WA Economic Regulation Authority

2009-2012 PRICE REVIEW

ELECTRICITY DISTRIBUTION and TRANSMISSION SERVICES

in the

WESTERN POWER

SOUTH WESTERN INTERCONNECTED SYSTEM

COMMENTS ON THE ERA DRAFT DECISION

by

Western Australia Major Energy Users

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

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

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Executive Summary

The Western Australian Major Energy Users (WAMEU) represents a coalition of large energy users in Western Australia and it welcomes the opportunity to provide comments on the Economic Regulation Authority (ERA) draft decision on the application for Western Power (WP) new access arrangement for the SWIN.

The WAMEU considers the ERA has undertaken a thorough and rigorous review, and its Draft Decision is strongly supported.

The ERA has clearly demonstrated that the ambit claims made by WP have not been fully justified and, in particular, the ERA has:

- Substantially amended the WP forecast of non-capital costs for the second access arrangement period.

- Substantially reduced the amounts of new facilities investment in the first access arrangement period to be included in the regulatory asset base (RAB), especially by the removal of capital contributions and the inclusion of an efficiency saving factor on the cost of the new facilities included in the WP assets.

- Substantially reduced the allowed new investment costs for the second access arrangement period.

- Substantially adjusted the weighted cost of capital (WACC) allowed to be used for the second access arrangement. The WAMEU, however, considers the ERA has applied higher values to the WACC parameters than should be the case, notwithstanding that a slight conservatism is appropriate.

The WAMEU has noted that the ERA has decided to take a conservative approach in its review of WP costs. The WAMEU supports the need for slight regulatory conservatism as the alternation could be much higher costs for consumers from supply losses if the regulator is too aggressive in its assessment of a monopoly’s costs. However in light of the WA government decision that the Tariff Equalisation Fund should be recovered by a Tariff Equalisation Contribution levied on SWIN users, the double impact on consumers of both the TEC and regulatory conservatism might result in unintended consequences from distorted pricing signals. The WAMEU recommends the ERA take this distortion into account.

The WAMEU notes the need for the ERA when assessing WP tariff proposals, to ensure that the tariffs developed are demonstrably as close to cost reflectivity as possible, in order to send appropriate price signals to all consumers accessing the network services.

A very significant issue has emerged since the ERA`s draft decision concerning the abolition of transition tariffs. The ERA may not have been aware of this issue but significant hardship is being experienced by some large users because of the sizeable increases in tariffs resulting from the decision to remove the transition tariffs initially developed to minimise price shock. The ERA is strongly urged to address this issue as WP`s actions are arbitrary and would appear to be unconscionable and lack necessary awareness and integrity in its relations with end users.

In relation to service performance standards the WAMEU notes that the targets for service performance set for the first access arrangement period appeared to be set quite conservatively and as a result allowed WP to demonstrate an outperformance. The service performance standards set for the second period reflect the actual performance achieved in the first period with some requirement to further improve, reflecting the permitted increases in opex and capex allowances for the second period. Decisive action is required now in order that a challenging service performance incentive scheme (akin to that established in Victoria by the ESCV) can be implemented when the next access arrangement is introduced.

1. Introduction

The Western Australia Major Energy Users (WAMEU), representing a coalition of large energy users in Western Australia welcomes the opportunity to provide comments on the ERA's Draft Decision on the SWIN proposed access arrangements revisions.

In its earlier submission on the SWIN proposal, the WAMEU expressed its concerns with the proposed network charges, reflecting primarily:

- An increase of more than 50% in operational expenditure (non-capital costs)
- An increase of more than 75% in capital costs
- An increase in the weighted cost of capital of some 220 basis points
- The rolling into the capital base of capital contributions

The concerns also extend to the proposed modest increases in efficiency savings and in service performance standards, notwithstanding the very substantial increase in costs claimed.

The WAMEU also contended, in its earlier submission, that the effects of the Global Financial Crisis have resulted in very significantly changed economic circumstances, and therefore required a considerably more moderate and reasoned access arrangement proposal and the need to rigorously justify all non-capital and capital cost claims in the second access arrangement period.

