

# Allowable Revenue Determination – Independent Market Operator

30 March 2007

Economic Regulation Authority



WESTERN AUSTRALIA

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For further information, contact:

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

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## Determination

1. On 28 November 2006, the Independent Market Operator (**IMO**) submitted its proposed forecast expenditure for the period 2007/2008 – 2009/2010 (**Review Period**), for which the IMO seeks to recover revenue.
2. In assessing the Allowable Revenue of the IMO, the Economic Regulation Authority (**Authority**) has considered the proposed forecast expenditure submitted by the IMO, 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 (**Market Rules**).
4. The Authority has determined the IMO's Allowable Revenue for the Review Period as that shown in Table 1 below.

**Table 1**      **IMO – Allowable Revenue**

Revenue	2007/08	2008/09	2009/10
<b>Allowable Revenue</b>	<b>\$10,351,000</b>	<b>\$10,542,000</b>	<b>\$8,776,000</b>

5. The detailed reasons for this determination are set out in this document.

## Reasons for the Determination

### Summary of Application

6. The **IMO's** application, received 28 November 2006, provides details of its forecast expenditure for the Review Period, for which the IMO seeks to recover revenue. The IMO proposed the Allowable Revenue set out in Table 2 below.

**Table 2**      **IMO – Allowable Revenue Request**

Amount	2007/08	2008/09	2009/10
Allowable Revenue	\$10,351,000	\$10,542,000	\$10,209,000

*Source: IMO application (28 November 2006), page 1*

7. Pursuant to clause 2.22.12(a) of the Market Rules, the Allowable Revenue must be sufficient to cover the forward looking costs of providing market functions, as discussed in paragraph 16 of this determination.
8. In support of its Allowable Revenue application, the IMO supplied a proposed expenditure statement for the period, set out in Table 3 below.

**Table 3**      **IMO – Expenditure Statement**

Expenditure	2007/08	2008/09	2009/10
Employee Costs	\$3,133,000	\$3,370,000	\$3,505,000
Accommodation	\$265,000	\$273,000	\$282,000
Supplies and Services	\$3,589,000	\$3,470,000	\$3,661,000
Depreciation	\$2,964,000	\$3,124,000	\$2,559,000
Borrowing Costs	\$455,000	\$321,000	\$220,000
Total Expenses	\$10,366,000	\$10,558,000	\$10,227,000
less: Interest Income	(\$16,000)	(\$16,000)	(\$18,000)
<b>Allowable Revenue</b>	<b>\$10,351,000</b>	<b>\$10,542,000</b>	<b>\$10,209,000</b>

Source: IMO application (28 November), page 1

## Legislative Requirements

### *Disaggregation of the Western Australian Electricity Industry*

9. The operation and regulation of the Western Australian electricity industry is governed by the *Electricity Industry Act 2004 (Act)*.
10. 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**).
11. Regulation 5 of the Regulations provides for the establishment of the Market Rules, relating to the operation of the SWIS.
12. The Market commenced on 21 September 2006, pursuant to regulation 6(3) of the Regulations and clause 1.8.2 of the Market Rules.
13. 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 Independent Market Operator*

14. The IMO is established under regulation 4(1) of the *Electricity Industry Regulations (Independent Market Operator) Regulations 2004*.
15. The IMO has functions conferred by the *Electricity Industry Regulations (Independent Market Operator) Regulations 2004*, the *Electricity Industry (Wholesale Electricity Market) Regulations 2004*, and the Market Rules.
16. Clause 2.1.2 of the Market Rules provides a detailed listing of the functions of the IMO, which are as follows:
  - a) to administer the Market Rules;
  - b) to operate the Reserve Capacity mechanism, the Short Term Energy Market (**STEM**) and the balancing process;
  - c) to settle such transactions as is required under the Market Rules;
  - d) to carry out a Long Term Projected Assessment of System Adequacy (**PASA**) study and to publish the Statement of Opportunities Report;
  - e) to administer tender processes for Network Control Services where required by the Market Rules and to enter into Network Control Service Contracts;
  - f) to process applications for participation, and for the registration, de-registration and transfer of facilities;
  - g) to release information required to be released by the Market Rules;
  - h) to publish information required to be published by the Market Rules;
  - i) to develop amendments to the Market Rules and replacements for them;
  - j) to develop Market Procedures, and amendments and replacements for them, where required by the Market Rules;
  - k) to make available copies of the Market Rules and Market Procedures, as are in force at the relevant time;
  - l) 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;
  - m) to support the Economic Regulation Authority in its market surveillance role, including providing any market related information required by the Authority;
  - n) to support the Authority in its role of monitoring market effectiveness, including providing any market related information required by the Authority; and

