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29 May 2012

Mr Robert Pullella
Executive Director, Access
Economic Regulation Authority
PO Box 8469
Perth Business Centre
PERTH WA 6849

publicsubmissions@erawa.com.au

Dear Robert

RE: SUBMISSION IN RESPONSE TO THE DRAFT DECISION ON PROPOSED REVISIONS TO THE ACCESS ARRANGEMENT FOR THE WESTERN POWER NETWORK

Horizon Power welcomes the opportunity to comment on the draft decision for the above access arrangement.

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.

Whilst none of Horizon Power's networks is covered by the Access Code, Horizon Power does take this opportunity to provide comments on individual issues raised in the draft determination.

Efficiency targets

Government Trading Entities, such as Western Power and Horizon Power, are already subject to an annual Efficiency Dividend of 5% on discretionary operating expenditure, introduced in the 2011-12 Budget, which has been further increased[1] in the 2012-13 Budget.

Horizon Power is concerned that broad brush application of compounded efficiency

[1] The 5% Efficiency Dividend for GTEs is increased by 2.5% in 2012-13, 4% in 2013-14, 5.5% in 2014-15 and 6% in 2015-16. Refer to Department of Treasury (2012), Budget Paper No. 3, Economic and Fiscal Outlook, Appendix 7, p 331.

targets, over and above the government's Efficiency Dividend presents an onerous burden on service providers. This is particularly pertinent when utilities are faced with ageing asset bases that require increased levels of maintenance, an increasing legislative and regulatory burden and proposed changes to service standards.

Horizon Power is supportive of the efficient delivery of electricity services. However, problems occur when a regulator implements or recommends additional efficiency targets without providing clear linkages as to where or how these efficiencies are expected to be realised and without due explanation or justification for the size of the efficiency target. When a broad brush efficiency target is applied, it is difficult for a service provider to relate the proposed expenditure reduction to a future operating cost profile that is based on the rolling forward of actual operating costs in line with growth forecasts and service delivery requirements.

A better approach would be for the regulator to work with the service provider to determine what efficiencies may be achievable and, if implemented, how the reduced cost profile would impact upon levels of activity and service delivery. An approach of this manner will improve the efficient operation of the service provider whilst minimising any detrimental impact upon service delivery for customers both now and in the future.

Escalation

Horizon Power is reassured that the Economic Regulation Authority (ERA) recognises that labour and materials costs can escalate at a greater rate than the Consumer Price Index (CPI) and has reflected this in its draft determination. However, Horizon Power is concerned that any escalation factors adopted for labour and materials correctly reflect the actual cost pressures faced by Western Australian utilities. These cost pressures are particularly acute where service providers operate in regional Western Australia (WA), as Horizon Power does, and in doing so are in competition with the resources sector for materials and labour.

The adoption of actual collective labour arrangements to reflect short term labour costs is welcomed. However, Horizon Power is concerned that the Wage Price Index may not fully represent the forward costs of labour in WA. Horizon Power would prefer the regulator to review a range of labour cost escalators, including historical labour costs and anticipated levels for future collective arrangements and use this information to adopt a labour escalator more representative of the future labour costs that are likely to be incurred by service providers in WA.

Horizon Power is aware that if a basket of materials moves by CPI the cost of materials moving at a higher rate than CPI will be cancelled out by materials moving at below CPI. However, Horizon Power is concerned that the materials, e.g. copper, aluminium and steel, that feature significantly in commonly used supplies/products and which drive the cost of these supplies are properly accounted for in estimates of future efficient operating costs. Again, where there is competition for materials, such as exists in regional WA, this only seeks to increase the pressure on material costs and drives escalation rates even higher.

Capital contributions

Horizon Power, like Western Power, receives capital contributions and gifted assets from customers. These funds are treated as revenue under Australian Accounting Standards and service providers are required to pay tax on this revenue. Horizon Power agrees with Western Power that the net tax costs arising from capital contributions and gifted assets should be recovered from customers and not borne by the company. Horizon Power notes Western Power's argument that by not recovering these costs from all network users via network tariffs, WA service providers are:

- treated inconsistently as compared with service providers in Eastern States;
- contributing to inefficiency in customer-funded access arrangements; and
- effectively charging customers for gifting assets or capital contributions to Western Power.

Rate of return

It is Horizon Power's view that the level of systematic risk faced by Western Power and other WA service providers is higher than our national counterparts, due to the nature of our resource-based economy and the relative immaturity of our regulatory system.

Therefore, Horizon Power is concerned that the ERA, in taking a more austere view than the Australian Economic Regulator (AER) regarding some weighted average cost of capital (WACC) parameters, is imposing an overly low rate of return on Western Power's asset base. This is particularly relevant for equity beta, which at 0.65 (as adopted by the ERA) is lower than the 0.8 level consistently used by other regulators in calculating WACC.

Moreover, to increase the benchmark credit rating to A- for this access arrangement, when BBB+ has been adopted nationally for the utility sector for all recent regulatory determinations, is surprising and has not been fully explained by the ERA. This is further questionable when considering that the AER, in its last WACC review,[2] noted that whilst there was evidence to support a benchmark credit rating of A-, the AER was not persuaded to move away from the existing BBB+ benchmark credit rating at that time given the submissions it had received.

The arguments to move to a post-tax WACC are understandable. However, Horizon Power suggests it would be advisable to give service providers sufficient notice of such a change so that they are able to fully prepare for and model the implications of this significant amendment to regulatory methodology. Service providers would need to:

- understand the impacts of a lower return on capital on the overall revenue requirement; and
- ensure they are able to appropriately determine their future tax liabilities for inclusion as a separate 'building block' in the calculation of the regulatory requirement.

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[2] AER (2009), Final decision, Electricity Transmission and Distribution Network Service Providers, Review of the Weighted Average Cost of Capital.

Service Standard Benchmarks

Horizon Power notes with interest the proposed changes to Service Standard Benchmarks (SSBs) for Western Power. Whilst Horizon Power is not subject to the same service standard measures as Western Power there is some concern that, over time, all electricity service providers will at least be expected to report on SSBs to provide comparative information for the ERA's annual network and retail performance reports. This is currently the case with SAIDI[3] and SAIFI[4] for Horizon Power. Although Horizon Power is not required by legislation to provide electricity to any level defined by SAIDI and SAIFI, it does report on performance against these two measures and this performance is publically reported by the ERA.

Consequently, any proposed changes to existing SSBs and the introduction of new SSBs that are adopted by Western Power could ultimately have an impact upon other service providers. If the ERA does propose to request SSB type information from service providers other than Western Power, it is important that any additional costs associated with collecting, recording and monitoring new or revised SSB type performance measures be properly understood and accounted for in future funding requests or inquiries.

Tariff Equalisation Contribution (TEC)

Horizon Power would like to take this opportunity to reiterate that whilst the source of funding for the TEC is a matter for government to determine, Horizon Power's overarching concern is that the TEC be set and gazetted at a level that represents the additional, efficient costs required to supply electricity to regional WA.

Concluding remarks

Horizon Power is pleased to take the opportunity to respond to the draft decision on proposed revisions to the access arrangement for the Western Power Network and looks forward to the findings in the final decision.

Yours sincerely

[redacted]

David Tovey
Company Secretary /
Manager External Affairs

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3 System Average Interruption Duration Index (measured in minutes)
4 System Average Interruption Frequency Index (number of events)