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HORIZON POWER

30 April 2012

Mr Rajat Sarawat
Executive Director, Economics
Economic Regulation Authority
PO Box 8469
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Dear Rajat

RE: SUBMISSION IN RESPONSE TO THE DRAFT REPORT: INQUIRY INTO THE EFFICIENCY OF SYNERGY'S COSTS AND ELECTRICITY TARIFFS

Horizon Power welcomes the opportunity to comment on the draft report for the above inquiry.

Horizon Power is a commercially focused, State Government-owned power company that provides quality, reliable power supplies to Western Australia's booming regional economy. We are responsible for generating, procuring, distributing and retailing electricity to residential, industrial and commercial customers and resource developments in our service area.

Our service area is outside of the south west corner of the State and covers 2.3 million square kilometres across the Kimberley, Pilbara, Mid West and southern Goldfields (Esperance) regions.

Horizon Power provides some general comments on the inquiry and then responds to the individual findings from the draft report.

General comments

Horizon Power generally supports the determination of cost reflective tariffs for electricity customers as this provides information to customers on the real cost of supplying electricity across the State. However, any proposed move to cost reflective tariffs in the South West Interconnected System (SWIS) should also be accompanied by:

- more detailed and time related demand information for customers to enable them to change their consumption behaviour;
- the gradual phasing of any price increases via a 'glide path' to limit further price shocks for customers;
- continued provision of the Tariff Adjustment Payment (TAP) to Horizon Power and Synergy until cost reflective tariff levels are reached;
- continued provision of adequate subsidy to Horizon Power (via the Tariff Equalisation Contribution [TEC] or Community Service Obligation [CSO]) to reflect the additional costs of supplying electricity to regional Western Australia; and
- the provision of direct subsidies to eligible customers in financial hardship rather than embedding electricity subsidies in tariffs as this distorts the true cost of electricity usage.

Comments on individual issues

This submission addresses each of the draft findings in turn as outlined below.

1. *Synergy's demand forecast - The Authority considers Synergy's demand forecasting approach and assumptions to be appropriate and has accepted Synergy's demand forecasts for the pricing period.*
2. *The Authority considers Synergy's energy consumption forecasting process to be efficient and accepts Synergy's energy forecasts for the period 2013/13 to 2015/16.*
3. *The Authority considers Synergy's methodology and estimates for dispatching energy to be efficient.*

   Horizon Power has no comment to make on the first three findings.

4. *The Authority considers that Synergy may not be able to respond immediately to the carbon price. As a result, while Long Run Marginal Cost (LRMC) provides an indication of the efficient level of cost over time, it is more appropriate to adopt Synergy's actual contract costs for 2012/13 and 2013/14, followed by the LRMC approach for the following two years when determining Synergy's efficient costs. The Authority notes that:*
   a. *the LRMC is slightly lower than Synergy's forecast average cost of dispatch in 2012/13, mainly due to a lower carbon intensity of the new entrant generator; and*
   b. *from 2014/15 onwards, the LRMC is substantially below Synergy's forecast average cost of dispatch, due to both a lower energy cost and a lower carbon cost.*

Horizon Power agrees with the Authority that Synergy (or any other existing electricity service provider) is unable to immediately respond to the carbon price by amending existing electricity supply arrangements.

However, Horizon Power is concerned that two years is too short a period of transition from actual contract costs to a LRMC cost to serve and that this should be extended to a period that better accommodates the practical issues around renegotiating contract rates, exiting existing contracts or tendering for new electricity supplies. The transition period should therefore be commensurate with the practical activities that need to occur to progress to an optimal generation mix.

5. *The Authority considers Synergy's procurement of Renewable Energy Certificates (RECs) to be efficient.*

Horizon Power has no comment to make on the Authority's finding with regards Synergy's procurement of RECS. However, the Authority should be aware that the price of Large-scale Generation Certificates (LGCs) is very sensitive to market conditions with the resultant prices for LGCs fluctuating accordingly. Furthermore, Horizon Power is concerned that the average market price for LGCs is increasing over time. Consequently, the purchasing of RECs going forward will place a larger cost burden on those companies who are subject to this legislative requirement.

