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Access Arrangement Review
Electricity Access
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DRAFT DECISION ON WESTERN POWER'S PROPOSED ACCESS ARRANGEMENT REVISIONS

The Department of Treasury and Finance (DTF) is pleased to submit the following comments to assist the Economic Regulation Authority's (Authority) in making its final decision on Western Power's proposed revised access arrangement (AA2). We appreciate this opportunity to provide further comment

As you may be aware, the Government was not provided the opportunity to review Western Power's amended access arrangement information prior to submission to the Authority. As a result, many elements of AA2 are currently not reflective of Government policy, in particular proposed expenditure levels remain significantly in excess of approved budget levels.

Whilst we acknowledge the vital role that the Authority plays in determining the level of economically efficient investment in electricity networks, it is our view that there is a range of efficient outcomes across a range of expenditure levels and it remains the responsibility of Government as a matter of policy to determine acceptable network outcomes and service standards associated with that level of expenditure which balances competing funding priorities, prudent financial outcomes and acceptable electricity costs to consumers.

The Draft Decision has highlighted a number of areas in which we are of the opinion that the regulatory environment may not be achieving the desired outcomes from the Government's perspective, including the following:

- levels of expenditure sought by Western Power have remained high throughout the Access Arrangement review process;

- the Authority's publicly stated opinion of an historical underspend on the electricity network is difficult to reconcile with previous regulatory decisions, the profile of average network asset age and condition relative to other networks, and the history of significant increases in actual expenditure. This position is not helpful in determining appropriate funding levels or in curbing unrealistic expenditure ambitions at Western Power;

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- the lack of sufficient rigour in Western Power's various submissions suggests that the Authority will face a difficult position forecasting with any accuracy an efficient level of expenditure over the following Access Arrangement period. Such a forecast is therefore of limited guidance to the Government in any subsequent review of approved funding levels based on the final decision of the Authority;

- frequent references to recent improvements in expenditure governance at Western Power are not sufficiently evidence-based at this juncture to overcome the regulatory risk faced by the Government in approving any increase in funding levels;

- there appears to have been considerable uncertainty on the part of Western Power as to the level of information disclosure required to satisfy the Authority, leading to the highly unsatisfactory outcome of an arbitrary penalty applied to reflect inefficiencies that cannot be quantified. Until such time as this process is clarified, the Government cannot reasonably be expected to place further investment capital at risk of non-recovery; and

- the position of the Authority that Western Power and the Government are indifferent between cash flow today or in the future when adjusted by the discount rate does not take into consideration the Government's financial constraints, nor does the Weighted Average Cost of Capital make any reference to the Government's opportunity cost of capital.

Whilst acknowledging the importance to the community and the economy of a reliable and secure electricity network, endorsement of the level of investment proposed by Western Power leaves the Government with two unattractive outcomes. Firstly net debt would need to be raised to levels that are not consistent with the Government's financial targets, thus placing constraints on the capacity to invest in other essential areas and potentially affecting other community services. Secondly, standard electricity charges would need to be increased to levels that would have a detrimental flow-on impact to the general public through a significant increase in the retail price of electricity.

It is in this context that we submit for your consideration the following issues which are discussed in more detail in Attachment A:

- changes in economic conditions;
- approval of actual capital expenditure for the first Access Arrangement period;
- capital expenditure for the second Access Arrangement period;
- non-capital expenditure for the second Access Arrangement period;
- service standard benchmarks;
- capital contributions;
- deferral of revenue;

- pricing;
- adjustment mechanisms;
- expenditure governance – Regulatory and NFIT tests;
- regulatory financial statements;
- Weighted Average Cost of Capital; and
- the tariff equalisation contribution.

If you have any queries in relation to our comments, please do not hesitate to contact Noel Souness on 9222 9332.

