Government of **Western Australia**
Department of **Finance**

Our ref : 2012/00917; 00105729
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Dear Mr Rowe

DRAFT DECISION ON WESTERN POWER'S PROPOSED REVISIONS TO ITS ACCESS ARRANGEMENT FOR THE THIRD REGULATORY PERIOD

Thank you for the opportunity to provide a submission to the Economic Regulation Authority's (the Authority's) draft decision on Western Power's proposed revisions to its access arrangement for the third regulatory period.

This submission is provided by the Department of Finance as representative of both the shareholder of Western Power and the advisors of energy policy to the State Government. This submission has been prepared following consultation with the Departments of the Premier and Cabinet, State Development and Treasury.

In general, the Department of Finance is supportive of the approach taken by the Authority, to drive Western Power to achieve efficiencies in the operation of its network and deliver lower costs to consumers.

However, the key issue that I wish to bring to your attention in this submission relates to the framework which the Authority has adopted for the calculation of the Weighted Average Cost of Capital (WACC) and any unintended outcomes which could flow from current instability in global financial markets. The Authority should carefully consider what its draft determination on the WACC means for consumers, government and Western Power in terms of economic efficiency and network reliability; and the importance of regulatory certainty.

Firstly, while a low WACC has obvious short term benefits to consumers through lower network tariffs, there is a risk that an insufficient return to the network operator for its investment in its assets could deter efficient investment in the network resulting in reduced reliability over the long term.

Insufficient investment could also result in otherwise higher costs to consumers in the longer term due to the need for increased investment and maintenance costs in the future.

This risk is further amplified in Western Power's situation if the Authority's WACC estimate is below Western Power's actual cost of debt. The Authority is therefore encouraged to undertake a practical "sense-check" of the outcome of its deliberations to ensure that both long term financial sustainability and network reliability are assured.

Secondly, in terms of the cost of debt, the approach taken by the Authority to use a theoretically efficient cost of debt rather than Western Power's actual cost of debt, is consistent with current regulatory practice and supported in principle. However, it is noted that Western Power, unlike its private sector counterparts, is subject to government policy that restricts it from seeking alternate debt funding arrangements and relying solely on debt sourced by the Western Australian Treasury Corporation.

Again, this can have the unintended consequence of Western Power being unable to meet its debt servicing costs because of any shortfall between the Authority's 'efficient' cost and its actual cost. The Authority is therefore requested to balance the regulatory approach of using a benchmarked, 'efficient' cost of debt with the use of Western Power's actual cost of debt in its WACC calculations for its final determination.

The Authority's attention is also drawn to the risk of using a 20 day average to calculate the risk free rate given the significant degree of uncertainty and volatility in international financial markets at present.

Given the turmoil in the financial markets emanating from Europe at the moment and the cascading effect that has on international financial markets, it would seem risky to base a five year WACC determination on a 20 day average in this environment.

The Authority is therefore requested to consider this matter further in its deliberations and determine what would be a more appropriate averaging period that ensures Western Power is not 'locked in' to an artificially low return on its assets for the entire five year regulatory period, as a result of this current market volatility.

In broader terms but still related to the WACC, the Authority is also requested to consider the importance of regulatory certainty and how it impacts Western Power and indirectly, its end consumers.

As the WACC is such a significant portion of the regulated revenue of a network provider under an access arrangement, such substantial variations to the WACC framework can have wide ranging implications. This is not to say that the Department of Finance is providing comment on the arguments of a pre- versus a post-tax approach. Rather the concern is the potential for inefficiencies resulting from the Authority's departure from a pre-tax real WACC framework mid-way through the revisions assessment process.

Regulatory uncertainty surrounding the Authority's preferences with respect to WACC frameworks may also have implications for investment in the State more broadly.

In this regard, the arguments the Authority presented to the AEMC in December 2011[1] against determining the WACC methodology outside the access arrangement review process is noted.

However, while the Authority may only be regulating one provider, that provider (Western Power) is responsible for the transmission and distribution network of the entire South West Interconnected System and therefore the implications to the State and its shareholder, the State Government, are quite significant.

In undertaking consultation on the Authority's preferred WACC methodology outside of the access arrangement approval process, a comprehensive analysis of all the issues can be debated in a forum free of the other aspects of an access arrangement approval process.

A further point I wish to raise is in regards to the Authority's decision on disallowing Western Power's proposed network control expenditure and abolishing the D-factor scheme. There is a potential risk that these decisions may dis-incentivise Western Power to seek non-capital solutions for its network.

On the one hand, the Authority has made a draft recommendation that because there is significant uncertainty surrounding the costs of Western Power's proposed network control expenditure, it will not pre-approve any such expenditure and instead require Western Power to seek to recover those expenses in the next regulatory period.

At the same time, the Authority considers that the D-factor scheme which was designed to allow Western Power to recover any additional operational expenditure if it was used to defer approved capital expenditure, is in effect redundant. This is because the Authority considers the Access Code already provides for the recovery of such expenditure, under Section 6.76.

It is understood however, that Western Power has questioned the Authority's interpretation of the Code, in that it does not consider Section 6.76 provides it adequate certainty that it would be able to recover such additional operational expenditure in future regulatory periods.

The Department of Finance's concern in this regard is the effect this uncertainty could have on the types of investment decisions made by Western Power.

[1] AEMC Rule Change Proposal: *Economic Regulation of Network Service Providers*

The Authority is therefore requested to consider this issue further and seek to provide reasonable certainty to Western Power that it would be able to recover such operational expenditure in future regulatory periods, if that expenditure can be proven to be incurred efficiently. This should then provide Western Power the certainty it needs to assess all non-network options on an equal basis with the traditional capital intensive network solutions and determine the most cost effective and efficient solution.

I note the Authority has adopted a positive position in relation to Western Power's wood pole replacement program, by providing it with the flexibility to spend beyond its forecast on wood pole replacement. The Authority's accommodative approach to this issue will assist Western Power to efficiently implement the program.

The final issue I wish to bring to your attention, of which you are no doubt aware, is the recent gazettal of the *Electricity Networks Access Code Amendment 2012*. The effect of the Code amendment is to increase the amount of money Western Power can recoup by way of headworks charges from 1% to 4% of distribution system target revenue for the access arrangement period. This Code amendment means that the Access Code now provides for the introduction of headworks schemes such as Western Power's proposed distribution low voltage connection scheme (DLVCS).

Thank you again for the opportunity to provide input into this review process and I hope you find this is a useful input. Should you or your staff wish to discuss any of these matters further, please feel free to contact either myself or David Murphy at david.murphy@finance.wa.gov.au, or on 6551 1105.

Yours sincerely

[redacted]

Anne Nolan
DIRECTOR GENERAL

29 May 2012