Economic Regulation Authority

Media Statement

2 May 2018

Economic Regulation Authority releases draft decision on Western Power's access arrangement

The Economic Regulation Authority has not approved Western Power's proposed access arrangement for 1 July 2017 to 30 June 2022.

The ERA's draft decision sets target revenue of $7.38 billion that Western Power can earn over the five-year period. This is 5.6 per cent below the amount requested by Western Power in its proposed access arrangement.

The access arrangement is required under the *Electricity Networks Access Code 2004* and sets out the terms and conditions, including prices, for third parties seeking to access the network.

ERA Chair Nicky Cusworth said the access arrangement was reviewed with the intent of promoting economically efficient investment in, and operation of, Western Power's network and services.

"This is the first access arrangement period for which Western Power has forecast a decline in energy consumption, highlighting the changing nature of the electricity industry as consumers adopt new technologies," she said.

The ERA's draft decision will maintain average network service charges at the current level in real terms.

"While the Government, not the ERA, sets electricity prices, network charges make up around 45 per cent of total electricity costs for residential customers," Ms Cusworth said.

"This draft decision creates no further upward pressure on prices for Western Australians.

"The ERA has also made changes to Western Power's price control which will see Western Power take on more of the risk of fluctuations in demand, rather than this falling on customers."

The ERA's draft decision document details the reasons for its decision and the 91 amendments required in order for the access arrangement to be approved.

There is an explanatory statement at the conclusion of this media statement.

Interested parties are invited to make submissions on the ERA's draft decision by **4:00pm, 30 May 2018**. Submissions can be made via the ERA's website at www.erawa.com.au/consultation

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EXPLANATORY STATEMENT

This explanatory statement provides interested parties with a summary of the ERA's draft decision on proposed revisions to the fourth access arrangement for Western Power's network (AA4). This overview does not form part of the ERA's draft decision or the reasons for the draft decision.

The draft decision

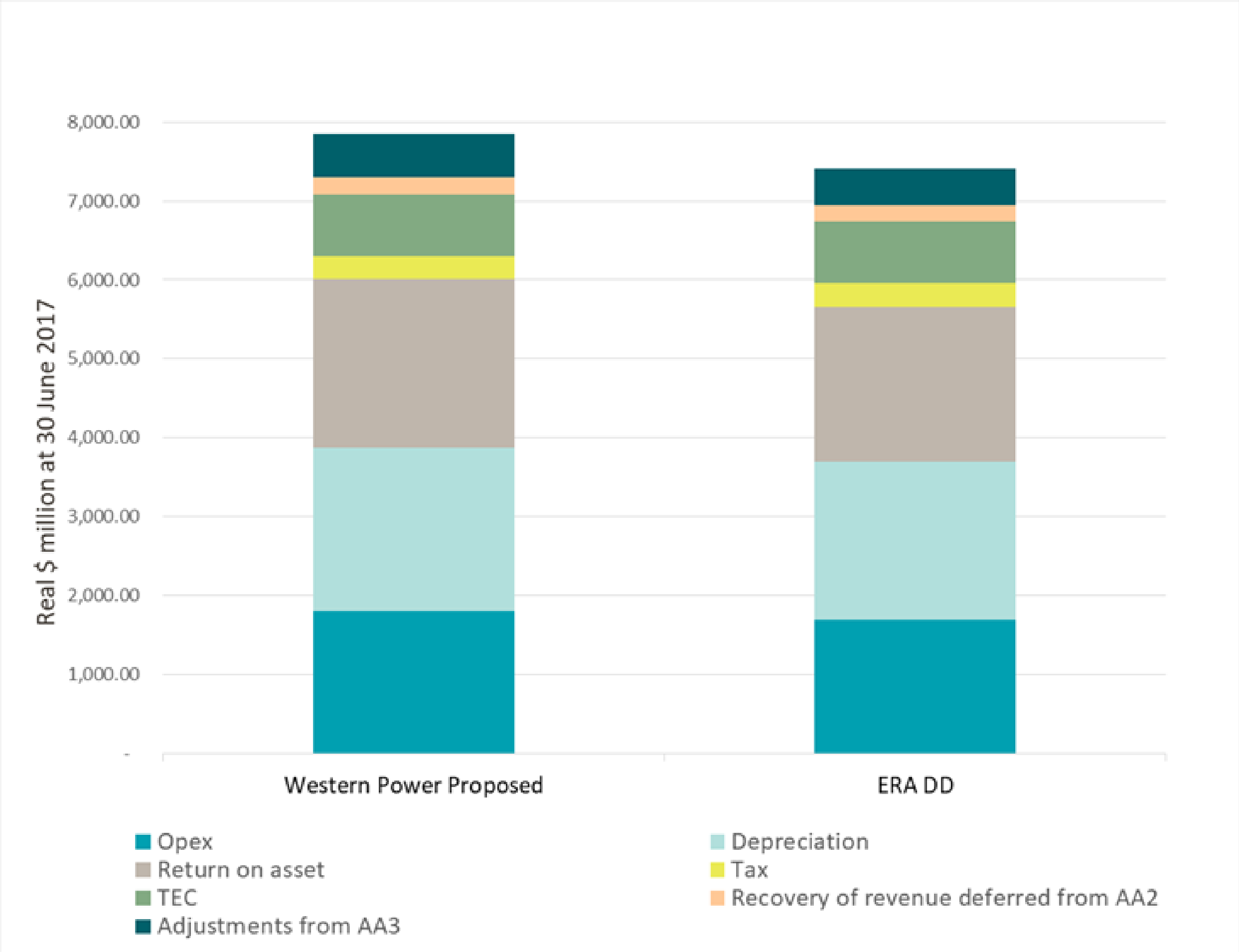
The ERA does not approve Western Power's proposed access arrangement for the period 1 July 2017 to 30 June 2022.

