Government of **Western Australia**
Office of **Energy**

Our ref: FIN/0102

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Inquiry into the Funding Arrangements of Horizon Power
Economic Regulation Authority
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OFFICE OF ENERGY'S SUBMISSION ON THE DRAFT REPORT FOR THE INQUIRY INTO THE FUNDING ARRANGEMENTS OF HORIZON POWER

Thank you for the opportunity to provide a submission on the Economic Regulation Authority's (Authority) Draft Report for its Inquiry into the Funding Arrangements of Horizon Power (Horizon). The Office of Energy (OOE) recognises and commends the effort both the Authority and Horizon have invested in this Inquiry to this point.

The OOE continues to support this Inquiry into Horizon and in particular the need to increase transparency around regional cost reflectivity. The Inquiry will inform future decisions on Horizon's funding arrangements and support the sustainability of regional service provision.

The OOE has addressed the issues raised by the Draft Report in our submission set out in Attachment 1.

The OOE notes that this is a Draft Report and that there are ongoing discussions with Horizon in a number of areas. This submission presumes that the Final Report will be informed by those discussions, public submissions and further analysis.

For further detail please contact Jason Dignard on 9420 5671 to discuss any issues raised in this submission.

Yours sincerely

ANNE HILL
A/COORINDATOR OF ENERGY

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The Office of Energy (OOE) continues to support the high-level objective of increasing the transparency of Horizon Power's (Horizon) service performance standards, expenditures and cost reflectivity to:

- facilitate the sustainable supply of reliable and efficiently provided electricity to regional customers;
- inform sustainable funding arrangements for regional electricity provision; and
- support the future significant economic growth in regional Western Australia.

Though desirable at a high level the OOE views that the Draft Report has largely focused on the goal of reducing the Tariff Equalisation Contribution. The OOE believes that this goal needs to be clearly balanced with the need to ensure sustainable regional electricity supplies. In this regard, the Terms of Reference clearly focus on the determination of efficient expenditures and efficient cost-reflective tariffs.

The OOE notes and has some concern that the Economic Regulation Authority (Authority) on a number of critical points has dismissed its expert technical advisor's findings. The Authority's divergence from Parsons Brinkerhoff's key findings lacked detailed justification.

The OOE recognises that this is a draft report and that there are ongoing discussions with Horizon in a number of areas. This submission presumes that the Final Report will be informed by those discussions, public submissions and further analysis.

The OOE's comments on the issues raised by the Authority's Draft Report are detailed below.

Service Level Standards

The Draft Report has used existing service standards detailed in the *Electricity Network (Network Quality and Reliability of Supply) Code 2005*. The Authority has not proposed a change to existing service standards.

The OOE had anticipated that the Authority might investigate the question of appropriate service level standards for Horizon's service areas and the impact of a variation in standards on the level of cost-reflective tariffs.

Understanding the relationship between standards and costs could inform assessment of the appropriateness of the present standards and whether, on balance of cost and service benefit, changes to standards might better serve the interests of customers and the public.

Capital Base

The OOE notes that the Draft Report excludes "gifted assets" from the State Government. For example, the Draft Report does not allow Horizon to include any capital expenditure associated with the Pilbara Underground Power Program (PUPP) into its capital base.

The OOE views that this is inappropriate as it does not recognise that the majority of the PUPP capital expenditure is funded by Horizon through an equity injection.

Like any other capital expenditure that Horizon funds, either through equity or debt, these expenditures should be rolled into Horizon's capital base and it is appropriate for Horizon and its shareholder to receive a return of and return on this investment. Similar to any other asset, Horizon will have to replace these assets at the end of their economic lives.

Presumably a portion of Horizon's present capital base initially required significant Government funding through equity injections at the time of construction, but the Draft Report does not appear to recommend discounting of Horizon's asset base on this ground.

Over-Budget Operating and Capital Costs

The Draft Report has recommended that over-budget operating and capital costs are borne by Horizon and not included in calculations of cost-reflective tariffs.

The OOE has some concern over the Draft Report's treatment of over and above budgeted amounts. The OOE's concern is that the methodology for determining cost-reflective tariffs should be about determining efficient costs rather than an exercise in forecast accuracy. It is important to recognise that there are various stages of forecast estimates and certainties and regional costs can be quite variable.

For Horizon to be penalised for pursuing efficient procurement practices but failing to have a forecast accuracy of 100% does not seem appropriate. If this was the case it would certainly increase Horizon's risk and therefore its required rate of return.