The WAMEU has closely examined the ERA's Draft Decision and notes the thorough and rigorous approach taken by the ERA in reviewing the SWIN proposal. This is in stark contrast to the WP application which showed all the hallmarks of an ambit bid. The fact that ERA had to delay release of its draft decision for many months after it was due for release as ERA sought more and better information from WP, supports our view that the WP application was deficient in many aspects and had provided inadequate evidence to support its claims. That the ERA then had to carry out its own assessment with such extraordinarily detailed analysis only goes to reinforce a view that the WP application was fundamentally flawed.

At the most fundamental level, the WP application would have resulted in a massive increase in costs for consumers using the electricity transport service. That WP considered that consumers could readily afford such a large increase in costs at a time when many businesses and residential consumers are facing considerable financial hardship as a result of the global economic downturn, reinforces a view that the WP application lacked reality.

Since the ERA's draft decision, the WAMEU has become aware of the WA Government's decision to continue to require that the Tariff Equalisation Fund be funded through a Tariff Equalisation Contribution levied on the distribution network in the SWIN.

We understand from advice from sources that the ERA has estimated that as a result of the need to collect TEC from SWIN users, the average real increase in network tariffs that would flow from the ERA's draft decision will be 17% p.a. for the next 3 years compared with 8.5%. This is a disappointing outcome, as it will clearly represent a severe price shock to users, who will be facing very significant price increases from the impending implementation of the Carbon Pollution Reduction Scheme and the expanded Renewable Energy Target.

Against this background, the WAMEU considers that the ERA needs to take a less conservative approach in its final decision, and seek to apply further efficiency savings from Western Power, including taking a more realistic approach to the calculation of the WACC parameters.

The WAMEU considers the ERA has provided the necessary rigour to ensure that its draft decision both recognises the needs of WP to enable it to provide the services expected by consumers in terms of growth and reliability, and balancing this against the expectations of consumers for the efficient costs of providing the services, commensurate with the needs for long term security and safety.

Accordingly, the WAMEU strongly supports the Draft Decision although it points out in this submission that in some areas the ERA has taken a pragmatic approach to the WP application in allowing some costs for which there may be arguments for their exclusion.

2. Non-Capital Costs

The WAMEU had raised in its earlier submission its strong concerns with the proposed substantial increases in forecast non-capital costs and urged the ERA to ensure that the non-capital cost claims be examined in the context of a network service provider **efficiently** minimising costs. The concerns held by the WAMEU were quite numerous, but they were also held by many other stakeholders. These concerns included:

- The disconnection between cost claims and the projected increase in demand for energy, especially in the light of the effects of the Global Financial Crisis.
- The questionable cost escalation assumptions.
- The lack of detail and justification in the proposed access arrangement.
- The absence of benchmarking of cost claims against those of other comparable network service providers.

There was a host of other reasons advanced to cast doubt on the veracity of cost claims.

In particular, the WAMEU noted that in a number of other jurisdictions, entities similar to WP have claimed significant increases in costs (both capital and non-capital) due to escalation of labour and materials which exceeded the general inflation expected in Australia. There is a clear pattern that has emerged in seeking increases above inflation for these input costs. At the same time most businesses operating in a competitive environment have had to be absorbed these increases when they occurred, and as the impacts of the financial crisis have resulted in significant downturns in sales, competitive businesses have had to develop more efficient methods of managing their costs.

The experience of businesses operating in a competitive environment is in stark contrast to the WP application where WP had sought significantly large increases in costs effectively for providing much of the same service as previously. The approach and draft decision of the ERA has recognised this and made adjustments accordingly.

The WAMEU notes the line by line approach taken by the ERA in assessing the non-capital costs claims and supports the Draft Decision as detailed in Table 48, page140 of the Draft Decision.