- o) to carry out any other functions conferred, and perform any obligations imposed, on it under the Market Rules.

### *Allowable Revenue*

- 17. The revenue earned by the IMO is specifically provided for in the Market Rules to be revenue that can be recovered from Market Participants for the conduct of IMO services (Allowable Revenue).
- 18. In accordance with clause 2.22.1 of the Market Rules, the IMO must seek the approval from the Authority of its Allowable Revenue for the 3 year period 2007/08 to 2009/10, for the following services:
  - a) market operation services, including the IMO's operation of the STEM and Balancing and the IMO's settlement and information release functions;
  - b) system planning services, including the IMO's performance of the Long Term PASA function, operation of the reserve capacity mechanism and functions under Chapter 5 of the market rules; and
  - c) 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 these Market Rules.
- 19. Clause 2.22.12 prescribes the matters that the Authority must take into account when determining the Allowable Revenue of the IMO. First, clause 2.22.12(a) states that the Allowable Revenue must be sufficient to cover the forward looking costs of providing the IMO'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 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.
- 20. In making this determination the Authority has considered each of the above items (i. to iv.) separately.
- 21. Second, clause 2.22.12(b) provides that:

“the Allowable Revenue must include only costs which would be incurred by a prudent provider of the services described [above] ..., acting efficiently, 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.”

22. The Authority considers the above requirement to be a high threshold for cost-efficient service delivery in the performance of the IMO’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.
23. The Authority notes the difficulties associated with the forecasting of costs, and hence Allowable Revenue, in the first 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 the IMO’s service provision.
24. Finally, clause 2.22.12(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.”

### *Determination Process*

25. The determination process is set out in clause 2.22.3 of the Market Rules, as follows:
  - a) the IMO 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 the IMO 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 the IMO for the Review Period, for each of the services described in clause 2.22.1 of the Market Rules, by 31 March 2007.
26. The IMO submitted its proposal for Allowable Revenue on 28 November 2006.
27. The Authority undertook a public consultation process as required, including publishing an issues paper and issuing an invitation for public submissions on 21 December 2007.
28. The Authority engaged consultants to provide advice on the IMO’s application and its compliance and conformance with the relevant provisions in the Market Rules.
29. The consultants also provided advice with respect to the efficiency of the IMO as compared to other like organisations via a benchmarking process.
30. The Authority makes this determination pursuant to, and in satisfaction of, the requirement for the Authority to determine the Allowable Revenue of the IMO for

the Review Period, as stated in clause 2.22.3(c) of the Market Rules reproduced in paragraph 25 above.

## Public Submissions

31. In accordance with clause 2.22.3(b), the Authority undertook a public consultation process, including publishing an issues paper on 21 December 2007 and issuing an invitation for public submissions.
32. Public submissions in respect of the determination of the IMO's Allowable Revenue were received from:
  - a) Alinta Sales Pty Ltd (**Alinta**); and
  - b) the Electricity Retail Corporation trading as Synergy (**Synergy**).
33. Alinta's submission identified the following issues relevant to the Authority's consideration of the IMO's Allowable Revenue application:
  - a) Alinta considered that costs related to the substantial system development costs, noted in the IMO's application as a potential Declared Market project for 2009/2010, not be included in the IMO's Allowable Revenue for the first Review Period.
  - b) Alinta recommended that the Authority consider an economic incentive scheme for the IMO to promote operational efficiency.
34. Alinta also submitted that it welcomes an opportunity to comment on any finding that the Authority's consultant presents. However, due to time limitations, 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.
35. Synergy's submission noted the risks and uncertainty associated with the first Review Period but raised no specific issues for consideration by the Authority.
36. The issues identified in the above public submissions have been considered in the Authority's determination.

