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Australian Energy Market Operator's allowable revenue and forecast capital expenditure proposal for the period 1 July 2022 to 30 June 2025: Issues Paper

The Australian Energy Council (the "**AEC**") welcomes the opportunity to make a submission to the Economic Regulation Authority ("**ERA**") on its Issues Paper relating to Australian Energy Market Operator's ("**AEMO**") proposed allowable revenue and forecast capital expenditure for the sixth allowable revenue period ("**AR6**").

The AEC is the industry body representing 20 electricity and downstream natural gas businesses operating in the competitive wholesale and retail energy markets. These businesses collectively generate the overwhelming majority of electricity in Australia and sell gas and electricity to over 10 million homes and businesses.

In its AR6 proposal, AEMO is seeking total allowable revenue for AEMO's Wholesale Electricity Market ("**WEM**") functions of $156.2 million and forecast capital expenditure of $69.4 million. This represents a 57 per cent increase in allowable revenue compared to the allowable revenue approved by the ERA for AR5 and will result in market fees rising by 60 per cent from $1.143 per MWh over the AR5 review period to $1.823 per MWh during AR6.[1]

End customers have borne the cost of higher market fees over recent allowable revenue periods and the combined increase in allowable revenue and capital expenditure in AR6 is another incremental cost that they will bear. Any forecast costs should be reasonable and justifiable so that market fees are kept to a minimum in AR6. AEMO's AR6 proposal should provide evidence that the requested revenue and capital expenditure is in the long-term interests of consumers in relation to the price, quality and reliability of goods and services provided in relevant markets.[2] Further, the ERA may consider assessing whether the proposed significant increase in market participant fees creates a barrier to competition, specifically new market entry.

The AEC applauds the ERA for the work it has already done in analyzing AEMO's proposal. The AEC makes the following comments on AEMO's proposal and the Issues Paper to assist with the ERA's review.

Additional forecast capital funding proposal anticipated during AR6

AEMO forecasts capital expenditure of $69.4 million but notes that "the capex forecast excludes projects that are insufficiently specified at this time, particularly the introduction of five-minute settlement (5MS) and

[1] See p1-2, Australian Energy Market Operator's allowable revenue and forecast capital expenditure proposal for the period 1 July 2022 to 30 June 2025 Issues paper

[2] Refer s. 26(1)(b) of the Economic Regulation Act 2003.

implementing DER aggregator participation."[3] AEMO indicated in an October 2021 briefing that these activities will cost in the range of $35 million to $60 million during AR6.[4]

The AEC has consistently advocated that market participants should not pay for government led market reform, including in our:

- Submission to the ERA on the AEMO allowable revenue and forecast capital expenditure proposal for 2019/20 to 2021/22[5];
- Response to the ERA on the AR5 draft decision[6];
- Submission to the Energy Transformation Implementation Unit on the DER Roadmap Draft Implementation Rules; and
- Most recently, in our submission to the ERA on AEMO's in-period funding request for Distributed Energy Resources Roadmap activities in AR5.[7]

Funding reform via market fees adds difficulty to AEMO's task of minimising market fees and, in many cases, it disproportionately penalises existing market participants due to these fees being charged on a $/MWh basis. The AEC is concerned that this would in fact exacerbate the cross-subsidies which caused the problem in the first place. As market fees are charged on $/MWh basis, rooftop solar PV owners would have little exposure to the additional charges, while generators and loads without rooftop solar PV would be penalised for an issue they did not cause and cannot control. The AEC encourages the ERA to review the way AEMO's costs are recovered from market participants and address these issues with Energy Policy WA.

In addition, the AEC considers that the ERA should not approve allowable review and capital expenditure requests relating to future market reforms that do not have regulatory certainty in terms of government approval, timeframes, design and implementation. In this context, the ERA is encouraged to engage with the State Government to determine whether AEMO's budget request is consistent with State Government expectations.

That aside, the AEC broadly supports deferring projects with uncertain costs to an in-period submission. This approach will minimise contingency costs and allow the ERA to scrutinise the projects when they are better defined.