Anthony Kannis
EXECUTIVE DIRECTOR
INFRASTRUCTURE AND FINANCE

10 September 2009

DEPARTMENT OF TREASURY AND FINANCE'S SUBMISSION ON THE DRAFT DECISION ON WESTERN POWER'S PROPOSED ACCESS ARRANGEMENT

CHANGE IN ECONOMIC CONDITIONS

In recognition of changes in the Western Australian and international economies flowing from the Global Financial Crisis, we view that Western Power's revised expenditure levels need to be soundly based on updated underlying assumptions. This will likely result in a number of projects being delayed and revisions to cost escalations and reductions being required as appropriate.

Western Power's investment program is based on load forecasting methodology which employs linear regression techniques. We observe that Western Power's modelling appears overly optimistic in so far as it continues to project increases in energy usage consistent with former economic boom conditions into the future. It is considered that significantly more care needs to be taken around the timing of growth and capacity expansion related projects and consideration given to deferring these where appropriate.

Whilst conservative network planning exerts a preference for network expenditure to take place sooner, in the context of significant falls in State revenues, financial conservatism will influence the deferral of expenditure where possible to better align outgoings with a pick-up in revenues associated with any improvement in economic conditions. This element of State budgeting is not captured in the approach taken by the Authority, which assumes that the business (and its owner) is indifferent between present and future cash flows when adjusted by the WACC .

- *The DTF requests the Authority to give consideration to whether Western Power has appropriately revised its AA2 expenditure proposals for the impact of changed economic conditions.*

APPROVAL OF CAPITAL EXPENDITURE FOR FIRST ACCESS ARRANGEMENT (AA1) PERIOD

We have significant concerns over the Authority's Draft Decision to revise down Western Power's capital base at 30 June 2009 by $472 million.

Whilst it is agreed that the information disclosed was not sufficient for the Authority to fulfil its requirements to assess New Facilities Investment Test (NFIT) expenditure under the *Electricity Network Access Code 2004* (Access Code), in Western Power's defence the regulatory environment in which Western Power operates is in its relative infancy and the Draft Decision arguably represents the first indication of the full extent of disclosure required by the Authority to make a proper assessment.

It is apparent that this misunderstanding will need to be addressed as a matter of paramount importance in the forthcoming regulatory period and this issue is discussed further below. However, this leaves the matter of the treatment of AA1 expenditure to be resolved and an accurate assessment of excluded investments to be estimated.

We are of the view that an arbitrary penalty of 15 percent is an unsatisfactory means of effectively penalising Western Power for its failure to fulfil the informational requirements of the Authority. Western Power's approach to seeking NFIT approval for expenditure was apparently never specified with sufficient clarity for this outcome to be avoided.

We observe that the *Guidelines for Access Arrangement Information* produced by the Authority in June 2008 did not provide sufficient guidance to Western Power nor did this appear to be clarified at any of the subsequent meetings between the parties prior to and during the submission period. As a result, we are of the view that these factors may have contributed to the failure on Western Power's part to properly record, store and communicate the relevant information to the Authority in the form it subsequently requested.

We believe that it is inappropriate under these circumstances to apply an arbitrary 15 per cent penalty to the total amount of new facilities investment over the period. This approach creates a dangerous precedence, imposing an unacceptable risk to the Government in authorising any further expenditure by Western Power.

We note that there are three alternative options available to the Authority to deal with evaluation of AA1 expenditure:

1) Assessment of all requested information

We have expressed a strong preference to Western Power to comply with the Authority's request for all relevant project expenditure information so that an accurate assessment can be made of actual expenditure inefficiency over the period. We understand that there is further relevant information available and believe that given the significant amounts of investment at risk, every possible opportunity should be given to Western Power to fully comply with its obligations.

2) Revaluation of the Asset Base

The Access Code gives the Authority the choice between a revaluation of the entire asset base or determining efficient additions to the asset base. In the event that adequate expenditure information is not provided, we request that consideration be given to a revaluation of the asset base (consistent with the code) as a preferred alternative to an arbitrary penalty.

