

WA Economic Regulation Authority

2012/13-2016/17 PRICE REVIEW

**ELECTRICITY DISTRIBUTION and TRANSMISSION
SERVICES**

in the

SOUTH WESTERN INTERCONNECTED SYSTEM

Response to the ERA Draft Decision

by

Western Australia Major Energy Users

April 2011

Assistance in preparing this submission by the Western Australia Major Energy Users (WAMEU) was provided by Headberry Partners Pty Ltd and Bob Lim & Co Pty Ltd.

The content and conclusions reached are the work of the WAMEU and its consultants.

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Executive Summary

This submission has been prepared by a coalition of several large energy users in Western Australia whose businesses are significantly affected by electricity costs, reliability, quality and security. The Western Australia Major Energy Users (WAMEU) welcomes the opportunity to provide comments on the draft decision by the Economic Regulation Authority (ERA) on the application by Western Power (WP) for the 2012/13-2016/17 price review of WP services.

There was little doubt that the WP application was an ambit claim and the draft decision by the ERA demonstrates this. The outworkings of the draft decision is that overall average tariffs will marginally decrease in real terms from what is an already high level. The fact that the current tariffs were already probably overstated by some 23% means that the tariffs for AA3 implied by the draft decision probably remain overstated. But because the draft decision seeks to implement a real reduction over the next regulatory period, means a return to more equitable tariff levels.

The WAMEU strongly urged the ERA to undertake its own comparative analysis of all of Western Power's claims and the WAMEU is pleased that the ERA has done this. The work by the ERA consultant, Geoff Brown and Associates (GBA), clearly demonstrates the benefit of this comparative analysis because it highlighted that the WP application contained a massive overstatement of revenue requirements and did not reflect value for money or the ability of consumers to pay such high tariff claims.

An overview of this submission

WP has proposed what can only be described as totally unjustifiable increases in network charges of an average of about 50% for AA3 above the tariff that applies in 2010/11.

The increases WP sought were primarily driven by:-

- An increase of about 30% in operational expenditure
- An increase of about 50% in capital expenditure
- An increase in the weighted cost of capital of some 200-300 basis points

The draft decision has resulted in:

- Operational expenditure remaining about the same level as WP actually used in AA2 of \$435m pa, which the WAMEU considers is appropriate;
- Western Power's claims for capital expenditure were probably 50% too high, as the forecasts for demand and consumption did not support such large increases; the ERA draft decision has reduced the allowed capex by some 35% to levels similar to current actual levels
- The outcome of the draft decision on the weighted cost of capital (WACC) generally reflects most of the WAMEU recommended set points with the exception of the debt risk premium. Despite this, the actual WACC calculated for the draft decision is considerably lower than expected due to the recent significant fall in the forward price of 10 year Commonwealth Government bonds (CGS). But the failure of ERA to recognise the fact that WP obtains its debt at a considerably lower debt risk premium than the amount allowed in the draft decision, is of serious concern as there is no logical justification for this decision

Parameter	Value range proposed by WAMEU	WAMEU recommended set point	ERA DD set point
Risk free rate	Based on the nominal 10 year CGS	Based on the nominal 10 year CGS	Based on the nominal 5 year CGS
Inflation	Using RBA current data, then trend to 2-3% target range	2.5%	2.55%
Debt premium	Based on cost from WATC	20 bp	202.7 bp
Gearing	To reflect actual gearing	80%	60%
Equity premium	Within the range 5-6%	600 bp	600 bp
Equity beta	Within the range 0.5-0.80	0.70	0.65
Gamma	As set by ACT	0.25	0.25
Equity raising	No allowance except where equity is actually raised externally		Costs to apply to implied externally raised equity
Debt raising	No cost as debt facility is already in place from WATC		12.5 bp

- WP proposed a reduced service performance in return for its massive increase in tariffs and proposed to reduce the measures of service performance. The ERA draft decision has required a better outcome for consumers but the service standard benchmarks are still set too low and are readily achievable based on past performance and therefore do not impose any pressure on WP to improve performance. This is inconsistent with an incentive regulatory regime.

Overall, the draft decision results in a much better outcome for consumers than would be the case if the WP application had been accepted in full. Even so, comparisons with the tariffs in other Australian jurisdictions show that the ERA DD still allows WP to impose a significant premium on users of its network.

WAMEU does not consider that the arguments put by WP that the density and geographical coverage of the SWIN is unique and cannot be compared with other jurisdictions. We would point out that the networks in South Australia (ETSA Utilities), country NSW (Country Energy) and North Queensland (Ergon) probably have more challenging environments to operate in than that of the SWIN. Yet, the cost/service comparison for the SWIN does not compare well with these other networks.

The WAMEU has a residual concern that a significant proportion of the lower allowed revenue in the draft decision results from the fall in the risk free rate (5 year CGS) and that a movement upwards will cause the average tariffs to show real increases rather than real reductions. However, it is noted that since the ERA published the draft decision, CGS rates have fallen further.

The WAMEU is pleased that the ERA, in its draft decision, has recognised the arguments WAMEU made in its response to the WP application. When compared with the very large proposed increases in revenue sought by WP, the ERA draft decision proposes a much more balanced outcome, albeit still too high when compared with network costs in other jurisdictions and with underwhelming service performance standards sought and set when compared to actual service delivery.

1. Introduction

1.1 About the WAMEU

The Western Australia Major Energy Users (WAMEU) represents a coalition of major energy consumers operating in the Western Australia Electricity Market (WEM). The WAMEU comprises the following companies, including Cockburn Cement, Tiwest, Doral, Boral, Burswood Entertainment Complex, Laminex Group, Perron Group, Iluka Resources and Millennium Organic Chemicals.

The aggregate electricity usage by the members of WAMEU shows that they consume a significant proportion of the electricity generated in WA. Therefore, they are highly dependent on the following transport networks to deliver efficiently the electricity so essential to their operations. The members are also heavily dependent on local suppliers of equipment and services, and therefore have an obligation to represent the views of these local suppliers. With this in mind, the WAMEU requests that the ERA take the views expressed herein as also representing those of smaller electricity using facilities that may not have the opportunity or resources to directly participate in this pricing review.

The companies represented by the WAMEU (and their suppliers) have identified that they have an interest in the **efficient cost** of the energy network services as these comprise a large cost element in their electricity and gas bills.

Electricity is an essential source of energy required by each member company in order to maintain operations. A failure in the supply of electricity will cause every business affected to cease production, and WAMEU members' experiences are no different, and thus the **reliable supply** of electricity is an essential element of each member's business operations.

With the introduction of highly sensitive equipment required to maintain operations at the highest level of productivity, the **quality** of electricity supplies has become increasingly important with the focus on the performance of the distribution business, because it directly controls the quality of electricity delivered. Variation of electricity voltage (especially voltage sags, momentary interruptions, and transients) by even small amounts now has the ability to shut down critical elements of many

production processes and operations. Thus member companies have become increasingly more dependent on the quality of electricity services supplied.

Each of the businesses represented by WAMEU has invested considerable capital in establishing their operations and in order that they can recover the capital costs invested, long-term **sustainability** of energy supplies is required. If sustainable supplies of electricity are not available into the future, these investments will have little value.

Accordingly, WAMEU members are keen to address the issues that impact on the **efficient cost, reliability, quality** and the long term **sustainability** of their electricity supplies.

The members of WAMEU acknowledge that energy transport plays a pivotal role in the electricity market. The transport networks, both developed and proposed in this application, allow consumers to identify the optimum location for investment in its facilities, and also for generators to locate where they can provide the **sustainable, reliable and high quality supplies at lowest (efficient) cost** for consumers. WAMEU members recognise that the cost of providing the transport systems are a significant element of the total cost of delivered electricity, and careful consideration must be given to all the elements comprising the networks.

1.2 A review of a key aspect of AA2

In its response to the WP application, the WAMEU pointed out that as a result of significant underspending of opex and capex compared to that implicit in the allowed tariff charges and the fact that the ERA allowed WP a considerably higher debt risk premium than WP actually incurred, WP made a significant increased profit as a result.

The WAMEU noted that:

“WP has underspent on both the opex and capex allowances provided by the ERA by some considerable margin. The effect of the under-run on capex was about \$240m over the three years (assuming the forecast for 2011/12 is accurate). The impact of this underspend in capital expenditure is that the WP has received some \$50m in return of capital that it never spent. The underspend in opex was also considerable, amounting to some \$145m over the three years.

In addition, WP also received its largest single benefit because of the decision on the cost of debt and its high gearing level. WP was able to access debt at a fraction of the allowance ERA provided in the WACC calculation, and this effect was further enhanced by a much higher gearing level awarded by ERA.”

In its annual reports for 2009, 2010 and 2011, WP incurred average debt costs of 5.2%, 5.0% and 5.5% respectively compared to its debt liabilities, with all the debt being provided by the government. Gearing (debt to debt plus equity) was 81%, 83% and 83% respectively, implying that the average debt cost was 5.25% with a gearing of >80%¹. In contrast, in its AA2 decision, ERA allowed a debt rate of some 913 basis points, at a gearing rate of 60%. The net effect of these two differences was to reduce WP’s actual WACC by some 240-250 basis points, so that the ERA decision caused consumers to pay a premium of some \$270m for the provision of debt – a cost consumers never incurred. This issue, of government owned corporations paying less for their borrowings than the cost allowed by a regulator, is addressed in detail in attachment 1 to this submission².

In summary, WP was able to enhance its profitability considerably due to the combined effects of less capex spent, a higher cost of return of capital due to the lower capex spent, less opex spent and a considerably lower actual WACC than that allowed by the ERA. This overall increase in profitability for WP in AA2 is of the order of some \$700m over the three years of AA2³.”

In response the ERA commented that some of this benefit would be “clawed back” through the investment adjustment mechanism. The WAMEU points out that the amount clawed back is a small proportion of

¹ ERA assumed a notional gearing of 60% is required to achieve a credit rating of BBB+. In fact, all debt used by WP came from the WA government, which has a AAA credit rating. The fact that WP actually operates at 80% gearing and still benefits from the WA government AAA credit rating is totally overlooked by ERA

² This is the amended response the Major Energy Users provided to the AER in March 2010 in regard to the cost of debt, with specific reference to that provided by government treasury corporations to government owned corporations.

