Our Reference: DMS 3183555v2
Enquiries: Simon Adams
Telephone: (08) 6212 1076

22 December 2008

Rob Pullella
Access Arrangement Review
Electricity Access
Economic Regulation Authority
PO Box 8469
Perth BC WA 6849

Dear Mr Pullella,

Western Power's Proposed Revisions to the Access Arrangement – Submissions on Price Control

Synergy appreciates this opportunity to provide the following submissions on the price control elements submitted by Western Power under its proposed revised access arrangement (**PRAA**). Synergy acknowledges the assistance of NERA Economic Consulting in making these submissions.

Unless otherwise specified, words in italics in this submission have the same meaning as in the Electricity Networks Access Code (**Code**).

1. SUMMARY

In these submissions Synergy:

- outlines the impact to *consumers*, in terms of significant price increases, of the Authority approving the price control elements of the PRAA;
- sets out its understanding of the Code requirements against which the Economic Regulation Authority (**Authority**) will assess the price control elements of the PRAA;
- provides details of the areas in which Synergy is unable to determine the extent to which the price control elements of the PRAA meet the requirements of the Code due to the lack of publically available information;
- to the extent that it has been able, expresses its views on certain areas where Synergy has concerns that the PRAA does not, or may not, meet the requirements of the Code; and
- requests the Authority to carefully review the sufficiency of the information provided in the PRAA and to clearly set out in its draft decision the process it

T: (08) 6212 2222 F: (08) 9221 4628 W: synergy.net.au E: info@synergy.net.au
228 Adelaide Terrace, Perth WA 6000. GPO Box K851, Perth WA 6842. ABN: 71743446839

adopted in forming its view of whether the PRAA meets the Code requirements together with its detailed reasons.

At a high level and as detailed later in this submissionSynergy's concerns with the proposals presented in the PRAA, are as follows:

- The information provided in support of the expenditure proposals in the Access Arrangement Information is high-level and, in Synergy's view, is insufficient to satisfy the requirements of section 4.2 of the Code. Synergy submits that the information provided falls far short of what is typically submitted by regulated businesses in other jurisdictions and does not provide a basis by which the Authority, *applicants* and *users* can form an opinion as to whether the PRAA complies with the Code.

- Western Power is proposing to roll all capital expenditure from the first *access arrangement period* into its asset base, but, in Synergy's view, Western Power has not adequately demonstrated that this expenditure satisfies the *new facilities investment test* (**NFIT**).

- In relation to the WACC, Western Power has provided little justification for departing from the Authority's previously preferred approach of using a 20 day sample period to determine the risk free rate and the debt margin. The plausible range provided by the supporting report of KPMG submitted by Western Power also appears to have taken a view that must favour Western Power.

- The gain sharing mechanism proposed by Western Power does not, in Synergy's view, satisfy the objective in section 6.21(c) of the Code of providing incentives to reduce costs that are neutral with respect to the timing of the reduction.

- The interactions between the investment adjustment mechanism, the gain sharing mechanism and the service standard adjustment mechanism need to be carefully considered to ensure that they are consistent and provide appropriate incentives when combined. Synergy has concerns that, as proposed, the arrangements provide an incentive for Western Power to 'gold plate' the network to improve *service standards*, and to inefficiently substitute capex for opex.

- Western Power's proposed D-factor does not, in Synergy's view, have any basis in the provisions of the Code. In particular the D-factor appears to provide a route for Western Power to bypass the NFIT for *capital expenditure* in that (and contrary to the provisions of the Code) under the proposed D-factor such expenditure need not be related to the provision of *reference services*. Synergy strongly believes that Western Power's proposed D-factor should be rejected by the Authority.

- The significant price increases proposed between the last year of the first access arrangement period to the first year of the next access arrangement period do not appear to take into account the price shock objectives of sections 6.4(c) and 7.4(d) of the Code.

2. IMPACT OF WESTERN POWER'S PROPOSED INCREASE IN CHARGES

The revenue proposals submitted by Western Power represent a substantial increase compared to the *target revenue* for the current *access arrangement period*. Overall, in 2009/10 the proposed increase in *target revenue* is [43%], with further [30%] increases in both 2010/11 and 2011/12. In addition Western Power is proposing additional revenue increases of $191.3m ($14.6m opex and $177.3m capex) to be locked in now and applied to the third *access arrangement period*.

The increases in *target revenue* proposed by Western Power, if accepted by the Authority without amendment, would have a significant impact on the final retail tariffs that *consumers* pay, since *charges* (i.e. network tariffs) form a substantial component of final retail tariffs. For example, Synergy's standard A1 customer price is currently approximately 15.5c/kWh. The current network charge component of the A1 price is approximately 6.94 c/kWh. If the PRAA is approved, this will result in the network charge component of the A1 price increasing by approximately an additional 9.21 c/kWh to 16.15 c/kWh over the *access arrangement period*. All else equal, this represents an average annual A1 increase from $886 per annum in 2008/09 to $1,410 per annum in 2011/12, excluding impacts from higher generator RETS/MRET and CPRS costs. This increase does not take into account the future impact on prices as a result of the revenue that Western Power is seeking to lock-in now for the third *access arrangement period*.

The Authority is aware that, currently the level of prescribed retail tariffs significantly under-recovers the actual costs of serving *consumers*. Synergy anticipates that this situation will have to be addressed and notes that tariff increases of, for example 47% for the A1 tariff, have been mooted to ensure that retail tariffs are cost reflective. To also increase network tariffs by the order of magnitude proposed by Western Power at the same time as the under-recovery issue is being addressed could well result in the overall tariff increase becoming unsustainable, particularly as Synergy is very concerned about inflicting a price shock to its customers.

Synergy appreciates that Western Power is facing increased drivers for expenditure in response to the rapid growth in demand for electricity and expectations for the future development of the electricity market in the South West Interconnected System (**SWIS**). However, given the magnitude of the increases proposed, it is imperative that the Authority carefully scrutinises the proposals to ensure that the planned expenditure is necessary and meets the criteria set out in the Code.

3. THE INFORMATION REQUIREMENTS OF THE CODE

Section 4.2 of the Code requires that the *access arrangement information* must enable the Authority, *users* and *applicants* to:

- understand how the *service provider* derived the elements of the *proposed access arrangement*; and
- form an opinion as to whether the *proposed access arrangement* complies with the Code.

Synergy considers that the information provided by Western Power in its Access Arrangement Information, particularly in relation to its proposed operating and capital expenditure, for the second *access arrangement period* falls short of this Code requirement.

Synergy has, throughout the submission, highlighted areas in which it considers that the information provided falls short, particularly compared with what could be expected in light of the information provided by regulated network businesses in other jurisdictions.

Given that there is insufficient publically available information for interested parties to form the understanding and opinion required by section 4.2, Synergy submits that the Authority must:

(a) carefully consider whether it has sufficient information to perform the assessment required of it by the Code;

(b) if not, to require Western Power to provide such information;

(c) once such information has been provided, to complete its assessment of whether the PRAA complies with the Code requirements; and

(d) set out in its draft decision the process it adopted in forming its view of whether the PRAA meets the Code requirements, together with its detailed reasons including the type of information the Authority relied upon.

Synergy submits that, in the circumstances, this process in necessary in order for the decision making process to be sufficiently transparent, as required by the Code.

