Explanatory notes regarding the price control arrangements

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{Outline: This document provides explanatory notes for *price control*, which is included in Western Power's *access arrangement* in accordance with section 5.1 of the *Code*.}

CONTENTS

1 Introduction

The purpose of this appendix is to provide further explanation of the proposed revenue cap arrangements, the correction factor, the treatment of capital contributions at the next access arrangement review and the investment adjustment mechanism as set out in this Access Arrangement. It is intended that these notes may assist in the interpretation of the price control arrangements set out in section 5 of this Access Arrangement should the need arise.

2 Details of proposed control

In accordance with the Authority's draft decision, Western Power has adopted a revenue cap for the transmission and distribution networks. The form of revenue cap, the correction factor and the investment adjustment mechanism is essentially the same for both the transmission and distribution network (so the following comments are equally applicable to both the transmission and distribution networks).

The revenue caps specify a total dollar amount (in $ million) that can be recovered by Western Power from its customers for each year of the access arrangement period in respect of the sale of covered services (where actual revenue received by Western Power is apportioned appropriately between the transmission and distribution networks). The specified dollar amount will be increased to take account of actual inflation (CPI) over the course of the access arrangement period. This type of adjustment is standard in many forms of price control. It is noted that there is no X factor as such because the revenue cap amount is specified in dollars for each year, and is derived from a forecast of efficient total costs.

The revenue cap also uses a correction factor (termed the "K factor"), which allows the maximum revenue in one year to be adjusted (up or down) for any shortfall or over-recovery of revenue in preceding years. Such shortfalls or over-recoveries typically occur because actual revenue depends on a number of parameters, notably tariff sales, which are difficult to forecast with 100% accuracy.

A complicating factor is that the revenue cap proposed by Western Power includes revenue from:

- the sale of reference services;
- the sale of non-reference services; and

- capital contributions.

It is particularly difficult to forecast capital contributions accurately because they depend on the actions of third parties who are making decisions to connect to Western Power's network (and pay a capital contribution). This forecasting issue could have an impact on the stability of reference tariffs if Western Power's revenue cap required the company to ensure that each year the sum of actual revenue collected from the three sources listed above did not exceed the revenue cap. For example, if capital contributions in year 1 are much higher than forecast (and are expected to continue at this higher level in future years), Western Power would need to reduce revenue from tariff customers in order to remain within the revenue cap. Such an outcome would be undesirable because the costs of servicing tariff customers would not have changed in a manner that would justify such a reduction in tariffs.

To address this problem, Western Power applies a capital contributions adjustment mechanism which temporarily puts to one side any difference between the forecast and actual capital contributions received in each year of this access arrangement period. However, any such differences are recognised at the next access arrangement period through the capital contributions adjustment mechanism. This approach means that the K factor (which adjusts the maximum allowed revenue in each year of this access arrangement period) does not apply to capital contributions.

At the next access arrangement period, Western Power also proposes an investment adjustment mechanism (IAM) which addresses differences between forecast and actual capital expenditure for particular categories of capital expenditure. This adjustment is different in nature to the K factor, as the latter adjusts for differences between allowed and actual <u>revenue</u> – whereas the IAM adjusts for differences in capital expenditure (or cost) forecasts. The IAM applies to capital expenditure that Western Power believes is especially difficult to forecast.

These categories are:

- Capital expenditure arising from the connection of new generation capacity to the transmission or distribution network from 1 July 2006;
- Capital expenditure arising from the connection of new load to the transmission or distribution network from 1 July 2006; and
- Capital expenditure in relation to the augmentation of the capacity of the transmission or distribution networks for the provision of covered services from 1 July 2006.

A further complicating issue is that Western Power's view is that the revenue control arrangements should facilitate the provision of services by Western Power outside the scope of the access arrangement where this can be agreed with the customer. This view is consistent with section 2.5 of the Code, which states:

> "Nothing in this *Code* except:
>
> (a) an *applications and queuing policy* in an *access arrangement*; and

(b) the ringfencing objectives and any ringfencing rules approved for a *network* by the *Authority* under Chapter 13;

(c) and any applicable *technical rules*,

limits:

(d) the *services* a *service provider* may agree to provide to a *user* or *applicant*; or

(e) the terms for, or connected with, the provision of *services* which may be agreed between a *service provider* and a *user* or *applicant*; or

(f) the *covered services* which may be the subject of an *access dispute* or award under Chapter 10; or

(g) the terms for, or connected with, the provision of *covered services* which may be the subject of an *access dispute* or award under Chapter 10."

To give effect to this provision, the revenue cap should allow Western Power to negotiate a network connection so that the costs and revenues associated with this connection fall outside the revenue cap.

Therefore:

- In determining the actual capital contributions revenue received (for the purposes of making an adjustment at the next access arrangement period for any difference between forecast and actual capital contributions revenue received), Western Power is able to exclude a particular capital contribution.
- By the same token, in calculating the revenue adjustment to be applied through the IAM, if Western Power chooses to exclude an amount from the actual connection contributions revenue received, it must also exclude the associated capital expenditure from the IAM.

The example set out in the table below illustrates a situation in which Western Power and the user agree that the provision of a $40 million new connection is to be outside the scope of the access arrangement. The interaction of the K factor (which relates to revenue over- or under-recoveries) and the IAM (which relates to difference between forecast and actual capital costs) is illustrated below:

	Forecast at start of this AA period	Actual outcomes at end of this AA period under the proposed AA	Impact of revenue correction (K factor) at next AA period	Impact of IAM at next AA period
Capital contributions revenue received	100	60	+40 [forecast minus the actual amount determined under the revenue cap arrangement]	-40 [the amount of capital contributions revenue excluded in the calculation of actual revenue under the revenue cap]
Excluded contribution	0	40		
Total in present value cash terms	100	100	+40	-40

The above table shows that:

- whilst the revenue correction mechanism (the K factor) would allow revenue in the next access arrangement period to be increased by 40 (because under the revenue cap arrangement, Western Power is deemed to have received revenue of only 60 compared to the forecast of 100);
- the IAM would have a correspondingly negative effect on revenue in the next access arrangement period (because the capital base will be 40 lower than expected as a result of the excluded capital contribution revenue).

This example is highly simplified, but it shows that the K factor and IAM operate together within the revenue cap arrangements to have the effect of allowing Western Power to exclude particular capital contributions from the revenue cap (with the agreement of the relevant user), without affecting charges to other customers. This is an appropriate outcome.

3 Concluding comments

Western Power believes that the revenue cap arrangements set out in this Access Arrangement and described here are appropriately designed and consistent with the Code requirements.