentre hosting, specialist database, IT and infrastructure support, high-speed fibre links, and telecommunications.

⁶ The rental rate for the IMO premises (which has an area of 857 m²) commenced at \$660/m² in 2012, with annual increases of 4 per cent each October built into the current 10 year lease agreement (this includes an option for IMO to exit the lease after 5 years).

Cost or calculation parameter

Key Assumption

Issue 3

Interested parties are invited to make submissions on the key assumptions employed by the IMO in deriving its proposed GSI Allowable Revenue for the second review period.

2.4 Forecast Capital Expenditure

The IMO's proposal for forecast capital expenditure over the second review period includes a key strategic IT planning document; the IT Roadmap.⁷ This document is used by the IMO to ensure that the planning, delivery, management and use of its IT systems optimally support its business requirements.

The IMO's estimates of capital expenditure are based on the current hourly rates required to implement each project, with a 2.5 per cent CPI applied annually.

This is the fourth technology roadmap that the IMO has developed, and the second to incorporate the requirements of the GSI.

A summary of the capital requirements used in deriving the IMO's proposed GSI Forecast Capital Expenditure for the initial Review Period is presented in Table 4 below.

Table 4 Proposed GSI Capital Expenditure for the Second Review Period

\$'000 (nominal)	2016/17	2017/18	2018/19	Total
GSI Rule Changes	88	90	92	270
GSI Enhancements	93	95	97	285
Corporate Support	33	4	22	59
Forecast Capital Expenditure	215	189	211	614

3 Process to be followed by the Authority

The Authority considers that it is appropriate to review IMO's proposal in light of the transfer of its GSI functions to AEMO. The Authority therefore intends to conduct an analysis of the IMO's projected revenue and capital expenditure on the basis of cost per function, as well as cost per FTE, and allocate revenue to the functions to be transferred to AEMO and exclude functions to be assigned to an alternative government agency (the rule change, compliance and monitoring functions). The Authority will also compare the IMO's projected revenue with costs incurred by the IMO during the previous review period.

The Authority considers that as AEMO is well established in the Eastern States, it would be appropriate to benchmark the IMO's actual and projected costs for providing GSI services

⁷ Independent Market Operator, *Fourth IT Roadmap: 2016-2019*, 8 September 2015.

against the actual and projected costs incurred by AEMO for the provision of similar services in the Eastern States, provided relevant information can be obtained.

The Authority notes that the West Australian gas market is unique in its size and isolation, and will take into account that efficiencies of scale that might apply to the operation of the GSI services in the Eastern States may not be applicable in Western Australia. The Authority also notes that bespoke software and system architecture is and has been required by AEMO and the IMO respectively to manage its data and services, and will take this into account.

The Authority also intends to benchmark the IMO's proposal against both the projected and actual corporate costs of a comparably sized organisation, such as the ERA.

The process that the Authority intends to apply in its determination is to:

- Assess the proposal against likely changes to the revenue requirements associated with the provision of the GSI services as a result of the transfer of these functions from the IMO to AEMO.
- Determine the likely differences in revenue requirements as a result of the compliance monitoring and enforcement, and rule change functions being separated from other GSI functions, which have been transferred to AEMO.
- Assess the proposal against benchmarks of the actual costs in the period 2013-2016 of parallel services provided by the IMO in the provision of both GSI and WEM related services where possible (e.g., the development of rule changes).
- Benchmark the costs of the GBB and GSOO against similar gas information services provided by AEMO in the Eastern States, where possible.⁸
- Seek further supporting information for the proposed Allowable Revenue and Forecast Capital Expenditure sufficient to demonstrate that it is consistent with costs that would be incurred by a prudent provider of services, acting efficiently and seeking to achieve the lowest sustainable cost of delivering these services in Western Australia.
- Identify and assess whether recurring expenditure requirements and payments are recovered in the year of the expenditure.
- Assess whether amounts of depreciation and amortisation included in the Allowable Revenue have been appropriately determined from Capital Expenditure.

Issue 4

Interested parties are invited to make submissions on the process that the Authority intends to follow in assessing the IMO's allowable revenue and forecast capital expenditure.

⁸ The Authority notes that in some instances it may not be practical to undertake such benchmarking as there are no directly comparable entities to the IMO in other jurisdictions in terms of scale of operation, structure of the business and nature of activities.