4. ROLL-FORWARD OF THE REGULATORY ASSET BASE

4.1. Code Requirements

The Code requires the *capital base* for the start of the second and subsequent *access arrangement periods* to be determined in a manner that is consistent with the *Code objective*. The notes to the Code highlight that a 'roll-forward' methodology would represent an acceptable approach. Western Power has adopted this approach.

Section 6.51A of the Code allows for *new facilitates investment* to be added to the *capital base* where such investment:

- satisfies the *new facilities investment test* (**NFIT**); or
- the Authority otherwise approves it being added to the *capital base* if:
  - it has been, or is expected to be, the subject of a *contribution*; and
  - it meets the requirements of section 6.52(a); and
  - the *access arrangement* contains a mechanism designed to ensure that there is no double recovery of costs as a result of the addition.

Section 6.52 of the Code sets out the NFIT, which essentially has two parts (both of which must be satisfied):

- part (a) essentially requires that the *new facilities investment* be prudent and efficient;
- part (b) of the test requires that one of the following be satisfied:
  - the *anticipated incremental revenue* from the *new facility* is expected to at least recover the *new facilities investment*; or
  - the *new facility* provides a *net benefit*; or

- the *new facility* is necessary to maintain the safety or reliability of the *covered network* or its ability to provide contracted *covered services*.

4.2. Western Power's Proposal

Western Power is proposing that all investment that it has incurred in the current *access arrangement period* is rolled in to its regulatory asset base.

Western Power considers that all of its investment meets the NFIT. The information provided by Western Power in its Access Arrangement Information in support of this position appears to effectively be the following:

- A statement that Western Power does not believe that the NFIT requires after-the-event reviews of capex, given the strong financial incentives to minimise capex that are present in the regulatory regime.[1] Western Power points to the approach adopted by the Essential Services Commission in Victoria (**ESCV**) in relation to the regulation of gas distributors in support of this position.
- Appendix 5 to the PRAA is a review by PB Power, commissioned by Western Power, of whether Western Power's capex for investments to which the *investment adjustment mechanism* (**IAM**) applies (ie, growth related capex) meets the NFIT.
- A statement that: 'The expenditure incurred during the current access arrangement period has also been constrained by resourcing issues, providing further confidence that the actual expenditure incurred is prudent and efficient and satisfies the requirements of the NFIT.'[2]

Western Power also notes that it is reverting to the conventional regulatory treatment of *capital contributions*, which will have the effect of creating a one-off increase in its revenue requirement in the current period.[3]

4.3. Synergy's Comments

The requirement in section 6.51A of the Code for *new facilities investment* to satisfy the NFIT before it can be added to the *capital base* is a key constraint in order to ensure that Western Power has strong incentives to make certain that its investment is prudent and efficient. This guards against *users* and *consumers* having to pay for inefficient investment. The importance of ensuring that investment satisfies the NFIT is increased by the IAM included in Western Power's first *access arrangement*, which allows Western Power to include in its revenue requirement for this *access arrangement period* the revenue foregone on actual expenditure in the current *access arrangement period* above forecast levels.

Western Power points to the incentive properties of the current regime as providing comfort to the Authority as to the prudency and efficiency of actual capital expenditure, and of obviating the need for an after-the-event analysis of individual capex projects.

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1 Western Power Access Arrangement Information, p. 176.

2 Western Power Access Arrangement Information, p. 33.

3 Western Power Access Arrangement Information, p.11.

Synergy submits that the incentive properties of the regulatory regime applying to Western Power in the first *access arrangement period* are considerably weaker than those applying in other jurisdictions, and in particular are weaker than those applying to the gas distributors in Victoria. Specifically, the IAM applying to a substantial potion of Western Power's capex in the first *access arrangement period* means that Western Power has not faced any real commercial incentive to minimise its capital expenditure for these categories, since any expenditure in excess of that forecast (including foregone return) is able to be adjusted for at the start of the current *access arrangement period*.

Western Power's own consultants, Harding Katz, recognise that the incentive properties of the regulatory regime faced by Western Power are only relevant to categories of expenditure **not** covered by the IAM (emphasis added).[4]

Capital expenditure covered by the IAM relates to growth related capital expenditure. In the first *access arrangement period* this investment had a total value of around $2.5 billion, which is close to half of the total proposed capex for this period.

In summary, Synergy submits that there is a substantial amount of capex covered by the IAM in the first *access arrangement period* for which the incentive properties of the regulatory regime mean that commercial incentives alone should not be relied upon to establish that the investment satisfies the NFIT. As a corollary Synergy submits that there needs to be some form of after-the-fact investigation in relation to these projects in order to ensure that the Code requirements are met.

Western Power has provided as an Appendix to its Access Arrangement Information a report which it has commissioned by PB Power to assess whether the capex Western Power undertook in the first *access arrangement period* satisfies the NFIT.[5] Synergy considers that the information provided in this report falls well short of the information that could be expected to be provided in order to substantiate that the total investment satisfies the NFIT. The PB Report focuses on the procedures in place within Western Power, and then provides four case studies to establish that Western Power's actual practice aligns with these procedures and results in expenditure that is prudent and efficient. These four case studies cover projects that, in total, have a capital value of $65.4m (and three of the four projects have capital values of less than $10m each). This compares with total capital investment over the first *access arrangement period* covered by the IAM of more than $2.5 billion. That is, the value of the case study projects analysed represents less than 3% of the total expenditure covered by the IAM. Synergy submits that this small sample size provides insufficient information from which the Authority can form an opinion as to whether the investment satisfies the requirements of the Code in relation to the NFIT.

Synergy also notes that no information is provided by Western Power in its PRAA as to which, if any, projects included in its actual capital expenditure for the first *access arrangement period* have satisfied the regulatory test requirements of the Code.

Finally, Western Power states in its Access Arrangement Information that its expenditure in the first *access arrangement period* has been constrained by resourcing issues and

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4 Reported in Western Power Access Arrangement Information, Appendix 5. PB Power Assessment of AA1 Capex – NFIT submission, Section 2.

5 Western Power Access Arrangement Information, Appendix 5. PB Power Assessment of AA1 Capex – NFIT submission, Section 2.

that this provides further confidence that the actual expenditure satisfies the NFIT. Synergy submits that the fact that expenditure was below the level that Western Power would have liked cannot logically be not linked to the issue of whether the expenditure that was undertaken was prudent and efficient in accordance with Code requirements.

In conclusion, Synergy submits that there is insufficient detailed information for it to determine whether the Code requirements in relation to capital expenditure have been met. Further, Synergy submits that the Authority needs to be satisfied that the capex undertaken by Western Power in the first *access arrangement period* meets the requirements of the Code in order for it to be included in the *capital base*, and specifically that it satisfies the NFIT. In Synergy's view the incentives in the regulatory regime (in particular the IAM) mean that the Authority cannot rely on these incentives to ensure that all actual expenditure passes the NFIT. Synergy therefore considers that the Authority will need to undertake an after the event review of actual capex. The level of detail currently provided by Western Power in the Access Arrangement in relation to its investment in the first *access arrangement period* appears insufficient for this purpose. In this respect Synergy re-iterates its submissions under heading 3 above.

