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16 July 2010

Inquiry into the Funding Arrangements of Horizon Power
Economic Regulation Authority
PO Box 8469
Perth Business Centre
PERTH WA 6849

E: publicsubmissions@erawa.com.au

Attn: Sara O'Connor

Dear Mr Rowe

RE: Inquiry into the Funding Arrangements of Horizon Power

Please find attached Alinta Energy Limited's submission to the Economic Regulation Authority's (the Authority) *Inquiry into the Funding Arrangements of Horizon Power: Issues Paper.*

Alinta Energy Limited (Alinta) welcomes the opportunity to provide comment on the Authority's issues paper, and considers this paper but one in a series of steps put in place leading to cost reflective electricity tariffs across Western Australia (WA). Alinta understands this inquiry seeks to establish Regional Power Corporation's (Horizon Power) efficient level of costs and cost reflective tariffs to supply regional WA[1]. Those tariff levels will help inform the Government's decision regarding the level of the current subsidy, the Tariff Equalisation Contribution, to be funded by customers in the South West Interconnector System (SWIS) and paid into the Tariff Equalisation Fund (TEF).

Generally, Alinta supports the approach taken or the positions outlined by the Authority within the issues paper. Alinta's position reflects an expectation that energy policy will consistently require consumers to pay a price for an essential service, such as electricity supply, that is reflective of an efficient cost of service provision. Any divergence between the ultimate price levied and the efficient costs should be covered by the provision of a Community Service Obligation (CSO). A lack of a timetable to remove the TEC or replace it with a CSO is a critical addition to the current energy policy, and something that would be welcomed by Alinta.

A summary of those issues Alinta wish to bring to the Authority's attention is provided below, and addressed in more detail in Attachment A. Alinta has commented only on certain issues arising from the Authority's issues paper. The absence of a comment on a specific issue should not be taken to indicate Alinta supports, or does not support that particular section of the paper.

The key challenge for the Authority is to recommend to the Minister of Energy a regulatory framework that disciplines Horizon Power's operating and capital expenditure. Alinta is concerned that the current structure of the TEC ensures that Horizon Power's operating practices are not subject to adequate external scrutiny. From Alinta's perspective it follows that Horizon Power's current costs are likely to be

[1] Economic Regulation Authority, Issues Paper – Inquiry into the Funding Arrangements of Horizon Power page viii

inefficient. Importantly, Alinta notes the recent and material escalation in Horizon Power's costs as evidence of the lack of external discipline.

Another crucial challenge for the Authority is to examine the best way to ensure that Horizon Power does not use the Uniform Tariff Policy, and the TEC, as a means to adopt alternative business or service delivery models, which increase its cost to serve that simply flow through to SWIS network customers. For instance, Alinta is concerned that Horizon Power's recent decisions to adopt a devolved service model, and the proposal to increase the energy consumption threshold at which customers are able to take the uniform tariff have been made on the basis of being 'commercially' protected by the structure of the Uniform Tariff Policy and the TEC. Alinta sees the Authority's proposed regulatory framework to the Minister of Energy as a means to address this issue.

Should the Authority have any questions with regard to Alinta's submission or require further information please contact Lance Brooks, on 07 3011 7667.

Yours sincerely

James Reynolds
General Manager
Regulation and Market Development
Alinta Energy Limited

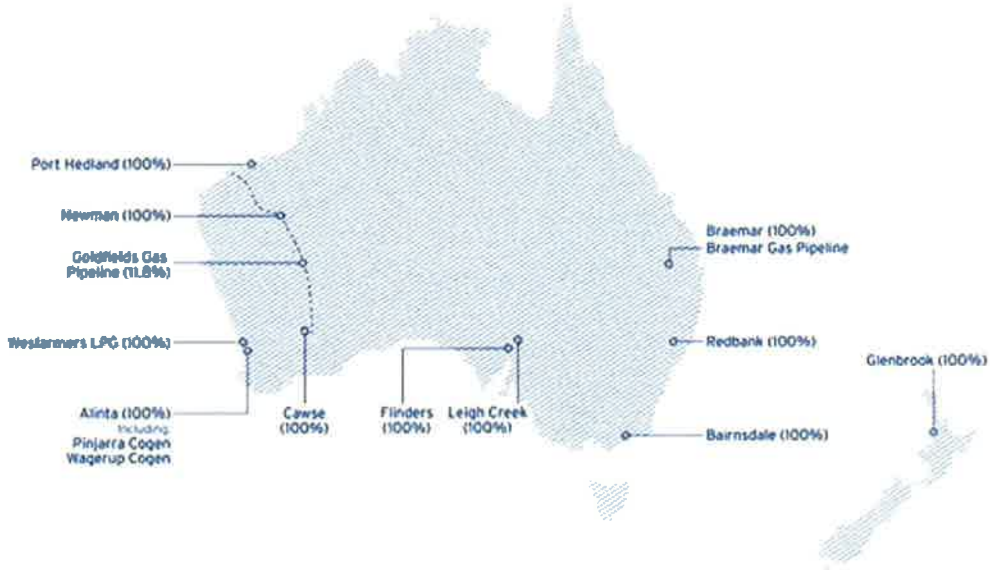
Attachment A – Inquiry into the Funding Arrangements of Horizon Power

