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Energy Policy WA
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Allowable Revenue Framework Review - Consultation Paper

The Australian Energy Council (the "**AEC**") welcomes the opportunity to make a submission on the Allowable Revenue Framework – Consultation Paper ("**Consultation Paper**")[1].

The AEC is the peak industry body for electricity and downstream natural gas businesses operating in the competitive wholesale and retail energy markets. Our members collectively generate the overwhelming majority of electricity in Australia, sell gas and electricity to millions of homes and businesses, and are major investors in renewable energy generation. The AEC supports reaching net-zero by 2050 as well as a 55 percent emissions reduction target by 2035, and is part of the Australian Climate Roundtable promoting climate ambition.

Background

The AEC welcomes a review of the Allowable Revenue Framework. While the Australian Energy Market Operator ("**AEMO**") performs a critical role in ensuring the secure and reliable supply of electricity in the Wholesale Electricity Market ("**WEM**"), the rapid increase in AEMO costs over recent years has placed an added financial burden on end consumers and created a pain point for Market Participants who have little certainty of forward-looking costs.

Any reform of the Allowable Revenue Framework will require compromises from all stakeholders. Absent some mechanism that will incentivise AEMO to better manage costs and meet project deadlines, there are no silver bullets that will instantly solve all of the problems with the Allowable Revenue Framework. Instead, the AEC suggests that there needs to be a series of reforms that combine to edge the framework towards a more optimal design.

The AEC has made this submission through a lens of prioritizing:

- AEMO being able to adequately perform its role;
- AEMO costs having a more stable glide path to give Market Participants more certainty of future costs;
- Accountability, oversight and transparency;
- 'Easy wins' over large reforms; and

[1] See Allowable Revenue Framework Review – Consultation Paper

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- Non-Business as Usual ("**BAU**") projects being scrutinised and funded by the right stakeholder. Government-led reforms should be funded by the government.

This submission is also informed by the independent report commissioned by the AEC and prepared by Rennie Advisory on the causes of AEMO's rising costs, and recommendations to amend the Allowable Revenue Framework ("**Rennie Report**").[2]

(1)(a) Do stakeholders consider that a review of governance arrangements for WEM and GSI functions is necessary or required?

The AEC strongly supports a review of governance arrangements. A key contributing factor to AEMO's increasing costs is the volume of projects driven by the State Government or Energy Policy that AEMO is being required to implement without decision makers having first put together a budget, undertaken a cost/benefit analysis, or assessed its priority. The number of new projects, cost increases and project delays highlights the need for governance arrangements need to be revisited. While the rule change process might still be fit for purpose, the review should consider how governance has played out in practice with policy implemented without budgets being developed, a cost benefit analysis being undertaken, and thought given to whether the policy is really a priority.

(1)(b) Do stakeholders support the proposed approach to AEMO executive performance indicators?

(1)(c) Which (if any) of the incremental improvement options identified do stakeholders think would be effective in sharpening reputational incentives?

(1)(d) Are there other incremental improvements, not listed, which stakeholders consider may strengthen reputational incentives?

The challenge with the existing Allowable Revenue Framework is that AEMO is not incentivized by reputation. Indeed, AEMO has a track record of spending funds above its approved limits, and delaying or reprioritising projects, and this hasn't forced a change in behaviours.[3] For example:

- In reviewing AEMO's second in-period submission, the ERA estimated that \$15 million to \$18 million of the requested additional funding for labour costs had already been incurred by AEMO and it had been paid via debt financing.

- The second in-period submission was required because AEMO would have exhausted most of its originally approved AR6 funding (\$142.3 million) by 30 June 2024.

- The proposed Relevant Level Method changes, which are broadly supported and has already received \$16m in funding, is being pushed out to the 2028 capacity cycle by AEMO.

- When the ERA compared AEMO's AR5 project expenditure to its actual expenditure, it found that:

    - 9 projects exceeded budget by \$10.1m;

    - \$5m was spent on projects that were not assessed by the ERA; and

    - 5 projects were not started during AR5.