In cases where 'Government frameworks' have led to cost over-runs, for example the cost over-runs from delays in decisions on the South Hedland power station, the OOE views that Horizon should remain whole and if the Tariff Equalisation Contribution (TEC) will not cover these costs they should be covered by a direct Government subsidy.

Reduction in Capital Expenditure

The Draft Report has recommended a lower contingency allowance for non-generation projects, from 10% to 4.6%.

The Draft Report argues that this is in line with the Australian Economic Regulator and that the size of the capital program determines the project contingency risk. Electranet was used as a benchmark as its capital programme is of a similar magnitude.

The OOE has concern with the Draft Report's argument for lower contingency, as contingency is not just affected by capital program size but rather is impacted by where the work is done. In Horizon's particular case there needs to be a recognition of the geographic diversity of its service area and variability of Western Australian regional costs. The South Australian transmission business, Electranet, may not be directly comparable.

Efficiency Target

The Draft Report recommends an efficiency target of 1% real compounded per annum be applied to the 2009/10 level of controllable unit operating costs per connection.

While the Authority has recognized that much of Horizon's costs are not controllable in the short term, the proposed efficiency target seems arbitrary, very ambitious and could be unreasonably onerous if either or both of the selected base costs, or the reduction amount, is inappropriate.

- Over four years such an efficiency target equals a nominal reduction of approximately 17.0% (assuming a CPI of 3%).
- This arbitrary reduction fails to recognise any increased efficiencies built into Horizon's numbers.
- Horizon and the Authority have not been through this regulatory process yet and are likely still getting comfortable with the data. As a result it may be most appropriate that any efficiency target in this first period is conservative.
- Given the potential size of this reduction, the OOE believes the Authority should very carefully consider its recommendation. In particular it is noted that the draft recommendation is significantly more challenging that that suggested by the Authority's consultant, Parsons Brinkerhoff. In fact, Parsons Brinkerhoff reported that the large controllable costs of Corporate Overheads was within a benchmark range and was not unusual.
- The Draft Report acknowledges that efficient operating costs can increase where there is significant growth. While the Draft Report recommends a target built on cost per connection, it is unclear whether this approach would be effective or most appropriate in excluding the impact of growth.

Cost Escalation

The Draft Report recommends the eight cities CPI forecast as its preferred escalator for Horizon Power's cost base. Additionally, the Authority notes that if in later years actual efficient costs do exceed CPI then a future inquiry can correct for this. This is a forward looking adjustment and would not retrospectively compensate Horizon for the previous inquiry period.

The OOE has concern that the Authority is proposing to use a general escalator over escalator/s that more accurately reflect Horizon's specific regional costs going forward, potentially significantly understating movements in Horizon's costs and exposing Horizon to increased risks. The OOE views that it is appropriate to use the best escalator available, particularly if Horizon is taking on more risk by not being retrospectively compensated for poorly forecast cost escalation.

This is confirmed by Parsons Brinckerhoff's key finding that Horizon's "use of escalators is appropriate and this is backed up by two independent surveys and analysis of electricity industry materials and labour costs in Western Australia and Australia as a whole".

Source of Funds

The OOE supports in principle the Draft Report's recommendation that the TEC be funded by a Community Service Obligation (CSO) paid directly to Horizon.

If this is not to be the case the TEC funding method needs to be sufficiently flexible to allow Horizon to recover efficient costs rather than rigidly locking Horizon to long term forecasts of TEC.

Sustainable Operation in Horizon Power's Business Environment

It is important that Horizon's operating parameters are sustainable and reasonable for the business environment within which it operates as a Government-owned trading enterprise this includes paying down debt. To be viable, Horizon requires support through the TEC and/or directly from Government. While it is appropriate that these funds are managed to drive efficient operation, this limitation must not be unreasonable.

It is in the nature of large electricity businesses that there can be a significant time between action and effect. Consequently, it is possible that unreasonable targets might encourage insufficient asset maintenance and tardiness in expansion, not evident at first, but leading to poor service, inadequate capability, and a potential for costly and inefficient catch-up in later years.

In determining efficient expenditures it is important that the Authority's model include appropriate business viability criteria to assess the sustainability of Horizon over time.

Future Review

The OOE supports a second inquiry into Horizon to be undertaken in three years time to further review Horizon Power's actual costs, the impacts of the first Inquiry and consider new efficiency targets with an increased knowledge of Horizon's operations.