5. FORECAST EXPENDITURE FOR THE SECOND ACCESS ARRANGEMENT PERIOD

5.1. Code Requirements

Section 6.4 of the Code relevantly requires that the *price control* in an *access arrangement period* must have the objective of:

> "(a) giving the *service provider* an opportunity to earn revenue ("**target revenue**") for the *access arrangement period* from the provision of *covered services* as follows:
>
> (i) an amount that meets the forward-looking and efficient costs of providing *covered services*."

The Authority is therefore required to determine that the expenditure proposals put forward by Western Power do indeed reflect the 'forward-looking and efficient costs' of providing *covered services*.

In addition:

- section 6.40 of the Code relevantly requires that the *non-capital costs* component of *approved total costs* for a *covered network* must include only those *non-capital costs* which would be incurred by a *service provider efficiently minimising costs*; and
- section 6.51 of the Code allows that the forward-looking and efficient costs of providing *covered services* may include costs in relation to *forecast new facilities investment* for the *access arrangement period* "which at the time of inclusion is reasonably expected to satisfy the [*new facilities investment test*] when the *forecast new facilities investment* is forecast to be made".

As noted above, Western Power is required under section 4.2 of the Code to provide sufficient information in its Access Arrangement Information for the Authority and other interested parties to form a view in relation to the efficiency of the expenditure proposals and whether or not the proposed *new facilities investment* is reasonably expected to satisfy the *new facilities investment test*.

5.2. Western Power's Proposal

Western Power is proposing substantial increases in both its capital and operating expenditure over the second *access arrangement period*.

Western Power is proposing a 95% increase in its capital expenditure over the forthcoming *access arrangement period*. Western Power notes in its Access Arrangement Information that this increase is primarily associated with what it says are required increases in capacity expansion.[6] There is a 'step-change' in projected capital expenditure for capacity expansion between 2008/09 and 2009/10, from $188.26m to $460.25m.

Forecast operating expenditure is 42% higher than for the current *access arrangement period*.[7] In particular there is a doubling of preventative routine maintenance.

In relation to both operating and capital expenditure, Western Power identifies the following as the three key drivers of the substantial increase in expenditure being proposed for the next *access arrangement period*:[8]

1) the unprecedented growth in electricity demand and the connection of additional generation capacity;
2) the on-going impact of previously constrained expenditure, due to changes in expenditure priorities during the current *access arrangement period*; and
3) the continuing increase in unit costs, particularly in light of the resources boom in Western Australia.

The following additional driver is identified in relation to projected capital expenditure:

4) More onerous safety, health and environmental regulations.

Appendix 1 to the Access Arrangement Information provides further information in relation to the capital and operating expenditure projections 2009/10-2011/12.

5.3. Synergy's Comments

Synergy considers that it is critical that the substantial increase in capital and operating expenditure being proposed by Western Power is subjected to rigorous scrutiny to ensure that it is sufficiently substantiated and consistent with the Code requirements.

In that regard, Synergy considers that the publically available information put forward by Western Power in its Access Arrangement Information is not comprehensive enough to provide interested parties or the Authority with sufficient confidence that the proposed expenditure is required in accordance with the Code during the second *access arrangement period*. In this respect Synergy re-iterates its submissions on what it sees as the Authority's task set out under heading 3 above.

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[6] Western Power Access Arrangement Information, p.75.

[7] Western Power Access Arrangement Information, p. 83.

[8] Western Power Access Arrangement Information, p.68.

In terms of the key drivers for the increase in expenditure identified by Western Power, Synergy has a number of observations, which are set out below.

5.3.1. Requirements to connect additional future generation

Synergy supports Western Power's objective of identifying in advance the need for future network augmentation in order to ensure that network capacity does not have an adverse impact on the development of the competitive generation market.

However, as acknowledged by Western Power, to a large extent this proposed investment is speculative.[9] Western Power has modelled a total of 600MW of new generation capacity but it:

> 'recognises that the actual generation projects that proceed could be significantly different to the assumptions [underlying the expenditure projections].'[10]

Western Power does not identify in its Access Arrangement Information the amount of projected expenditure that is linked to these speculative assumptions about future generation development (compared to committed generation projects). Western Power proposes that this capex be subject to the IAM, in order to address this uncertainty.[11]

However, in the case of expenditure related to generation expansion, Synergy notes that the uncertainty is in relation to whether generation projects proceed and in the locations identified by Western Power, rather than the cost of those projects. Synergy submits that the IAM addresses cost uncertainty, but not the more fundamental uncertainty as to whether the investment is needed and will occur in the first place.

Synergy considers that it is important to ensure that *users* and *consumers* do not end up paying for network augmentation that is not, in the end, required, because actual generation and location decisions are different from those assumed by Western Power. As a consequence, Synergy submits that it would be appropriate for the Authority to consider excluding this speculative investment from the baseline capex and opex projections, and to instead address the inherent uncertainty through utilising the provisions in section 6.58 of the Code (section 6.58) in relation to speculative investments.

5.3.2. Backlog due to changes in priorities in current access arrangement period

The second factor noted by Western Power as driving the increase in its expenditure projections is the backlog in expenditures due to changes in expenditure priorities in the current *access arrangement period*.

During the first *access arrangement period*, Western Power has exceeded its forecast expenditure for both opex and capex. Western Power states in its Access Arrangement Information that this has been a result of a change in the priorities for different expenditure. However, Synergy notes that Western Power's publically available Access Arrangement Information does not provide any detailed analysis of the differences between forecast and actual capex and opex over the first review period. This is in

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9 Western Power Access Arrangement Information, p.28 and p.65.

10 Western Power Access Arrangement Information, p. 66.

11 Western Power Access Arrangement Information, p. 28 and p. 66.

contrast to the information typically provided by other regulated businesses and required by regulators in other jurisdictions. For example, TransGrid's submission to the AER earlier this year contained a whole chapter on historical expenditure, and the differences between forecasts and actual outcomes over the period.[12] Similarly, the recent submissions by the NSW electricity distribution businesses provided similar information and analysis to the AER.[13]

It therefore appears difficult, on the basis of the publically available information provided, for *users, applicants* and the Authority to come to a view on the extent to which the backlog in expenditure is the result of an efficient reallocation of priorities during the first access arrangement period. As discussed in section 4.3, Synergy submits that Western Power has not demonstrated that the change in capital expenditure has resulted in investments that satisfy the NFIT requirements of the Code. There is also no discussion of the efficiency of the operating expenditure made in the first access arrangement period.

It also appears difficult for *users, applicants* and the Authority to be satisfied that a similar reallocation of expenditure will not occur during the coming *access arrangement period.*

5.3.3. Escalation in input costs

The third key driver put forward by Western Power for the increase in projected expenditure is the escalation in input costs assumed by Western Power.

The escalators used by Western Power are based on an Access Economics report prepared for Western Power in April 2008. The Access Economics report is included as Appendix 2 of the Access Arrangement Information submitted by Western Power.

Synergy notes that this analysis was undertaken before the current financial crisis and the significant change in economic outlook. Synergy submits that it is therefore essential for the Authority to test the assumptions underpinning that analysis, in order to ensure that it remains valid. In that regard, Synergy notes that the AER has recently adopted more conservative escalation factors for both labour rates and materials than those submitted by the businesses in assessing the regulatory submissions put forward by the NSW and ACT electricity distribution businesses and the transmission business in NSW and Tasmania. [14] These more conservative values reflect the change in the current economic outlook. In its Draft Decision for TransGrid, the AER commented that:

> 'The AER also notes that if the global economic conditions worsen, the capacity for TransGrid (and other energy businesses) to access the resources required for the delivery of its capex program, including skilled staff, may be improved.'[15]

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[12] TransGrid Revenue Proposal 1 July 2009 – 30 June 2014, May 2008. See chapter 6.