³ Despite WP actually using less capex and opex than it was allowed by ERA, it is acknowledged that WP does propose to return a relatively small proportion of the over-recovery it received. In table 77, it calculates that it will return \$43.6m as a result of the investment adjustment mechanism. This point is reinforced in the ERA DD

the overall excess profit WP enjoyed because of its actions and the government benefits provided through lower debt costs.

The ERA has a responsibility to ensure that the costs incurred by consumers are efficient. This certainly did not occur in AA2. The impact of the benefit WP had by under-running the allowance in AA2, is that the tariffs for AA2 are overstated. So any comparison of AA3 tariffs with those of AA2 need to be seen in this context, even though there may have been a claw back for some unused capex allowed in AA2.

Despite the AA2 tariffs being overstated, the WAMEU notes that distribution tariffs permitted under the ERA draft decision for AA3, still are **increasing** from AA2 tariffs, although the transmission tariffs show a distinct reduction.

Overall, the ERA draft decision for AA3 still allows WP a much higher cost for the provision of its services than has been demonstrated by WAMEU to be warranted.

2. An overview of the draft decision

Against the background of very substantial underspending by WP of its allowed capex and opex in the current AA2 period and a claim for a massive increase in both opex and capex for AA3, the draft decision has applied some considerable paring of the claimed amounts and the resultant movement in tariffs shows a considerable reduction from that sought by WP.

- The DD converts a claimed step increase of 37% in revenue from 2011/12 to 2012/13 to a small fall in allowed revenue.
- Real revenue increases claimed thereafter of 15% per year for the following four years has been replaced by a small reduction in real revenue.

The factors identified by ERA in the DD for the significant reduction in the tariffs claimed by WP are related to:-

- Essentially retaining the opex at levels similar to those that applied in the middle year of AA2
- Essentially retaining the capex at levels similar to those that applied in AA2.
- A decrease in the real pretax WACC by some 400 basis points of which nearly half can be attributed to a reduction in the risk free rate (10 year CGS)

Notwithstanding the substantially increased opex and capex claims, WP proposed that its benchmarks for service performance should be lower than the five year historical average actual performance. This effectively meant that WP proposed a reduction in service performance, whilst claiming a massive increase in revenues! The ERA draft decision has required higher service levels but not to the same level that WP has actually been delivering service to consumers. This is not in the interests of consumers nor of WP, as the regulator should be incentivising WP to drive for efficiency and productivity gains. The ERA's DD actually is rather perverse in terms of efficiency and productivity growth.

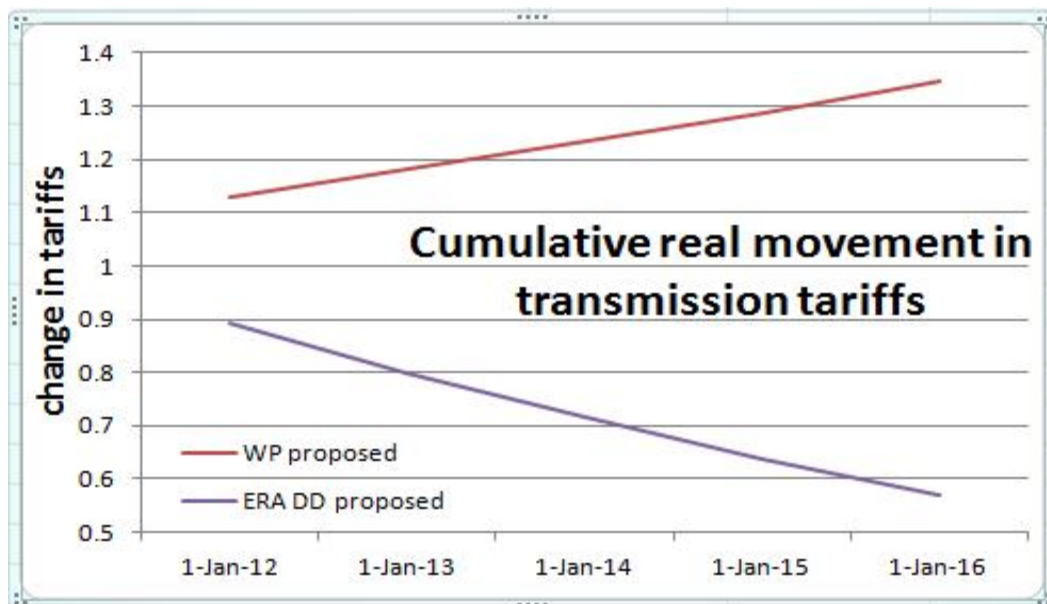
WP advised that because of its large capex program they will have to accommodate a reduction in service to reflect the greater amount of planned outages that will occur under the enhanced capex program. ERA has agreed that this should occur. The WAMEU considers that the ERA is wrong in this decision because the actual service levels were also

achieved with outages caused by the same level of capex in AA2 that will occur in AA3.

2.1 The impact of the transmission program⁴

WP sought a significant increase to its notional average transmission tariffs for AA3 above those applying in AA2. The ERA draft decision reduces these significantly.

The ERA decision results in a very large reduction in tariffs over time compared to the WP application for a large increase. What is important to note is that the underspend in transmission capex and opex in AA2 showed that the transmission tariffs in AA2 were grossly overstated and the ERA decision rectifies this anomaly for AA3. Consumers require a claw back on the excessive revenues provided to WP that were never spent. The following chart shows the impact of the ERA draft decision.

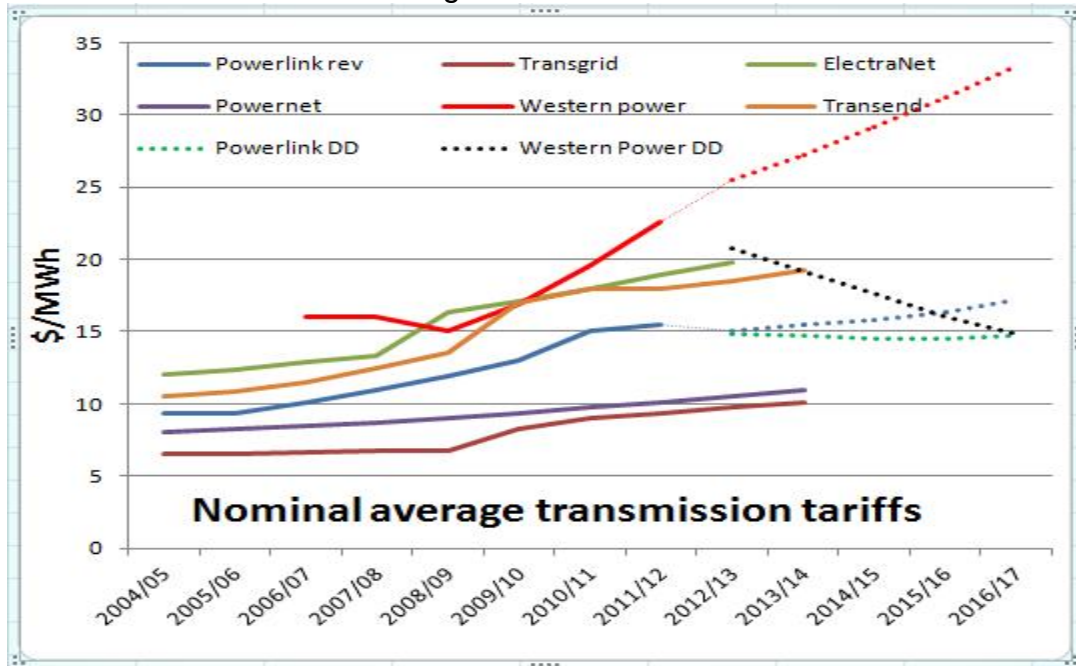


Source: ERA DD

To put the ERA draft decision into context, the following chart (included in the WAMEU response to the WP application) has been updated to show the effect of the ERA DD. This shows that the ERA draft decision merely

⁴ It is important to note that the calculations of tariffs (both transmission and distribution) are based on the claimed and allowed X factors included in the applications and decisions. Neither WP nor ERA provided forecast consumption figures as these are basically immaterial when assessing a revenue cap. Consumption expectations are however very important to consumers who value the cost of electricity services in terms of the amount of electricity consumed

brings the WP transmission average tariffs back over time into the high end of an acceptable range of nominal average tariffs when compared to other Australian nominal average transmission tariffs.

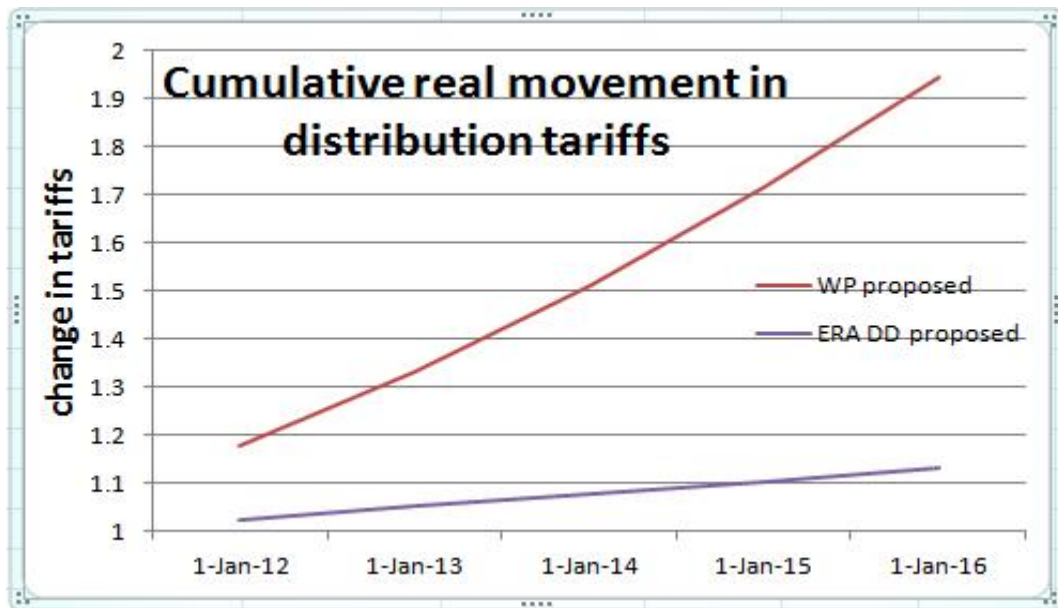


Source: Regulatory decisions, WP AAI, Powerlink application & DD, ERA DD

The WP transmission application demonstrated a real lack of credibility according to WAMEU analysis. The WAMEU considers that the ERA draft decision results in an outcome which is still only barely acceptable when it is considered that WP operates a combined transmission and distribution business, which should show clear financial benefits to end users through reducing the overheads that operation of separate businesses would see. In addition, this actually presents the ERA the opportunity to drive WP to achieve further efficiency and productivity gains.