3) Reducing the base amount of inefficient expenditure through additional information

We do not favour further qualitative arguments in defence of the efficiency of Western Power's expenditure. However to the extent that the Authority's consultants have provided further evidence of efficiency in specific expenditure areas, it is believed that the base to which the penalty is applied could be further refined/reduced as follows:

- The review by Geoff Brown & Associates (GBA), *Review of Expenditure Governance Western Power,* noted that materials and equipment comprise up to 70 per cent of the total cost of primary assets on power transmission and distribution systems. The review found that Western Power's tendering processes for purchases of materials and equipment appear thorough and robust. This may suggest that any penalty (be it 15 per cent or a lower amount) could be applied to the non-materials and equipment asset component of the new facilities investment; and

- The GBA Review also found that the AA1 regulatory period was characterised by significant changes within Western Power and that governance arrangements have improved over the period. This would suggest that any penalty for inefficiencies could be scaled down over the AA1 period.

- *The DTF requests the Authority to exercise as much discretion as is possible to allow Western Power to fully comply with information requests.*

- *The DTF requests that the proposal to apply an arbitrary penalty to AA1 expenditure be avoided if possible through either the consideration of further information or a revaluation of the asset base.*

- *In the event that the Authority decides to proceed with a penalty, the DTF requests the Authority to consider excluding amounts for expenditure demonstrated to be efficient, such as materials and equipment expenditure, and that any inefficiency reduction factor be scaled down over time.*

CAPITAL EXPENDITURE FOR SECOND ACCESS ARRANGEMENT PERIOD

We note that the Authority has incorporated into its Draft Decision the forecasts of AA2 capital expenditure provided by Western Power in its letter dated 25 May 2009, whilst noting that it expects further information will be provided. Limited justification was provided by Western Power to support this proposed level of expenditure which is significantly in excess of the current approved 2009/10 Budget position.

The Draft Decision has demonstrated to the Government that there are significant risks around approving expenditure that has not been subjected to the Authority's NFIT test. It has also become apparent that Western Power does not currently understand what is required of it to seek regulatory approval for new facilities investment.

Under these circumstances we will be recommending that the Government not approve any increases in funding without prior NFIT and/or Regulatory Test approval and due consideration of associated project justification documentation.

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It is our view that the inclusion by the Authority in the final decision of any amount in excess of current approved Budget funding levels exposes the outcome to a strong risk of over-charging of network tariffs.

We note the distinction between expenditure that is likely to satisfy the new facilities investment test (as currently included in the Draft Decision) and expenditure that is in actuality likely to be incurred. We believe that the current approved Budget is a better reflection of likely expenditure in the general context of uncertainty in the economic environment and in the specific context of regulatory risks exposed by the Draft Decision.

- *The DTF requests the Authority give appropriate consideration to Western Power's approved funding position in its forecast of AA2 capital investment.*

NON-CAPITAL EXPENDITURE FOR SECOND ACCESS ARRANGEMENT PERIOD

It is noted that in its Draft Decision, the Authority determined that 2007/08 non-capital costs provided a sufficient basis for the efficient level of costs upon which to assess forecasts of non-capital costs over the subsequent Access Arrangement period. This level of expenditure is $52.1 million or 18% above the level of expenditure approved as efficient in the first Access Arrangement period. This forecast came into effect in April 2007.

We observe that there appears to be considerable uncertainty in forecasting the efficient level of non-capital expenditure and that this risk has a significant impact on the profitability of the network provider's business.

We consider that Western Power and therefore the Government are taking on a large risk from the fact that there is no post-adjustment mechanism for non-capital expenditure. That is, additional required non-capital expenditure over that initially approved cannot be recovered in the next regulatory period.

So as not to penalise Western Power for undertaking additional required non-capital expenditure to meet approved service standards, we believe it is reasonable for the Authority to:

- recognise discretionary and non-discretionary non-capital expenditure classes; and
- allow the pass through of any additional required non-discretionary non-capital expenditure to the next regulatory period, assuming efficient procurement processes can be proven.

With regards to forecast maintenance expenditure, both preventative and corrective, we are concerned about the arbitrary nature the Authority has used in its Draft Decision for reducing forecast expenditure. This method limited the year-to-year increases in forecast expenditures to 15 per cent. It should be recognised that Western Power's increased levels of asset condition information has resulted in revised maintenance expenditures and the arbitrary 15 per cent increase does not necessarily recognise specific required expenditure.