## Authority's Assessment

37. The Authority had regard to the report prepared by the consultant, Stamfords Advisors and Consultants, that reviewed the IMO's application and conducted an extensive analysis of the information provided.
38. The full consultant's recommendations can be found in Stamfords' report entitled 'Assessment of Allowable Revenue – Independent Market Operator' which is available on the Authority's [web site](#).
39. The Authority also had regard to issues raised in public submissions and the matters specified in the Market Rules.
40. The Authority's reasoning focuses on those matters of the IMO'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.

## Revenue Relating to Amortisation Expenditure for the 2009/10 Year

41. The IMO is seeking the amounts of depreciation set out in Table 4 below as a component of its Allowable Revenue.

**Table 4**      **IMO – Depreciation**

Expenditure	2007/08	2008/09	2009/10
Depreciation	\$2,924,000	\$3,124,000	\$2,559,000

*Source: IMO application (28 November), page 8*

42. Part of the forecast depreciation costs include depreciation (amortisation) of costs relating to a new system development in 2009/2010. These 2009/2010 system development costs are forecast to be \$8.6 million. Depreciation (amortisation) of these costs in the IMO's application is \$1.433 million in 2009/2010.
43. Based on the IMO's application, these 2009/2010 system development costs are not sufficiently certain to be allowable under the Allowable Revenue determination. The IMO's application (page 11) states that such system development costs:
 

“...would need to be subject to a thorough cost benefit analysis prior to any decision to proceed. The IMO may also determine that a major project is a Declared Market Project as described in the Market Rules 2.22.13.”
44. The Market Rules make provision for obtaining an increase in the Allowable Revenue in the case of such projects. If the IMO decided to proceed with the project, clause 2.22.13 enables the IMO to declare it a Declared Market Project. However, the IMO must obtain approval from the Authority for an increase in the Allowable Revenue relevant to the project before commencement of the project (clause 2.22.14).

45. In addition, while the IMO's application amortises these 2009/2010 system development costs over a three year useful life, clause 2.22.14 requires that, should the project be declared a Declared Market Project, the Authority will determine the period over which the incremental Allowable Revenue will apply.
46. The forecast 2009/2010 system development has not been requested by the IMO as a Declared Market Project and the Authority has not determined such.
47. Stamfords noted that the depreciation (amortisation) allowable under the Allowable Revenue determination currently includes depreciation (amortisation) of the 2009/2010 system development costs.
48. In accordance with this analysis, Stamfords recommended the following amendment be made to the allowable revenue proposed by the IMO:

The Allowable Revenue for the 2009/2010 year must be decreased by \$1.433 million in accordance with the amendment required to the allowable depreciation in the IMO's application. Should the system development project become more certain the IMO may consider it a Declared Market Project and incorporate it into the Allowable Revenue for that period.

49. Table 5 below sets out the depreciation costs, as amended, for which Allowable Revenue is recommended by Stamfords to be calculated.

**Table 5      IMO – Depreciation (amended)**

Expenditure	2007/08	2008/09	2009/10 <sup>1</sup>
Depreciation (application)	\$2,924,000	\$3,124,000	\$2,559,000
Less non-allowable Depreciation			\$1,433,000
Depreciation (allowable)	\$2,924,000	\$3,124,000	\$1,125,000

*Source: IMO application (28 November), page 8, Consultant's calculations (Stamford's report, 'Allowable Revenue - Independent Market Operator')*

50. The Authority acknowledges the submission provided by Alinta also proposing that \$1.433 million of the 2009/2010 depreciation expense not be included in the Allowable Revenue for the relevant year.
51. The Authority agrees with the consultant's assessment above and recommendation. Accordingly, it determines that the Allowable Revenue proposed by the IMO for the 2009/2010 year must be decreased by \$1.433 million in accordance with the amendment required to the allowable depreciation in the IMO's application.