Alinta Energy Limited (Alinta) welcomes the opportunity to provide comment on the Authority's issues paper, and considers this paper but one in a series of steps put in place leading to cost reflective electricity tariffs across Western Australia (WA). Alinta's submission covers the approach to be adopted by the Authority and the impact of a Uniform Tariff Policy on WA's electricity market.

Overview of Alinta

Alinta is an ASX-listed electricity generation businesses. Our portfolio is diversified by geographic location, fuel, source, customers, contract type and operating mode. Alinta's generation portfolio consists of base, intermediate and peak load power stations.

As shown in Figure 1, Alinta and its related corporate entities, have significant interests in the WA energy sector through the various legal entities – the most well-known being Alinta Sales Pty Ltd, which is the main retailer in the WA retail gas market with over 595,000 customers.



Source: http://www.alintaenergy.com/about-us/overview.aspx

Figure 1 Alinta Energy assets

The Approach
Alinta generally support the regulatory approach to be adopted by the Authority in determining the efficient cost levels, revenue requirements and service standards of Horizon Power over the period 2009-10 to 2013-14. Alinta considers that the Authority's regulatory approach needs to consist of:

- A robust and transparent consideration of Horizon Powers cost to serve (by region);
- An explicit recognition of Horizon Power's obligations with respect to quality and reliability of service;
- Setting of prices based on the determination of an efficient costs;
- Examining the appropriateness of current approached to cost allocation in terms of alignment with the setting of shadow prices;
- Introduction of performance incentive measurement, monitoring and reporting; and
- A requirement for transparent and regular regulatory reporting across all aspects of the regulatory regime.

The balance of this document focuses on those issues that Alinta suggest are critical in the Authority's considerations.

Forecast Capital and Operating Expenditure
Key to the Authority gaining an understanding of the efficient level of costs and cost reflective tariffs will be the development of the proposed capital and operating expenditure for Horizon Power over the forecast period. In order to gain this understanding the Authority will be required to review the District Asset Management Plans (DAMPS) and the Asset Management System (AMS) developed and maintained by Horizon Power.

Alinta understands any acquisition of new assets by Horizon Power must first go through an internal 'gating' process where by the business and engineering aspects of a proposed project are to be submitted reviewed and approved.

The issues paper highlights several concerning outcomes of the latest review of Horizon Powers AMS. More specifically the review highlighted the inaccuracy of the data existing within the AMS, the failure to fully account for any asset disposal and under utilisation as reflected in DAMPS and the lack of control around setting and meeting due dates for Asset Management Plan reviews and substation inspections.

Alinta also has concerns that the TEC, and the Uniform Tariff Policy, is facilitating an operating environment where Horizon Power:

- chooses service delivery models without due consideration to the most efficient option;
- assume business practices that do not necessarily achieve service standard obligations by adopting the most effective practices.

A key role for the Authority is to identify an arrangement that seeks to discipline Horizon Power approach and decision making.

As a result of these issues coupled with the fact Horizon Power have not previously had to accurately account for its Regulated Asset Base (RAB), Alinta believes the capital and operating expenditure budgets as provided within the issues paper have not been calculated from an efficient cost base and therefore potentially fail to provide an accurate forecast of the expenditure requirements for the future period.

Alinta recommend the Authority:

- Review Horizon Powers 'gating' process and in doing so identify the methodology applied in developing its capital and operating expenditure budgets.
- Identify what, if any, external discipline currently exists over the level of Horizon Power's capital and operating expenditure.