[13] See for example, Integral Energy's Revenue Proposal, Sections 4.5 and 4.6.

[14] See for example, AER, NSW Draft Distribution Determination 2009-10 to 2013-14, p. 180 and Appendix N, p.537, 541 and p. 547.

[15] AER, TransGrid Transmission Determination 2009-10 to 2013-14 – Draft Decision, 31 October 2008, p.85.

5.3.4. Increasingly onerous safety, health and environmental regulations

Western Power cites 'increasingly onerous' safety, health and environmental regulations as being an additional driver for the increase in capital expenditure.[16] However, it appears from the Access Arrangement Information that much of the increase in expenditure is driven by improved compliance with **existing** regulations, rather than new obligations (emphasis added). Information in the Access Arrangement Information in relation to new obligations appears to be limited to the following paragraph:

> 'A number of new requirements have been imposed upon Western Power by the Energy Safety Directorate particularly in relation to bush fire preparedness and safety, navigable waterways and substation security. There are also a number of safety and reliability issues that have arisen due to changes in (Australian and/or Industry) standards, and in response to specific incidents. Addressing these issues will also require some additional capital expenditure compared to recent historic levels.'[17]

Synergy submits that the above information is vague and does not provide any adequate detail on the exact changes in regulations facing Western Power, and the implication for Western Power's costs. Neither is this information contained in Appendix 1 to the Access Arrangement Information. In particular, Synergy understands that the Energy Safety Directorate requirements referred to by Western Power have been in place for a while and there are no new significant obligations.

Western Power does note in its Access Arrangement Information that part of its projected increase in expenditure is the result of improving its compliance with **existing** obligations (emphasis added). The Access Arrangement Information contains a table that identifies five primary compliance issues.[18] Further details of the quantum of projected expenditure associated with improved compliance are provided in Appendix 1 to the Access Arrangement Information. However Western Power has not provided any explanation for whether its current lack of compliance is a result of re-allocating expenditure during the current *access arrangement period*, and, if so, what assurance the Authority has that such re-allocation will not happen again during the second *access arrangement period*. Western Power also indicates that going forward its performance will continue to be less than 100% compliant,[19] but does not indicate what extent of compliance is expected as a result of the proposed increase in expenditure.

5.3.5. Lack of substantiating information

Synergy submits that there is a general lack of sufficient supporting information provided by Western Power for its projected expenditure increases. Given that the increases proposed are substantial, and will drive significant retail tariff increases for *users* and *consumers*, it is imperative that the Authority be provided with sufficient information on which to base its decisions. In this respect Synergy re-iterates its submissions on what its sees as the Authority's task as set out under heading 3 above.

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16 Western Power Access Arrangement Information, p.25.

17 Western Power Access Arrangement Information, p.71.

18 Western Power Access Arrangement Information, p. 71.

19 Western Power Access Arrangement Information, p. 31.

An example of the lack of information is Western Power's proposal to spend $98.95 million in the next regulatory period to replace approximately 350,000 faulty three-phase meters. The discussion of this investment is limited to two short paragraphs.[20] Synergy submits that the Access Arrangement Information lacks the necessary transparency for *users, applicants* and the Authority to assess a number of the key features of this proposed investment, such as:

- the details of the sampling and testing done on the meter that determined that this meter population required replacement;
- the specification of the 'smart' meters that Western Power intends to use to replace the faulty meters;
- details of the NFIT that demonstrated that the specified 'smart' meters provides a net benefit over the use of accumulation (or interval) meters; and
- the extent, if any, that benefits from 'smart' meters (for example through lower meter reading costs) are now reflected in the future operating costs of Western Power.

It would also appear that the Code provisions in sections 6.61 and 6.62 in relation to redundant capital would require the redundant faulty three-phase meters to be removed from Western Power's *capital base*. However from the publically available Access Arrangement Information it does not appear that Western Power is proposing to remove the redundant meters from the *capital base*. If these meters are not to be removed from the *capital base* then Synergy submits that the Authority must have sufficient information to be satisfied that Western Power's original decision to invest in the faulty three-phase meters was prudent.

Synergy also submits that the information provided in relation to the augmentations proposed by Western Power in the next *access arrangement period* is very high level. The proposed augmentations are listed in the Access Arrangement Information.[21] However there is no demonstration that these pass the NFIT criteria or the regulatory test. Western Power states that:

> 'Many of the forecast capital expenditures proposed in this submission have not yet been subject to the NFIT assessment, which is routinely carried out as part of the development of specific business cases. The planning processes applied by Western Power to determine the need for network investment, however, and the evaluation of options, are already well aligned with the intent of the NFIT with response to business drivers, performance outcomes and the prudence and efficiency of investments. The capital expenditure forecasts proposed in this submission are based on a 'bottom up' assessment of the investment requirements based largely on these planning processes. As such, Western Power is confident that the investments proposed in this submission satisfy the NFIT.'[22]

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[20] Western Power, Access Arrangement Information, Appendix 1 Capital and Operating Expenditure 2009/10 to 2011/12, section 7.8.1.

[21] Western Power Access Arrangement Information, p.68.

[22] Western Power Access Arrangement Information, p.26.

Given that the approach proposed by Western Power in relation to actual expenditure[23] appears to be to assume that all expenditure passes the NFIT, it appears that at no point in the process is Western Power proposing to actively apply the NFIT requirement of the Code. Western Power states that the fact that it has scaled back its preferred program due to resource constraints 'should provide further confidence that Western Power's capital expenditure program satisfies the requirements of the NFIT.'[24] Synergy considers that this is irrelevant to the required assessment of whether the proposed expenditure passes the NFIT.

6. WACC

6.1. Code Requirements

The *weighted average cost of capital* (**WACC**) measures the rate of return that Western Power may earn on its regulated assets over the forthcoming regulatory period. The WACC represents the weighted average cost of debt and equity as calculated under section 6.64 of the Code.

Section 6.64(a)(ii) of the Code relevantly states:

> "An *access arrangement* must set out the *weighted average cost of capital* for a *covered network*, which:
>
> (a) if a determination has effect under section 6.65
>
> (ii) must use the methodology in the determination under section 6.65 unless the *service provider* can demonstrate that an *access arrangement* containing an alternative methodology would better achieve the objectives set out in section 6.4 and the *Code objective*"

Section 6.65 of the Code states:

> "The *Authority* may from time to time make and *publish* a determination (which subject to section 6.68 has effect for all *covered networks* under this Code) of the preferred methodology for calculating the *weighted average cost of capital* in *access arrangements*."

On the 25 February 2005, the Authority published its preferred WACC methodology determination pursuant to section 6.65 that, relevantly provides:[25]

- the capital asset pricing model (**CAPM**) be the methodology used for calculating the return on assets;
- financial modelling be applied in real terms;

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[23] See the discussion in section 4.3 in relation to Western Power's proposed treatment of capital expenditure in the first access arrangement period.

[24] Western Power Access Arrangement Information p.33

[25] ERA, Determination of a preferred methodology for calculating the weighted average cost of capital for covered electricity networks, 25 February 2005, page 1.