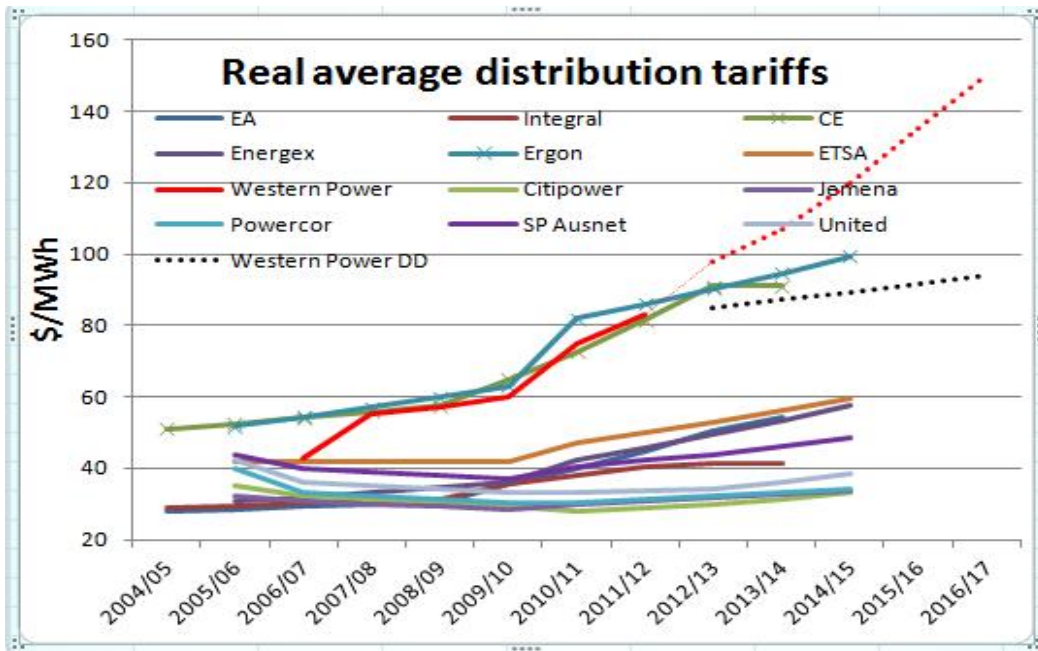
2.2 The impact of the distribution program

In the case of distribution, WP proposed that the average real tariff should nearly double over the next five years. This is shown in the following chart which plots the impact of the difference between the WP application and the ERA DD.



Source: ERA DD

Despite the ERA DD paring back allowed opex considerably, the allowance for distribution capex remains only marginally below the amounts claimed in the WP application. The result allows a small increase over time of the tariffs in real terms. The following chart shows both the WP application and ERA DD in comparison to other distribution tariffs in real terms.



Source: Regulatory decisions, WP AAI, ERA DD

The ERA DD would appear to constrain the WP distribution tariffs to similar tariff values as occur in Country Energy and Ergon regions even though it is much more akin to that of ETSA in SA, and Powercor and SP Ausnet in Victoria, because it has a number of large centres serving significant rural communities but also a relatively small number of very large users embedded in its network. Even if the ERA DD is to stand, the WP distribution average tariff is still markedly excessive. The fact the WP is an integrated transmission and distribution business should provide lower costs than these stand alone distribution businesses and should be reflected in the Final Decision.

The ERA needs to assess the impact of its draft decision when compared to tariffs applying in other regions to ensure that its decision is reflective of best practice and demonstrates clear efficiency. The wide gaps between WP and its comparators are very revealing and are of concern to WAMEU.

3. Forecasts

3.1 Inflation

In its application WP used forecasts of CPI of:

- 3.25% for the 2011 calendar year
- 3.00% for 2012
- 3.25% for 2013
- 2.5% for the remaining years to December 2020

From these figures, WP derives a geometric average of these forecasts of 2.70% and proposes that 2.7% be used in the WACC calculation

The WAMEU considers that the ERA decision to use an inflation forecast of 2.55% annually reflects other regulatory decisions in Australian jurisdictions and sits in the middle of the Reserve Bank's target range of inflation of 2-3% annually.

3.2 Demand

The WAMEU recognises that increases in demand are the main drivers for capex, although a proportion of the capex claimed by WP reflects a need for replacement of aged and fully depreciated assets.

Increases in demand and growth, which impacts on the asset base, also affects opex allowances, especially where the network is extended. Thus, the assessment of expected demand is an important element of the process in setting future allowances.

The DD notes that it has based its forecast demand on the 2011 WO annual planning report (APR) which shows a lesser forecast growth in demand for the SWIN than was included in the 2010 APR⁵. The 2011 APR forecasts a "central" expectation of growth similar or perhaps slightly lower than the historic trend.

The WAMEU concurs with the ERA that the appropriate basis for setting the forecast increase in demand should be based on the latest information available.

⁵ This change between years is also reflected in the IMO 2011 SoO

The WAMEU also reiterates its concern that there is an incentive for WP to overstate its expected growth in demand although it acknowledges that the Incentive Adjustment Mechanism does reduce this incentive a little.

3.3 Consumption

The method of recovery of the allowed revenue is heavily influenced by consumption, although some consumers do pay for part of the network service provision through demand tariffs. Under a revenue cap approach (as is used by WP) the assessment of consumption is less of an issue than if a price cap approach was used.

Notwithstanding this, consumers measure their costs in terms of the volume of electricity used and therefore the absence of a forecast of expected consumption makes it difficult for consumers to assess the reasonableness of the allowances. To assess this impact, the WAMEU used the established X factor adjustments to develop a comparison of the WP application and the ERA DD outcomes. The provision of forecast consumption figures would make this comparison more appropriate.

3.4 Cost escalators

ERA accepts that the allowances it makes for opex and capex should be adjusted to the expected future movements in material and labour. This creates some challenges for the ERA as it (along with every one else) cannot predict the future. Because of this, the ERA along with other regulators, seeks input from experts who do attempt to predict the future. As the WAMEU showed in its response to the WP application, forecasts can turn out to be very wrong as was demonstrated in forecasts of the movement of the \$A to the \$US. Despite this, the ERA is persisting with forecasting future movements in costs and locking these into the allowances in the revenue.

The WAMEU affiliate, Major Energy Users (MEU), has suggested to the AER that a national energy network escalator is developed and calculated annually and this should be used to escalate network tariffs rather than CPI. This approach would overcome the challenge of assessing ex ante what might happen in the future and result in an accurate escalator that reflects what actually occurs. This is the approach used in the construction industry where long term construction contracts are awarded.

The MEU approach has an additional feature in that it does not require every escalator to be reduced to real terms which adds a second source of potential error.

3.4.1 Materials cost increases

The WAMEU notes that the ERA draft decision has only allowed for material price movements in accordance with the movements of CPI.

The WAMEU supports this approach as it is of the view that the complexities and inaccuracies inherent in any attempt to forecast future movements and the mix of materials is a fraught exercise.

3.4.2 Movement in labour costs

The ERA has used a forecast for changes in the cost of labour from two sources:

1. For the earlier stages, the collective agreement between WP and the CEPU
2. For the latter stages of the AA3 period, one developed by Macromonitors reflecting the cost of movement in the EGW (electricity gas and water) labour.

This cost adjustment is applied across all opex costs and does not recognise that large elements of the WP labour force are not in the CEPU, nor do they get paid at rates used by field staff that comprise the EGW classification. This approach has the potential for distorting the allowance for labour escalation.

Due to the revised closing date for submissions, the WAMEU Has become aware of the debate surrounding the use of average weekly ordinary time earnings (AWOTE) and labour price indices (LPI) used assist in forecasting future movements in labour. In this regard, Deloitte Access Economics provided the AER with a well balanced view on why LPI is a more appropriate tool for forecasting future labour movements for regulatory purposes⁶ by responding to criticisms of its recommendation to use LPI in preference to AWOTE.

⁶ This report can be accessed at <http://www.aer.gov.au/content/item.phtml?itemId=753918&nodeId=1362755b9d62696f7ae704e9a325bf8a&fn=DAE%20Response%20to%20issues%20raised%20in%20the%20Powerlink%20regulatory%20proposal%20%28%20March%202012%29.pdf>

The WAMEU is of the view that the LPI approach should be used by the ERA in preference to the approach

The other issue, from the WAMEU's point of view is that the ERA approach does not impose cost improvements through improved productivity. In this regard, the AER approach is quite clear in that productivity improvements must be included in the labour cost allowances. To this end, the AER has used the productivity adjusted Labour Price Index developed by Access Economics as the basis for labour price movements.

The ERA should only allow labour price movements which reflect improvements in productivity. This approach reflects the pressures seen by firms exposed to competition, which is what regulation is supposed to deliver.

4.5 Conclusions

Whilst there are elements of the ERA approach to forecasts that the WAMEU finds difficult to accept because of inherent problems of forecasting, overall the WAMEU considers that the ERA draft decision on forecasts reflects a reasonable basis for addressing the issues.

4. Setting the RAB and depreciation

4.1 Setting the RAB

The WAMEU appreciates the rigour that the ERA has taken to assess the change in the value of the RAB over AA2 and the setting of the RAB for the start of AA3.

The ex post assessment by the ERA of the efficiency of actual capex has led to a reduction in the roll forward value of the RAB. The WAMEU appreciates the fact that the ERA has the power to impose the outcomes of an ex post review of capex and notes that there seems to be support for this practice to be included in the AEMC's current review of the NEM rules

4.2 Depreciation – changes

The ERA reviewed the revised depreciation rates proposed by WP and has allowed adjustment of asset lives for the items identified by WP for change.

The WAMEU considers that the ERA draft decision to set the asset life of the SCADA equipment at a greater life than that proposed by WP reflects a pragmatic approach to the issue and the WAMEU supports the ERA.

5. Weighted Average Cost of Capital (WACC)

The weighted average cost of capital (WACC) used in a regulatory decision has the single greatest impact on the allowed revenue. Overstatement of the WACC provides an incentive to over invest and this was identified by a number of independent observers in the past 12 month, including Garnaut, Parry/Duffy in the report to the NSW government and IPART. Equally, a WACC that is too low can lead to underinvestment leading to the spectre of reduced service performance.