The detailed reasons for the ERA's decision are outlined in the draft decision document, together with 91 amendments required before the access arrangement will be approved.

Table 1: Comparison of Western Power's proposal and the ERA's draft decision

	Western Power proposal	ERA draft decision
Target revenue	$7,817 million	$7,380 million
Weighted Average Cost of Capital	6.09%	6.00%
Capital base at the beginning of AA4	$8,967 million	$8,917 million
Forecast capital base at the end of AA4	$10,414 million	$9,962 million
Capital expenditure	$3,515 million	$3,048 million
Operating expenditure	$1,805 million	$1,696 million

Figure 1: Comparison of Western Power's proposal and the ERA's draft decision



Next steps

Interested parties are invited to make submissions on the ERA's draft decision by 4:00pm, 13 June 2018. Submissions can be made online at www.erawa.com.au/consultation.

Any submission by Western Power may include a revised proposed access arrangement taking into account the ERA's required amendments.

Under Section 4.17 of the *Electricity Networks Access Code 2004*, the ERA will consider any submissions received on the draft decision, and make a final decision to either approve or to not approve Western Power's proposal (or revised proposal if received).

Timing of the draft decision

The preparation and assessment of AA4 was delayed by the previous State Government's proposed changes to Western Australia's electricity market, announced in March 2015.

These changes included transferring regulation of the Western Power network from the ERA to the Australian Energy Regulator.

This created uncertainties about the regulatory framework and made it difficult to plan its submission for AA4 effectively. In June 2015, the ERA approved a deferral of the revisions submission date from 1 March 2016 to 31 December 2016.

Legislation to enact the regulatory changes was introduced to State Parliament in June 2016, but by November 2016 it became clear this legislation would not pass before the March 2017 election. Consequently, Western Power continues to be subject to the State-based regulatory scheme.

To provide Western Power with sufficient time to prepare its submission, the Minister for Energy amended the Access Code to extend Western Power's submission deadline to 2 October 2017.

Western Power's third access arrangement (AA3) remains in effect until AA4 is approved.

Energy outlook

Western Power has forecast a decline in energy consumption during the AA4 period. This is the first access arrangement for which Western Power has forecast reductions in demand.

One of the main reasons for this forecast decline in demand is the increase in use of solar photovoltaic cells, which is making it harder to forecast demand for electricity networks around the world.

Target revenue

The ERA's draft decision sets target revenue of $7.38 billion that Western Power can earn over the five-year period. This is 5.6 per cent below the amount requested by Western Power in its proposed access arrangement.