- the *weighted average cost of capital* be formulated on a pre-tax basis, using the Officer formula with the taxation adjustment calculated using a forward transformation;
- the debt premium be based on market evidence of debt costs for businesses with a credit risk profile consistent with a BBB or BBB+ credit rating (sources of relevant market evidence may include CBA Spectrum and Bloomberg estimates of corporate bond yields);
- nominal risk free rates to be derived from Commonwealth 10 year bond rates with terms of 10 years, calculated on the basis of a 20 trading day average of the yields, taken at the final day of the month prior to a decision on an access arrangement;
- real risk free rates to be derived from a 20 trading day average of the yields on Commonwealth index-linked bonds with terms of 10 years, taken at the final day of the month prior to a decision on an access arrangement;
- the inflation forecast for the relevant period is the difference between the nominal risk free rate and real risk free rate (calculated using the Fisher equation); and
- an appropriate benchmark gearing assumption be adopted to encourage efficient financing decisions.

6.2. Western Power's Proposal

Western Power's proposal generally complies with the Authority's preferred WACC methodology. However, Synergy submits that Western Power departs from the preferred approach in the following respects:

- the use of a 60 day sample period, to derive the nominal risk free rates, real risk free rates and the debt margin, at a date that is not linked to the Authority's final determination; and
- the estimation of the 10 year inflation forecast by reference to the Reserve Bank of Australia (RBA) short term inflation forecasts and the mid point of the RBA target inflation rate for longer forecasts.

KPMG was commissioned by Western Power to provide an estimate of the plausible range for each WACC parameter. The KPMG report is attached as Appendix 6 to Western Power's Access Arrangement Information.

Based on estimated ranges for each of the WACC parameters, KPMG concluded that the reasonable estimate of Western Power's real pre-tax WACC lies between 8.50 per cent and 11.12 per cent. The parameter values estimated by KPMG are reproduced below in Table 6.1.

Table 6.1: KPMG Reasonable Range[26]

Parameter	Low	High	Point Estimate
Nominal risk free rate*	6.45%	6.45%	6.45%
Real risk free rate*	3.62%	3.62%	3.62%
Expected inflation	2.73%	2.73%	2.73%
Gearing ratio	60%	60%	60%
Debt margin*	3.366%	3.658%	3.658%
Market risk premium	6.0%	7.0%	6.0%
Equity beta	0.90	1.10	1.0
Imputation credits	50%	0%	50%
Nominal cost of equity	11.85%	14.15%	12.45%
Pre-tax real WACC	8.50%	11.12%	8.95%

** To be updated for Final Determination.*

Western Power has proposed to employ a real pre-tax WACC of 8.95 per cent to determine its *target revenue* during the next regulatory period. Western Power notes that this point estimate lies towards the lower end of the reasonable range estimated by KPMG. Western Power says that the point estimate was selected to:[27]

- moderate - within the constraints determined by the need to maintain business viability - the price increases that are required for the forthcoming access arrangement period; and
- to propose a WACC value that is demonstrably within a reasonable range, and which will therefore be accepted by the Authority.

6.3. Synergy's Comments

Synergy has the following two comments in relation to Western Power's WACC proposal:

- Western Power provides little justification in its Access Arrangement Information for departing from the Authority's preferred approach of using a 20 day sample period to determine the nominal and real risk free rate and the debt margin; and
- the plausible range presented by KPMG appears to have a favourable skew.

Section 6.64(a)(ii) of the Code requires Western Power to demonstrate that a departure from the methodology set out in the Authority's 2005 WACC methodology determination:

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26 KPMG, Western Power: Weighted Average Cost of Capital, July 2008, page 2.

27 Western Power, Revised Access Arrangement Information for the Network of the SWIS, 1 October 2008, page 104.

'would better achieve the objectives set out in section 6.4 and the *Code objective'.*

While Western Power sets out a number of reasons for the change to the methodology for calculating the inflation rate, no detailed explanation is provided on the Access Arrangement Information for changing the sample period. The only discussion appears to be contained in the KPMG report, which simply states that:

> "A longer sampling period has been adopted by Western Power in order to better manage interest rate risk within the current market environment. In addition Western Power proposes that the sampling period dates be kept confidential between itself and the ERA and in order to preserve this confidentiality, the sampling period should not be linked to the date of the ERA's final decision."[28]

Synergy submits that this single statement neither reveals how a longer sampling period would allow Western Power to better manage interest rate risk nor demonstrates that this change will better achieve the objectives of section 6.4 or the *Code* objective. Further, Synergy submits that, in accordance with section 4.2 of the Code, it is incumbent on Western Power to articulate to the Authority how its proposed changes promote the objectives. Synergy submits that Western Power has not, on the publically available information, met this obligation. In this respect Synergy re-iterates its submissions on what it sees as the Authority's task in these circumstances set out in heading 3 above.

Synergy also submits that the anticipated decline in the nominal risk free rates combined with the high debt margins create the conditions whereby a regulated business would have a strong incentive to choose a sample period that occurs well before its final decision. Synergy notes that the AER recently rejected the sample periods for EnergyAustralia, Integral Energy, Country Energy and ActewAGL and stated:[29]

> "The AER did not agree with the period proposed on the basis that it considered the proposed dates of the period were too far removed from the final determination date and the commencement of the next regulatory control period. A period that is too far removed from the final determination date may not provide the most relevant information. This is consistent with past practice by the AER and other state regulators, and supported by CAPM theory.[30]"

Synergy also notes that the range suggested by KPMG does not include values that have been adopted by other Australian regulators which suggest a WACC below KPMG's plausible range. For example, the Australian Energy Regulator (AER) recently released

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[28] Western Power Access Arrangement Information, Appendix 6, KPMG, Weighted Average Cost of Cpaital July 2008, p. 2.

[29] AER. *Australian Capital Territory distribution determination 2009-10 to 2013-14: draft decision*, 7 November 2008, page 135

[30] Martin Lally, *The cost of capital for regulated entities*, report prepared for the Queensland Competition Authority, 26 February 2004, p. 63.
Kevin Davis, *Report on risk free interest rate and equity and debt beta determination in the WACC*, report prepared for the ACCC, 28 August 2003, p. 16.

proposed WACC parameters for electricity transmission and distribution businesses which contained the following WACC parameter values:[31]

- 0.80 equity beta;
- 6.00% MRP;
- credit rating of A-; and
- 0.65 gamma value.

Table 6.2 applies these values to the sample period used by Western Power. Synergy submits that this leads to a real pre-tax WACC of 7.81 per cent, which is substantially below the lower bound of 8.50 per cent suggested by KPMG.

Table 6.2
AER Proposed Values

Parameter	Low	High	AER Estimate
Nominal risk free rate*	6.45%	6.45%	6.45%
Real risk free rate*	3.62%	3.62%	3.62%
Expected inflation	2.73%	2.73%	2.73%
Gearing ratio	60%	60%	60%
Debt margin*	3.366%	3.658%	3.094%[32]
Market risk premium	6.0%	7.0%	6.0%
Equity beta	0.90	1.10	0.80
Imputation credits	50%	0%	65%
Nominal cost of equity	11.85%	14.15%	11.25%
Pre-tax real WACC	8.50%	11.12%	7.81%

** To be updated for Final Determination.*

It is not Synergy's intention to advocate the correctness of the AER's parameter values, rather to highlight that KPMG's estimates appear to have a favourable skew. The AER's parameter values suggest that Western Power's point estimate is closer to the middle of the plausible range rather than, as claimed, the bottom of the range.