What has not been carried out for many years by regulators is a benchmarking of WACC along with benchmarking of the various financial indicators that result from a regulatory decision. The fact that the Productivity Commission review on network benchmarking specifically identifies WACC as a key element in its review, implies that there is a good basis for instituting some form of benchmarking in the WACC assessment. After all, WACC is a cost to consumers, and regulators are required to ensure that the WACC costs are regarded like every other cost item and ensure that they are efficient.

In discussions with the AER, as they developed their proposed rule changes for network regulation, members of the Major Energy Users (MEU) – an affiliate of WAMEU – provided the AER with actual WACC values used within their organisations. They identified that all of the firms present had operations that were high investment (similar to the network businesses), they were all subject to high levels of competition and had WACC levels similar or lower to those awarded by the AER to regulated firms. Whilst this form of benchmarking is at a high level, it shows that the WACC levels awarded to monopoly businesses were too high, especially taking into account the differences in the risk profiles⁷ of the businesses.

The WAMEU sees that the ERA draft decision on WACC lacks any comparisons of the actual WACC outcomes of other businesses to assess its reasonableness. Having said that, the WAMEU does recognise the indepth analysis that ERA has devoted to setting the WACC inputs and is of the view that the actual outcome of a nominal post tax WACC of 6.52% would put the WACC awarded to WP in the lower end of the range of WACCs that capital intensive firms are achieving at the current time. It would be expected that being a defensive stock, WP would expect to be at the lower end of the range of WACCs experienced. .

⁷ Investors refer to energy network businesses as “defensive” stocks for very good reason – they provide a monopoly service which have very low rates of elasticity and provide a good and regular return

The WAMEU would recommend that ERA carryout some benchmarking of the WACC it calculates, along with assessment of whether the WACC calculated delivers financial indicators that reflect similar outcomes for firms in the competitive sector. The ERA should also benchmark the historical WACC of WP with that of the allowed WACC to identify whether the historic actual WACC achieved by WP provides guidance as to what the new WACC should be

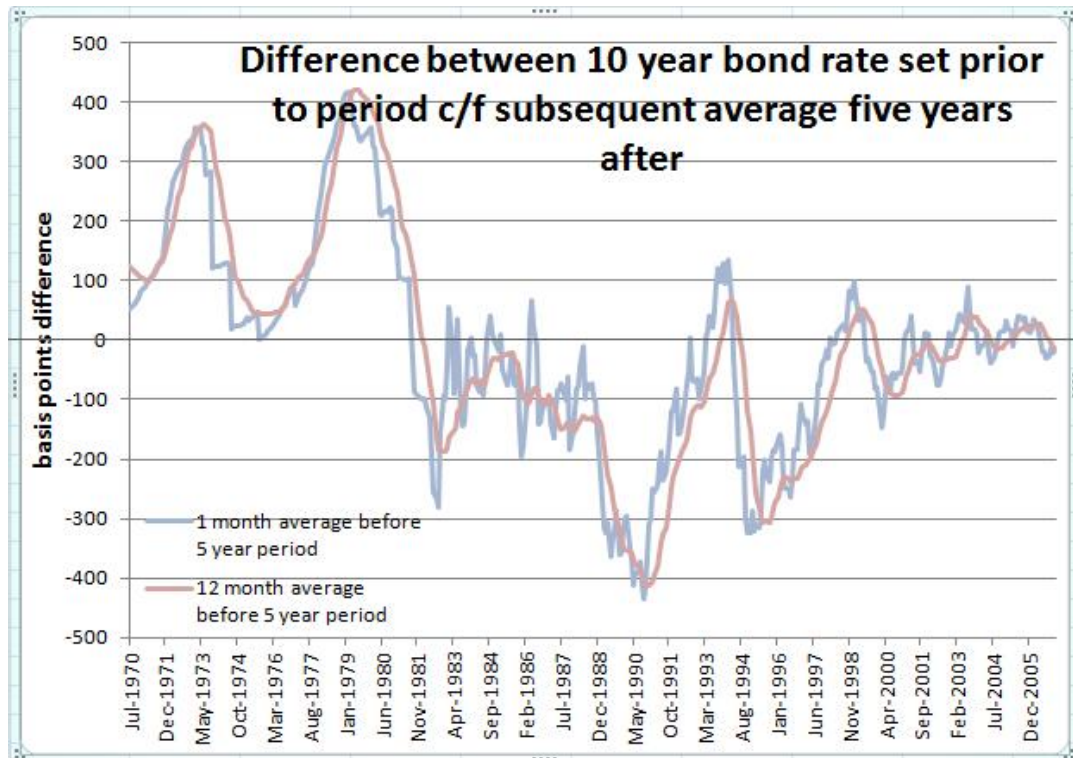
5.1 Risk free rate

In the early years of network regulation, the ACCC used the 5 year CGS as the basis of its decisions. This was appealed by the regulated firms who argued that as the market risk premium was assessed against the 10 year CGS, then the 10 year CGS should be used as the risk free rate used by regulators. Since then the 10 year CGS has been used as for this purpose.

The ERA has provided sound reasons for a change in this approach and the WAMEU sees that the ERA provides a good case for change, especially when it is considered that the cost of debt is a significantly larger element of the WACC calculation and that debt is acquired on much shorter terms than 10 years which has been the approach used in the WACC calculation. The arguments provided by ERA have convinced the WAMEU that the term of the risk free rate should be based on 5 year CGS, with appropriate adjustment made for assessing the market risk premium.

The WAMEU notes that regulators tend to allow the use of the most recently published Commonwealth government bonds (CGS) as the risk free rate, setting this value from a relatively short averaging period prior to the actual decision. The WAMEU has a concern that using a short averaging period, whilst it might be a current indication of what the market sees as the risk free rate, will tend to lead to erroneous assessments over the 5 year regulatory period, as the WAMEU has seen significant movement of the values of CGSs over short periods of time.

WAMEU affiliate, MEU, has investigated whether there is a significant difference between setting the risk free rate on a 1 month average period before a decision and averaging the risk free rate over a 12 month period. These two values were compared to the average CGS for the subsequent 5 year period for which the allowance would apply. This comparison is shown in the following figure.



Source: RBA data (10 year CGS), calculation by MEU

What this chart shows is twofold:

1. The setting of the risk free rate based on the value of the CGS before the regulatory period does not historically provide an equivalent average value for the following 5 years, although in recent years (since the mid 1990s) the error introduced is not great and would impose a maximum 100 basis point error margin
2. The use of 12 month averaging greatly reduces the volatility inherent in averaging over the shorter period without greatly changing the error inherent in using historic data to forecast future movements and results in a potential maximum 50 basis point error

With this information the WAMEU suggests that the ERA should use an averaging period of 12 months to set the risk free rate.

5.2 Inflation

The WAMEU (as pointed out earlier) considers the ERA has made a sound assessment of the expected rate of inflation.

5.3 Debt risk premium

The issue of the debt risk premium, particularly as applied to government owned energy networks, is vexed and has become the focus of rule change proposals to the NEM.

The WAMEU is of the view that debt is a cost and should be treated as such, similar to the setting of opex. The setting of the debt allowance should reflect the most efficient way debt can be sourced and the allowance for debt should be calculated in this way.

Under the Competition Policy Agreement, government treasury corporations are required to provide debt to government owned utilities as if the debt reflected the credit rating of the utility. This debt provided by the T-Corps to their related entities reflects the credit rating of the entity. Thus, the cost of debt provided by WATC to WP is set on a rate reflecting the credit rating of WP.

ERA should set its debt cost in the WACC calculation based on the cost of debt that WP accesses at from WATC and not based on a theoretical assessment of corporate bonds.

However, as the WAMEU notes above, ERA should also benchmark the cost of debt it calculates with the cost of debt that WP actually achieves. In this regard, the WAMEU sees that WATC has provided debt to WP at a cost of about 5.0-5.5% for the past three years. The calculation of debt used by ERA indicates that debt should cost WP no more than 5.82% in nominal terms which includes a debt issuing cost of 12.5 basis points.

Thus the ERA calculation has provided WP with a premium for its cost of debt of between 20 and 60 basis points. This is not efficient.

Further, as the WAMEU pointed out in its response to the WP application, WP has an automatic roll over facility on its debt. To include in the cost of debt, a cost that WP will not incur, is not efficient and can be likened to a “smoke and mirrors” approach.

The WAMEU reiterates the point it made in the response to the WP application, that the ERA must recognise the actuality of the source of WP’s debt and only allow WP to recover the cost of debt based on the debt rate that WP is liable for. To do otherwise is to award an inefficient cost.

5.3 Gearing

The ERA considers that the efficient benchmark gearing for a regulated energy network is 60% debt and 40% equity and asserts that over time this gearing level will be reached by the efficient network. The ERA provides no evidence to support this assertion.

What the market shows, especially for government owned networks, is that gearing is increasingly displaying higher levels of debt, implying that the efficient level of debt is probably higher than 60%. As the WAMEU noted in its response to the WP application, WP gearing has consistently increased over time and is currently operating at 80%.

There is no reason why ERA should persist in its view that 60% gearing is efficient, when the market (especially for government owned networks) is clearly showing that a higher gearing is possible and still retains the benchmark credit rating.

5.4 Market (equity) risk premium

The change of using 5 year CGS as the risk free rate, rather than the 10 year CGS, affects the value of the market risk premium MRP), as the historically used value for MRP used by regulators has been 6% above the 10 year CGS.

The ERA draft decision to use an MRP of 6% above the 5 year CGS would appear to be contrary to the generally held regulatory practice. The ACCC in its regulatory decisions considered that the 5 year CGS was the appropriate risk free rate to use for the 5 year regulatory period but on appeal to the National Electricity Tribunal (now the Australian Competition Tribunal), the Tribunal considered that the MRP of 6% applied to the 10 year CGS was appropriate and the ACCC complied with the direction of the Tribunal.

The ERA has researched this issue thoroughly and this is clearly detailed in its draft decision. The WAMEU and its affiliate MEU have long been of the view that the MRP varies year on year and that setting a long term value might not reflect the short term outlook of this parameter. In particular, the growth in asset value of the share market since the GFC

has shown that the main element of the return on shares has been from dividends and not growth. As a result the forward looking MRP would reflect a lesser value for the MRP than the long term value of 6%. This is clearly demonstrated from the ERA analysis.