It should be noted, however, that deferring projects to an in-period submission is not without drawbacks. The main issue is that there is no way for market participants to accurately include these unknown future costs in their long-term contracts. Market participants risk impacting their competitiveness if the costs they include are too high, and if they defer including the costs then their future contracts may not reflect all of the market fees. To assist with this, the AEC suggests that AEMO should continually refine the potential costs and give regular updates to assist market participants in their forecasting.

Performance standards

The ERA can, when determining (or undertaking a reassessment of) AEMO's allowable revenue and forecast capital expenditure, take into account any other matters it considers relevant to the ERA's determination.

The AEC recommends the ERA considering whether AEMO's allowable revenue proposal should contain key performance indicators and/or service standard benchmarks in relation to the services AEMO provides in the

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[3] See p3, Allowable Revenue and Forecast Capital Expenditure 2022-23 to 2024-25: Proposal to the Economic Regulation Authority
[4] See p18, Allowable Revenue and Forecast Expenditure (AR6) - July 2022-June 2025: Industry engagement session
[5] See AEC submission on Australian Energy Market Operator allowable revenue and forecast capital expenditure proposal for 2019/20 to 2021/22
[6] See AEC submission on AR5 Draft Decision
[7] See AEC submission on AR5 in-period funding

electricity and gas markets in Western Australia. It is reasonable for market participants who are paying for AEMO's services to obtain visibility of its service standard performance. Further, the establishment and publication of appropriate key performance indicators or service standard benchmarks will assist the ERA to assess the reasonableness of future AR requests based on service provider performance in the previous period. The AEC notes in relation to other regulated activities such as networks access, a range of regulated efficiency measures exist. These include:

- Service standard benchmarks whereby a service provider is required to meet minimum standards of service.
- Investment adjustment mechanisms that corrects for economic loss or gain due to differences between forecast and capital expenditure.
- Gain sharing mechanisms that incentivise a service provider to minimise costs as the provider keeps the benefits of any out-performance of operating cost forecast and incurs the costs of under-performance during a defined period.

The ERA, in the performance of its allowable revenue determination functions, should consider whether it is in the long term interests of consumers for the WEM rules to include service standard mechanisms applicable to AEMO in the performance of its WEM functions for which it seeks to recover costs from market participants in the form of market fees.

Labour costs

The Issues Paper notes that "at 46.9 per cent, labour costs are the largest proportion of overall allowable revenue costs in AR6. AEMO is estimating labour costs of $73.2 million in AR6, an increase of $24.5 million (50 per cent) over approved labour costs in AR5. This increase is primarily due to a forecast increase in permanent staff."[8]

AEMO's proposal of 31 new full-time permanent positions in AR6 is a significant increase and comes at a time when more processes are being automated. The AEC encourages the ERA to thoroughly review the labour cost estimates[9] and satisfy itself that these positions are justified and cannot be performed more economically in another way, such as through short-term contracting or reallocating existing teams.

Depreciation

Depreciation is the second highest component of AEMO's proposed allowable revenue in AR6. AEMO estimates depreciation costs at $50.9 million.

The AEC understands that AEMO calculates depreciation on a straight-line basis using the capital expenditure on an asset and the assumed economic life of that asset. Depreciation costs may be higher with this method if AEMO is investing in assets with a short economic life. The ERA should therefore be satisfied that AEMO are investing in assets with a sufficient economic life.

In addition, the AEC encourages the ERA to explore other depreciation methods that may help to create a flat overall capital cost recovery profile. In this context, there are merits in considering the real annuity method so depreciation costs can be more easily forecast.

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[8] See p8, Australian Energy Market Operator's allowable revenue and forecast capital expenditure proposal for the period 1 July 2022 to 30 June 2025 Issues paper

[9] While it is noted that a component of the labour cost increase relates to inflation, remuneration reviews and terms of the enterprise bargaining agreement, average annual salaries of approximately $263,000 (i.e. the labour cost increase divided by proposed new full time positions) appears to be above market rates.

