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### **Framework and approach for Western Power's fifth access arrangement review: Draft Decision**

The Australian Energy Council (the “AEC”) welcomes the opportunity to make a submission to the Economic Regulation Authority (the “ERA”) on the *Framework and approach for Western Power's fifth access arrangement review* (the “**Framework and Approach**”) Draft Decision (the “**Draft Decision**”).

The AEC is the industry body representing 22 electricity and downstream natural gas businesses operating in the competitive wholesale and retail energy markets. These businesses collectively generate the overwhelming majority of electricity in Australia and sell gas and electricity to over 10 million homes and businesses.

The AEC makes the following comments in relation to the Draft Decision:

#### **Stand-alone power systems**

The ERA notes in the Draft Decision that:

*“The legislative changes in Western Australia allow Western Power to install and operate a stand-alone power system in its entirety. However, the costs of stand-alone power systems can be added to Western Power's regulated asset base and recovered from all network users only if they meet the requirements of the new facilities investment test.”<sup>1</sup>*

The ERA also points out that Western Power is installing stand-alone power systems in parts of the network where it is cheaper than maintaining the existing network.

The AEC expects that the ERA will closely scrutinise the installation of the stand-alone power systems to ensure that they are only being employed, and rolled into the regulated asset base, in circumstances where they are a least cost solution. Competition should also be encouraged in the provision of stand-alone power systems and the AEC encourages the ERA to consider whether a third-party could provide the stand-alone power system, as part of the Alternative Options mechanism, at a lower cost.

#### **Network connected batteries**

The AEC, along with various stakeholders, raised concerns with Energy Policy WA on the proposed changes to the Electricity Networks Access Code 2004 (the “**Access Code**”) that allowed the network operator to use network connected batteries to provide services to the competitive market.<sup>2</sup> Of particular concern is Western

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<sup>1</sup> See page 10, [Framework and approach for Western Power's fifth access arrangement review Draft decision](#)

<sup>2</sup> See [AEC submission on the proposed changes to the Electricity Networks Access Code](#)

Power's ability to use regulated network batteries to earn unregulated revenue (through, for instance, a lease payment with a third party intermediary).

The central issue is that Western Power is overly incentivised to make investments in network connected battery solutions, as compared to other assets that could provide equivalent network support services, even where network connected batteries may not be the most efficient solution because it can recover the cost of building the asset plus keep 100% of the revenue up to the materiality threshold.

At the time, Energy Policy WA claimed that we "incorrectly assumed that when Western Power acquires storage works to alleviate a network constraint or limitation the total capital expenditure will be rolled into the regulated asset base."<sup>3</sup> However, Economic Insights has taken a similar view to the AEC, Oakley Greenwood<sup>4</sup> and other stakeholders by concluding:

*"Our interpretation of these features is that the full cost of the batteries would be included in the regulatory asset base if they passed the NFIT (and hence the return of and return on this capital would be recovered from reference services tariffs), and if they were used to also provide noncovered services then Western Power could retain at least 70% of the net incremental revenue (defined above) and more if the materiality threshold of \$1 million (for all multi-function assets combined) was not reached."*<sup>5</sup>

Far from a theoretical issue, Western Power's ability to roll the full capital cost of a network connected battery into the capital base will incentivise it to over-invest in network connected battery services because they will recover the full cost of building the asset plus keep the revenue. In contrast, third parties will not automatically recover the cost of building the asset and have exposure to full market risk. This creates an uneven playing field and is likely to have the effect of crowding out parties who may otherwise have competed for the provision of those services

Energy Policy WA suggested that such concerns could be addressed by "the ERA (who) can develop ringfencing rules where it considers that a covered network is not adequately adhering to the ringfencing objectives."<sup>6</sup> However, the ERA has pointed out in its Draft Decision:

*"The ringfencing objectives in the Access Code also do not consider storage services. There are specific provisions prohibiting network service providers from generating, purchasing or selling electricity. However, there are no ringfencing requirements for any other activities apart from a requirement that the service provider must keep separate accounts and records for the covered network. This would apply only if the battery was not part of the covered network. As noted above, allocating capital costs between covered and non-covered services could be difficult."*<sup>7</sup>

To address this issue, the ERA proposed in the Draft Decision to classify services provided by batteries as an excluded service. Given that the changes to the Access Code have been gazetted and the issues described above are unlikely to be corrected in the near-term through further amendments to the Access Code, the AEC supports the ERA in classifying network connected batteries as excluded services.