The ERA requires Western Power to review its overall revenue smoothing profile (how it proposes to recover its target revenue over an access arrangement period) to avoid price shocks for the AA4 period, and reduce the likelihood of price shocks for the next access arrangement after 2022.

Western Power proposes to defer revenue from the transmission service and bring forward an equal amount of revenue for the distribution service to reduce the increase in charges for the transmission service.

Transmission-only customers expressed concerns in their submissions about possible large increases in tariffs. Other stakeholders commented on the equity of transferring revenue between services.

Based on the 2016/17 Price List Information, 58 customers are connected directly to the transmission network, generating $78 million of revenue. They do not pay distribution charges.

The ERA considers that transferring revenue between services is not consistent with the Access Code objectives, and it requires this proposal to be amended.

Western Power must ensure its proposed prices do not result in price shocks for any individual reference service, and has the ability to rebalance tariffs within the price control.

The ERA also requires changes to the gain share mechanism, which allows Western Power to retain the benefit of expenditure that is less than forecast in an access arrangement period. The changes will ensure savings benefit users a year earlier than under the current arrangement.

It has also recommended the removal of rewards and penalties for the service standard adjustment mechanism. This mechanism is designed to give Western Power an incentive to maintain service standards and improve service standards only where the improvement is of value to customers. The ERA's proposed changes aim to avoid over-investment, as customers have indicated they are mostly satisfied with current service standards.

Price control

The Access Code requires an access arrangement to include a "price control", which means the provisions in an access arrangement which determine target revenue.

Under Western Power's current price control, any changes in energy consumption or customer numbers compared with forecast demand affect charges to users during the access arrangement period. This is because any under (or over) recovery of revenue compared to the target is passed through to users in the following year's charges.

This puts all demand risk on users, and can result in charges to users being significantly different from those projected at the time of an access arrangement decision. This is not consistent with the price control objectives including avoiding price shocks.

Exposing Western Power to demand risk could also encourage it to develop more efficient tariffs, to seek to connect new customers and to offer services that meet user requirements and benefit Western Power through increased revenue, reduced costs or a combination of both.

The ERA requires amendments to the price control to:

- remove the correction factor for under or over recovery of target revenue; and
- ensure the forecast revenue recovery from Western Power's proposed tariffs in each year's Price List are based on customer numbers and volumes consistent with the demand forecast approved with the AA4 decision.

Western Power's performance during the previous access arrangement

Western Power achieved or exceeded its service performance benchmarks and targets for almost all performance measures in each year of AA3.

The service standard benchmarks and targets proposed by Western power for AA4 are, in most cases, higher than those which applied during AA3 due to this improved service performance.

Western Power's capital expenditure over the AA3 period was substantially lower than forecast. Transmission expenditure was $957.23 million, or 43.1 per cent, below forecast, while distribution expenditure was $2.86 billion, or 17.7 per cent, below forecast.

This was largely due to demand growth over the AA3 period being much lower than expected, with 40 of 68 planned capacity expansion projects not proceeding.

Operational expenditure over the AA3 period was also $60 million lower than forecast.

In general, the ERA has noted a more active approach to stakeholder engagement by Western Power throughout the process of preparing its AA4 proposal, and a greater focus on customers.

Capital expenditure for AA4

Submissions from some stakeholders questioned whether declines in peak demand could result in under-utilisation of assets, and whether some of the existing asset base should be written down as a result.

The ERA does not know whether demand has declined to the extent that it is possible to identify assets that no longer contribute to providing covered services. Western Power's forecasts suggest peak demand will fall slightly over the AA4 period.

The ERA intends to monitor asset utilisation during AA4 to inform its decision at the next access arrangement review.

Western Power's proposed growth expenditure is based on 2016 demand forecasts, as it did not have time to take into account more recent forecasts. Western Power also says it did not have time to fully consider the effect of the retirement of the Muja AB, Western Kalgoorlie and Mungarra generators on security of supply and network reliability.

Western Power proposes to provide updated forecasts following the draft decision to take into account the latest demand forecast and generator retirements.