The extent of the favourable skew is further underscored by the reasonable ranges articulated by other Australian regulators. For example the AER cited the following reasonable ranges from previous jurisdictional decisions:[33]

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31 AER, *Statement of the revised WACC parameters (transmission) and Statement of regulatory intent on the revised WACC parameters (distribution), Proposed*, December 2008.

32 Debt margin includes 12.5 basis points for debt raising costs.

- equity beta of between 0.50 and 1.11;
- market risk premium of between 4.00 per cent and 7.00 per cent; and
- gamma of between 0.30 and 1.00.

Given the importance of the rate of return to Western Power's revenues and the prices paid by customer, Synergy submits that careful consideration of the WACC parameters is warranted. However, given the lack of publically available information it is impossible for *users* and *applicants* to do this. Therefore, it falls to the Authority and in this respect Synergy re-iterates its submissions set out under heading 3 above.

7. INCENTIVE MECHANISMS

Western Power is proposing to include in its PRAA a number of different incentive mechanisms.

7.1. Investment Adjustment Mechanism

7.1.1. Code Requirements

Section 6.15 of the Code requires that where a *price control* sets *target revenue* by reference to the *service provider's approved total costs*, then the *access arrangement* must contain an *investment adjustment mechanism* (**IAM**). Synergy submits that the IAM is effectively a mechanism detailing how any investment difference for the *access arrangement period* is to be treated by the Authority at the next *access arrangement review*.

The Code does not prescribe the form of IAM, and in fact allows for the IAM to make no adjustment to the *target revenue* for the next *access arrangement period* in respect of any investment difference. However section 6.17(b) of the Code requires that the IAM must be consistent with any *gain sharing mechanism.*

7.1.2. Western Power's Proposal

Western Power is proposing that the same form of IAM that has applied in the first *access arrangement period* is applied in the second *access arrangement period*. The IAM covers any difference between actual and forecast transmission and distribution capital expenditure, with the exception of refurbishment or renewals expenditure, or IT assets.[34]

Synergy understands that the aim of the IAM is to ensure that Western Power is economically neutral with respect to any differences between forecast and actual capital expenditure, whether higher or lower.[35]

7.1.3. Synergy's Comments

Synergy submits that the IAM removes incentives for Western Power to adopt efficient non-network alternatives to network capex because any underspend on capital

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33 AER, *Review of the weighted average cost of capital (WACC) parameters for electricity transmission and distribution: Issues Paper*, August 2008, pages 39,54 and 74.

34 Western Power Access Arrangement Information, p.175.

35 Western Power Access Arrangement Information, p.175.

expenditure compared to that forecast at the time of the Access Arrangement will not result in an increased return to Western Power. Synergy understands that this is in contrast to the arrangements applying to network businesses in other jurisdictions; where there is no ex post adjustment for the difference between forecast as outturn capex, the service provider does have an incentive to achieve efficiencies in capital expenditure where possible, including the adoption of non-network alternatives to augmentation, where this is a lower cost solution.

Synergy further submits that the impact of the IAM on Western Power's incentives to adopt non-network solutions underpins part of Western Power's proposed 'D factor' (see section 7.4 below). Rather than introducing an *additional* incentive mechanism to counteract the incentives provided under the IAM, Synergy submits that it would be preferable to adapt the proposed IAM to directly address this issue. Such an approach would be consistent with the framework set out in the Code, which does not limit the form of IAM that can be adopted.

7.2. Gain Sharing Mechanism

7.2.1. Code Requirements

Section 6.21 of the Code requires that an *access arrangement* must contain a *gain sharing mechanism* unless the Authority determines that a gain sharing mechanism is not necessary to achieve the *price control* objective set out in section 6.4(a).

Section 6.2 of the Code relevantly further requires that a *gain sharing mechanism* must have the objective of:

(a) achieving an equitable allocation over time between *users* and the *service provider* of innovation and efficiency gains in excess of *efficiency and innovation benchmarks*;

(b) being objective, transparent, easy to administer and replicable from one *access arrangement* to the next; and

(c) giving the *service provider* an incentive to reduce costs or otherwise improve productivity in a way that is neutral in its effect on the timing of such incentives."

Section 6.25 of the Code requires that "the *Authority* must determine how much (if any) of the *surplus* results from efficiency gains or innovation by the *service provider* in excess of the *efficiency and innovation benchmarks* in the previous *access arrangement*."

7.2.2. Western Power's Proposal

Western Power is proposing that a *gain share mechanism* apply in the second *access arrangement period*. The proposed form of gain sharing mechanism is discussed in section 4.6 of Western Power's AAI and set out in detail in Appendix 8 of the Access Arrangement, and in particular the 'Explanatory Notes regarding the price control arrangements'.

Synergy submits that key features of Western Power's proposed *gain sharing mechanism* are:

- the mechanism applies to operating expenditure only, and not to capital expenditure;
- the amount that can be added to Western Power's *target revenue* in the third *access arrangement period* as a result of the *gain sharing mechanism* is based on an **average** of the efficiency gains made over the second *access arrangement period* (emphasis added). This average gain is retained for the entire third *access arrangement period*;
- all differences (gains) between actual and projected capital expenditure are attributed to management effort (see AA5.14C).

7.2.3. Synergy's Comments

Synergy submits that the *gain sharing mechanism* proposed by Western Power does not appear to be compliant with the requirements of the Code. In particular, as noted above, section 6.21(c) of the Code requires that the *gain sharing mechanism* must have the objective of giving the *service provider* an incentive to reduce costs or otherwise improve productivity in a way that is neutral in its effect on the timing of such incentives.

Under the periodic regulatory review regime established by the Code, there is no ex post adjustment for difference between forecast and actual opex at the end of the regulatory period. However, forecast opex going forward into the third *access arrangement period* may be expected to reflect the efficiency gains 'revealed' in the second *access arrangement period*. As a result, Synergy submits that Western Power has an incentive to make efficiency gains early within any regulatory period, as it gets to retain those gains for the remainder of the regulatory period. In the later years of a regulatory period, Western Power may have an incentive to defer gains, as any gains made would only be retained until the start of the new regulatory period.

Synergy submits that the incentives with respect to the timing of efficiency gains are well recognised by regulators, and underpin the rationale for gain sharing mechanisms of the type allowed for under the Code. Consistent with section 6.21(c) of the Code, one objective of such mechanisms is to ensure that the *service provider* faces an equal incentive to make gains in each year of the regulatory period. In the language of the Code, the gain sharing mechanism should ensure that the service provider's incentive to reduce costs "is neutral in its effect on the timing of such initiatives".

Under the gain sharing mechanism proposed by Western Power, the amount that can be added to the target revenue in the third *access arrangement period* would be determined by the **average** of the gains made in each year (emphasis added). Western Power is proposing that this average amount would be added to the *target revenue* in each year of the third *access arrangement period*. Synergy submits that this approach does not address the incentives in relation to timing, since any gains made earlier in the period are still retained for longer than gains made later in the period. As a result, the proposed gain share mechanism does not meet the objective set out in section 6.21(c).