The Authority's consultant Wilson Cook & Co, tasked with reviewing the forecast expenditure for the second Access Arrangement, considered that the increased expenditure on preventative maintenance was prudent, justified and overdue. Particularly, it was based on recognised practice for plant.

Consideration should be given to the impacts of proposed reductions in preventative maintenance on corrective maintenance.

- *The DTF requests the Authority to consider Western Power's asset condition information when setting maintenance expenditures.*

- *The DTF requests the Authority to consider the pass through of required additional non-discretionary non-capital expenditure to the next regulatory period.*

SERVICE STANDARDS BENCHMARKS

We support the Authority's amendments to include new service standards benchmarks for:

- loss of supply event frequency;

- average outage duration; and

- reliability measures (SAIDI and SAIFI) for customers served by the 15 per cent of worst performing feeders.

The Authority notes that the two new transmission benchmarks should be consistent with those that apply to transmission businesses in the National Electricity Market. We support consistent 'calculation methods' of service standard measures, however we do not support applying the same 'quantum' of benchmark. It is noted that benchmarking has recognised limitations and various factors complicate the comparisons and require the exercise of considerable judgement when comparing inter-jurisdictional benchmarks.

The Authority has detailed that it "considers that service standard benchmarks must be established at values that are reasonable forecasts of the values of the relevant services standards to be achieved during the access arrangement period, and are the values that users of the network can expect to be achieved."

On this basis, given the Draft Decision's reductions in expenditure, we believe it is not appropriate to hold service standard benchmarks at the levels initially proposed by Western Power. We encourage appropriate revisions to Western Power's service standard benchmarks.

- *The DTF requests the Authority to consider setting new service standard benchmarks at regional specific levels.*
- *The DTF requests the Authority to revise service standard benchmarks for revised levels of expenditure.*

CAPITAL CONTRIBUTIONS

We support the Authority's decision to accept Western Power's movement to the conventional treatment of Capital Contributions for the following reasons:

- It reduces Western Power's debt on the basis that the Queensland model is financially unsustainable because Western Power will need to increase its debt to finance current expenditure requirement up to a point that Western Power reaches a debt limit.
  - This is even more important in the current environment were the ability to take out debt is constrained. If debt is not available this would result in Western Power having to reduce its expenditure levels or the Government may have to reduce expenditures on other priorities (such as health and education).
  - Additionally, the Queensland model would have real cash flow implications for Western Power.
- It removes intergenerational equity concerns (the Queensland model lowers target revenue and prices in the short term, but leads to higher target revenue and prices in the long term).
- It sends appropriate price signals (discouraging higher inefficient demand and reducing required network investment).
- It removes tariff variability from the unknown size and timing of capital contributions.

However, we do not support the adoption of the conventional capital contribution treatment and the Authority's proposed deferral of revenue. This deferral recovers all incremental revenue in the AA2 period over the asset life starting from the next regulatory period. The Authority's proposed deferral of revenue effectively has the same effect as the Queensland capital contribution methodology. Deferral of revenue is discussed further in the next section.

It is noted that moving to the conventional model will create a one-off increase in revenue and tariffs in AA2. In this case, the Access Code's requirement to avoid price shocks does not have to be satisfied by smoothing revenue over the life of the asset base, it can be achieved within one or two regulatory periods.

- *The DTF notes the Authority's support for the Conventional Capital Contribution methodology.*

DEFERRAL OF REVENUE

We do not support the Authority's proposed deferral of revenue.

Western Power in its proposed revisions to its Access Arrangement proposed a modest deferral of target revenue from the second access arrangement period to the third or subsequent access arrangement periods. Western Power originally proposed to defer $191.9 million (real dollars at 30 June 2009) an amount less than the increment to target revenue that arises from the capital contribution treatment.

Western Power stated the purpose of this deferral was to reduce proposed increases in reference tariffs in AA2 that result in the change in capital contribution treatment. This was to have regard to optimising the anticipated price increases at the commencement of, and during, the third access arrangement period. That is, deferred revenues were to be recovered in the third access arrangement period.