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<sup>3</sup> See 6, [Proposed Changes to the Electricity Networks Access Code: Stakeholder Submissions Summary](#)

<sup>4</sup> See [Implications of Network Ownership of Grid-Side Battery Assets on Competition in the Wholesale Electricity Market](#)

<sup>5</sup> See page 40, [Notes on ERA Issues Paper: Framework and approach for Western Power's fifth access arrangement review](#)

<sup>6</sup> See 6, [Proposed Changes to the Electricity Networks Access Code: Stakeholder Submissions Summary](#)

<sup>7</sup> See page 12, [Framework and approach for Western Power's fifth access arrangement review Draft decision](#)

## Demand Management Innovation Allowance

The AEC supports the ERA's draft decision to include an annual demand management innovation allowance ("DMIA") based on 0.08 per cent of approved target revenue.

The AEC noted in its submission on the issues paper that project eligibility and reporting requirements are critical to ensure that the DMIA only funds projects that are genuinely innovative and likely to provide consumers a positive cost/benefit outcome within a reasonable period, does not duplicate other projects either nationally or internationally, and does not fund new lines of business for the network operator in competition with network users. The AEC looks forward to commenting further on these matters as part of the consultation process on the DMIA guideline.

## Applying the pricing principles

In the Draft Decision, the ERA notes that the new Access Code pricing principles under clause 7.3G and 7.3H "...will provide greater flexibility and clarity for setting tariffs for all customers. The Code amendments will require Western Power to undertake a more detailed cost allocation focused on each reference service and ensure that each tariff is cost reflective."<sup>8</sup> The Draft Decision states "...that more cost-reflective pricing structures for the current residential and business bi-directional services will enable the existing bi-directional services to be extended to include residential and business end-use customers with batteries and electric vehicles".

The Draft Decision also points to Energy Policy WA's warning that Western Power's revenue uncertainty could lead them to prefer more conservative network pricing structures such as higher fixed charges and flat per kilowatt hour rates. Energy Policy WA considered such pricing structures would reduce retailers' ability to offer tariffs that incentivise consumption behaviour and investment decisions (such as batteries) that would support the efficient operation of the power system and place downward pressure on costs.<sup>9</sup>

Among residential and business classes, there are groups who are vulnerable to these types of pricing policies. A higher fixed charge rate may not support initiatives to reduce demand or consumption, and if implemented some customer groups will have little or no opportunity to mitigate their exposure by doing what has historically lowered electricity bills; changing consumption patterns or investing in efficient energy solutions. These outcomes should not be left to chance.

The AEC suggests that the Framework and Approach should set out the ERA's expectation in relation to how Western Power should address:

- The additional costs likely to be associated with meeting demand at times of greatest utilisation of the network for the generation and consumption of electricity (refer clause 7.3G(a)).
- The locational impact of customers that use a reference service and the extent to which these costs vary between different locations on the network (refer clause 7.3G(b))
- The allocation of fixed costs to reference tariffs such that it minimises distortions to the price signals for efficient usage and also ensure the reference tariffs that comply with the pricing principle set out in section 7.3G (refer clause 7.3H(c)).

Given Energy Policy WA's views, and the impact cost reflective tariffs have on retailers developing efficient products and on customer behaviour, the AEC considers that the Framework and Approach should set out the ERA's expectation in relation to these three pricing matters.

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<sup>8</sup> See page 40, [Framework and approach for Western Power's fifth access arrangement review Draft decision](#)

<sup>9</sup> See page 38, [Framework and approach for Western Power's fifth access arrangement review Draft decision](#)

## Form of price control

The AEC agrees with the ERA's view that the "current price control provides strong incentives for Western Power to develop more efficient tariffs, encourage the connection of new customers and offer services that meet user requirements and benefit Western Power through increased revenue, reduced costs or a combination of both."<sup>10</sup>

Any changes to the price control should be in the interests of consumers with a view to lowering costs.

The Draft Decision does highlight a concern that the requirement to manage revenue risk could incentivise the network operator to under-forecast demand. The ERA suggests that there are a number of factors that would discourage or mitigate this behaviour. Provided the Access Code's pricing principles are effectively applied, the AEC agrees with the ERA's views and considers that behaviour to under-forecast demand would also be counter intuitive because it would lead to reducing the network operator's forecast investments and regulated asset base.