Of course, the AEC acknowledges that these examples should be put in a context where AEMO has been dealing with rapid change and a raft of new reforms. However, the intent is to highlight that a typical for-profit business would ordinarily be driven to operate efficiently and avoid these outcomes. AEMO's status as a not-

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[2] See AEMO's budget framework – analysis and options for change
[3] See p3, Australian Energy Market Operator's AR6 second in-period allowable revenue and forecast capital expenditure proposal – Final determination

for-profit business compelled by WEM Rules means that reputational damage is not a sufficient incentive. This is noted by the Economic Regulation Authority:

> "…[AEMO] must prioritise delivery of reform and transition activities to deadlines set in the WEM Rules and by the State Government and Energy Policy WA. As a result, AEMO is incentivised to prioritise the timely delivery and full scope of reform work, over limiting cost pressures."[4]

The AEC supports the options listed in the Consultation Paper to sharpen reputational incentives.[5] These measures will improve transparency and give a more Western Australian focus to local operations. Having said that, the AEC has strong concerns that these measures alone will not be enough to incentivise AEMO. It is for this reason that the AEC supports a review of governance arrangements and identifying other improvements to strengthen reputational incentives.

Recommendation 1: Link financial incentives for senior executives to the satisfaction of KPIs

In the United Kingdom, the Office of Gas and Electricity Markets is establishing a performance-based RIIO framework (Revenue = Incentives + Innovation + Outputs) for the new National Electricity System Operator ("**NESO**"). NESO's licence conditions will link executive remuneration to performance against KPIs. The AEC considers that such an approach should also be considered for AEMO.

Linking financial incentives for senior executives to the satisfaction of KPIs would require an amendment to AEMO's constitution and a restructuring of AEMO so that the executives are solely Western Australian focused. However, this could be implemented over the next two years to align with the first post-implementation review and it would act as a genuine incentive for executives to ensure AEMO operates efficiently and delivers projects on schedule.

(2)(a) Do stakeholders support separating BAU and non-BAU expenditure?

Yes, the AEC supports separating BAU and non-BAU expenditure (albeit there is further commentary on non-BAU expenditure below). This approach was also recommended in the Rennie Report.

(2)(b) What stakeholder consultation should occur during preparation of the budget proposal?

The AEC supports the proposal in the Consultation Paper requiring AEMO to consult with stakeholders during the preparation of its non-BAU budget. Engagement through the Market Advisory Committee's ("**MAC**") Major Projects Working Group also seems sensible. However, it is noted that not all stakeholders are members of the MAC and it is suggested that there are also other forms of consultation. For instance, AEMO could hold a wider industry forum and use its WA Strategic Energy Forum.

(6)(a) Do stakeholders support the proposed assessment and approval process?

(6)(b) Do stakeholders agree with the proposed role of the Independent Panel?

The Consultation Paper proposes a shift from the ERA assessing AEMO's submissions to ensure they are acting prudently and efficiently to a model where an Independent Panel reviews each project plan but ultimately AEMO approves its own project plan and budget:

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[4] See p32, [Australian Energy Market Operator's AR6 second in-period allowable revenue and forecast capital expenditure proposal – Final determination]()
[5] See p25-26, [Allowable Revenue Framework Review – Consultation Paper]()

> *"For non-BAU expenditure, Energy Policy WA proposes that AEMO would have final approval role, but that the ERA would first approve the overall process for planning and managing projects and their expenditure, and a panel of independent experts, convened by the Coordinator of Energy, would review each individual project plan. AEMO would need to consider and respond publicly to the Panel findings prior to finalising and approving the project plan and budget."*[6]

The AEC has strong concerns that this approach will take the guardrails off AEMO. AEMO will no longer be held accountable, and with reputational incentives limited, they will be left unchecked to approve their own budget creating a real risk of further cost increases. Put simply, giving AEMO free reign to approve its own budget will not improve accountability or address the rising costs and forecasting errors raised by stakeholders.

The AEC considers that this approach has not improved on the model proposed in AEMO's rule change proposal where it also had the ability to approve its own budget. The AEC does not support AEMO having the authority to approve each project plan and instead proposes the following:

Recommendation 2: ERA or Independent Panel should have the final approval role

Having the ERA or the Independent Panel make the final approval decision would add a layer of accountability, keep checks on AEMO, and give more confidence to stakeholders.