6. *The Authority has adopted the actual contract costs for Synergy in the first two years; being 2012/13 and 2013/14, followed by the LRMC cost approach for the following two years; 2014/15 and 2015/16.*

Please refer to the response relating to draft finding no. 4.

7. *The Authority has adopted the actual retail operating costs for Synergy in the first two years; being 2012/13 and 2013/14, followed by $81.50 per customer (in 2011/12 dollars) for the following two years; 2014/15 and 2015/16.*

Horizon Power suggests that the Authority should allow sufficient time for Synergy or any other service provider to deliver efficiency savings in its unit retail operating cost. Horizon Power is of the opinion that two years may not be a sufficiently long timeframe to achieve this given that efficiencies may need to come from revising internal processes or structural reorganisations. Furthermore, any overly ambitious efficient level of retail unit cost incorporated in cost reflective tariffs in the SWIS will only increase the level of the TEC in order for Horizon Power to continue to supply electricity in regional Western Australia.

8. *The allowance of $81.50 per customer (in 2011/12 dollars) for retail operating costs should apply to all tariff customers; contestable and non-contestable. Additional efficient costs associated with the acquisition and retention of contestable customers are recovered through Synergy's retail margin.*

Horizon Power suggests that there are differing types of costs and levels of costs associated with retailing to different classes of customers. This is particularly apparent for Horizon Power given the diversity of its customer base.

If higher acquisition and retention costs exist for contestable customers in the SWIS then this should be reflected in either the retail operating cost or the retail margin. However, the Authority has set a single unit operating cost for contestable and non-contestable customers and a standard retail margin for contestable and non-contestable customers. Therefore, there is no mechanism for Synergy to collect the additional costs associated with retailing to contestable customers. Horizon Power suggests an appropriate response would be to have a customised retail margin or cost reflective level of unit retail operating cost for each identifiable customer class. This would ensure that the costs associated with retailing to those customers appropriately reflect the risk profile for each customer class.

9. *Retail operating costs are escalated by 3.375 per cent over the review period.*

Horizon Power is reassured that the Authority has separately considered labour and non-labour escalation for the Synergy inquiry and reflected the different rates of escalation of these two elements when determining cost reflective tariffs.

Operating within regional Western Australia, Horizon Power is acutely aware of the impact of labour costs on the cost to supply electricity. Competition for scarce labour resources in the regions by resources and mining companies is driving labour costs higher, particularly for Horizon Power, which in turn increases Horizon Power's efficient cost to supply electricity. Horizon Power is therefore encouraged that the Authority has recognised this market condition in the Synergy inquiry. Horizon Power is aware that the labour price index may not be representative of actual or forecast labour costs in regional Western Australia. However, the Authority's use of a labour price index which increases at a faster rate than non-labour items over the inquiry period is reflective of the Authority's understanding of the current labour market and the challenges this provides to service providers in attempting to control the costs to supply electricity.

10. *Depreciation is separately accounted for in Synergy's cost and the Authority considers that the average annual depreciation cost of $14.10 per customer to be appropriate.*

During the Authority's 2010/11 inquiry into the funding arrangements of Horizon Power, the Authority did not allow actual capital expenditure (over and above budgeted amounts) to be included in Horizon Power's regulated capital base. The Authority recommended that where projects managed by Horizon Power ran over budget, these costs should not form part of the efficient cost to serve. Horizon Power would expect, for reasons of regulatory consistency, that this same approach was applied to Synergy's forecast capital costs over the inquiry period.

11. *The Authority recommends that the TEC be removed from Western Power's Network Charges and be funded by a CSO for the consolidated revenue.*

The funding of the subsidy to Horizon Power to cover the additional costs incurred in supplying electricity to regional Western Australia is a matter of government policy. Consequently, it is for the government to decide on the most appropriate mechanism to deliver this subsidy.

12. *Synergy has little control over its ancillary services costs. The Authority therefore recommends that forecast costs for ancillary services be included in the costs to be recovered from Synergy's customers.*
13. *As a participant in the WEM, Synergy cannot avoid market fees and has little influence on the expenditure incurred by the IMO and System Management. The Authority therefore considers it is appropriate for Synergy to recover the payment in full from its customers.*

As it does not participate in the WEM, Horizon Power has no comments to make on draft findings nos. 12 and 13.

