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

Attention: Sara O'Connor, Analyst

Dear Ms O'Connor

SUBMISSION TO DRAFT REPORT ON HORIZON POWER'S FUNDING ARRANGEMENTS

Western Power welcomes the opportunity to comment on the Economic Regulation Authority's (the ERA) draft report - *Inquiry into the Funding Arrangements of Horizon Power* (the Inquiry), released 16 December 2010.

Western Power will submit revisions to its access arrangement by 10 October 2011. In the context of Western Power's current progress in drafting these revisions to the access arrangement, please find comment on those issues relevant to the prudent and efficient operation of an electricity distribution and transmission business in Western Australia.

Western Power's comments to the Inquiry refer to recommendations 4, 7, 8, 9 and 10. It is Western Power's position that, in determining the:

- incentives to achieve efficient operating costs - it must be ensured that Horizon Power is provided with incentives to achieve cost efficiencies, rather than imposing arbitrary efficiency targets which are unlikely to achieve the objective of balancing benefits to customers and the service provider
- calculation of the weighted average cost of capital - the return on investment must be sufficient in order to attract financial capital in a constrained financial capital environment. This will reduce the likelihood of inefficient deferral of investment
- appropriate Tariff Equalisation Contribution (TEC) levels, funding and implementation - Western Power supports the ERA's recommendations regarding the provision of a direct Community Service Obligation (CSO) rather than collecting TEC from Western Power customers and supports the calculation of the TEC based on the net impact on government

<u>4. An efficiency target of one per cent compounded per annum be applied to the 2009/10 level of controllable unit operating costs per connection.</u>

Under the terms of reference for the Inquiry, the ERA is required to "consider and incorporate incentives for Horizon Power to develop and implement efficiency measures". Section 6.21 of the *Electricity Networks Access Code 2004* (the Access Code), requires that Western Power propose a gain sharing mechanism (GSM) which provides such incentives to improve efficiency in operating performance. While it is understood that the intent of the ERA's recommendation is to provide a similar incentive mechanism in the form of an efficiency target on controllable operating costs, Western Power does not agree that the proposed use of an efficiency target is appropriate and suggests that the ERA further assess the development of an incentive mechanism similar to the GSM.

The analysis undertaken by Parsons Brinckerhoff (PB) in the *Operating and Capital Expenditure Review* which justifies the proposed efficiency target for Horizon Power is overly simplistic and misleading. PB has plotted the price path for Victorian electricity distribution network businesses and inferred that the efficiencies necessarily flow through to operating expenditure. This is inappropriate to be used to determine an appropriate efficiency measure as the analysis ignores the main drivers for the downward trending price path, including:

- reductions in the Weighted Average Cost of Capital (WACC), noting that the WACC for the rural distributors was 1 percentage point higher than the other distributors prior to 2001[1]
- unanticipated demand growth resulting in the revenue earned being greater than the forecast building block revenue[2]
- the removal of metering and public lighting opex and management fees from related parties from the opex forecasts, effective from 2001[3]
- the removal of costs that were considered to be of a retail nature prior to the commencement of full retail contestability from the operating expenditure forecast, effective from 2001[4]

If PB were to analyse the variation in operating expenditure for the Victorian distribution network businesses, it would have noted that, while operating expenditure was on average 1% lower in real terms in 2001-05 than in 1999[5] ($351 million per annum compared to $355 million in 1999 across the five distributors, in July 1999 dollars), these costs increased by 21% in real terms compared to the normalised expenditure between the 2001-05 and 2006-10 regulatory periods[6].

It is understood that the ERA has used a number of reasons to justify the application of efficiency savings, including the high level of corporate overheads, the 'top heavy' nature of Horizon Power's organisation and to the lack of competitive pressure from the market, referring to Victorian electricity distributors. However, the ERA has failed to take into consideration other issues raised by PB, relevant to the efficiency of such a business, including but not limited to:

- the specific circumstances of a small, geographically dispersed business[7]
- that Horizon Power "undertakes good practice in monitoring the appropriate level of management structure required in its districts"[8]

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[1] Essential Services Commission, Victoria, Electricity Distribution Price Review 2006-10 Final Decision, Volume 1 Statement of Purpose and Reasons, October 2005, p.383

[2] Essential Services Commission, Victoria, Electricity Distribution Price Review 2006-10 Final Decision, Volume 1 Statement of Purpose and Reasons, October 2005, p.11

[3] Essential Services Commission, Victoria, Electricity Distribution Price Review 2006-10 Final Decision, Volume 1 Statement of Purpose and Reasons, October 2005, p.9

[4] Office of the Regulator-General, Victoria, Electricity Distribution Price Determination 2001–05, 2000, p.48-49