(7)(a) Do stakeholders support the proposed funding period for BAU expenditure?

Yes, the AEC supports the proposed funding period for BAU expenditure.

(7)(b) Do stakeholders support the proposed indexation of BAU expenditure to reflect changes in underlying costs?

Yes, the AEC supports the proposed indexation of BAU expenditure on the basis that the ERA determines the appropriate indexation.

(7)(c) Do stakeholders support the proposed indexation to include an assumed efficiency gain?

The AEC considers that AEMO should have to provide evidence of efficiency gains to the ERA for their assessment on whether an efficiency gain can be included in the indexation.

(8)(a) Do stakeholders support the proposed funding period for non-BAU expenditure?

Yes, the AEC supports the proposed funding period for non-BAU expenditure.

(8)(b) Do stakeholders support the twice per year review by the Independent Panel?

Yes, noting the AEC's recommendation that the ERA or the Independent Panel should be responsible for the final approval of project plans.

(9)(a) Do stakeholders agree that uncertainty measures are not required for non-BAU expenditure?

The Consultation Paper states:

> *"For non-BAU projects less than $5 million total cost, AEMO can begin project execution activities up to three months before the project plan has been reviewed and approved by the Independent Panel."*[7]

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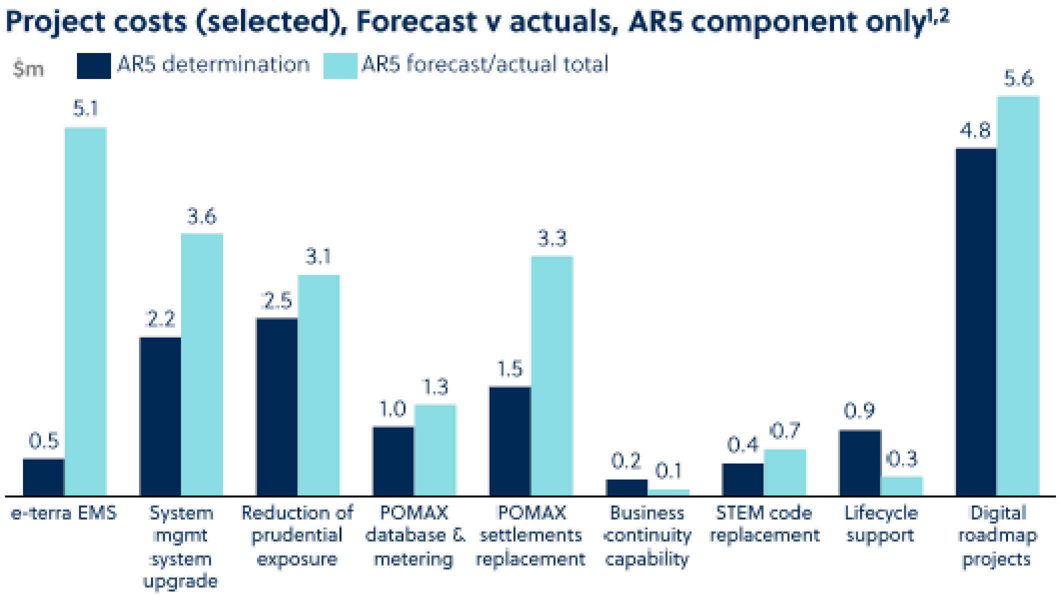
[6] See p34, [Allowable Revenue Framework Review – Consultation Paper]
[7] See p39, [Allowable Revenue Framework Review – Consultation Paper]

The AEC is concerned about this proposal. The AEC notes that of 18 projects that were approved in the AR5 determination, nine of those projects exceed their budget and many of those projects were initially expected to be less than $5 million. The cumulative impact of these budget exceedances was significant as shown below.



Source: Rennie Report

The AEC suggests that these smaller non-BAU projects should have the same level of scrutiny as large non-BAU projects and not be allowed to begin execution before the project plan has been reviewed and approved. The AEC also contends that where the projects are the result of a policy direction a determination should made before commencing any work on the budget and who should fund the project. In short, the AEC considers that any government-led reforms should be funded by the government.

(10)(a) Do stakeholders support the proposed approach to reducing volatility in market fees?