Western Power's proposal was for a modest deferral of revenue, both in terms of amount and time.

The Authority's Draft Decision considers that the price shock effect of the change in capital contributions treatment on users should be minimised by deferral of the entire amount of the increment to target revenue of $407.2 million (real dollars at 30 June 2009). Additionally, the Draft Decision proposes recovery of a constant amount in each year subsequent to the second access arrangement with the total recovery period equal to the average life of network assets.

The Authority states that the "change in treatment of capital contributions is designed to have a neutral commercial effect on Western Power's business in present value terms." Effectively, this implies that Western Power is indifferent between a modest recovery of deferred revenue, both in terms of dollar quantum and time, or a maximum possible deferral.

We do not support this maximum deferral by the Draft Decision as it is solely based on present value indifference. Though neutral in present value terms, the decision is not commercially neutral for Western Power because it fails to recognise the current funding constraints experienced by Western Power and the negative cash flow implications that would result. The decision would result in Western Power having to take approximately $400 million of debt out and this amount would reduce over the assets life as revenue and interest is recovered. If funding is not available this would mean that Western Power would have to reduce its expenditure elsewhere or other Government priorities (such as health and education) may have to be reduced.

Additionally, from a consumer perspective in nominal terms it lowers target revenue and prices in the short term, but leads to higher target revenue and prices in the long term. Thus sending inappropriate prices signals and encouraging higher inefficient demand and increasing required network investment, which may be stranded in the future with appropriate prices.

We support Western Power's modest proposal to transition the initial effect of the change in treatment of capital contribution on target revenue and network tariffs by smoothing the impact over a short period. In this case the AA2 period and the first year of the AA3 period.

We note that section 7.5 of the Access Code requires the Authority, in reconciling any conflicting objectives for the pricing methods, or determining which objective should prevail, should have regard to the Access Code objective and should permit the objectives of section 7.3 to prevail over the objectives of 7.4 (including avoiding price shocks). Section 7.3(a) states an access arrangement must have the objectives that reference tariffs recover the forward-looking efficient costs in providing reference services.

We believe that Western Power's modest deferral is appropriate and should be approved by the Authority. The Authority's decision on the maximum deferral of revenue may well be beyond the *propose and approve* model, as Western Power's proposal may be consistent with the Access Code.

We are concerned that if approved such a decision would create a precedent to defer any unwanted price impacts across a network asset's life impeding the ability of the Authority to consider future access arrangements on their individual merit; sending inappropriate price signals; and cumulating future price increases.

- *The DTF requests the Authority to consider whether Western Power's modest proposed deferral of revenue is consistent with the Access Code and approve it on that basis.*

PRICING

We do not support the side-constraints in the Authority's Draft Decision as it does not recognise the 2009/10 network tariff CPI + 5% limit. Given network tariffs have been limited in 2009/10 the side-constraints will have to increase to ensure recovery of revenue.

In revising the side-constraints, consistent with section 2.3(b) of the Access Code and taking into account the Access Code objective, the Authority should recognise the objective in section 6.4(a) of allowing for recovery of efficient costs of provision of services should prevail over the objective of section 6.4(c) avoiding price shocks.

As a mechanism to smooth prices over the period while ensuring Western Power recovers forward-looking efficient costs, a network tariff increase as at 1 January 2010 should be considered.

It is noted that if the levels and timing of expenditure and associated network tariffs are accepted, and unless a significant increase in retail tariffs occurs, Synergy's retail tariffs will be significantly further from cost reflectivity than they are now. Sending appropriate price signals to customers supports the efficient allocation of resources, and provides incentives for energy efficiency. In the current environment of fiscal constraint, increasing electricity demand, increasing cost, high network utilisation and raised environmental awareness, economic and energy efficiency are of particular importance.

- *The DTF requests the Authority to revise the side-constraint to recognise the network tariff limit applied in 2009/10.*

ADJUSTMENT MECHANISMS

We support the introduction of both the gain sharing and service standards adjustment mechanisms, thus providing Western Power with incentives to provide services in the most efficient way.

