



Economic Regulation Authority

 WESTERN AUSTRALIA

Level 6, Governor Stirling Tower
197 St Georges Terrace
Perth Western Australia 6000

GPO Box 8469
Perth Business Centre
Western Australia 6849

Telephone 61 8 9213 1900
Facsimile 61 8 9213 1999
Website www.era.wa.gov.au

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NOTICE

Final Decision on Western Power's Proposed Access Arrangement Revisions

The Economic Regulation Authority today issued its [final decision](#) on Western Power's proposed access arrangement revisions for the South West Interconnected Network.

The Authority's final decision is to not approve the proposed access arrangement revisions. Reasons for this decision are set out in detail in the final decision document, together with 45 amendments that the Authority requires in order to approve the revisions. An overview of the final decision is provided in the [explanatory memorandum](#) attached to this notice.

Western Power submitted its proposed access arrangement revisions to the Authority on 1 October 2008. On 16 July 2009, the Authority issued a draft decision to not approve the revisions.

Under section 4.19 of the *Electricity Networks Access Code 2004*, Western Power may submit amended proposed access arrangement revisions to the Authority within 20 business days of the release of the Authority's final decision; that is by 6 January 2010.

Under section 4.21 of the access code, the Authority must issue a further final decision to approve or not approve Western Power's amended proposed access arrangement revisions. If the Authority's further final decision is to not approve Western Power's revisions, or if Western Power does not submit amended proposed access arrangement revisions, the Authority is required to draft and approve its own revised access arrangement.

The final decision and related documents, including notices, consultant reports and public submissions are available from the Authority's [web site](#).

For further information contact:

General Enquiries

Ms Sarah Walsh
Manager Projects
Ph: 61 8 9213 1900
Fax: 61 8 9213 1999

Media Enquiries

Ms Sue McKenna
Ms Joanne Fowler
The Communications Branch Pty Ltd
Ph: 61 8 9472 4411
Mb: 0424 196 771 (Sue)
0408 878 817 (Joanne)

LYNDON ROWE
CHAIRMAN

4 December 2009

EXPLANATORY MEMORANDUM

The purpose of this explanatory memorandum is to provide interested parties with a summary of the Authority's final decision on proposed revisions to the access arrangement for Western Power's South West Interconnected Network (SWIN). This explanatory memorandum does not form part of the Authority's final decision or the reasons for the final decision.

The Decision

The Authority today issued its final decision on Western Power's proposed access arrangement revisions for the SWIN, which distributes electricity to more than 840,000 residential and business properties stretching from Kalbarri to Albany and Kalgoorlie, and including Perth.

The Authority's decision does not approve Western Power's proposed revisions for the second access arrangement for the network, a period of three years from 2009/10 to 2011/12.

The Authority's reasons have been set out in detail in its final decision document, together with 45 amendments required for the Authority to approve Western Power's proposed revisions to the access arrangement.

Revenue Cap and Reference Tariffs

The Authority's final decision allows for three increases in average electricity network charges of 16.3 per cent to be introduced in March 2010, July 2010 and July 2011. These increases, which are expressed in "real" terms, comprise a 12.9 per cent increase in transmission tariffs and a 17.7 per cent increase in distribution tariffs at each of these points in time. If these increases were passed through to retail electricity tariffs, it is estimated that residential electricity tariffs would increase in real terms by approximately 7 per cent at each of these points in time over the period of the access arrangement.

Western Power's revenue will increase by about 70 per cent in the last year of the second access arrangement period compared with revenue in 2008/09.

The increases in network reference tariffs are a result of several factors, including the following.

- The Western Australian Government has required distribution network reference tariffs to include an amount of \$479 million in "tariff equalisation contributions" to finance a subsidy paid to Horizon Power. The amount of the tariff equalisation contributions has been substantially increased over the amount of \$213 million that applied for the first three year access arrangement period. The tariff equalisation contribution is a significant factor in distribution network tariffs. In the second access arrangement period, the tariff equalisation contribution represents 23 per cent of distribution network tariff revenue.
- Investment in the SWIN in the first access arrangement period was 53 per cent greater than forecast. With most of this additional investment having been rolled into the capital base of the network, reference tariffs have increased through a return on investment and depreciation allowances.
- Planned investment in the SWIN over the second access arrangement period is approximately 50 per cent higher compared to the first access arrangement period, which has added to the increase in reference tariffs, resulting from a return on investment and depreciation allowances on this investment.

- Non-capital costs for the operation and maintenance of the SWIN have increased by approximately 31 per cent over the second access arrangement period, including an amount claimed by Western Power to be necessary to address a backlog of maintenance works.
- The rate of return on investment (weighted average cost of capital) has increased from 6.76 per cent in the first access arrangement period to 7.98 per cent for the second access arrangement period (expressed on a real, pre-tax basis), driven mainly by an increase in the cost of debt financing following the global financial crisis.