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Regulatory precedence for the application of an annuity method of depreciation includes:

- ERA determinations under the Western Australia Railways (Access) Code 2000
- The ERA's determination for the recovery of deferred revenue resulting from the change in WP's treatment of capital contributions in the calculation of target revenue between AA1 and AA2
- ERA determination for light emitting diode streetlight asset tariffs (for FY2020)
- AER determinations for streetlight assets
- Queensland Competition Authority determinations for Sunwater and Seqwater
- New South Wales Independent Pricing and Regulatory Tribunal determinations for State Water (pre-2006)
- Essential Services Commission of Victoria determination for Southern Rural Water (pre-1 July 2006 assets)
- United Kingdom's Water Services Regulation Authority determinations for under-ground water assets

Project scope

The Issues Paper points out that "more than a third ($3.6 million) of AEMO's cost estimate to fund its DER capital expenditure program ($9.4 million) is not directly related to AEMO's obligations arising from the DER roadmap."[10] This is due to two projects on market visibility and DER data access and management. AEMO state that these projects are "driven by market need".[11]

The AEC considers that projects created by AEMO's own initiative should not automatically receive funding and may not be warranted during AR6 given the significant increase in WEM market participant fees. If these are genuine projects that truly meet a market need then AEMO should justify them to the ERA by providing more details on:

- Who is driving the need;
- Who benefits from these projects being delivered;
- Why is AEMO uniquely responsible for meeting this need;
- Is this the best use of resources; and
- Whether this will create any duplication of data.

Contingency

Contingency forms a significant part of the forecast WEM reform expenditure. In the AR6 period, AEMO is proposing a contingency of $11.4 million (34 per cent) and this has increased since AR5 when the average contingency was 22 per cent.

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[10] See p26, Australian Energy Market Operator's allowable revenue and forecast capital expenditure proposal for the period 1 July 2022 to 30 June 2025 Issues paper

[11] See p112 and 113, Allowable Revenue and Forecast Capital Expenditure 2022-23 to 2024-25: Proposal to the Economic Regulation Authority

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In the Issues Paper, the ERA has undertaken an excellent review of AR5 expenditure to understand how AEMO uses project contingency once it has been approved by the ERA. Most notably, the ERA noted that:

- "In some instances, AEMO has included high project contingencies of up to 56 per cent for its capital projects; and
- Typically, AEMO's spend falls below its estimates and project contingencies are not always used."[12]

This occurred during AR5 when AEMO used $5.1 million of approved contingency for the identified projects, while the remaining $6.3 million contingency was not required on the projects it was identified for because these projects came in under budget.

AEMO outlines in its proposal how they will attempt to manage and control contingency expenditure. They say that:

> "AEMO's intent is to not spend project contingency where possible … As a further control, the CEO & Managing Director will withhold c. 30% of the proposed contingency, meaning this amount cannot be released without detailed justification, consideration of options to avoid contingency, and express permission from him."[13]

The problem is that once the forecast capital expenditure is approved by the ERA, the ERA has no regulatory oversight of whether or how the funds are spent. In other words, AEMO are able to use these contingency funds however they wish once they are approved. For this reason, the ERA needs to satisfy itself that the proposed contingency amount is accurate and justifiable, and AEMO is not incentivised to over forecast contingency. The AEC suggests AEMO be required to provide transparency on how it used the excess contingency funds in AR5 to help inform the ERA's decision making on appropriate contingencies for AR6. Further, AEMO should be required to disclose to the market in its AR6 proposal how it would seek to spend the contingency balance should it not fully use the approved AR6 contingency on the identified projects in its proposal.

Purchasing and market testing arrangements

The Issues Paper discusses AEMO's purchasing policy and suite of processes for procurement activities. Given the magnitude of AEMO's AR6 request, the AEC encourages the ERA to substantiate with AEMO that these policies and procedures will be used consistently, such as through internal or external audits.

Conclusion

The AEC sincerely appreciates the ERA's review of AEMO's proposed forecast allowable revenue for AR6 and for the related consultation process. The AEC encourages the ERA to consider the issues raised above.

Any questions about our submission should be addressed to Graham Pearson, Western Australia Policy Adviser by email to graham.pearson@energycouncil.com.au or by telephone on 0466 631 776.

Yours sincerely,

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Australian Energy Council

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[12] See p22, Australian Energy Market Operator's allowable revenue and forecast capital expenditure proposal for the period 1 July 2022 to 30 June 2025 Issues paper

[13] See p93, Allowable Revenue and Forecast Capital Expenditure 2022-23 to 2024-25: Proposal to the Economic Regulation Authority