EXPENDITURE GOVERNANCE – REGULATORY AND NFIT TESTS

We encourage the Authority to clarify with Western Power new facilities investment test information and requirements to help more fully integrate NFIT into Western Power's expenditure governance arrangements, which will facilitate and improve regulatory processes going forward.

The findings of the Authority's Draft Decision highlight systemic issues in capital expenditure by Western Power and in the process of regulatory oversight. We are working closely with Western Power to change the way in which the capital program is evaluated, implemented and subsequently communicated to the Authority and Government. Significant changes are necessary for the regulatory process to work effectively.

We have interpreted the Authority's preferred approach as effectively representing a three-stage regulatory approval process, consisting of:

- a broad pre-approval of aggregate expenditure at the time an Access Arrangement is approved;
- frequent and regular technically detailed New Facility Investment Test (NFIT) and Regulatory Test submissions immediately prior to project and program-specific expenditure; and finally
- an acquittal of actual versus budget expenditure with explanations of any variance, as part of the subsequent Access Arrangement submission.

Whilst this interpretation represents a potentially valid approach that is broadly consistent with the Access Code, it has not to date been clearly articulated and communicated to Western Power. We would prefer the Authority to engage directly with Western Power to establish and articulate an effective process that is clearly understood by all parties to the regulatory process.

It is anticipated that changes to the funding approval process will flow from the resolution of the regulatory approval process.

- *The DTF requests that the Authority formally engage with Western Power, and potentially the Office of Energy and DTF in developing effective expenditure approval processes and associated funding approvals.*

REGULATORY FINANCIAL STATEMENTS

The Authority's consultant BDO Kendalls Corporate Finance (WA) Pty Ltd who was tasked with matters relating to Western Power's regulatory financial statements in its *Regulatory Financial Audit* recommended that Western Power prepare half yearly Regulated Financial Statements. We support this recommendation. The preparation of Regulated Financial Statements according to the Authority's Guidelines for Access Arrangement Information allows for monitoring of actual expenditure trends, assessing the compliance of revenue and expenditure according to the access arrangement forecasts.

- *The DTF requests the Authority to require the preparation of half yearly Regulated Financial Statements.*

WEIGHTED AVERAGE COST OF CAPITAL (WACC)

We note and agree with the influence of the Australian Energy Regulator (AER) over the Authority's WACC determination given the significant resources expended by that body on this issue and the resultant high quality of this evidence-based decision.

We are therefore somewhat surprised that the Authority has chosen to only partially adopt the findings of the AER with further revisions applied that did not appear grounded in sufficient explanation as to why the treatment of Western Power should differ from its national counterparts.

In our view the level of systematic risk faced by Western Power is if anything, higher than its national peers, due to the nature of our resource-based economy and the relative immaturity of our regulatory system, which in the event of a fixed percentage penalty of inefficiency, currently puts more capital at risk the more is spent.

- *The DTF requests the Authority fully adopt the findings of the AER in setting the WACC.*

TARIFF EQUALISATION CONTRIBUTION

The Access Code provides for target revenue to include an amount of tariff equalisation contributions (TEC). The TEC ensures the financial viability of Horizon Power while enabling the maintenance of uniform electricity tariffs in areas outside of the SWIS. It is funded by payments made by Western Power from access revenue collected from network users in the South West Interconnected System (SWIS).

Consistent with the Electricity Retail Market Review's draft recommendations that the TEC be converted to a Community Service Obligation (CSO), in its Proposed Revisions to the Access Arrangement Western Power did not make an allowance in target revenue for TEC.

Subsequent to this the Government has made the decision to retain the TEC over the payment of a CSO. As a result, the TEC will need to be included in target revenue in the Authority's ultimate determination. We will advise the Authority of the TEC amounts over the regulatory period once they have been gazetted.

So as not to disadvantage Western Power, the Authority should ensure that all TEC amounts (including those for 2009/10) are recovered through regulated revenue over the second regulatory period.

- *The DTF requests the Authority ensure that all Tariff Equalisation Contribution amounts in the second regulatory period are recovered in this period.*