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<sup>1</sup> Note a small rounding error

52. In this regard, the Authority notes that if the IMO resolved to proceed with the system development it may seek the Authority's approval for the project to be a Declared Market Project in accordance with clause 2.22.14 of the Market Rules.
53. The Authority agrees that the remaining depreciation is allowable in accordance with clause 2.22.12(a)(ii).

### **Uncertain Cost Estimates**

54. The IMO has included in its application estimates for certain costs that are not able to be readily forecast and relate to the purchase of supplies and services from third parties. Accordingly, the IMO has sought to recover revenue for a number of uncertain expenses in the first Review Period. These have been estimated for each year and amount to approximately \$1.8 million. The significant expenditures for the 2007/08 year relate to:
  - a) travel;
  - b) strategic development and training;
  - c) rules and procedures;
  - d) review of processes and criteria; and
  - e) dispute management.
55. Clause 2.22.7 of the Market Rules states that any underspending from Allowable Revenue will be carried over to the following year. Correspondingly, the Minister is required to approve the relevant budget for the IMO in accordance with clause 2.22.9. This may create an incentive to spend the full estimated amount regardless of the particular merits as the IMO will "lose" the amount for the next year.
56. This incentive is exacerbated by the newness of the operating environment created by the market commencing operation on 21 September 2006 and the lack of historic information to enable historic performance to be utilised.
57. Therefore, Stamfords has recommended that the Authority should as part of its determination recommend that an assessment be made of the utilisation of the estimated amounts stated above when the Minister considers the approval of the relevant annual IMO budgets. If, in the approval process for the 2008/2009 and 2009/2010 budgets, the analysis determines that the uncertain expenditure amounts are not being fully utilised, the Authority should recommend to the Minister that the total IMO budget be reduced by the estimated amounts not utilised, and the Allowable Revenue be adjusted accordingly in accordance with clause 2.22.7.
58. The Authority notes that the inclusion of uncertain estimates in allowable revenue is not necessarily inappropriate given the newness of the market, recognising that some cost items are more uncertain and have no historical basis on which they can be assessed.
59. The Authority therefore agrees with Stamfords' assessment that the estimated amounts are appropriate and consistent with the Market Rules.
60. 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 IMO budget be reduced by the amounts not utilised, and the Allowable Revenue be adjusted accordingly in accordance with clause 2.22.7.

### **Benchmarking**

61. A benchmarking analysis was undertaken which involved identifying entities that exist in other jurisdictions performing similar services to the IMO, as identified in clause 2.22.1 of the Market Rules.
62. Under clause 2.22.12(c) of the Market Rules the Authority is required to benchmark the IMO's Allowable Revenue, where possible, against the costs of providing similar services in other jurisdictions.
63. The organisations and their jurisdictions that were utilised in the benchmarking analysis were:
  - a) National Electricity Market Management Company (**NEMMCO**) (Australia);
  - b) Electricity Market Company (**EMC**) (Singapore); and
  - c) Independent Electricity System Operator Canada (**IESO**) (Canada).
64. Through the benchmarking process it was evident that no other market is identical to the Western Australian Market. It was 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 the IMO under the Market Rules.
65. The results of the consultant's analysis determined that the cost of providing like services in other jurisdictions were not materially different from the cost structure utilised by the IMO in support of its Allowable Revenue application.
66. The Authority agrees that subject to its reservations relating to some specific areas assessed in the determination, the benchmarking assessment by Stamfords suggests that, broadly speaking, the costs of providing like services in other jurisdictions is not materially different to those proposed by the IMO.

### **Incentivisation**

67. A public submission provided by Alinta suggested that the Authority consider developing an economic incentive scheme in the Allowable Revenue determination that would provide the IMO with a financial incentive for achieving operational efficiencies.
68. Stamfords advised that the placement of conditions upon the determination was not within the scope of the Authority's role for determining Allowable Revenue in accordance with the Market Rules.
69. The Authority agrees with Stamfords' advice that there is no scope within the Market Rules to include a performance based structure in the Allowable Revenue

determination. Accordingly, the Authority has not placed conditions upon the determination.