Table 48 Amended forecast non-capital costs (real $ million at 30 June 2009)

	2009/10	2010/11	2011/12
Transmission – proposed	100.90	105.97	112.78
Transmission – amended	**69.59**	**81.14**	**89.03**
Distribution – proposed	393.99	416.48	436.37
Distribution – amended	**263.74**	**301.38**	**330.75**
Total – proposed	494.89	522.44	549.15
Total amended	**333.32**	**382.52**	**419.77**

The ERA draft decision indicates that some costs have not been justified by WP but despite this has permitted some of these costs to remain. In a truly competitive environment, the market would determine whether these costs can be absorbed. The WAMEU, however, considers that the ERA is probably correct to take a slightly conservative view (as it has done) as the cost to consumers for failure of the network due to costs being pared too tightly will be greater than the potential saving in not allowing the (perhaps) unjustified cost to remain.

Because of this conservative approach being taken now, the ERA should note for future reference, that this was permitted in this review, but it should not take the same approach at the next review should it prove to be incorrect with the benefit of experience during the access arrangement period. If it does not allow in the future for this conservatism taken now, then the outcome moving forward will be a compounding effect and result in the conservatism having a cumulative effect increasing at each review. This important aspect of economic regulation has only been recognised by Australian energy regulators in recent times.

The WAMEU supports both the approach taken by the ERA and the outworkings of its analysis on non-capital costs.

3. Capital Base and New Facilities Investment: Current Access Arrangement Period

A major concern raised by the WAMEU in its earlier submission was whether the actual (and proposed) investments were prudent and efficient.

The WAMEU notes the ERA's consultant's (BDO Kendall's) independent review of Western Power's regulatory accounts in the first access arrangement period, viz:

> "…there may be some costs claimed by Western Power as new facilities investment in the first access arrangement period that may not appropriately be added to the capital base" (ERA, page 150).

We, consequently, note the ERA's assessment that reflecting internal deficiencies and conflicting information Western Power had:

> "…not applied an appropriate degree of rigour in determining the value of new facilities investment in the growth categories of investment." (ERA, page 162).

The ERA added that:

> "…the Authority considers that deficiencies in the processes of planning and procurement during the first access arrange period suggest a degree of inefficiency in that part of new facilities investment that was undertaken by Western Power; that is, the capital projects and programs other than assets constructed by other parties and gifted to Western Power. The Authority is not satisfied that the entire amount of new facilities investment undertaken by Western Power in the first access arrangement period and financed by capital contribution (including investment financed by capital contributions, but excluding gifted assets) meets the requirements of section 6.52 (a) of the Access Code". (ERA, page 163/4).

Accordingly, the WAMEU supports the ERA draft decision to remove total capital contributions of $526.04m in the first access arrangements period from the capital base.

This is the correct decision as to include capital contributions in the capital base would represent "double dipping" by Western Power and is inconsistent with the Code and, just as importantly, in equity as affected consumers would be required to pay twice for the service provided. For WP to receive a return on the funds provided by consumers to connect to the network and to charge consumers for this return is patently inequitable.

The WAMEU notes with respect to new facilities investment claims for the second access arrangement period that the ERA assesses that there:

> "… has been systematic over-engineering of capital projects resulting in inefficiencies in the design of network assets."

and

> "… have been deficiencies in the planning and governance of capital works…" (ERA page 165)

The ERA has decided – and this is strongly supported by the WAMEU – to account and assign estimated values for "inefficiency" as follows and to reduce the cost claims by:

- $63.5 million for transmission
- $65 million for distribution
- A further reduction of 15% of the new facilities investment to reflect the likely inefficiencies in the undertaking of investment

Table 60 Amounts of new facilities investment in the first access arrangement period to be added to the capital base (real $ million at 30 June 2009)[288]

