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*.}

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1. Introduction

The purpose of this appendix is to provide further information in relation to the proposed revenue cap arrangements 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. Furthermore, sections 3 and 4 provide details of how revenue adjustments will be made in relation to costs arising from unforeseen events and changes in the *technical rules*.

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.

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 during the next and, if appropriate, subsequent *access arrangement periods* through the capital contributions adjustment mechanism. The role of the capital contributions adjustment mechanism 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.

Western Power has the flexibility to spread the capital contributions adjustment mechanism over a number of regulatory periods. This flexibility is subject to the constraint that the adjustments to target revenue in respect of any capital contribution will occur over a period not greater than the assumed regulatory-depreciation lives for the assets to which the capital contributions related.

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 revenue – 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.

3. Revenue Adjustment for Unforeseen Events

In accordance with sections 5.4 and 5.5 of this Access Arrangement, the *target revenue* for the next *access arrangement period* may be adjusted for unforeseen events that occur in the *first access arrangement period*.

This section describes the process under which Western Power will determine this revenue adjustment amount. There is no provision in forecast expenditures to account for possible *force majeure* events although there is provision to cover reasonable insurance costs.

This provision for revenue adjustment covers those costs (termed "unrecovered costs" in section 6.6 of the Code) which are net of any insurance payment or other cost recovery, and which were incurred prudently.

It is proposed that the expenditure included in the adjustment to *target revenue* for unrecovered costs be treated as an addition to the forecast revenue entitlement submitted in the next *access arrangement period*. This amount is to be spread evenly over each year of the next *access arrangement period.*

To give effect to this purpose, the adjustment to the *target revenue* for the next *access arrangement period* must leave Western Power economically neutral by taking account of:

(a) The effects of inflation, both in this *access arrangement period* and the next; and

(b) The time value of money as reflected by the real pre-tax WACC as applied in this *access arrangement period* and the next.

4. Revenue Adjustment for Technical Rule Changes

In accordance with sections 5.7 to 5.10 of this *Access Arrangement*, the *target revenue* for the next *access arrangement period* may be adjusted for changes to the *technical rules* that occur during the *first access arrangement period*.

This section describes the process under which Western Power will determine this revenue adjustment amount.

It is proposed that the expenditure included in the adjustment to *target revenue* for changes to *technical rules* be treated as an addition or subtraction to the forecast revenue entitlement submitted in the next *access arrangement period*. This amount is to be spread evenly over each year of the next *access arrangement period*.

To give effect to this purpose, the adjustment to the *target revenue* for the next *access arrangement period* must leave Western Power economically neutral by taking account of:

(a) The effects of inflation, both in this *access arrangement period* and the next; and

(b) The time value of money as reflected by the real pre-tax WACC as applied in this *access arrangement period* and the next.