Synergy submits that the form of gain sharing mechanism typically adopted by network businesses in other jurisdictions does not involve any averaging of gains. Rather, any gain is retained for a period of five years (consistent with the length of the regulatory period), regardless of the year in which the gain is made. Under this approach, Synergy submits that the business is neutral as to the timing of efficiency gains and has no incentive to defer efficiency gains from one regulatory period to the next[36].

In relation to other aspects of the proposed gain sharing mechanism, Synergy makes the following observations:

- Western Power appears to be proposing that all gains are attributed to management effort (see AA5.14C), but has not provided any substantive justification for this position;
- The amount of the gain calculated is the absolute difference between forecast and outturn opex, rather than the incremental amount; (This is in contrast to the approach taken by regulators in other jurisdictions. For example, ESCOSA commented that:

  'For operating expenditure, efficiency gains are measured on an incremental basis. Operating expenditure exhibits a strong correlation from year to year, with business initiatives to reduce operating costs usually resulting in a permanent reduction in operating costs. The incremental calculation of efficiency benefits is therefore measuring the additional improvement in efficiency in a given year, over and above the improvements that have been achieved through initiatives in previous years.'[37])
- The arrangement proposed is not symmetric, in that if there is an average loss over the period Western Power is not proposing that this would be carried over to the third *access arrangement period*.

Finally, consistent with section 6.17(c) of the Code, Synergy submits that the interaction between the IAM and the gain-share mechanism needs to be considered. Under the proposed arrangements, Western Power could be inappropriately rewarded for inefficiently shifting expenditure from opex (and receiving a gain share) to capex (where it would be kept neutral under the IAM). It may be appropriate for Western Power to provide the Authority with details in relation to its maintenance/replacement policies in order to guard against this, as occurs in other jurisdictions.

7.3. Service Standard Adjustment Mechanism

7.3.1. Code Requirements

Section 6.30 of the Code requires that an *access arrangement* must contain a *service standard adjustment mechanism* (**SSAM**). The Code does not prescribe the form of SSAM.

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[36] See for example the discussion in: AER, *Electricity Distribution Network Service Providers – Efficiency Benefit Sharing Scheme*, June 2008; ESCOSA, *Electricity Distribution Price Review: Efficiency Carryover Mechanism, Discussion Paper*, December 2002, section 3; Office of the Regulator-General, Victoria, *Electricity Distribution Price Determination 2001-05, Volume 1 Statement of Purpose and Reasons*, p.83.

[37] ESCOSA, *Electricity Distribution Price Review: Efficiency Carryover Mechanism, Discussion Paper*, December 2002, section 3.2.2.

7.3.2. Western Power's Proposal

Synergy submits that the SSAM proposed by Western Power has the following key features:

- it places 0.5% of revenue at risk;
- it applies to both transmission and distribution; and
- it is symmetric, in that in imposes a penalty on Western Power if it does not meet the specified standards, and rewards Western Power if these standards are exceeded.

7.3.3. Synergy's Comments

Synergy notes that under the SSAM as proposed by Western Power and set out in sections 5.24A and 5.24B of the PRAA payments are triggered by the absolute difference between the target standard and actual outcomes. Synergy submits that this is in contrast to the service incentive arrangements applying in other jurisdictions, which typically relate to the incremental change in the difference between the target and actual performance each year, rather than the absolute difference between the target and actual outcome.[38] That is, the formula adopted is typically:

[(Target-Actual) in year t-2] – [(Target-Actual) in year t-3]

Where no change in target service standards is proposed over the regulatory period the targets in effect become redundant in the operation of the mechanism and the service incentive payment is determined by:

[Actual in year t-3] – [Actual in year t-2]

The AER recently noted that:

> 'By acting on the cumulative difference between actual and targeted performance, the scheme only rewards (penalises) long term systemic changes in performance rather than year on year (absolute) variations.'[39]

Under the approach proposed by Western Power, in the event that the target *service standard* is set too high, Western Power would incur a penalty if it under-performed this target in each year of the *access arrangement period*, even if the *service standards* did not actually worsen over the period. Similarly, in the event that the target *service standard* is set too low, Western Power would receive a payment under the SSAM if it out-performed this target, even if the *service standards* did not actually improve over the period.

Synergy submits that it is also important that the Authority considers the interaction between the SSAM and the IAM and the gain sharing mechanism.

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[38] See for example: AER, *Electricity Distribution Network Service Providers - Service Target Performance Incentive Scheme, Final Decision*, June 2008, p.9; Essential Services Commission of Victoria, *Electricity Distribution Price Review 2006-10, Final Decision Volume 1, Statement of Purpose and Reasons*, p. 90.

[39] Op cit, p. 9.

Taken together, the IAM and the SSAM appear to provide incentives for Western Power to 'goldplate' the network in order to achieve higher service standards, as it would receive both cost recovery for the additional investment through the IAM and also an incentive payment under the SSAM.

In relation to the interaction with the gain sharing mechanism, Synergy notes that the penalty amount under the SSAM if service targets are not achieved need not match the benefit amount Western Power receives under the gain share mechanism as a result of lower expenditure. Synergy submits that this mismatch has the potential to distort incentives.

7.4. D-factor

7.4.1. Code Requirements

Western Power is proposing an additional "incentive mechanism" (the 'D-factor') to be included in the *price control* for the second *access arrangement period*.

Synergy submits that there does not appear to be any provision under the Code for the inclusion of an additional amount in Western Power's *target revenue* relating to the D-factor. In particular, the *target revenue* described in section 6.4(a) of the Code does not make provision for additional incentive mechanisms of the kind proposed by Western Power.

7.4.2. Western Power's Proposal

Western Power appears to be proposing an additional 'D-factor' to allow for the recovery of:

i. any additional opex as a result of deferring or avoiding capex; and

ii. any additional opex or capex in relation to demand management initiatives.

Western Power says that it's proposed D-factor 'will provide scope for the company to recover the efficient costs associated with demand side initiatives'[40].

7.4.3. Synergy's Comments

Western Power refers in its AAI to the D-factor adopted by the AER for the distribution business in the NEM.

Synergy submits that the D-factor adopted in NSW and being developed by the AER[41] is in the context of a price cap, and addresses the disincentive that otherwise exists for distribution businesses to adopt demand management measures which reduce the kWh sold and therefore their revenue. In contrast, Synergy submits that Western Power's D-factor is proposed in the context of a revenue cap, ie, there is no adverse impact on Western Power's revenue if the number of kWh sold falls.[42] As a result, Synergy

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40 Western Power Access Arrangement Information, p. 15.

41 AER, *Demand Management Incentive Scheme, Energex, Ergon Energy and ETSA Utilities 2010-2015, Final Decision, October 2008.*

42 Western Power highlights risk of kWh increasing, which relates to accuracy of D forecasts rather than demand management initiatives.

considers the adoption of the term 'D-factor' and Western Power's comparison with the mechanism adopted with the AER is not correct.

The first set of circumstances identified by Western Power in which the D-factor would apply is where additional opex is incurred as a result of deferring or avoiding capex. It does not appear that this circumstance is limited to demand side measures, but rather would apply in all cases where opex is substituted for capex.