Cost Efficiency – Cost Base

Alinta considers that in setting an appropriate efficient cost base the Authority will be required to review and appropriately value the tangible or service provision assets for each function of Horizon Power's value or service delivery chain – generation, network and retail. In determining the efficient costs base and subsequently the cost reflective tariffs specific to Horizon Power, Alinta encourages the Authority to, as much as possible, utilise a range of analysis tools, including:

- Top down and bottom up benchmarking of the cost of energy, network costs and retail operating costs against both incumbent comparable businesses and hypothetical new entrants within the SWIS and National Electricity Market (NEM);
- Internal benchmarking of those costs where Horizon Power both procures and supplies the service through its own assets and personnel (or combination);
- Valuation of the Depreciated Optimised Replacement Cost (DORC) for Horizon Powers asset base; and
- Assessment of Horizon Powers contracts for fuel supplies used in its service delivery and the tendering and procurement for such contracts.

Further comment for each function of the value or service delivery chain is provided below.

Generation

As a result of the significant dependence of Horizon Power on the procurement of generation from privately-owner generators[2] and the appearance of generation as the major contributor to the overall (unit) cost to serve Alinta considers it prudent the Authority determine an appropriate valuation of Horizon Power's generation assets and review Horizon Power's business processes with respect to it's tendering and procurement process for generation and operation of generation facilities.

Alinta considers that Horizon Power's generation assets should be valued at the geographic level. In completing the valuation of Horizon Power's generation assets Alinta notes the Authority should employ the deprival value or more specifically the Depreciated Optimised Replacement Cost (DORC) methodology. Adopting the DORC methodology intuitively provides for optimisation of Horizon Power's asset base and in doing so provides an accurate base for assessing the future expenditure requirements of Horizon Power.

[2] Alinta note Horizon Power purchase a small amount of renewable generation from Verve.

Alinta understands that for the majority of Horizon Power's 37 isolated or islanded networks the energy supply will be procured from a limited number of fuel sources. That is, there is limited competition within these areas making it critical that Horizon Power's tendering processes create sufficient competition for the market. In addition the Authority should complete an internal benchmarking of those costs incurred though Horizon Power's Power Purchase Agreements (PPA) with costs associated with ownership and operation of its generation facilities.

Network

Whilst Alinta agrees with the Authority that a valuation of Horizon Power RAB should be rolled forward from the creation date of Horizon Power (April 2006), Alinta encourages the Authority to firstly determine an efficient cost base as at 2006.

As per Horizon Power's generation assets in completing the valuation of Horizon Power's assets Alinta notes the Authority should employ the deprival value or more specifically the Depreciated Optimised Replacement Cost (DORC) methodology.

Alinta notes a depreciation charge is included by Horizon Power as part of its unit cost of supply. Without further information with respect to the calculation of depreciation from Horizon Power Alinta cannot comment further on its calculation. However, as part of determining Horizon Power's 'building blocks' Alinta considers a straight line depreciated methodology using the weighted average asset lives for the transmission and distribution network as the appropriate methodology in calculating the return of capital for Horizon Power.

Without precedent for the calculation of a return on capital for Horizon Power Alinta maintains that the Authority in calculating an appropriate WACC should apply a consistent methodology to that of its previous determinations. The Authority needs to ensure that this approach takes into account Horizon Power's risk profile.

Further to this Alinta note Horizon Power do not own and operate all networks to which it is connected. In light of this Alinta recommend the Authority review the network charges Horizon Power incurs for these geographic areas, particularly, the process taken around commercial agreement to these charges.

Retail

As one of Western Australia's largest energy retailers Alinta has first hand experience at understanding the gains that could be made by a business in reducing its retailing cost to serve (CTS). As the monopoly supplier for the region, be it as a result of high operating costs or legal obligation, it could be argued that Horizon Power, in the absence of a regulatory framework that identifies the CTS, has reduced incentives to ensuring its retail business operates efficiently and competitively.

Alinta supports the commercial confidentiality associated with CTS, and would ordinarily consider that any regulatory examination of such retail costs is undertaken in a manner that ensures confidentiality is maintained. However, in Horizon Power's case the cost to serve is substantially greater than the revenue collected from uniform tariffs, which is subsequently reflected in the size of the TEC provided by SWIS customers (c.$4,847.51 per Horizon Power connection in 2011/12).

For this reason, Alinta suggests that the Authority looks to consider Horizon Power's retail CTS through a transparent examination of current costs with the results compared to other comparable businesses. Alinta considers the publication of Horizon Power's retail CTS to be an important component of the Authority's regulatory approach.