## Price setting for new transmission nodes

Western Power's New Transmission Nodes Policy sets the annual connection price for connection assets dedicated to single users as 1.88% of the full capital cost.<sup>11</sup> This amount is meant to recover the expected operation and maintenance costs for the connection asset. However, determining the connection prices based on the "full capital cost" leads to unintended consequences.

Firstly, the connection price is not cost reflective and can overstate the annual O&M costs. This is because many aspects of the capital cost have no requirement for ongoing O&M and the full capital cost can ultimately include a range of items not directly related to the cost of the asset, such as costs incurred by delays or unforeseen events, or even fast-tracking progress to recover time.

Secondly, calculating the connection price based on the full capital cost incentivises Western Power to inflate the capital cost to boost their annual O&M payments. This is not desirable, creating a potential barrier of entry for users seeking a connection and going against the Access Code objectives.

The AEC suggests that a better approach would be to estimate maintenance costs as a percentage of the capital cost of the maintainable items rather than the full capital cost.

## Depreciation

Item 7.3H(c) of the Access Code requires that revenue expected to be recovered from each reference tariff must minimise distortion to the price signals. In addition, to support this requirement, item 6.4(b) and 7.1D require that:

1. Users are able to predict the likely annual changes in target revenue during an access arrangement period; and
2. The network operator must provide a forecast of the weighted average annual price change for that reference tariff for each pricing year of the access arrangement period.

Therefore, the way depreciation is calculated and applied to capital-related costs and the approved total costs directly impacts the effectiveness and outcome of the Access Code requirements.

The AEC notes that 4.A2(e) of the Access Code requires the ERA to set out in the Framework and Approach its decision over the form of price control, having regard to the objectives in section 6.4. In this context, the AEC considers application of a real annuity method of depreciation<sup>12</sup> would better serve clauses 6.4(b) and

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<sup>10</sup> See page 38, [Framework and approach for Western Power's fifth access arrangement review Draft decision](#)

<sup>11</sup> See Appendix A page 2, [2020/21 Price List Information](#)

<sup>12</sup> Given by: Depreciation = annuity – return on the regulated capital base

6.4(c) and meet the Access Code objective – while remaining consistent with clauses 6.43 and 6.70 - when compared to the straight-line depreciation approach that has been applied in Western Power's previous access arrangement periods.

The improvement would be due to the flat overall capital cost recovery profile that the real annuity method affords and the fact that network users face a higher weighted average cost of capital than Western Power. A move to the real annuity method of depreciation would thus improve the net present value of network user's cash flows without impacting the net present value of Western Power's cashflows, which would place downward pressure on network prices and ultimately retail prices. Moreover, the move would provide some benefit for the network by preserving the network's capital base for longer, resulting in a stronger balance sheet over the life of the assets.

In addition, the AEC also considers the real annuity method would better achieve the outcomes of clause 7.3H(c) of the Access Code and permit the network operator to more easily and effectively deliver on its obligations under ENAC clause 6.4(b) and 7.1D so that users can easily predict the financial impact before the release of a price list.

Regulatory precedence for the application of an annuity method of depreciation includes:

- ERA determinations under the Western Australia Railways (Access) Code 2000
- The ERA's determination for the recovery of deferred revenue resulting from the change in WP's treatment of capital contributions in the calculation of target revenue between AA1 and AA2
- ERA determination for light emitting diode streetlight asset tariffs (for FY2020)
- AER determinations for streetlight assets
- Queensland Competition Authority determinations for Sunwater and Seqwater
- New South Wales Independent Pricing and Regulatory Tribunal determinations for State Water (pre-2006)
- Essential Services Commission of Victoria determination for Southern Rural Water (pre-1 July 2006 assets)
- United Kingdom's Water Services Regulation Authority determinations for under-ground water assets

## Conclusion

The AEC sincerely appreciates the consultation process conducted by the ERA. The ERA has spent considerable time and effort engaging with stakeholders and has taken a balanced view in response to comments received through the process. The AEC further welcomes the opportunity to provide the above feedback on the Draft Decision.

Please do not hesitate to contact Graham Pearson, Western Australia Policy Manager by email on [graham.pearson@energycouncil.com.au](mailto:graham.pearson@energycouncil.com.au) or by telephone on [redacted] should you wish to discuss this further.

Yours sincerely,

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