	2006/07	2007/08	2008/09
Transmission			
Total new facilities investment	306.86	317.00	443.64
Reduction equivalent to $63.5 million nominal in 2008/09	0	0	(63.50)
Revised total new facilities investment	**306.86**	**317.00**	**380.14**
15 per cent reduction	(46.03)	(47.55)	(57.02)
Value to be added to the capital base	**260.83**	**269.45**	**323.12**
Distribution			
Total new facilities investment	448.03	481.29	582.91
Reduction equivalent to $65 million nominal in 2007/08	(22.31)	(22.31)	(22.31)
Revised total new facilities investment	**425.72**	**458.98**	**560.60**
Gifted assets	(23.68)	(39.60)	(94.30)
New facilities investment net of gifted assets	402.04	419.39	466.30
15 per cent reduction	(60.31)	(62.91)	(69.94)
Value to be added to the capital base (including gifted assets)	**365.41**	**396.47**	**490.65**

The WAMEU sees that there is a need for the ERA to provide strong discipline so that WP (a natural monopoly network business) will take a much more rigorous approach to new investment in the future. Too many of the monopoly network businesses see regulation as effectively allowing the businesses to operate with a “cost plus” mentality. Economic regulation is an approach which is to provide the discipline of a competitive market on monopoly businesses, so it is incumbent on the regulator to ensure this discipline is imposed. What the ERA has carried out in its assessment of the current period provides WP with the recognition that such discipline will be applied in the future, so that WP will develop into a more efficient business.

The WAMEU considers that the approach by the ERA and the conclusions it reaches are a much better reflection of the real needs of the SWIN than the apparent ambit claims sought by WP

4. Capital Base and New Facilities Investment: Second Access Arrangement Period

The WAMEU agrees with the ERA draft decision on its assessment of the capital base at the commencement of second access arrangement period, viz:

$million	**ERA assessment**	**Proposed**
Transmission	$2,199.18	$2,415.47
Distribution	$2,651.57	$2,911.66

The WAMEU is of the view that the ERA has provided appropriate adjustments to the claims by WP. In this regard, the WAMEU notes the revisions to the expected growth in demand and consumption and that these more realistic assumptions and projections have been taken into account in the development of the revised allowance for new investment.

It is clear that the ERA has identified that WP has not been rigorous in establishing the details of its capital implementation reviews to ensure the New Facilities Investment Test (NFIT) shows an investment is warranted, because the ERA has discounted some actual expenditure before it can be included in the RAB. That the ERA has had to do this indicates a clear failure by WP in implementing the NFIT assessment and in its subsequent management of each project to ensure the actual outcome is the same capital cost on which the NFIT was based. It is totally unacceptable that a capital allowance which is demonstrated under the NFIT to be warranted, should be allowed to over-run and then have the over-run included in the RAB. To allow such an occurrence defeats the purpose of the NFIT which is to demonstrate the amount of capital that is acceptable for a project. There must be some form of capital expenditure discipline

Notwithstanding that there are amounts of capex which have been reduced from those claimed by WP in establishing the new regulatory asset base, the WAMEU expects that prior to formal commitment to any new works, the WP will be required to demonstrate that the investment meets the requirements of the NFIT, and the amount of the capital used as the basis for the project. WP should retain these records for review by ERA at the next access arrangement review.

The WAMEU, therefore, concurs with the stated view of ERA:

> "The Authority expects that Western Power will provide further information to support revised forecasts of new facilities investment prior to the Authority's final decision on the proposed access arrangement revisions. The Authority also notes that all new facilities investment to occur in the second access arrangement period will still have to be assessed as to whether it satisfies the new facilities investment test, either at the time of revisions to the access

> arrangement for the third access arrangement period or at the time of any application by Western Power under provisions of sections 6.71 and 6.72 of the Access Code." (ERA page 183)

It was noted that the WP expectation of capital investment included for capital contributions made by consumers. As noted above, the WAMEU considers that it is totally inappropriate for WP to get a return (ie effectively charge consumers) for assets paid for by consumers.

In this regard, the ERA provides a detailed breakdown of what it considers to be the appropriate values for WP investment less capital contributions, which can be added to the regulatory assets base so that WP can gain a return on the value of **its investments** (exclusive of capital contributions) to be made in the period.