The confidentiality that covers the implicit examination of electricity retail CTS in other jurisdictions through regulation of electricity tariffs makes a clear comparison challenging. The Authority could overcome this challenge through:

- back-casting a range of retail CTS by taking the approved regulated electricity tariffs from other jurisdictions and deducting the cost of wholesale energy, which could be estimated by taking an annualised NEM region pool price and setting a premium to reflect the cost of Over The Counter (OTC);
- commissioning an analysis of electricity retailer only businesses to determine a benchmark CTS; or
- examining the theoretical CTS of a new retail entrant for Horizon Power's franchise or supply zone.

Moreover, as identified in the Authorty's Issues Paper[3] Horizon Power's overhead charge is substantial representing between $0.11 and $0.10 per kWh for most regions, and contributing between 42.3% and 16.4% towards individual elements of the unit cost to supply by region. As the overhead charge consists of retail, and corporate business costs, determining Horizon Power's retail CTS, and its relative efficiency is critical.

Cost Efficiency – Incentives

In determining the relative efficiency of Horizon Power's cost structure the Authority will be better positioned to determine any level of inefficiency with current costs. For instance, the Authority when examining Horizon Power's operating and maintenance costs through the findings of a technical analysis and benchmarking study may find the current costs are not representative of an efficient service provider. In doing so the Authority may identify the best way to provide Horizon Power with the incentive to seek out efficiencies in its operations.

Alinta suggests that the Authority look to set a direct efficiency mechanism to specific cost elements as part of its regulatory approach. In doing so the Authority would be implementing a glide path that provides Horizon Power with the incentive to implement ongoing efficiencies at the segment and building block level. Alinta maintain that moving Horizon Power from its current cost structure to the end point would form the basis of setting an ultimate efficient level of costs for Horizon Power's cost base, and would provide comfort to the WA Government, and SWIS users that the need for the TEC is being driven by structural cost differences not inefficient practices.

Pricing

A fundamental principle within a 'user-pay' price setting for a monopoly business is that tariffs be set according to the efficient cost to supply the customer or group of customers. Generally, efficiency in pricing for final tariffs is achieved where the tariff levied lies between the stand alone (upper bound) and

[3] Economic Regulation Authority (ERA), Issues Paper – Inquiry into Funding Arrangements of Horizon Power, pages 35 & 36,

the avoidable (lower bound) cost to supply. Importantly, if there are differences in the cost to supply between customer groups then society's overall welfare is enhanced by setting tariffs to reflect these differences. Alinta considers Horizon Power's total cost function would readily and easily be separated into the direct cost to supply its two interconnected networks and 37 isolated or islanded systems.

Alinta supports the Authority applying a pricing method to set cost reflective tariffs that takes account of efficient costs, is forward looking, has regard to revenue adequacy[4], and provides appropriate investment signals. On this basis, the tariff structure needs to be driven by the Long Run Marginal Cost (LRMC) of supply. Alinta Energy notes the current usage charges paid by Horizon Power's customers do not accurately reflect its LRMC.

For investment in electricity infrastructure, particularly network and generation assets, a large proportion of the total costs of supply are fixed. As a result LRMC can be quite low. If prices are set on a marginal cost alone basis then the business may be unable to recover its full costs.

Accordingly, a tariff using a price at LRMC needs to be accompanied by a fixed component that is set having regard to the business revenue adequacy. Alinta considers a practical construction of Horizon Power's LRMC would consist of:

- A Short Run Marginal Cost (SRMC) – consist of direct costs to provide services; and
- An Average Incremental Capital Cost (AIC) for the next step in asset size – expected capital expenditure by the additional quantity being added.

The fixed component of the cost reflective tariff could be referenced to the recovery of a capital charge associated with Horizon Power's current value of the electricity assets servicing the particularly region.

Depending on the availability of information, and the Authority's examination of the efficiency of Horizon Power's purported costs, Alinta suggests that a cost reflective tariff be set for each region, consisting of a fixed component and an LRMC as set out in Figure 2.

Further to this Alinta suggests that the Authority explore the merits around combining the isolated supply areas into a virtual tariff zone for the purposes of applying the pricing methodology.

Through identifying cost reflective tariffs be region (or virtual zone), the WA Government and the Authority will be positioned to identify the extent of subsidy provided by the TEC to each region.