[5] Office of the Regulator-General, Victoria, Electricity Distribution Price Determination 2001–05, 2000, p.xii

[6] Essential Services Commission, Victoria, Electricity Distribution Price Review 2006-10 Final Decision, Volume 1 Statement of Purpose and Reasons, October 2005, p.8

[7] Parsons Brinckerhoff, Inquiry into Funding Arrangements of Horizon Power – Operating and Capital Expenditure Review, 27 October 2010, p.14

- new and revised processes, systems and methodologies recently embedded in the business[9]

PB's assessment of Horizon Power's controllable operating expenses does not indicate significant inefficiencies, as would be suggested by the recommendation of a reduction of 3% ($17.6 million) over the regulatory period. Furthermore, while initiatives identified as improving business practices will increase the rigour of the governance processes and quality of documentation, such improvements will not necessarily provide reductions in operating costs.

Western Power considers it appropriate to provide Horizon Power with similar incentives to achieve efficiencies such as those provided by a GSM under Section 6.21 of the Access Code. For the reasons outlined above it is unclear that the proposed recommendation for a 1% per annum efficiency saving would necessarily be effective, and achieve the objective of balancing benefits to customers and the service provider.

7. A real pre tax benchmark WACC of 6.49 per cent be used for regulatory modelling and calculation of cost reflective tariffs for this inquiry

The WACC is a critical component of a regulated business's revenue requirement as it provides for the return on both the regulated asset base and forecast capital expenditure. Western Power has an interest in the ERA's proposed WACC of 6.49 per cent, as Western Power is required to propose an appropriate WACC to apply to its covered network as part of its AA3 submission.

Western Power does not wish to comment on the ERA's recommended WACC value of 6.49 per cent for Horizon Power, but instead focus on the methodology used to calculate parameters from which the WACC is derived. In particular, Wester Power wishes to comment on the proposed methodology used to calculate the debt risk premium (DRP). At this time, Western Power does not support the ERA's proposed methodology used to calculate the DRP value.

The ERA's proposed DRP methodology is currently being reviewed, following the release of the Discussion Paper *Measuring the Debt Risk Premium: A Bond-Yield Approach* (Discussion Paper). Western Power made a submission to the Discussion Paper, in which concerns and comments regarding the proposed procedure for determining the DRP were highlighted.

Western Power's primary concern with the ERA's proposed methodology is that it will systematically underestimate the cost of capital for a regulated business. By underestimating the cost of debt, there is a significant risk that the return on investment will not be sufficient to attract funds and will ultimately lead to the inefficient deferral of investment.

Recommendations 8 and 9

Western Power does not support the use of the Tariff Equalisation Contribution (TEC), as it represents a substantial cross-subsidy between South West Interconnected Network (SWIN) and non-SWIN customers which ultimately results in a distortion of the actual cost of electricity. When calculating the contribution, either

[8] Parsons Brinckerhoff, Inquiry into Funding Arrangements of Horizon Power – Operating and Capital Expenditure Review, 27 October 2010, p.47

[9] Parsons Brinckerhoff, Inquiry into Funding Arrangements of Horizon Power – Operating and Capital Expenditure Review, 27 October 2010, p.8

through TEC or a direct subsidy, the net impact to Government should be considered.

Western Power is very supportive of the approach suggested by the ERA to replace the TEC with a direct Customer Service Obligation (CSO). This will mean that the extra funding required for Horizon Power to remain viable will come from all tax payers in WA, not just customers in the SWIN. This approach is also consistent with the provision of subsidies for other essential services in Western Australia, such as water.

10. Should the Government continue to subsidise Horizon Power through a TEC payment funded by SWIS network customers, the lower TEC should be gazetted. This will provide for the lower TEC to be passed through to lower distribution network tariffs in the SWIS.

Whilst Western Power does not support the use of the TEC, it acknowledges that if the TEC remains in place, it should be based on the net cost to government. This will also reduce any subsidy paid to Synergy as it will reduce the amount collected from Western Power customers through network tariffs.

However, thought should be given as to how this would be implemented, particularly for the 2011/12 pricing year. The price list detailing Western Power's tariffs for the 2011/12 financial year is required to be submitted for approval to the ERA by 28 April 2011. The ERA's final report on Horizon Power is due to be submitted to the Treasurer on 28 March 2011, allowing 28 days for tabling the report in Parliament it is uncertain if the lower TEC could then be gazetted with enough time to form part of the 2011/12 Price List.

Once again, thank you for the opportunity to comment on the draft report. Western Power looks forward to further considered discussions with the ERA on these and other issues ahead of the third access arrangement period.

Yours sincerely,

PHIL SOUTHWELL
GENERAL MANAGER REGULATION & SUSTAINABILITY

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