As submitted in section 7.1, in the absence of the IAM Western Power would have an incentive under the regulatory framework to adopt demand side measures and non-network solutions where these are efficient (ie, lower cost than network solutions), since the revenue cap for the *access arrangement period* is based on proposed network capex. However, Synergy submits that this incentive is negated by the current IAM.

Synergy suggests that the Authority consider the IAM in this light and particularly whether it may be appropriate to narrow the scope of the IAM (eg, to new connection capex only) or adapt it in some way. This would directly address the issue identified by Western Power, without the need to introduce a new mechanism.

Similarly, where substituting non-network for network solutions results in higher opex (offsetting lower capex), then this could be quarantined from the gain sharing mechanism, in order to avoid distorting incentives to undertake this form of efficient substitution of opex for capex. This is the approach proposed by the AER[43]. Again, the issue arises as a result of the specific design of the gain sharing mechanism (in this case the fact that it only applies to opex and not to both opex and capex). Synergy submits that it would be appropriate to address this apparent distortion by modifying the gain sharing mechanism, rather than seeking to introduce a new factor.

The second set of circumstances in which Western Power proposes that the D-factor applies is in relation to any additional opex or capex incurred by Western Power in relation to demand management initiatives.

Western Power's proposed D-factor would appear to result in a revenue adjustment in relation to **any** demand side initiative for both opex and capex, not just where a demand side initiative defers the need for a network solution (emphasis added). Western Power proposes that the justification for these projects would be limited to the provision by Western Power of a business case, ie a light-handed regulatory approach.[44]

Synergy strongly opposes the inclusion of a D-factor in these circumstances, for the following reasons:

- the activities covered by Western Power's proposal have the potential to include works that are outside of the scope of the *reference service* and that are potentially competitive activities;
- the D-factor appears to provide a mechanism for capex to avoid the NFIT and the regulatory test requirements of the Code, as there would be an automatic revenue adjustment under the D-factor justified on the basis of a 'business case'; and

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[43] Op cit, p.6

[44] Western Power Access Arrangement Information, p. 184.

- Western Power does not appear to be proposing any limit on the extent of expenditure that may be subject to the proposed D-factor, and therefore the extent of costs that users and *consumers* may be expected to meet.

Synergy notes that the objective of the demand management incentive scheme developed by the AER is to provide incentives for distributors to implement efficient non-network alternatives. In this context the AER commented that:

> 'The DMIS is not intended to be the sole, or the primary, source of recovery of demand management expenditure. The AER considers that the primary source of funding for demand management in a regulatory control period should be the forecast operating expenditure (opex) and capital expenditure (capex) approved in the [distribution business'] distribution determination'[45].

7.5. Price Shock

7.5.1. Code Requirements

Section 6.4(c) of the Code relevantly requires that the *price control* in an *access arrangement period* must have the objective of:

> "(c) avoiding price shocks (that is, sudden material *tariff* adjustments between succeeding years)."

Further, section 7.4(d) f the Code relevantly requires that the *pricing methods* in an *access arrangement period* must have the objective that:

> "(d) the structure of *reference tariffs* avoids price shocks (that is, sudden material *tariff* adjustments between succeeding years)."

The Authority is therefore required to determine that the *price control* and the structure of the *reference tariffs* put forward by Western Power has this objective.

7.5.2. Western Power's Proposal

Western Power says[46] that the PRAA meets the price shock objective of the Code by:

- deferring the recovery of some revenue until the third or subsequent *access arrangement periods*;
- the structure of reference tariffs being designed to minimise tariff rebalancing, principally by the imposition of side constraints on annual price movements for each tariff; and
- the forecast reference service revenue being smoothed across the *access arrangement period*, having regard to the likely price levels at the start of the third *access arrangement period*.

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45 Op cit, p.3.

46 Access Arrangement Information, pps 191 and 192.

7.5.3. Synergy's Comments

Synergy submits that the price shock objective set out in sections 6.4(c) and 7.4(d) applies not only to the years within an *access arrangement period* but also to the succeeding year between *access arrangement periods*. In this respect both sections use the words "succeeding years" compared to the language of the other subsections of those sections, which use the term *access arrangement period* such that consideration of the objectives in those paragraphs is confined to consideration of the *access arrangement period*.

Synergy further submits that the *price control* and the structure of the *reference tariffs* proposed in the PRAA do not appear to have taken into account the significant price shock between the first *access arrangement period* and the first year of the next *access arrangement period*, and thus do not meet the objectives of sections 6.4(c) and 7.4(d).

CONCLUSION

Synergy has highlighted a number of concerns in this submission in relation to the PRAA submitted by Western Power.

In many areas, including the roll-forward of the asset base and the justification for the substantial increases in both capital and operating expenditure, the information provided by Western Power does not appear adequate in accordance with section 4.2 of the Code to allow *Users, applicants* or the Authority to form an opinion as to the consistency of the proposals with the Code requirements. Given that the impact on *users* and *consumers* in the second access period is largely driven by the expenditure proposals, Synergy submits that it is extremely important that the Authority address this lack of information so that it can be completely satisfied that Western Power's proposals meet all the requirements of the Code. Further, Synergy submits that the Authority in its draft decision must demonstrate to users and *applicants* the process it has adopted to achieve this together with sufficient detailed reasoning to enable *users* and *applicants* to form the understanding and opinion set out in section 4.2 of the *Code*.

Synergy has also highlighted in this submission areas in relation to the proposed incentive arrangements that appear inconsistent with the Code requirements and which, if left unamended, appear to provide perverse incentives for Western Power when considered as a package.

Synergy sees the key task initially facing the Authority to be to analytically review the material Western Power has provided to determine:

1. whether it is sufficient with respect to the Code requirements; and
2. whether it is sufficient to allow the Authority to perform the tasks it needs to perform.

Where the information is insufficient, the Authority will need to require Western Power to provide further information. As discussed in this submission, the key areas that Synergy believes are not substantiated in the publically available information are:

- whether the capital expenditure undertaken in the first access arrangement (which differs substantially to that which was initially planned) meets the NFIT;
- whether the substantial increases in capital and operating expenditure proposed for the *second access arrangement period* are consistent with the Code requirements to

reflect the 'forward looking and efficient costs of providing covered services';

- whether the capital expenditure proposed for the second *access arrangement period* is reasonably expected to satisfy the NFIT; and
- the departure from the Authority's preferred approach of using a 20 day sample period to determine the risk free rate and the debt margin.

Where the Authority believes that Western Power has provided sufficient information, it needs to determine whether the information is accurate and whether it is satisfied that the application of the information is consistent with the Code requirements.

In this submission Synergy has highlighted the following areas in which it considers that Western Power's proposals are inconsistent with the Code requirements particularly:

- the proposed *gain sharing mechanism* is not consistent with the objective set out in section 6.21(c) of the Code for the mechanism to provide the *service provider* with a neutral incentive in relation to the timing of efficiency gains;
- the proposed D-factor is not supported by the Code and would allow Western Power to bypass the NFIT requirements for investments that are not part of the *covered services* and which could potentially be provided competitively; and
- taken together, the IAM, the SSAM and the gain sharing mechanism appear to provide incentives for Western Power to gold-plate the network and to inefficiently shift between opex and capex.

Synergy thanks the Authority for the opportunity to provide these submissions. Please do not hesitate to call me 6212 1076 if there is anything further you should like from Synergy.

Yours faithfully

SIMON ADAMS

Senior Legal Counsel