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

Submitted via email: publicsubmissions@erawa.com.au

INQUIRY INTO THE FUNDING ARANGEMENTS OF HORIZON POWER

Alinta Sales Pty Ltd (Alinta) appreciates the opportunity to comment on the Economic Regulation Authority's (the Authority) draft report of its Inquiry into the Funding Arrangements of Horizon Energy. A submission to the Authority's Issues Paper was made by Alinta Energy, the parent entity of Alinta, and while the attached submission is made by Alinta, it is also made on behalf of Alinta Energy.

Should you require any further information regarding Alinta's submission, or wish to discuss any details contained within Alinta's submission, I can be contacted on 9486 3749.

Corey Dykstra
Manager Regulatory Affairs
Alinta Sales Pty Ltd

ATTACHMENT

INQUIRY INTO THE FUNDING ARANGEMENTS OF HORIZON POWER

Funding Horizon Power through a Community Service Obligation payment

Alinta Sales Pty Ltd (Alinta) strongly supports the Authority's recommendation that the amount of Tariff Equalisation Contribution (TEC), which funds the losses incurred by Horizon Power in supplying electricity to consumers in regional and remote areas of Western Australia, be directly funded by Government through a community service obligation (CSO) payment to Horizon Power.

In response to the Government's Strategic Energy Initiative Issues Paper of March 2010, Alinta noted that governments often seek to achieve social objectives, at least in part, through non-transparent subsidies, including through non-cost reflective prices. Due to the non-transparent nature of such subsidies, recipients may be unaware of the extent of financial support that is being provided, the overall cost of such subsidies may be difficult to determine, and it may also be difficult to assess whether the subsidy is effectively targeted.

The current arrangements whereby electricity consumers in the South West Interconnected System (SWIS) are required to pay a tariff equalisation contribution (TEC) to funds the losses incurred by Horizon Power in supplying electricity to consumers in regional and remote areas of Western Australia in a prime example. As reported in the Authority's draft report of its Inquiry into the Funding Arrangements of Horizon Energy (the Inquiry), the cost of this compulsory levy is expected to jump by almost 125 per cent to $479 million for the three years from 2009-10 to 2011-12.

Requiring electricity consumers in the SWIS to fund Horizon Power's losses is at odds with the manner in which the $350 million loss incurred by the Water Corporation in supplying water and wastewater services to consumers in regional and remote Western Australia is funded. In that case, the Government makes a CSO payment from consolidated revenue to the corporation.

Moreover, the current cross-subsidy arrangements also undermine competition in the SWIS as it artificially increases retailers' operating costs, which is both likely to distort price signals that influence consumption decisions and decrease the competitiveness of new entrant retailers relative to the regulated tariffs required to be offered by the government-owned retailer, Synergy.

Amount of subsidy

It follows from the previous comments that Alinta does not support a continuation of the current arrangements, whereby the losses incurred by Horizon Power in supplying electricity to consumers in regional and remote areas of Western Australia is funded through a levy paid by electricity consumers in the SWIS.

However, if it were necessary for this practise to continue in the short-term, Alinta supports the Authority's recommendation that the amount of the levy imposed on electricity consumers in the SWIS should based on the efficient level of operating and capital costs expenditure needed to support the continued supply of electricity to consumers in regional and remote areas of Western Australia.

Operating costs

The Authority has recommended that Horizon Power should be subject to a (compounded) one per cent reduction in controllable unit operating costs (i.e. non-generation operating costs), which differs from PB's suggestion of an annual three per cent reduction in forecast controllable operating expenditure. Excluding the Authority's decision to remove operating costs incurred as a result of delays in obtaining funding approval for the South Headland power station project, the effect of the Authority's recommendation is to reduce Horizon Power's operating expenditure by $70.8 million over the period covered by the Inquiry compared with a $17.6 million reduction based on PB's approach.

While generally supportive of there being a mechanism to incentivise Horizon Power to efficiently reduce operating costs, Alinta considers there are some risks associated with the approach proposed by the Authority. Specifically, Alinta notes that the Authority justifies the proposed reduction in controllable operating expenditure on the following evidence.

- The high level of corporate overheads as a proportion of controllable operating costs.
- PB's observation that Horizon Power exhibits legacy processes and an organisational structure consistent a larger business that contributes to an apparent 'top heavy' organisation.
- The existing of two district offices in the Pilbara (West Pilbara district office in Karratha and East Pilbara district office in Port Headland), both of which are involved in running the NWIS.
- PB's recommendation of an annual three per cent reduction in controllable forecast operating costs.
- Horizon Power is not subject to competitive pressures from the market.

Alinta notes that while the Victorian electricity distribution business' have in the past achieved real operating unit cost reductions, the Australian Energy Regulator's (AER) final decision on Victorian Distribution Network Service Providers' proposed revisions to Access Arrangements in October 2010 approved significant increases in operating expenses for each of the five distribution networks. The AER commented that the additional expenditure was necessary "in the face of growing costs and demand", which appears to imply operating costs per kWh, or per connection, have increased. What is unclear is the extent to which past inefficiencies and/or previous economic conditions may have allowed businesses such as the Victorian Distribution networks to achieve real operating unit cost reductions.