Whilst the long term view of MRP is that it is 6%, the AER decided in 2009, that it should be increased to 6.5% demonstrating that the MRP does vary over time. More recently, the AER has reverted to the use of the long term average of 6% recognising that the market has changed. The move by the ERA to hold this same value but for the 5 year CGS is consistent with the recognised changing market conditions.

The WAMEU sees that the ERA approach to the setting of the return on equity is consistent with assessing a forward looking assessment of the market as it currently is.

From a benchmarking point of view, a nominal return on equity of 9.77% reflects a better return than most firms in the competitive arena are enjoying other than, of course, the large miners. On this basis the WAMEU considers that the ERA assessment of the return on equity for WP reflects what is being seen in the Australian corporate world.

5.5 Equity beta

In its response to the WP application, the WAMEU commented that:

“Recognising that equity beta is intended to reflect non-diversifiable risk and there has been little change in this since the ERA decision on AA2, the WAMEU considers that there is little reason for the ERA to change its view that equity beta for WP should be in the range of 0.5-0.8”

The ERA has carried out considerable additional research and developed a view that, contrary to the equity beta value of 0.8 used by the AER, the market is really displaying a value much lower than this. This is consistent with the views of WAMEU, and its affiliate MEU which has long been of the view that the market data really reflects a lower value of equity beta for electricity networks.

Calculations of equity beta for regulated energy transport networks have consistently shown a value well below 0.5 but these values have been discounted because of exogenous impacts such as from the “tech boom” in 2000 and higher values used. The WAMEU has been concerned that the approach recognised a view that conservatism is needed, yet

conservatism has been included in the setting of every WACC parameter with the result that the final WACC value is significantly overstated.

The analysis carried out by ERA on equity beta is considerable and well detailed. The ERA conclusion that equity beta lies between 0.5 and 0.8 is supported by the WAMEU and the decision to use the mid point of this range as the set point has a sound basis.

5.6 Gamma

A value for gamma has been set by the Australian Competition Tribunal and so far there been no persuasive evidence to change from this outcome, although the ERA does note that the payout ratio might be higher than the conservative value of 70% used.

5.7 Debt and equity raising costs

The ERA has allowed for 12.5 basis point premium on the cost of debt to reflect the cost of raising this debt.

It has also recognised that there should be no allowance for equity raising costs unless there is additional equity raised over the use of retained earnings and reinvestment of some dividends of equity. For the purposes of these the ERA has assumed retention of 30% of after tax profit and 25% of dividends would be reinvested. Unfortunately, the ERA has assumed that the gearing will be retained at 40% equity and that this will be raised in the open market at a premium of 3% of the value of the equity raised.

The ERA allowances do not reflect the actuality of the WP operations.

WP has a line of credit available from WATC and therefore does not incur debt raising costs as implied by the ERA draft decision. The WAMEU considers that the ERA should not allow for a cost that does not occur as this is not efficient.

WP has not raised any equity (and does not need to do so) and its gearing has risen from 60% debt to over 80% debt. Yet the ERA has provided WP with previous allowances to cover these costs. In the unlikely event WP does raise additional equity from its shareholder (WA government) then the costs of this will be both minimal and would have been covered in previous allowances.

Whilst the WAMEU does accept that there are costs associated for private firms raising equity on the open market, these costs do not apply to WP because of its unique shareholding arrangements.

The need to raise equity by established private firms is a rare occurrence because such firms almost invariably limit their capex needs to what is available to them from retained earnings – this is efficient and reflects reality. The ERA approach is falsely premised on three counts

1. For the ERA to both set an arbitrary benchmark of 40 % equity (and then assume that equity will be raised to retain this level) does not reflect actual best practice.
2. The ERA should also impose on WP the disciplines of the competitive market and limit the capital available to what WP can retain from its earnings, even if this does impinge on the dividends that it might pay. This is what occurs with firms in the competitive environment.
3. The ability of WP to increase its debt is quite readily available and does not impinge on its credit worthiness from its lender. Therefore assuming its lender will require an equity level of 40% is not borne out in practice

The WAMEU considers that ERA should not permit WP allowance for a cost that does not occur. The WAMEU accepts that there are costs incurred in raising debt if the entity has to seek debt or equity on the open market. The approach used by WP for providing for its debt and equity needs obviates the need for any debt raising costs.

In the case of equity raising costs, WP should have its capex limited to the amounts that it can fund from its earnings. As WP is a wholly owned government entity, then there is a case for new equity only if that is actually provided. The costs incurred with the raising of such equity should not be based on an open market approach but on what costs are actually likely to be incurred by a wholly owned entity from its government owner.

5.8 Tax on customer contributions

WP has claimed that it is subject to the tax implications of customer contributions for new connections and for receipt of assets paid for by customers that are deeded to WP. The WAMEU can see that these receipts by WP would have tax implications.

The WAMEU also sees that the ERA draft decision considers that the customer providing the capital contribution or the gifted asset should pay the cost of the tax WP incurs as a result of the transfer, in addition to the cost of the asset.

The WAMEU considers that WP receives a greater income from the additional revenue provided to it from these new customers so the addition of new customers adds value by resulting in more efficient use of the WP assets as a result of the additional load the new customer and the lower charges that occur as a result of the additional revenue. Overall, all customers benefit from new customers being connected to the network.

WAMEU can also see that customers, required by WP to make contributions (whether in kind or in cash) should not be required to pay an additional amount to WP to cover the tax liabilities WP incurs as a result of these transfers – such an increased cost would be a barrier to new customers connecting and which does not reflect the costs to the customer that is caused by the new connection. It would indeed be bizarre if a customer pays for assets which it then passes ownership to WP should be required to pay an additional amount just so WP could avoid a tax liability!

In practice, a cash contribution for a new connection does increase WP receipts in the year they are paid. WP uses this cash to partly pay for the new connection. If the expenditure and the customer contribution are received in the same financial year there is no tax implication. The issue for WP is where the cash receipt occurs in one year and the cash payment occurs in the following year. The cost to WP is in the time value of the tax paid on the receipt and the tax benefit the following year for the expenditure incurred. Pragmatically, the issue of the tax implications is avoided in total if the customer contribution is required by WP at or after when WP incurs the expenditure.

At most the cost to WP is relatively small (probably no more than 2% of the value of the customer contribution) and there is a benefit to all other consumers. As WP operates under a revenue cap, this cost is best absorbed across all consumers connected.

In the case of a deeded asset, WP has to make an assessment of the value of the deeded asset and declare this as a receipt. In practice, these deeded assets have no value to WP as it does not (and should not) receive a return on the asset. In fact, WP incurs a liability for these assets through the requirement to maintain the assets over their operating life

and to replace them at some time in the future. Pragmatically, the issue of the tax implications is avoided if WP declares the assets have no residual value to them after recognising the liabilities that their receipt entails.

In both cases the receipt of these (cash or deeded assets) there is the residual benefit of the increased revenue that results from their use by the new customer. Because WP operates under a revenue cap, the benefits of the increased usage provide a financial benefit to all consumers using the network through lower charges.

5.9 Conclusions

The application from WP for its WACC reflected that in the past, WP has enjoyed considerable commercial benefit from the approach taken by ERA in setting the WACC. This has resulted in an unnecessary transfer of wealth from consumers to WP and its government owner.

The WAMEU considers that significant portions of the WACC should reflect likely costs rather than be based on what is essentially a flawed assumption that WP seeks funding from the open market – it does not and its credit rating is unaffected by its increasing gearing.

Overall, the WACC outcome better reflects actuality but the ERA is still providing WP with an allowance for costs that WP will not incur, on the basis that WP is an entity operating in the private sector. But elsewhere this assumption is not held, suggesting a critical inconsistency in the ERA's assessment of WP..

The WAMEU recognises that many of the WACC parameters have been set at levels which the WAMEU considered were appropriate but the ERA has:

- Failed to set the debt risk premium at a level that reflects the way WP acquires its debt.
- Does not reflect the way WP actually acquires its funds
- Failed to recognise that WP has been able to increase its gearing to 80% debt without any impact on its credit rating or ability to acquire funds

The following table compares the WAMEU assessment of what constitutes reasonable WACC development with the ERA draft decision.

Parameter	Value range proposed by WAMEU	WAMEU recommended set point	ERA DD set point
Risk free rate	Based on the nominal 10 year CGS	Based on the nominal 10 year CGS	Based on the nominal 5 year CGS
Inflation	Using RBA current data, then trend to 2-3% target range	2.5%	2.55%
Debt premium	Based on cost from WATC	20 bp	202.7 bp
Gearing	To reflect actual gearing	80%	60%
Equity premium	Within the range 5-6%	600 bp	600 bp
Equity beta	Within the range 0.5-0.80	0.70	0.65
Gamma	As set by ACT	0.25	0.25
Equity raising	No allowance except where equity is actually raised externally		Costs to apply to implied externally raised equity
Debt raising	No cost as debt facility is already in place from WATC		12.5 bp

6. Capital Expenditure (capex)

The response to the WP application by the WAMEU was intended to highlight that the capex claim by WP for AA3 grossly overstated the need for capex in order to meet the requirements of expected growth and the need for replacement of assets. The WAMEU also highlighted that despite the ERA providing essentially the capex for AA2 that was sought by ERA, WP did not use the capex allowed, even though consumers paid as if it was fully expended. Despite actually using considerably less capex that was allowed, WP was still able to improve on the service standard performance, indicating that the actual capex was more than adequate for the need.

For AA3, WP sought a lesser amount of capex than that they had for AA2, but this was still considerably above the actual capex used for AA2. To substantiate its claim, WP provided a detailed “bottom up” assessment of what it perceived were the needs of the SWIN but failed to provide any “top down” assessment. The WAMEU sees that a “top down” assessment comprises at least three approaches to ensure that the capex needs are those that are essential for the provision of the service **and** are affordable for consumers.

The issue of affordability is critical for consumers. Already comparative studies were showing that WP charges for the provision of services were already too high and the claim for AA3 would have taken the costs well above comparable entities. In the NEM, advocates for low income consumers have already identified that the lowest income quintile of consumers were paying too high a proportion of their income for the provision of energy services. With the increases in charges proposed by WP, this would have exacerbated an already untenable situation.

