

The Allen Consulting Group

Tuesday 7 December 2010

Mr Jack Fitcher
Senior Manager Corporate Finance
Australian Energy Market Operator
Level 22
530 Collins Street
MELBOURNE VIC 3000

CC: Mr Ben Skinner

Dear Mr Fitcher

The Allen Consulting Group (ACG) has been asked by the Australian Energy Market Operator (AEMO) for further advice concerning the allocation of the 'unallocated' category of costs within the AEMO's general budget.

The 'unallocated' category of costs are those costs not directly attributable to any specific market activity of any specific market participant.

Previous ACG advice

In previous advice to one of your predecessor organizations (*Report to NEMMCO on economic issues relating to Participant Fee structure, 22 December 2005*), the ACG advised that unallocated costs be levied on 'Market Customers' rather than generators and MNSPs.

This was because unallocated costs should be borne by the electricity market's end-users.

In the absence of a capability to levy end-users directly, entities in the electricity supply chain nearest to end-users should be levied. Those entities are the Market Customers which offer retail electricity services to end-users.

The reasoning behind this advice was that, all else being equal, economically efficient fee-levying should minimise the number of steps in a supply-chain along which a levied fee is passed. Since the National Electricity Rules are silent on how to allocate unallocated costs, principles of economic efficiency (as set out in the National Electricity Objective) govern how unallocated fees should be levied.

To the best of our knowledge, we are unaware of any development in the national electricity market since that advice was given which might lead us to revise that advice.

Current EnergyAustralia issue

During your recent consultation on the Structure of Participant Fees in the National Electricity Market, EnergyAustralia has raised a concern that some Market Customers in New South Wales might not be

able to pass the fee on to end-users relatively quickly because of regulation of retail prices in New South Wales by the Independent Pricing and Regulatory Tribunal (IPART).¹

In its submission to the AEMO's consultation, EnergyAustralia states that increases in the AEMO's participant fees must be borne by Market Customers in New South Wales (rather than passed on to end-users) until the next IPART review when increases may be allowed to be passed on.

EnergyAustralia states that, given this risk borne by Market Customers in New South Wales, "a more reasonable way of allocating [unallocated] costs is to attempt to apportion them between the different categories of participant to better reflect where costs are incurred."²

Current ACG advice

First, it is worth noting that not all retail electricity customers in New South Wales qualify for regulated retail electricity prices.³

Second, unallocated costs do not arise due to the specific behaviour of any specific participant in the national electricity market. It follows that unallocated costs cannot, by their nature, be apportioned to "different categories of participant to better reflect where the costs are incurred."⁴ Rather, unallocated costs are to be apportioned according to principles of economic efficiency, consistent with the National Electricity Objective.

Third, the AEMO's fees are included as part of the costs which IPART allows Market Customers to recover from end-users in New South Wales. This cost-allowance is based on (linear-trend) predictions of the AEMO's future fees.⁵

Fourth, in the unlikely event that IPART's prediction of the AEMO's future fees were to be proved to be a significant underestimate of the AEMO's actual fees, so that Market Customers in New South Wales became obliged to bear some of the burden of the AEMO's fee increases during those periods between IPART's major reviews of retail pricing regulation, the ACG's previous advice would still hold.⁶ Efficiency in the setting of fees in supply chains to recover unallocated costs still mandates that they be levied either on end-users or else at a step in the supply chain as close as possible to end-users.

Yours sincerely



Richard Scheelings
Principal Economist

¹ See the EnergyAustralia submission, available at: <http://www.aemo.com.au/registration/nemfees11.html>.

² See page 1 of EnergyAustralia's submission.

³ The *Electricity Supply Act 1995* provides for IPART to set regulated retail prices for small retail customers (currently, those using less than 160 MWh of electricity per year) that are not supplied under a negotiated contract.

⁴ See page 1 of EnergyAustralia's submission.

⁵ See page 108 of IPART's Final Report of its *Review of regulated retail tariffs and charges for electricity 2010-2013*, available at: <http://www.ipart.nsw.gov.au/files/Final%20Report%20-%20Review%20of%20regulated%20retail%20tariffs%20and%20charges%20for%20electricity%202010%20to%202013%20-%20March%202010.PDF>.

⁶ These fees are not included in IPART's annual cost reviews, because they are considered 'relatively stable' over time (and therefore relatively easy to predict). See pages 143 and 148 of IPART's Final Report of its *Review of regulated retail tariffs and charges for electricity 2010-2013*.