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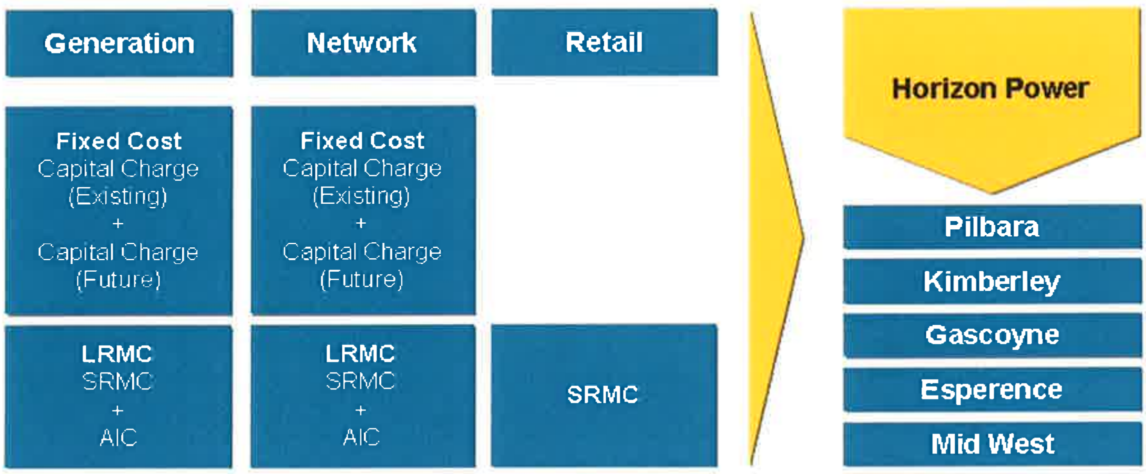
[4] Having a TEC/TEF in place ensures the revenue adequacy for the business is set by dis-regarding the Uniform Tariff. The TEC/TEF effectively represents a fixed charge component of the end tariff levied upon SWIS network users used to smooth out revenue recovery and provide the level of revenue adequacy to allow the business to earn 'normal' profits.

Horizon Power – Regional Cost of Supply



SRMC – estimated by direct costs

LRMC – estimated by average incremental cost, which consists of the return on and of capital for forecast capital expenditure divided by the expected quantity of additional capacity expected to be added from the capital investment

Figure 2 – Alinta's proposed cost reflective tariff structure for Horizon Power for each region

CPRS and RET

At this time Alinta considers the Authority's approach to modelling the potential impacts of the Commonwealth Governments Carbon Pollution Reduction Scheme (CPRS) on WA's energy market are appropriate. Given the significant delay to the potential scheme start Alinta recommends an additional and independent consultation be completed by the Authority regarding the impacts of the scheme at a time closer to the scheme start.

Service Standards and Reporting

Alinta generally agrees with the Authority's proposal to move forward with those recommendations of the recent review of Horizon Powers Code Standards[5] in determining the level of service standards with respect to the operation of its distribution network. In setting these standards Alinta agrees a suite of Horizon Power specific benchmarks, set by location and feeder type, will required in order to better assess the performance of Horizon Power. These specific benchmarks will form the basis for any future reporting obligations of Horizon Power.

Alinta note the level of transmission infrastructure owned and operated by Horizon Power presents a situation where the burden of additional compliance reporting obligations may far outweigh any potential benefits. Despite this Alinta considers failing to have in place reliability standards as part of the Reliability Code creates a greater risk to all users of the network. Alinta therefore does not agree with the recommendation provided for within the Authority's report and recommends an appropriate set of reliability standards be developed and included within the Reliability Code.

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[5] Economic Regulation Authority (ERA), Recommendation Report Review of Regional Power Corporation's Code Standards (October 2008)

At present Alinta is not aware of any legislative obligations placed upon Horizon Power, network users and operators to ensure the contractual arrangements between parties meet reliability requirements of the network. Failure to include such obligations may be detrimental to the operation of the network. At the very least, should the Authority proceed with its recommendation, it must review the contractual arrangements between parties to ensure appropriate systems and processes to measure transmission network reliability are in place.

Regulatory Reporting

Alinta considers that an important component of the regulatory approach is to establish regulatory reporting requirements for Horizon Power. Consistent with the Authority's approach towards other comparable business Alinta considers that the key reporting requirements should include:

- financial reporting, on an historic and prospective basis
- service standard and quality reporting
- efficiency gains or maintenance reporting.

