

Mr Ignatius Chin
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Economic Regulation Authority
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By email: ignatius.chin@era.wa.gov.au

31 January 2007

Dear Ignatius

Allowable Revenue for System Management and the IMO

Thank you for providing an opportunity to comment on the proposals for the allowable revenue for System Management and the Independent Market Operator (IMO) for the period 1 July 2007 – 30 June 2010. Alinta Sales Pty Ltd's (Alinta) comments are provided in the sections below.

Allowable revenue for System Management

Prudence and efficiency

As both the IMO and System Management has pointed out in their submissions, the Wholesale Electricity Market (WEM) is still in its infancy and no historic cost estimates have been established for the functions of the IMO and System Management. It is therefore difficult to provide an assessment of the level of the costs forecasted by System Management.

Alinta encourages the Economic Regulation Authority (ERA) to obtain independent consultancy advice on the appropriateness of the cost forecasts put forward by System Management. It would seem sensible to compare costs of similar functions in other jurisdictions and use that as a guideline to assess the forecast level of cost from System Management.

If the ERA decides to go down this route, or has already done so, Alinta would welcome an opportunity to comment on any findings that the consultants present.

Appropriateness of labour cost allocation

In the absence of historic performance data Alinta suggests that this is an area where it would be helpful to obtain independent consultancy advice.

Alinta notes that 19.1FTEs are now proposed to perform System Management's functions under the Market Rules, up from 14 FTEs – a 30% increase. The additional functions proposed to be undertaken by System Management appear to be labour intensive initial costs to setup System Management rather than an ongoing requirement. For example, *compilation of procedures and documents for rule participants*. Alinta asks the ERA to ensure itself that any costs recovered as System Management costs are not also recovered as 'network costs' through Western Power's Access Arrangement.



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Alinta also observes that System Management has escalated its labour cost forecast by 6% per annum whereas the IMO only forecasts a 4% per annum cost increase. As both organisations would be drawing on roughly similar types of skills for its labour force it would be logical to use the same forecast for the annual increase in labour costs.

Alinta asks the ERA to consider whether System Management may have overstated the forecast increase in labour costs and whether the forecast should be adjusted to the same level as the IMO's forecast.

Alinta encourages System Management to establish systems to accurately capture the time spent by different parts of its organisation on tasks directly related to its obligations under the WEM. Doing so would allow a more rigorous analysis of costs at the next review.

Appropriateness of functional cost and legal costs

Alinta acknowledges that it is difficult to forecast legal costs, especially in a newly established market. Alinta considers it important that System Management establishes systems to accurately capture any legal and functional costs that arise as a direct consequence of System Management's obligations under the WEM. An accurate record will be useful in forecasting these costs for the next review period.

Any over / under expenditure on these costs should be taken into account when setting the allowable revenue for the next period.

Alinta queries the rationale for allowing a 10% annual increase in legal costs. That rate is well above expectations on CPI movement and System Management's own expectations on the increase in labour costs.

Self insurance

Alinta would like to obtain a better understanding of what exactly is provided by the proposed \$500,000 per annum self insurance premium. In particular Alinta would like to understand:

- Which events would be covered by insurance
- Would any payouts be limited by the amounts set aside, and if so would any excess be passed on directly to users or would there be any sharing arrangements with System Management
- How would unused funds be treated in the event of System Management either obtaining insurance cover from a third party or coming to the end of the review period with a positive balance in the insurance pool.

Depreciation method of phase 1 IT costs

Alinta does not object to phase 1 IT costs being depreciated over a 3 year period rather than 5 years as originally envisaged as long as that is reflected in the IT costs in the subsequent review period.

Work programme

Alinta does not have any comments on the proposed work programme apart from asking the ERA to ensure itself that any costs recovered as System Management costs are not also recovered as 'network costs' through Western Power's Access Arrangement.

Operating expenditure

Alinta does not have any comments on the proposed opex expenditure of about \$100,000 per annum relating to IT.

Ancillary services costs

Alinta notes that historic costs in providing ancillary services under the WEM may not be available. However, similar services have been provided previously and therefore System Management presumably are in a position to forecast ancillary service costs that can be validated by an external consultant rather than entirely deriving the costs from a consultants report.

Alinta also queries the assumptions for using a 4% annual escalation of these costs during the review period. Is the 4% escalator linked to a CPI forecast or is it driven by something else?

Alinta would encourage the creation of an ancillary services market to allow competition in the provision of these services. As a first step, System Management should put ancillary services such as frequency and voltage control out for tender.

Benchmarking

As highlighted in comments above, Alinta encourages the ERA to obtain independent consultancy advice on the appropriateness of all cost estimates put forward by System Management. It would seem sensible to compare costs of similar functions in other jurisdictions and use that as a guideline to assess the forecast level of cost from System Management.

Other issues

Alinta encourages the ERA to consider an economic incentive scheme to apply to System Management. An economic incentive scheme would be important to ensure efficient provision of System Management's services.

The ERA could for example consider a benchmarking / yardstick approach where System Management's performance is evaluated relative to an established industry standard. Under such a scheme System Management could be compelled to make efficiency improvements if performing below the industry standard and be allowed to keep a portion of any efficiency gains if it over-performs compared to industry standards.

A sliding scale profit sharing scheme could also be considered. Under such an approach System Management would be allowed to share in any efficiency savings above and beyond the agreed prudent revenue level. At the same time, it would not be allowed to pass on the full amount of any cost increases above the agreed prudent revenue level.

Allowable revenue for the IMO

As no historic expenditure statistics are available for the IMO it is difficult to provide comments on the IMO's forecast expenditure. Alinta therefore encourages the ERA to obtain independent consultancy advice on the appropriateness of the cost forecasts put forward by the IMO and compare with the costs of similar functions in other jurisdictions.

Alinta queries the rationale for including an allowance in 2009/10 for anticipated system development costs. The IMO says on p11 in its submission that “...it is anticipated that substantial system development costs could be incurred if Market Participants seek more significant evolution of the market design...”. Such costs will not be incurred unless someone raises a change proposal which will have to stack up against the objectives of the market rules, including an assessment of the implementation costs. Alinta considers that these costs should not be included in 2009/10. Cost allocation can be addressed as part of the change proposal process. One option would be to allow any such costs to be recovered in the subsequent review period.

Alinta notes that the IMO's statement on p.9 of its submission that the IMO market fee adds around one half of one percent to the price of energy is misleading. The IMO fee rate is charged on both load and generation and the total cost will be reflected in the price seen by customers. To estimate the impact on customers it is therefore necessary to double the \$/MWh fee rate. Using the IMO's own price assumptions, the IMO fee therefore adds about 1% to the price of electricity.

Alinta considers that it would be beneficial to consider an economic incentive scheme for the IMO along similar lines to what we have highlighted for System Management. Alinta recognises that as the IMO is a not for profit organisation it may be more difficult to implement an economic incentive scheme for the IMO. It could however be beneficial in driving efficient and economic outcomes, and should be considered.

Please call me on 08 6213 7304 or Mark McKinnon on 08 6213 7316 if you would like to discuss any of the issues in this letter further.

Yours sincerely

A handwritten signature in blue ink that reads "Kristian Myhre". The signature is written in a cursive, slightly slanted style.

Kristian Myhre
Manager Market Analytics