The ERA will consider this new information in the final decision. Western Power must demonstrate that it has considered all options, including non-network options, and that proposed projects are reasonably likely to proceed.

Transmission

The ERA requires the removal of two projects which are unlikely to proceed from Western Power's forecast capital expenditure. These are the Central Business District new substation ($62.2 million), and the Picton-Busselton 132 kV line ($19.2 million).

The ERA also requires the removal of more than $100 million in forecast asset replacement and renewal expenditure, as there is a lack of robust detail in the AA4 proposal to justify this expenditure. This includes the removal of $20.5 million for power transformers, $20.1 million for protection systems, and $30.1 million for switchboards.

Distribution

The ERA's draft decision lowers Western Power's proposed distribution network capital expenditure by $135.1 million, or 5.48 per cent.

Western Power's proposed distribution expenditure for AA4 is lower than actual expenditure for AA3.

This is due to lower forecast demand and reductions in replacement and compliance costs, particularly for wood poles, through the adoption of a more risk-based asset management approach.

Corporate

The ERA will further consider Western Power's proposed corporate capital expenditure in its final decision, but requires more evidence of the net benefits of some of the proposed projects.

Its draft decision is to allow $370.9 million in expenditure, down from Western Power's proposal of $487.1 million. This includes requiring the removal of $24 million for new customer relationship software, as the ERA's technical consultant has classed this expenditure as excessive and there are other, more affordable options to consider.

Operating expenditure for AA4

Western Power is proposing $1,805.1 million operating expenditure for AA4, which is $695 million less than the costs approved for AA3.

The ERA assessed this proposal to ensure it meets the Access Code requirement of efficiently minimising costs.

The ERA's draft decision excludes a $28.3 million payment for Western Power's business transformation program, as it is not clear how any savings from the final stage of this program have been incorporated into the AA4 proposal.

The ERA also found an inconsistency between operational and capital expenditure on Supervisory Control and Data Acquisition (SCADA) and communications. Western Power proposes to spend more than $80 million across AA4 replacing ageing SCADA assets, which should lead to lower maintenance requirements for newer assets. However, Western Power has proposed base operating expenditure similar to actual expenditure in AA3.

The ERA considers that the proposed operating expenditure should be reduced by 50 per cent as the asset replacement program will replace at least 50 per cent of SCADA assets. Therefore, the ERA requires operating expenditure to be reduced by $6.2 million per year over AA4 ($31 million in total).

The ERA's draft decision is to approve $1,695.4 million in operating expenditure, which is 6.07 per cent lower than Western Power's proposal.

The ERA will further review growth factors, efficiencies and labour cost escalations before making its final decision.

Return on regulated capital base

The rate of return, based on a weighted average cost of capital, provides Western Power with a return on the capital it has invested in its business.

The ERA has not approved Western Power's proposed return on capital. Its decision sets a nominal after-tax weighted average cost of capital of 6 per cent, compared to Western Power's proposal of 6.09 per cent.

The ERA has made changes to the credit rating, gearing ratio, debt raising and hedging costs, and the market risk premium proposed by Western Power to calculate an efficient rate of return.

Time of use tariffs

Western Power proposed to introduce advanced metering infrastructure (smart meters) and time-of-use tariffs for AA4.

The intent of time-of-use tariffs is to encourage customers to spread their electricity use over the course of the day. Currently, residential customers tend to use most electricity between 3:00 PM and 9:00 PM on weekdays.

The users of Western Power's network are retailers, generators and large customers directly connected to the transmission network. Network tariffs do not necessarily provide a price signal to end-use customers (such as residential customers), but rather to these users.

The ERA does not consider the proposed new time-of-use tariffs should be mandatory. Mandating reference services is not consistent with the Access Code objective of promoting competition, or with the principles under section 26 of the *Economic Regulation Authority Act 2003* of furthering the interests of consumers.

Retailers should continue to have a choice between an anytime-use or time-of-use tariff for both new and existing customers. Providing Western Power sets its network tariffs to recover costs, the service that retailers select should be make no difference to it.

If Western Power wants a higher take-up of the time-of-use services, it can set the terms and reference tariffs for these services that make the services attractive to users.