Under the final decision, network reference tariffs are lower than those originally proposed by Western Power in October 2008 as a result of the factors listed below.

- **Capital Base**

Western Power originally proposed a capital base for the SWIN at the commencement of the second access arrangement period of \$5,262 million. This incorporated a claimed \$2,557 million of investment over the period 2006/07 to 2008/09 (in dollar values of 30 June 2009).

The Authority considered that this claimed amount of new investment did not fully meet the requirements of the access code due to inclusion of amounts in respect of projects that are not appropriate to add to the capital base, and deficiencies in Western Power's design and management of capital projects that cause the amounts of investment to include an element of inefficient expenditure. The Authority has determined that the amount of investment during the 2006/07 to 2008/09 period that may be added to the capital base is \$2,224 million, a reduction of 13 per cent. The Authority has determined that the capital base at the commencement of the second access arrangement period should be \$4,929 million.

- **Forecast investment**

The Authority has approved \$2,860 million of forecast investment for the three year period from 2009/10 to 2011/12. Subsequent to its submission of the proposed access arrangement revisions, Western Power reduced its forecast of investment in the second access arrangement period by \$859 million (23 per cent), providing for a lower amount of investment in the SWIN, reflecting lower expected rates of growth in forecast energy demand following the global financial crisis. The approved forecast investment represents an increase of 50 per cent over Western Power's investment expenditure during the first access arrangement period.

- **Rate of return (weighted average cost of capital)**

The Authority has approved a rate of return of 7.98 per cent (pre-tax real) rather than 8.95 per cent proposed by Western Power. The reduction in the rate of return from that proposed by Western Power reflects a view of the Authority of a lower cost of equity capital than contemplated by Western Power.

- **Forecast non-capital costs**

Subsequent to its submission of the proposed access arrangement revisions, Western Power has revised downwards its forecast of non-capital costs, taking into account budget constraints placed on Western Power by the Western Australian Government. With further adjustment of this forecast by the Authority, the amount of non-capital costs to be recovered in the second access arrangement period is \$1,327 million as compared with that originally sought by Western Power of \$1,566 million (in dollar values of 30 June 2009). The approved forecast of non-capital costs represents an increase of approximately 31 per cent over Western Power's actual expenditure (\$1,012 million) during the first access arrangement period.

- Deferral of revenue

Under the proposed access arrangement revisions, Western Power provided for a change in the manner that capital contributions are accounted for in the determination of a revenue cap and reference tariffs. This change in method would have had the effect of substantially increasing the amount of revenue to be recovered in the second access arrangement period. The Authority has determined that recovery of this additional revenue requirement resulting from the change in treatment of capital contributions (\$549 million in present value terms) should be recovered over the average economic life of network assets.

The Authority has had regard to significant increases in Western Power's network costs over the course of the first access arrangement period and that are forecast to occur over the second access arrangement period.

Reference tariffs in the first access arrangement period made provision for substantial increases in network costs. The Authority allowed these increases on the basis that they were necessary for additional works to maintain the network.

Actual costs for the first period have exceeded forecast costs by approximately 19 per cent for non-capital costs and 53 per cent for new facilities investment.

In the proposed access arrangement revisions for the second period, Western Power proposed further very substantial increases in costs over the actual level of costs in the first access arrangement period. The reference tariffs for the second access arrangement period reflect a 31 per cent increase in non-capital costs and 50 per cent increase in capital costs over actual costs in the first period.

A large part of the increase in costs is for additional maintenance activities, such as inspection and maintenance of wood poles. These additional activities should serve to improve the reliability of services in the third and subsequent access arrangement periods (commencing 2012). The Authority expects revisions to the access arrangement for the third access arrangement period to address the expected improvements in reliability through measures that may include setting more stringent service standard benchmarks and by increasing potential rewards and penalties for Western Power under the service standard adjustment mechanism.

A further large part of the increase in costs (approximately \$43 million) is to address a backlog of maintenance works. The Authority considers this to be in the nature of one-off costs to clear the backlog of works and expects that these costs will not be continued in the third and subsequent access arrangement periods.

While increases in costs are reflected in reference tariffs for the second access arrangement period, actual amounts of expenditure by Western Power in 2009/10 are subject to budget constraints imposed on Western Power by the Western Australian Government. The Authority does not know whether similar budget constraints will be applied to Western Power in 2010/11 and 2011/12 and, hence, whether Western Power will actually undertake the increase in maintenance activities provided for in the costs and reference tariffs approved by the Authority.

The Authority notes that budget constraints that result in maintenance expenditure being lower than the forecasts underlying target revenue and reference tariffs would result in users paying for a level of maintenance that may not occur. However, Western Power would still be subject to the service standard benchmarks and service standard adjustment mechanism of the access arrangement, including penalties for underperformance against the service standard benchmarks. Moreover, in future reviews of the access arrangement, the Authority expects that planned maintenance works that have been paid for by users will be taken into

account in setting cost forecasts and service standard benchmarks, even if Western Power has not actually undertaken these works.