From a large consumer viewpoint, the “two speed economy” has resulted in many manufacturing firms facing considerable international competitive pressures. The issue of affordability is just as intense for these firms as it is for low income energy consumers. Increasing energy network costs across the NEM and in WA have increased input costs to the manufacturing industry at the same time that they face falling prices for their products. The risk that the electricity networks face is that should some of the large users decide to close (as is happening with increasing frequency), the contribution they make to the networks’ revenue is lost, imposing greater cost pressures on those continuing to use the services. This is an aspect that the ERA must consider.

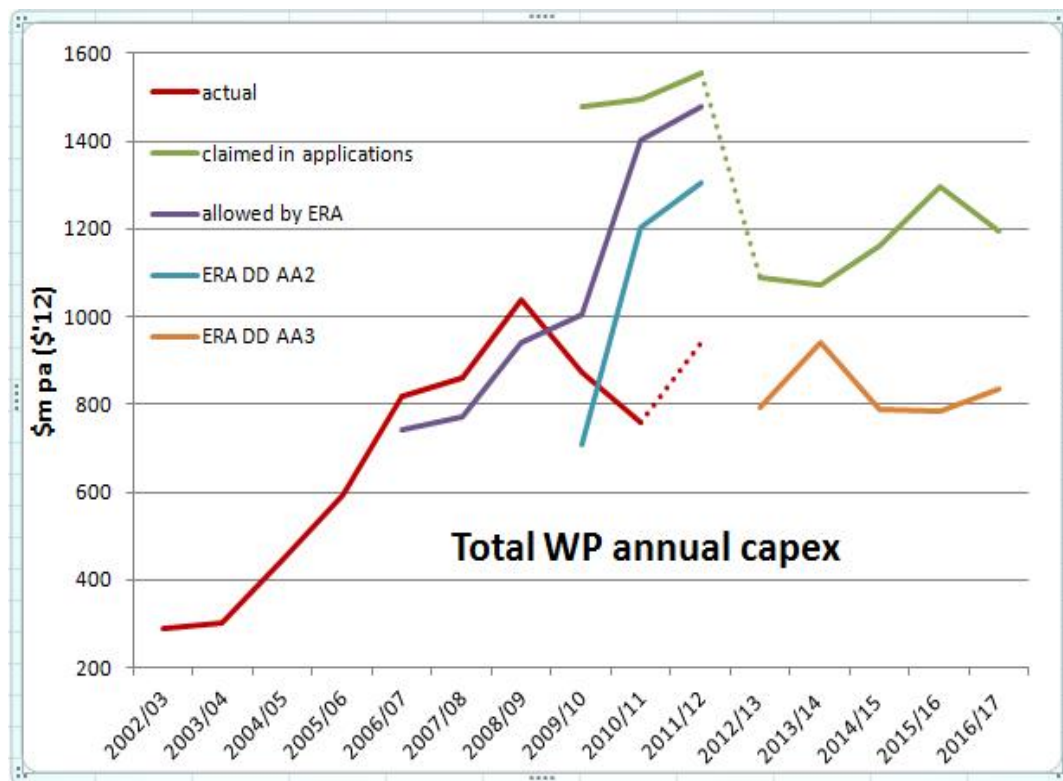
As well as the concern for affordability, the WAMEU notes that WP has not constrained its appetite for capex to match its ability to provide this capital within its own means and would have to access considerable funding from its provider of debt as well as from its internal resources. The WAMEU considers that, as a general rule, capex should be limited to what WP can service without increasing its debt levels (which currently exceed 80% of its funding) or seeking new equity – this is the approach firms in the competitive sector generally apply in regard to capex needs.

The third leg of concern that the WAMEU had in regard to the WP claims for capex were that they far exceeded the amount of capex (assessed on an annual basis) used in previous regulatory periods, even though the rate of growth forecast is much the same as it has been in the past. As the main driver for capex is growth, this form of “self benchmarking” provides a good indicator as to what the future needs should be.

The WAMEU sees that the ERA has approached the capex needs of WP from a “bottom up” assessment (with the assistance of Geoff Brown and Associates) coupled with some “self benchmarking”. The WAMEU notes with interest that the concept of externally benchmarking capex, opex and WACC is the focus of a current review by the Productivity Commission. The fact that such a review has been commenced, implies that there is a general view that regulation of electricity networks should include a greater amount of external benchmarking.

What is entirely absent from the ERA approach is any assessment of the capex requirement when measured on an external benchmarking process, from an affordability review or from an availability of capex concept.

Despite the reservations the WAMEU has about the processes used it considers that the ERA has provided WP with a capex budget that should be able to more than meet the needs of the network. To assist in reaching this conclusion, the WAMEU has updated the chart showing the history of WP capex together with the WP claim and the ERA draft decision.



Source: ERA DD and FD, WP applications, ERA DD

The ERA draft decision effectively results in the AA3 capex to reflect the actual capex needs seen in the AA2 regulatory period. Essentially, the outworkings of the ERA draft decision with regard to capex recognises that “self benchmarking” provides a good indication of what the network owner should be using for its capex.

At a high level, the WAMEU sees that the ERA detailed examination of the future capex needs reflects three core aspects:

1. That the capex for AA3 should reflect a similar capex need to period AA2 because the forecast growth for AA3 is similar to the actual growth experienced in AA2
2. The limitations put on WP by WATC in the provision of additional debt funding during AA2, actually provided a recognition of the affordability of the WP capex expectation for AA2.
3. The outcome of the ERA capex assessment, maintains the average tariff at current levels and addresses (in part at least) the WAMEU concern with the affordability of WP charges.

In its response to the WP application, WAMEU commented:

“In the 2008 revenue reset process, WP provided an application to ERA which stakeholders responded to. In the process of responding to the draft decision, WP provided ERA with a revised application which the ERA referred to in the draft decision. Subsequent to the draft decision WP provided a further revision to the ERA which the ERA used to finally set the allowances for WP⁸, and which was not available to stakeholders to review. The chart shows that the initial application was significantly higher than the first revision on which the ERA draft decision was based. The ERA final decision was based on the second revision which was higher than the first revised decision.”

As a footnote, the WAMEU expressed concern at the process whereby ERA permitted WP to make more representation (to which other stakeholders were not privy) in order to increase the capex allowance. ERA permitted a significant increase as a result of this representation by WP. The WAMEU hopes that the ERA will not permit this practice to occur again. In this regard the WAMEU notes that in the rule changes sought by AER for the NEM rules it makes it clear that additional representations and claims for capex for new activities should not be permitted.

6.1 An overview

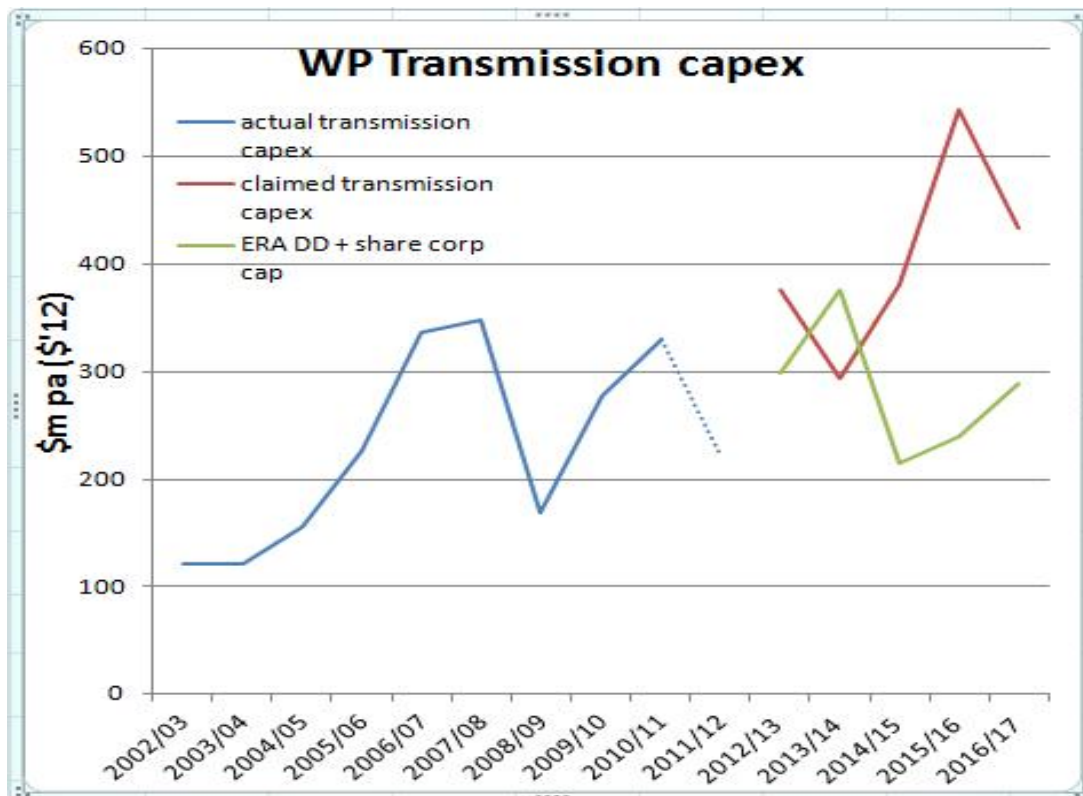
WP provided for its capex forecast in two sections – transmission and distribution. Fortunately, the ERA has reviewed capex on both a global basis and on a sector basis. The WAMEU sees that this approach by ERA is good regulatory practice for an entity which has the ability (should it so desire) to transfer capex from one sector to another should there be a need.

WAMEU noted in its response to the WP application that WP proposes to change the assumed time of expenditure on capital from the end of a year (as in AA2) to be assumed to occur in the middle of the year as is done by the AER. Whilst the WAMEU did not oppose this approach providing there was an appropriate adjustment to reflect the time value of money, it recognises the soundness of the arguments provided by ERA in not approving this change. The WAMEU supports the ERA in this decision.

⁸ This process effectively prevented other stakeholder involvement in the process. The WAMEU considers this is not good regulatory practice. Further, the WAMEU notes that the AER proposes to prevent this practice by its proposed rule changes currently being addressed under the AEMC processes.

6.2 Transmission capex

The chart below shows the actual capex incurred in AA1 and AA2 periods along with the claimed capex for the AA3 period and the ERA draft decision⁹.



Source: WP AAI 1, AAI 2 and AA3 documents, ERA DD

The chart clearly shows that the average actual capex for AA2 was about \$275m pa but the claim from WP showed a rise to over \$400m pa in AA3. The ERA draft decision provides an average allowance of \$284m pa over the five year regulatory period reflecting closely the actual needs for the same growth after allowing for input cost growth.