Alinta suggests that timing for regulatory reporting for financial and efficiency elements of the regulatory contract should be annual, while a quarterly reporting cycle for service standard and quality requirements.

Uniform Tariff Policy – Tariff Equalisation Fund (TEF)

Whilst Alinta commends the WA Government on its decision to move towards cost reflective electricity prices in the South West Interconnected System (SWIS), funding of the Uniform Tariff Policy outside of the SWIS through the Tariff Equalisation Contribution (TEC) / TEF perpetuate inefficiencies in WA's electricity market. Specifically, the maintenance of a legislated cross-subsidy between two groups of electricity users with disparate cost to serve functions distorts efficient consumption decisions.

The move towards cost reflective tariff provides an opportunity for the Authority and the WA Government to determine a 'glide path' for the removal of the TEC from the access arrangement of Western Power.

Direct Funding vs. Cross-Subsidies

Alinta considers the obligation on Horizon Power to supply electricity to most of its customers in each of its supply areas at the same price as applies in the SWIS be a Community Service Obligation (CSO) as defined in the WA Government's CSO Policy. The policy defines a CSO to:

> *"....arise(s) when a government specifically requires a public enterprise to carry out activities relating to outputs or inputs which it would not elect to do on a commercial basis, and which the government does not require other businesses in the public or private sectors to generally undertake, or which it would only do commercially at higher prices"*[6]

Consequently, Alinta considers that the cost incurred by Horizon Power as a result of the Uniform Tariff Policy should be funded in a manner consistent with the policy framework and principles established for CSOs. Specifically, that:

[6] WA Community Service Obligation Policy – Page 9

- The funding should have the desirable effects of improving the allocation of resources, reducing the cost of providing the service and stimulating the development of new technologies and products;
- The funding approach should facility accountability, public scrutiny and regular review;
- The funds necessary to meet the costs of the programs should be raised in an equitable manner;
- The costs of administering the funding scheme should be relatively low.

In addition, the Ministerial Council of Energy's (MCE) National Framework for Energy Community Service Obligations outlines several principles for the development and implementation of a CSO, including:

- An energy CSO should not be delivered by a mechanism employing cross-subsidies from one set of consumers to another;
- CSOs should not materially impede competition, particularly in upstream and down stream markets.

Funding Horizon Power's losses through a cross-subsidy from SWIS network users is inconsistent with the framework and principles outlined above. The TEF creates an inefficient allocation of resources, equating to a wealth transfer between those customers in the SWIS and Horizon Powers regional customer base. Further to this the TEF impedes competition within WA energy and the efficiency seeking discipline expected.

Instead, Alinta advocates a direct funding approach[7] of the losses incurred by Horizon Power as a result of the Government's Uniform Tariff Policy. The provision of a CSO payment funded directed from consolidated revenue would represent an improved approach and ensure that any inefficiency are not borne by SWIS network users[8].

Incentives and Competitive Neutrality

Alinta considers having already set the TEC amount for the period 2009-10 to 2011-12, reduces the incentives facing Horizon Power to operate as an efficient service provider. For instance, Horizon Power may develop its operating budget process having certainty on the level of the TEC payment. This may enable Horizon Power to defer, bring forward or simply ignore potential efficient investment opportunities.

In addition to this, the TEF may distort the incentives to other government owned corporations. Funds accumulated through the TEF flow between Western Power, Horizon Power, Synergy and Verve – all government owned corporations. The use of these funds for each business varies through either providing an operating subsidy or financing debt, eventually providing a dividend to the WA Government. The nature of these arrangements:

- Has the potential to distort the decision making of these businesses;
- Is likely to be inconsistent with competitive neutrality principles; and
- Is likely to be more costly to administer than to simply provide a CSO from consolidated revenue.

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[7] The direct funding approach is the preferred methodology as per the Western Australian Governments CSO Policy.
[8] Economic Regulation Authority (ERA), Issues Paper – Inquiry into Funding Arrangements of Horizon Power, page 12.
This is highlighted by the Authority within the issues paper where it is noted the "*TEC constitutes 23 percent of the reference tariff for distribution network services on the SWIS, and results in an annual average increase in average distribution network tariffs of CPI + 17.7 compared with CPI + 2% if the TEC was to be exclude.*"

Transparency

Currently Alinta is unaware of the cost allocation process adopted by Horizon Power in distributing the TEC between supply regions. Alinta considers the determination of efficient, cost reflective electricity prices by the Authority provides an opportunity for the WA Government and the Authority to accurately account for the TEC.