Other Revisions to the Access Arrangement

Other main revisions to the access arrangement include:

- the introduction of a new reference service, comprising a bi-directional service for connection points at residential premises where small-scale generation may be used to feed energy into the distribution network;
- revision of service standard benchmarks and inclusion in the access arrangement of a service standard adjustment mechanism that provides penalties for underperformance and rewards for out-performance of the benchmarks;
- inclusion in the access arrangement of a gain sharing mechanism, providing incentives for efficiency gains on the operation and maintenance of the SWIN;
- additional requirements under the contributions policy for Western Power to provide information to a user on the calculation of any contribution to be required from an applicant or user prior to commencement of a service; and
- inclusion in the contributions policy of a provision for Western Power to levy “headworks charges” for new connections in “fringe of grid” areas.

Summary information on these revisions to the access arrangement is provided below.

Reference Services

The Authority is requiring Western Power to include an additional reference service in the access arrangement to provide a bi-directional service. With this service, a single connection point is to function both as entry points and exit points. The reference service will cater for the requirements for network services that arise where small-scale renewable energy systems connect to the network and where electricity consumers participate in the Renewable Energy Buyback Scheme.

Service Standard Benchmarks and Service Standard Adjustment Mechanism

The revised values of service standard benchmarks for transmission and distribution services have been revised in the access arrangement. The revisions are based on the service standards achieved by Western Power in the first access arrangement period and, for the most part, represent an improvement in reliability of network services.

The Authority is requiring Western Power to include in the access arrangement two additional service standard benchmarks for the transmission network – “loss of supply event frequency” and “average outage duration”. The introduction of these additional service standard benchmarks for the second access arrangement period was contemplated by the Authority in its approval of the access arrangement for the first access arrangement period. The service standard benchmarks are consistent with requirements imposed on transmission network businesses elsewhere in Australia.

The revisions to the access arrangement include the introduction of a service standard adjustment mechanism. This will operate to provide incentives for improvements in reliability by imposing financial penalties on Western Power where reliability of network services fails to meet the service standard benchmarks, and financial rewards where reliability out-performs the benchmarks.

The Authority has rejected the service standard adjustment mechanism proposed by Western Power and requires that an alternative form of the mechanism be included in the access arrangement that:

- determines rewards or penalties on the basis of year-on-year improvements or declines in reliability performance as well as performance relative to service standard benchmarks in any given year;
- provides for penalties or rewards to apply in all cases where achieved reliability differs from the service standard benchmarks; and
- includes penalties or reward rates that would place about one per cent of Western Power's revenue at risk under reasonable worst case scenarios of reliability, although there is no limit on the size of penalties or rewards.

Incentive Arrangements

The proposed access arrangement revisions include a gain sharing mechanism, creating commercial incentives for Western Power to efficiently operate the network. The final decision approves the inclusion of this mechanism but requires amendments to strengthen the commercial incentives.

Queuing Policy

The access arrangement includes a queuing policy that determines the priority that an applicant for a network service has when capacity in the network is insufficient to meet all applications.

The queuing policy and operation of the "first-come-first-served" queue for services is a matter of substantial concern for many users of the network. The Authority is required by the access code to approve the first-come-first-served queuing rules, even though the Authority considers that these rules, combined with the structure of the wholesale electricity market and reserve capacity mechanism, do not serve to promote efficient investment in the electricity network and electricity generation.

The Authority considers that the potential inconsistency of the queuing policy with efficient investment cannot be resolved through the queuing rules in the applications and queuing policy. Rather, this requires consideration in a broader review of regulatory arrangements for the electricity market that considers network planning processes, the functioning of the wholesale electricity market, the treatment of new investment under the access code, and the queuing rules. The Authority has recommended that this issue be addressed as part of a co-ordinated strategy for future development of the wholesale electricity market.

Contributions Policy

The access arrangement includes a contributions policy that specifies the circumstances in which Western Power may require a user to pay an amount over and above a normal network tariff for a service and in respect of works to be undertaken by Western Power to enable provision of the service.

The final decision requires amendments to the contributions policy proposed by Western Power in the access arrangement revisions so as to ensure greater transparency for users in the calculation of contributions.

The final decision also requires that the contributions policy be amended to include details of Western Power's scheme of headworks charges, which provides for the sharing of costs that

would otherwise be levied as capital contributions at levels that would in many, if not most cases, thwart development in regional areas of the SWIN.

Other Matters

Western Power's revised proposed access arrangement includes a standard access contract for reference services, an applications and queuing policy and a transfer and relocation policy.

Generally, these contracts and policies are based on a model standard access contract and model policies in the access code. However, the Authority has determined that there are some material additions, omissions and variations from these models that are inconsistent with requirements of the access code and that amendments are needed to ensure their compliance with the access code.