The WAMEU notes that WP has revised its forecast of growth (which was the main driver of the AA3 capex claim) and the new forecast is similar to that in the IMO 2011. The draft decision mentions that as a result of the

⁹ Because the information provided by WP in the application regarding actual past capex did not separate corporate capex as it does for AA3, the chart shows transmission capex for AA3 plus one third of corporate capex for AA3 reflecting the proportions of the capex claims for each sector

reduced forecast, GBA and WP have discussed the implications of the lower value. The draft decision also reflects this lower forecast.

The WAMEU is not able to comment on the implications of specific projects because it is not privy to all of the information available to GBA and ERA. This means that the detail included in the draft decision must be taken as read as WAMEU does not have any additional information on which to make sound comment.

The WAMEU does have an observation as the relative amount of capex for replacement compared to augmentation (expansion and customer driven). The WAMEU has noted the widespread view by government and others that the increasing costs of networks is attributed to replacing aged assets. Comments are made (as they were in the WP application) that earlier under-investment has led to this need for asset replacement.

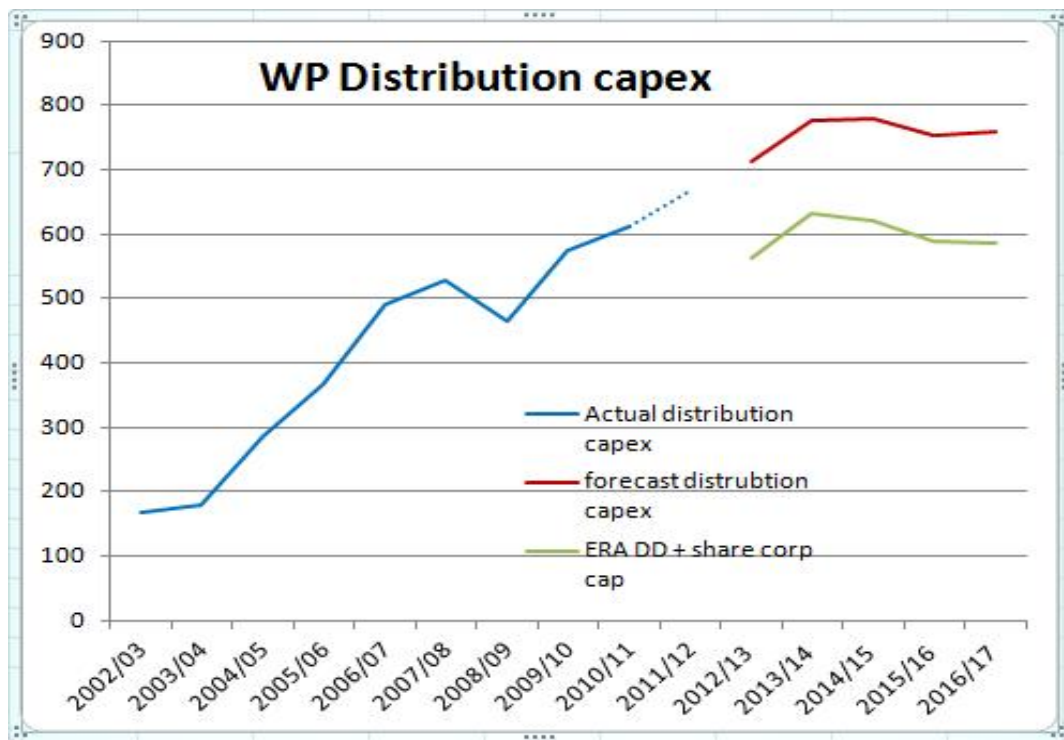
It is clear from the split of replacement to augmentation capex is that replacement of assets in the WP transmission network is a minor element of the total costs and that WP does not consider that their assets are of an age to justify replacement. This implicit observation seems to be reflected in other jurisdictions where replacement of assets (although incorrectly cited as a headline reason for the large capex claims) is not considered to be as great an issue as governments would have consumers believe.

The WAMEU considers that ERA should note this issue at the time when WP submits its application for AA4.

6.3 Distribution capex

The chart below shows the actual capex incurred in AA1 and AA2 periods along with the claimed capex for the AA3 period and the ERA draft decision. The chart reflects values for two thirds of corporate capex¹⁰ for AA3 to reflect equality with the earlier allowances.

¹⁰ This share of corporate capex reflects the ratio of distribution capex to transmission capex.



Source: WP AAI 1, AAI 2 and AA3 documents, ERA DD

The chart clearly shows that the average capex for AA2 was just over \$600m pa but WP claimed a rise to an average of over \$750m pa in AA3. The ERA draft decision reflects an allowance which is slightly under the actual investment of capex in AA2, assuming the forecast capex for the last year of AA2 is actually incurred. On this comparative analysis, the ERA draft decision on distribution capex would appear to be an appropriate allowance.

The commentary WAMEU made in section 6.2 regarding the challenges in it commenting sensibly on specific projects holds equally for distribution capex as well.

In its application, WP provides a statement on the under-investment for the entire AA2 period. In particular there is reference to the need to replace the wood poles used. The WAMEU notes that replacement capex for AA3 comprises nearly 30% of the allowance for capex, with augmentation (expansion plus customer access) and other capex being similar amounts.

The draft decision notes that despite the rate of growth being much the same as in AA2, the claim for distribution capex is some 55% higher than

actually incurred in AA2. The draft decision comments that its consultant (GBA) considers that this is appropriate, subject to an adjustment of 25% downward. Whilst this adjustment is supported, the WAMEU considers that the adjustment should be greater when assessed on an affordability basis, and be much the same as in AA2.

The WAMEU agrees with the ERA that the replacement of the wood poles must, in light of the electricity safety regulator comments regarding the state of the wood poles, be allowed the amount of funding sought. In light of the findings of the Victorian Bushfire Royal Commission that significant damage occurred as a result of the electricity supply arrangements, makes this issue one of significant concern.

However, the WAMEU notes with interest the observations of the electricity safety regulator regarding the ability to reduce costs by careful project planning and contract packaging. The incentive approach suggested by the ERA to minimise costs but attain a safer outcome is supported.

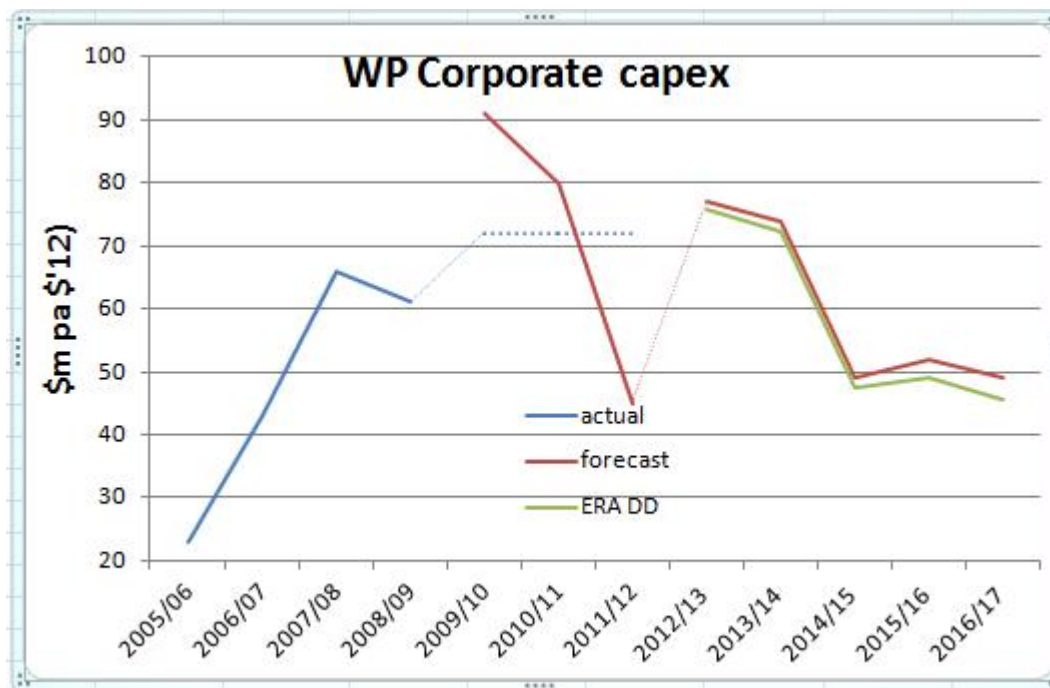
The WAMEU has little additional information regarding the other parts of the distribution capex on which to provide comment, and relies on the assessments by GBA and the ERA.

Overall, the WAMEU considers that the allowance in the draft decision for distribution capex is appropriate.

6.4 Corporate capex

In its previous applications, WP tended not to separate corporate capex from other capex, but the following chart was developed from a variety of WP sources, including the applications for AA2 and AA3. This chart shows the actual capex used for corporate needs (including IT) since 2005/06 and the ERA's draft decision in relation to corporate capex.

Essentially, the ERA draft decision accepts the bulk of the WP corporate capex requiring only a minor change to the IT budget.



Source: WP AAI from AA2 and AA3, ERA DD

On a benchmarking approach, it would appear that the corporate capex reflects the historical usage in AA2 and shows a downward trend reflecting the corporate capex incurred in AA1.

The WAMEU has no better information than that available to the ERA and its consultants and therefore supports the ERA draft decision.

6.5 Conclusions

Compared to the very ambitious capex claim made by WP for AA2, its claim for AA3 was more tempered but still rather ambitious, especially for the transmission capex.

The ERA draft decision would appear to support the WAMEU view that the capex claimed was too high. By examining the claims by WP in detail by GBA the outcome is an overall capex budget that reasonably reflects the actual capex incurred during AA2 under similar growth conditions.