We therefore accept the ERA assessment for the allowed investment for the next period (net of capital contributions) should be as follows:

Year/$m	**2009/10**	**2010/11**	**2011/12**
Transmission	293.46	629.41	650.63
distribution	394.09	500.91	538.60
Total	687.55	1130.32	1189.23

The WAMEU does not have the detailed information needed to be able to make a detailed assessment of the needs of the WP network over the coming period. What we did offer to the ERA was a view that the growth forecasts used by WP might be overstated in light of the current economic circumstances. We also added a view that the amounts claimed far exceeded the current levels of capex actually undertaken by WP, and its own benchmark activities did not support the large capex program planned.

5. Weighted average cost of capital

The WAMEU provided its view on what it considered to be appropriate WACC parameters for a monopoly business providing an essential service to WA consumers of electricity.

In particular, WAMEU notes WP and other regulated electricity businesses have relied on two basic approaches when seeking increases in the WACC parameters – using a long term basis to "… provide regulatory certainty …" when the longer term provides the with a benefit and at other times "… the current market conditions indicate …" when they seek the benefit of a recent increase in a parameter.

At the same time regulators consider that there "… needs to be credible and sustainable evidence …" to move from a demonstrably conservative value for a parameter before they will move to one which is more representative of the market.

The outcome of these two approaches is that there is consistently an overly conservative value applied to the WACC parameters embedded in the CAPM approach used by regulators. An approach which is too conservative provides a distinct detriment to consumers, requiring them to pay too much for an essential monopoly service. When the monopoly is a government owned entity (such as most electricity transport businesses including WP) this is tantamount to indirect taxation. It is not the purview of regulators to act as tax collectors for governments.

The ERA has made its own assessment which reflects a number of parameters having a range of likely values. In many cases the WAMEU considers the ERA has set the range too high when the data is examined in detail. Equally, the WAMEU considers that the ERA, if it is to err, should err on the side of a higher WACC rather than a too low WACC. Despite its concerns about the ERA being too conservative, overall the WAMEU supports the final outcome of the ERA draft decision in relation to WACC, if not its approach on specific WACC parameters.

The reasons for WAMEU supporting such a moderately conservative approach is the impact of failure of WP due to insufficient revenue will be much greater than providing a small bias of conservatism. Whilst the WAMEU considers that using parameters that deliver a real pre-tax WACC of 7.06% is probably higher than appropriate needed by WP, it accepts that a slight conservatism is appropriate.

On this basis, WAMEU accepts the ERA assessment but considers that it is at the high end of an acceptable range.

6. Tariff Development

6.1 General commentary

One of the residual concerns the WAMEU has, is that of tariff development. The WAMEU considers that tariffs should reflect the costs inherent in providing the service. What many WAMEU members see is that there is often a bias introduced into the tariff development which moves from cost reflectivity.

Traditionally, regulators have a view that a tariff should fall between the stand alone cost and the avoided cost. The WAMEU considers that this is the ultimate range, but these are the outer bounds of tariff setting and do not reflect a cost allocation of a shared service where the benefits of aggregation are shared with equity between all users. Inappropriate tariff development can result in two unacceptable outcomes:

- If the cost is too low then it does not send the economic signals to the users to wisely use the service provided. In the increasingly carbon conscious world, there needs to be strong and accurate signals to all electricity consumers as to the impacts of the decision they make.

  For example, charging network services on a basis of consumption increases the usage of a network for short periods of time with little regard for the amount of the network capability which lies idle for extended periods of time. The increasing penetration of refrigerative air conditioning has resulted in higher peaks in electricity demand but reduces the load factor in the networks and this requires large amounts of capital for network augmentation used occasionally.

  Setting tariffs based on demand rather than consumption provides a signal to those wanting high demand for short periods, the correct network cost to provide for such a service

- If the cost is too high, then it sends a signal that alternative options should be considered, such as bypass, self generation or even relocation. Any of these outcomes is economically inefficient both for the consumer and for the State at large.