The AEC supports the proposed approach to reducing volatility in market fees on the basis that the ERA reviews and makes a final decision on the annual revenue recovery adjustment mechanism and the smoothed revenue recovery profile for project expenditure.

(11)(a) Do stakeholders support the proposed reporting approach?

(11)(b) Do stakeholders support the proposed independent review of AEMO performance?

The AEC supports any measures that will increase transparency. However, the lack of reputational incentives, as noted previously, means that the proposed reporting and independent reviews alone are unlikely to change the behaviours that have seen costs increase and schedules slip.

(12)(a) Do stakeholders support a post-implementation review and the suggested timing?

Yes, the AEC strongly supports a post-implementation review.

A review after two years would provide a reasonable amount of time to assess the strengths and weaknesses of any amendments.

(12)(b) Do stakeholders support a one-off post-implementation review (rather than a recurring review, for example every 5 years)?

AEMO regularly cites the energy transition as the cause of their increasing costs and the reason why the existing framework is no longer fit for purpose.[8] AEMO also says that "this pace of change is expected to prevail throughout the next decade".[9] Given this, it would be prudent to have recurring post-implementation reviews to ensure the framework remains fit for purpose and hasn't created any unintended consequences.

Other comments

The review does not address the main cause of the cost increases

In recent years, there have been a number of projects to address the energy transition underway in the WEM. Most of these projects are driven by the State Government or Energy Policy WA, and AEMO has a requirement to implement these reform programs to deadlines set in rules and guidelines. However, the Rennie Report notes that most of the larger reforms, such as the WEM Reform, five-minute settlement, WEM Investment Certainty Review and Planning Criterion changes, did not undergo a cost-benefit analysis.

The volume of these reform projects being given to AEMO is outstripping their capacity. To compound the problem, many of these early-stage policies are given to AEMO to implement without:

1. A budget being developed;
2. Policy makers having sufficiently considered whether the reforms generate an adequate benefit for the cost;
3. Thought given to whether the policy is actually a priority; and
4. Consideration as to how the reform interacts with other projects, and whether it might create a duplication of efforts.

While the AEC welcomes the review of the Allowable Revenue Framework, the Consultation Paper doesn't address the main cause of AEMO's increasing costs – that is, the volume of projects that AEMO is being required to implement without decision makers having first put together a budget, undertaken a cost/benefit analysis, or assessed its priority.

The AEC makes the following recommendations:

Recommendation 3: Establish a database of past project costs to support project forecasts

A database of past project cost should be created to provide a stronger evidence base to support early-stage project cost estimation. The database could include WEM projects and similar projects from other jurisdictions and track any learning that could be applied to future projects. This recommendation was proposed in the Rennie Report.

Recommendation 4: Establish a screening process to review projects

Energy Policy WA should implement a gate process, where reform projects are screened, and costs and priorities are more robustly considered, before projects arrive at AEMO. This screening could leverage existing forums, such as the MAC, and identify the merits of the reform and whether the reform is being led by government or industry.

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[8] See p2, Rule Change Notice: Allowable Revenue Framework (RC_2024_01)
[9] See p3, Rule Change Notice: Allowable Revenue Framework (RC_2024_01)

Recommendation 5: Government-led reforms should be funded by the government

A concern with the existing Allowable Revenue Framework, which is not addressed in the Consultation Paper, is that some reforms being driven by the State Government have little support from Market Participants who are nonetheless still required to fund the projects. An example of this is five-minute settlement, which received mute support from Market Participants and was progressed without a cost-benefit analysis.[10]

The AEC considers that any government-led reforms should be funded by the government. This approach would address many of the accountability and oversight concerns regularly raised by stakeholders because the funding, timing and delivery of the projects would be jointly managed between Energy Policy WA and AEMO.

Conclusion

The AEC appreciates this opportunity to provide feedback on the Consultation Paper and encourages Energy Policy WA to consider the issues raised above.

Please do not hesitate to contact Graham Pearson, Western Australia Policy Manager by email on graham.pearson@energycouncil.com.au or by telephone on 0455 233 346 should you wish to discuss this further.

Yours sincerely,

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[10] See p16, AEMO's budget framework – analysis and options for change