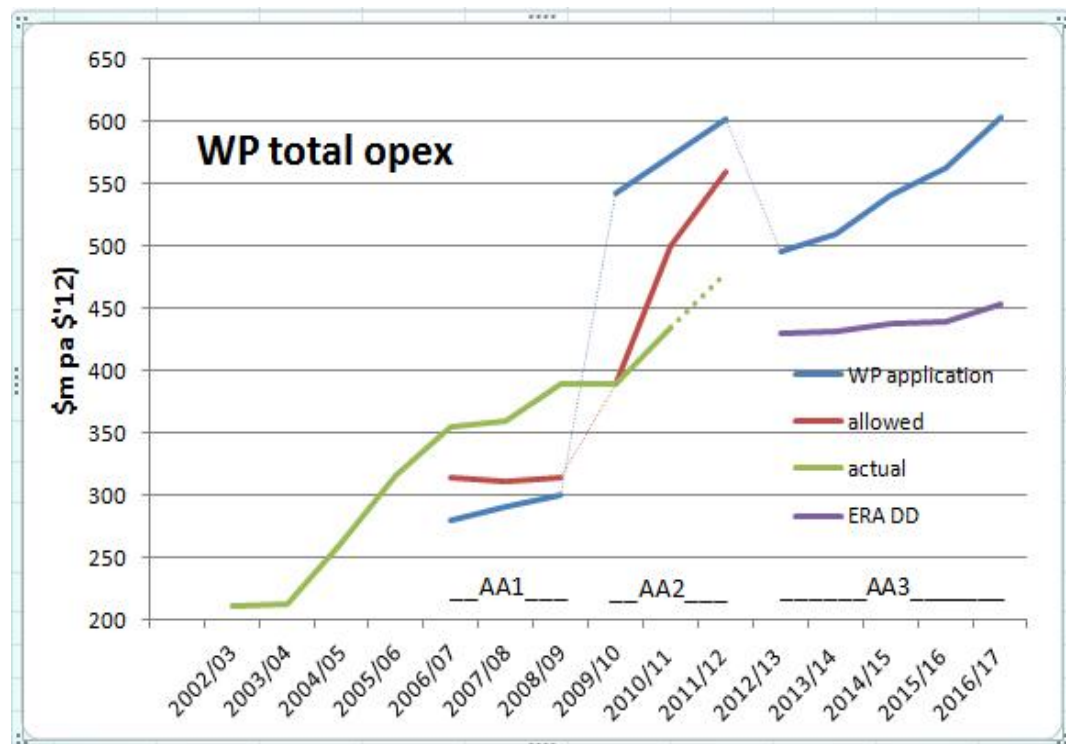
The only concern the WAMEU has regarding the analysis of the capex budget is that it has not included any benchmarking of the allowances to identify if the overall capex budget is efficient when compared to other similar network operations. And, if the comparisons are not flattering, the

ERA must apply stronger drivers to incentivise efficiency and productivity gains.

7. Operating Expenditure (opex)

7.1 An overview

In its response to the WP application, the WAMEU developed a chart showing the amount of opex (claimed, allowed and actual) regarding the SWIN for transmission and distribution. This chart has been updated to include the outworkings of the ERA draft decision.



Source: WP AAI 1, AAI 2 and AA3 documents, ERA DD

This shows that:

- WP under claimed for opex in AA1
- Even though the ERA allowed more opex than WP claimed, the allowance in AA1 was too small
- WP over claimed for opex in AA2
- ERA over allowed opex for AA2 even though it significantly cut back the WP claim
- WP has instituted a significant increase in opex for AA3 even though this is a lesser amount each year than it claimed for AA2
- ERA draft decision for AA3 basically reflects the actual opex incurred in AA2

7.1 Benchmarking

Benchmarking (self benchmarking and external benchmarking) are the tools most used to assess whether a regulated entity is approaching the efficient boundary. Thus, benchmarking is considered to be an essential element of whether an opex allowance is efficient.

GBA has carried out some benchmarking of the AA2 period but notes that its task was made more difficult because there is no other equivalent entity with which to benchmark it against. However, GBA aggregated the costs for the transmission plus distribution opex for the five NEM regions and compared these to WP opex against the same benchmarks.

In theory, WP should reflect a greater efficiency because of its aggregation and lower overheads, but the GBA analysis shows that the WP AA2 opex is not more efficient than its comparators. Indeed, GBA found that WP was less efficient than all except NSW in terms of opex/km line, less efficient than all except Queensland on opex/customer and significantly less efficient than all when measured against opex/RAB. In fact, using the GBA values for all the NEM regions on an unweighted basis, WP in AA2 was 15% less efficient in opex/km, 20% less efficient in opex/customer and 34% less efficient in opex/RAB.

If WP operated at the most efficient levels implied by the GBA benchmarking exercise, it would be operating at SA's opex/km (a 40% reduction), Victoria's opex/customer (a 40% reduction) and Queensland's opex/RAB (a 40% reduction). On this basis, the efficient boundary would appear to be some 40% less opex than was used in AA2. The WAMEU accepts that such a simplistic approach is likely to result in an opex that is less than is really needed, but it provides quantitative measures that indicate WP is far from the efficient boundary and that consumers are paying more than they should.

GBA observes that while there is an incentive scheme for driving opex to efficient levels, it considered that this was under powered to achieve the most efficient outcome. The WAMEU agrees that this must be the case because the WP AA2 opex is demonstrably less efficient than opex in the NEM regions.

Despite these figures clearly showing that WP opex is significantly less efficient, GBA and the ERA both consider that the AA2 opex is an appropriate starting point for setting future opex.

In its response to the WP application, WAMEU pointed out:

“The WP trend analysis and the benchmarking provided indicate that WP is generally more expensive than its comparators, as in most cases its current performance is above the line of average performance. Most similar businesses are lower cost performers than WP.

The data provided by WP shows that the performance for AA3 will be more expensive than the current performance, reinforcing the view that the claimed opex is considerably higher than it need be.”

Despite this clear evidence that benchmarking provided by WP showed that it was not currently and would not be efficient in the future (which the GBA analysis replicated), both GBA and ERA have started their analysis on the basis that the current opex is efficient. The analytical work by GBA and ERA then builds on this inefficient opex basis.

The WAMEU notes that GBA does recognise that the WP performance would indicate that it is not operating at the efficient boundary and has recommendation to implement a formal ex ante requirement by reducing the opex allowance through AA3 by 2% annually in real terms. This reduction has the cumulative effect of a 10% efficiency improvement over the life of AA3, yet the benchmarking evidence indicates that WP is more than 10% away from the efficient boundary.

The WAMEU assessment of WP opex when measured against the NEM benchmarks indicates that AA2 opex was more than 20% beyond the efficient boundary. To reach 20% improvement would require the efficiency factor to be set at 4% pa

The WAMEU notes that the WA government is requiring 5% annual efficiency gains for its other businesses and the ERA itself is of the view that the efficiency gain should be at least in the range of 2-3%. The WAMEU therefore considers that if the ERA is not going to require the 5% efficiency improvement sought by the government, then it should set the efficiency improvement requirement at 3% which is within its range of reasonable efficiency gains.

7.2 Approach to setting opex for AA3

The WAMEU supports the processes used by GBA and ERA to build on an efficient opex base, by adjusting for “one off” elements in base,

allowing for step changes, scale increases and growth adjustments. The issues that concerned WAMEU (and included in its response to the application) were that:

- Adjusting for the one off issues can be misused
- Scale increases need to be closely examined
- Growth factors need to reflect historical changes

The WAMEU noted that these concerns have been recognised in the GBA and ERA reviews.

The WAMEU also highlighted that those elements which are excluded from the “efficient base” of recurrent expenditure need to be closely examined as there has been a trend among networks to exclude as much as possible from the recurrent expended benchmarking and development of the excluded opex element is set from a zero baseline. Such an approach effectively limits the ability of benchmarking to achieve its goal of driving to the efficient boundary.

To overcome this, a view of global opex assists in identifying if the outworkings are excessive. The overview indicates that the ERA draft decision assessment for opex is probably appropriate in the absence of setting the base level cost at a more efficient level.

7.3 Conclusions on opex

WP made an ambitious ambit bid for a massive increase in opex. It has considerably underspent the allowances granted for AA2 indicating that the allowances for AA2 were too high.

The ERA (with the advice of GBA) has reduced the claimed opex by 20% and this new allowance shows consistency with the historic opex from AA2.

Benchmarking of AA2 opex shows that this is not at all near the efficient boundary and the WAMEU considers that, on benchmarking analysis, the actual opex in AA2 is almost certainly more than 20% away from the efficient boundary implying a requirement to impose an efficiency gain of 4% per annum over the life of AA3.

GBA recommends that an efficiency improvement of 2% pa is warranted and the ERA considers that efficiency improvement of 2-3% is appropriate.

The WAMEU therefore sees that ERA should set the efficiency improvement at 3% pa which is at the high end of its acceptable range.

8. Service standards and incentives

One of the important aspects that the implementation of a service standard performance measure achieves is a recognition that there is a relation between cost of providing a service and value to consumers that the service provides. This is the basis of the regulatory bargain.

As the ERA highlights in its discussion on service standards, the WP service performance is not better than that of other networks (indeed the WP performance is identified as often worse), and this is spite of the higher costs that WP imposes on consumers. This implies that WP charges more for a lesser service than its comparable businesses deliver.

In its application, WP sought to provide a lesser service (as measured by the performance targets) despite an increase in costs.

WP also sought to eliminate the quantitative incentive on transmission performance by use of a qualitative assessment from its direct connected customers.

The WAMEU did not agree with either of these approaches. The WAMEU suggested that there should be an incentive to rectify the worst performing feeders and an incentive to reduce transmission congestion such as is used in the NEM.

In its draft decision, the ERA has raised the targets for the incentive on service performance (but not to the level of current performance) and has decided that it would be too complex to impose an incentive on mitigating congestion and that incentivising improved performance on the worst performing feeders detracts from the averaging approach that is currently used.

The most important aspect of the ERA draft decision is that ERA has rejected the WP proposed approach to eliminate the qualitative transmission service performance incentive and to retain a quantitative incentive scheme. The WAMEU supports this.

Whilst the draft decision imposes a better outcome for consumers than that included in the WP application, the WAMEU is concerned that WP is not being sufficiently incentivised to improve those worst performing feeders. All consumers of the same class pay the same network charges. If some are condemned to receive a lesser service level by the WP proposed (and accepted by ERA) yet pay the same cost, then this is

iniquitous. Whilst the ERA has required better reporting on these worst performing feeders (and this is supported) the WAMEU considers the ERA should have imposed a greater incentive on WP to fix this problem.

The WAMEU also disagreed with the WP application whereby WP sought recompense for the costs incurred in a major storm during AA2. WP alleged that this was a force majeure event. The WAMEU agrees with the ERA that WP could have (and should have) been less exposed to the outcomes of this storm event by better management and concurs with the ERA decision to exclude the additional costs from the allowances for AA3.