14. *An appropriate retail margin for Synergy for the next four years is 3.5 per cent of its total costs.*

Horizon Power considers that the retail margin should reflect the full risk profile associated with retailing to a particular class of customers.

This is particularly important for Horizon Power in the Pilbara where there is considerable uncertainty around whether or not resource and mining projects proceed. Horizon Power has to ensure that this risk is fully captured in the contractual arrangements with large commercial customers for these arrangements to be fully cost reflective. Whilst Horizon Power recognises that the risk associated with retailing in the SWIS is probably lower than that of retailing in regional Western Australia, the risk of retailing to different customer classes should be recognised through varying retail margins depending upon the risk associated with different customer classes.

15. *The Authority considers that there is no justification for merging any tariff categories at this stage.*

Horizon Power notes that in the draft report the Authority does not propose to merge any tariff classes as part of this inquiry.

Horizon Power utilises the same uniform tariffs as Synergy and so any proposed changes to tariff structure or tariff classes will impact Horizon Power's future regulated revenue. Consequently, if the Authority's position to tariff classes is expected to change in the final report for the inquiry then Horizon Power should be consulted in advance of any proposed changes to be able to assess and advise on the potential implication for its revenues and costs.

16. *The Authority considers two years to be an appropriate period for Synergy to achieve the efficient gains necessary to move to cost reflective tariffs.*
17. *The Authority recommends that Synergy take steps to reduce wholesale electricity costs and retail operating costs over this two year period.*

Horizon Power is concerned that a two year period to reduce costs in order to move to cost reflective tariffs may not be achievable.

This is because some of the costs associated with procuring electricity and services from third parties are not within a service provider's immediate control to reduce. Examples of this would be where a service provider has negotiated fixed term Power Purchase Agreements with Independent Power Producers that cannot be renegotiated until the contract term ends or if a particular contract clause is triggered. Similarly, if certain services are outsourced to third party providers then again contracts may be in operation that are difficult, or costly, to alter in the short term.

18. *The Authority recommends that the subsidy to Horizon Power be provided by a CSO rather than the TEC and notes that the CSO will be partially offset as a result of moving to cost reflectivity.*

See above response to draft finding no. 11.

19. *The Authority recommends that regulated tariffs be retained for all contestable customers through to 2015/16 and re-assessed at the next review.*

Horizon Power notes the Authority's draft finding on retaining regulated tariffs for contestable customers until the date of the next review.

If, at the next Synergy inquiry, the Authority recommends eliminating regulated tariffs for contestable customers, then Horizon Power, and other retailers, may need to develop a commercial pricing plan to offer an alternative to regulated tariffs. The Authority should be aware that it will require significant planning to develop and administer such a plan, to communicate tariff and pricing changes to customers and to understand the revenue and cash flow implications that result from customers switching from cost reflective franchise tariffs to commercial pricing arrangements Consequently, the Authority should allow sufficient time for Horizon Power, and other retailers, to develop these alternative pricing arrangements if ever it recommends that regulated tariffs for contestable customers be removed.

20. *The Authority recommends that the next inquiry into the efficiency of Synergy's costs and electricity tariffs be conducted in 2014/15 rather than at the end of the four year review period to allow for a timely assessment of changes in Synergy's carbon cost.*

Horizon Power is concerned that whenever the State Government instructs the Authority to conduct a second inquiry into the efficiency of Synergy's costs and electricity tariffs, there is sufficient opportunity for Horizon Power to determine the impact of any changes to tariff classes or cost reflective levels on its future revenues and costs.

21. *The Authority recommends that if there are significant changes to economic conditions a mid-period review be undertaken.*

Horizon Power has no comment to make on the draft finding no. 21.

Concluding remarks

Horizon Power is pleased to take the opportunity to respond to the draft report the Synergy inquiry and looks forward to the findings in the final report.

Horizon Power wishes to reiterate that if the final report for the inquiry recommends any changes to tariff classes or tariff structure then, given the mirroring of uniform tariffs for regional electricity customers, it is imperative that Horizon Power is fully consulted on any proposal so that the impact of the changes upon Horizon Power's systems and process, revenue, costs and subsidies is fully understood.

Yours sincerely

[redacted]

David Tovey
Company Secretary/Manager External Affairs
HORIZON POWER