In its Draft Report, the Authority also referenced the Network Pricing Reset undertaken by the Northern Territory Utilities Commission for Power and Water, which had a similar targeted reduction in controllable unit operating costs imposed on it.

Alinta understands that Power and Water was subject to a total factor productivity (TFP) comparative analysis in order to derive an efficiency factor over the regulatory period. This analysis compared a number of major regulated networks, the nature of their network and customer base, and allowed the derivation of an efficient benchmark company given the circumstances of Power and Water's network operation.

The TFP regulatory approaches allow for diversity in customer density, geography, climate and demand to be accounted for before deriving how a firm performs in terms of a determined efficiency frontier. Such an approach, if undertaken for Horizon Power, could provide evidence of Horizon Power's efficiency compared to an efficient benchmark business. However, in the absence of such supporting comparative benchmarking analysis, the relevance of the reduction in unit operating costs applied to Power and Water to Horizon Power is unclear.

That said, Alinta is supportive of the Authority's recommendation that any proposals by Horizon Power that would see future operating expenditure increase above those eventually deemed to be efficient being required to be submitted to the Authority for review and approval.

Return on capital

In the case of Horizon Power, its enabling legislation requires that it act 'commercially'. Consequently, Alinta supports the Authority's recommendation that a 'benchmark' WACC be used for regulatory modelling and calculation of cost reflective tariffs. Such an approach is consistent with that applied to other natural monopoly electricity and gas network businesses, including Western Power.

However, whereas in the case of other natural monopoly electricity and gas network businesses, tariffs for network services provided by the respective businesses are then set to recover an amount of revenue equal to efficient operating expenditure, depreciation expense and a return on capital (using the 'benchmark' WACC), this is not the case for Horizon Power. Rather, the Government as the owner of Horizon Power, and the provider of both debt and equity capital to the business, has chosen to set prices at levels that are not sufficient to recover these costs.

For this reason, Alinta strongly supports the Authority's proposal that if electricity consumers in the SWIS are in the short term to continue to subsidise the losses incurred by Horizon Power in supplying electricity to consumers in regional and remote areas of Western Australia, the amount of TEC paid by consumers in the SWIS should not be calculated using the 'benchmark' WACC. However,

However, rather than using the alternative WACC proposed by the Authority, which is applied that to the entire capital base in order to calculate the amount of the TEC, Alinta proposes that the amount levied from electricity consumers in the SWIS would reflect only Horizon Power's 'direct' revenue requirement, which would be calculated as follows.

1. Establish efficient operating and capital expenditure
2. Establish efficient return of capital (depreciation) expenses
3. Establish interest costs based on 'benchmark' financing structure

4. Calculate the 'direct' revenue requirement based on:
    a. efficient operating expenditure
    b. efficient return of capital (depreciation) expenses
    c. 'Benchmark' return on debt capital

The amount of the TEC to be levied from electricity consumers in the SWIS would then be calculated as the 'direct' revenue requirement less the amount of actual (or forecast) revenue earned by Horizon Power. Such an approach recognises that in practise, providers of equity capital generally receive dividends only after all other direct costs have been paid. That is, returns to equity are discretionary.

Further, Alinta also considers that given in this case the Government has effectively elected not to receive a return on its equity, it should not require electricity consumers in the SWIS to meet this discretionary 'opportunity cost' component of Horizon Power's costs.

Service Standards

In its draft report, the Authority notes that Horizon Power's large commercial customers with usage above 4.38 GWh per annum are unable to access uniform tariffs and pay 'commercial tariff rates'.

However, Alinta understands that within the SWIS, uniform tariffs generally only apply to small-use customers consuming less than 160MWh per annum. To the extent that uniform tariffs may be available to customers outside the SWIS that would not have been available to those customers had they been located within the SWIS, Alinta considers that any shortfall between the costs of supply and revenue should not be funded by the TEC.

Future Inquiries or periodic reviews

Alinta strongly supports the Government giving the Authority a further reference to conduct a future inquiry of the same nature as the current Inquiry ahead of the end of the current Inquiry period.

Alinta also considers that the approach adopted by the Authority for future inquiries might be strengthened by requiring that Horizon Power to undertake the following steps and/or processes.

- Establish an optimised regulatory asset base, using the Depreciated Optimised Replacement Cost (DORC) valuation method
- Conduct more robust top-down demand forecasting
- A detailed ex-ante capital program itemised by regulatory category
- More detailed scheme based tariff calculations, including greater level of transparency around the allocation of corporate costs

Alinta notes that a DORC valuation of Horizon Power's capital base would also prove to be a useful and necessary input in developing a transparent regime for third party access to Horizon Power's transmission and distribution networks.

Alinta Sales Pty Ltd
31 January 2011