The WAMEU adjures the ERA to ensure that the tariffs developed by WP as a result of its revenue decision are as demonstrably as close to cost reflectivity as possible, so that the price signals seen by consumers are appropriate to the usage they make of the network and encourage the achievement of the maximum economically efficient use of the network.

6.2 The impact of the transitional tariff policy

The transition from a vertically integrated structure to the deregulated structure resulted in Western Power applying transitional tariffs for some 50 end users as a means to limit price shock but the subsequent abolition of these transitional tariffs has caused an even greater price shock, particularly to a small number of end users.

The process of applying and then abolishing the transition tariffs by WP was for them to advise retailers of the application and change rather than to the end users directly impacted. This means that some WAMEU members and other end users were firstly unaware they were on a transition tariff and later that it no longer applied. This has caused significant hardship, especially in the current economic times.

Direct dialogue between end users and WP has not resolved the situation, with WP saying any change from its current policy would result in “creating a precedent”.

The WAMEU is concerned that so many end users have been impacted by un-notified network pricing policies set by WP and a totally unexpected price increase resulting from a policy change. Whilst it is accepted that the change in policy has been known, the fact that WP elected to communicate only with the retailers, has created significant hardship for a number of end users.

In other jurisdictions the regulator has required the network monopolies to be aware that they should directly liaise with end users about such policies and there have been instances where such price shocks have been mitigated by regulatory fiat.

7. Service standards

Service performance is the balancing half of the regulatory bargain. For a given amount of revenue, paid by consumers, the consumers get a service which equates to the level of revenue provided. The challenge for a regulator is to reach the efficient levels of revenue and service performance. In the NEM the AER uses financial incentives to identify the efficient levels of revenue (especially non-capital expenditure) and service performance. The WAMEU would encourage the ERA to implement similar financial incentives for WP.

The WAMEU accepts that there is a correlation between allowed revenue and service performance, and considers that a service performance incentive program similar to that used in the NEM would allow WP to develop an approach which rewards improved service and punishes poorer service. Under such a scheme, WP would have the ability to offset increased costs against the financial reward for improved service. Such an approach would encourage WP to find the point where service performance is at its most efficient.

The ERA points out that generally the service standards targeted by WP are a little better than those achieved in the current period. They also point out that those targets set for the current period were in general achieved and in many cases achieved significant improvement. This highlights two aspects:

- The targets for service performance set for the first period were not overly challenging
- It is recognised there is scope for better performance

WP had requested in its application for large increases in revenue to allow for further improvement in service performance and despite the ERA advising that they would be reducing the revenue claimed, WP has advised it will still achieve the standards proposed. We also note that the ERA is proposing even further cost reductions than first indicated. The implication then is that if ERA reduces the allowed revenue as it proposes in the draft decision, then WP might seek lower targets for service performance.

The WAMEU does not accept that in this instance this should be the result of the ERA determined reductions in revenue. The service performance targets set for the second period are not significantly better than those already achieved in the current period and were achieved with less revenue than the ERA is proposing to allow for the second period. If there was no increase in revenue between the current period and the new period, there is an expectation that the currently achieved service performance measures would be replicated and therefore in the new period we would expect a continuation of the actually achieved performance measures.

In fact, the revenue allowed in the draft decision for the second period is significantly higher than that actually used in the current period. Therefore, under the regulatory bargain, increased revenue should result in improved service performance. This is a direct outworking of what occurs in a competitive market – a consumer will accept a real price increase for a product if the new product is superior to that that provided previously. On the other hand a consumer is unlikely to pay a higher price for a new product which is not superior to the old product.

The WAMEU considers that the modest improvements in service performance proposed are in keeping with the revenue allowance proposed by the ERA based on the current performance achieved and the revenue used to provide the performance.

The WAMEU also considers that the ERA should take the opportunity to implement a service performance scheme similar to the one established by the ESCV in 2005 as a good model for encouraging improved service levels to the most efficient level permitted by the revenue allowed by the regulator.

It is critical for consumers that the ERA set in train the collection of necessary data with a view to implementing a challenging service performance scheme now, or at the latest, at the commencement of the third access arrangement period