

2 February 2011

Mr Lyndon Rowe
Chairperson
Economic Regulatory Authority
PO Box 8469
PERTH BC WA 6849

Dear Chairperson

**WACOSS SUBMISSION TO THE INQUIRY INTO THE FUNDING
ARRANGEMENTS OF HORIZON POWER – DRAFT REPORT**

WACOSS thanks the ERA for the opportunity to comment on its draft report regarding the inquiry into the funding arrangements of Horizon Power.

About WACOSS

The Western Australian Council of Social Service (WACOSS) is the leading peak organisation for the community, and represents 300 member organisations and individuals, and over 800 organisations involved in the provision of services to individuals, families and children in the community. Each year, WACOSS member organisations deliver community services to hundreds of thousands of West Australians.

WACOSS is part of a national network consisting of State and Territory Councils of Social Service, and the Australia Council of Social Service (ACOSS). Our national coverage strengthens our capacity to represent the interests of low income and disadvantaged West Australians across the breadth of State and National agendas.

Our Submission

WACOSS welcomes the opportunity to comment on the *Inquiry into the Funding Arrangements of Horizon Power- Draft Report*. WACOSS understands that this inquiry seeks to consider the level of Horizon Power's efficient operating and capital expenditure and determine cost reflective tariffs for each year over the inquiry period from 2009-10 to 2013-14. WACOSS broadly supports the recommendations made by the Authority to encourage increased efficiency in electricity service provision and the prudent use of public funds. The over-arching objective of WACOSS is a focus on sustainable funding arrangements that improves the accessibility and affordability of essential services for regional low income and vulnerable households.



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WACOSS comments on ERA's recommendations and other information are detailed below:

Escalation

WACOSS appreciates the Authority's decision to establish Horizon Power's efficient level of costs to supply electricity to regional Western Australia (WA). WACOSS positively notes that the Authority has scrutinised Horizon Power's use of escalators. This process is important as it creates transparency and accountability in funding arrangements, which ultimately affect energy prices for consumers.

WACOSS notes that Horizon Power has used escalators that have not been independently verified to forecast operating and capital expenditure costs like those of Western Power. We also note that Western Power's escalators that have been verified by Access Economics. WACOSS supports consistency across the operations of electricity corporations and encourages Horizon Power to use independently verified escalation forecasts in the future. Accordingly, WACOSS supports the Authority's decision to preclude certain escalators in Horizon Power's cost forecasts.

Service Standards

Horizon Power is the regional electricity service provider for the majority of the geographic area of WA, excluding the South West and Kalgoorlie. The service area covered by Horizon Power is 2.3 million square kilometres stretching from Kununurra in the East Kimberley, through the Mid West towns to Esperance in the South. WACOSS acknowledges the challenges Horizon Power faces in terms of time taken to reach the source of the problem to affect repairs; the size of the area of supply; and the remote and isolated nature of many towns in its service area. In view of these challenges, WACOSS commends Horizon Power for a significant decrease in the average total length of all power interruptions to their customers.

WACOSS submits that efficiency should be seen as one of several measures of the performance of Horizon Power. Any performance measures to improve efficiency should not compromise the standards associated with affordability, access and customer service. Therefore, WACOSS supports the Authority's recommendation to retain the existing service level standards for the inquiry period.

Initial Capital Base (ICB)

WACOSS agrees with ERA's recommendation to use a historic cost valuation of Horizon Power's Initial Capital Base (ICB) based on the review of available evidence by Technical consultants, Parsons Brinckerhoff (PB) and the reasons set out in the Draft Report. WACOSS observes that this method of valuation seems the most suitable for Horizon Power's current circumstances. WACOSS notes that the Authority recognises that this methodology is contrary to the frequent use, in regulatory economics, of a current cost valuation methodology, such as the Depreciated Optimised Replacement Cost (DORC) or Optimised Deprival Value (ODV) to establish an ICB.

The Draft Report sets out that the ODV requires the calculation of anticipated future revenue streams generated by each asset. The establishment of future income streams is dependent on the size of the Tariff Equalisation Contribution (TEC), calculated by the cost of service model, which uses the ODV as input. WACOSS notes the circularity of the argument and understands the complication of using the ODV for this inquiry. WACOSS also sees that the Authority has tested the sensitivity of the cost of service model to different values of the ICB, which had little impact upon the overall cost of service.

However, WACOSS understands that asset valuation is a significant element of Horizon Power's efficient revenue requirement. The value of Horizon Power's fixed assets is fundamental to the calculation of the allowance for both the return on capital and depreciation in the "building block" approach. Given that Horizon Power may continue to accumulate capital assets, WACOSS questions the accuracy and appropriateness of historic cost valuation methodology in the future. As the revenue requirement informs the Government's decision about the level of TEC payable to Horizon Power, WACOSS supports any steps taken to ensure a consistent ICB valuation in the lead up to subsequent inquiries.

Total Operating Costs

(i) Non-controllable costs

WACOSS acknowledges that Horizon Power has a decentralised approach to deliver electricity services to regional towns and remote communities in WA. A decentralised business operating model has the capacity to deliver environmental and consumer benefits through a diversity of energy options in a more flexible and responsive way. WACOSS supports approaches by service providers that focus on the improvement of accessibility and affordability of essential services.

WACOSS notes that Horizon Power has forecast average operating costs of \$329.3m (real at 30.6.09) per annum over the inquiry period compared to a historical annual average of \$237.7m (real at 30/6/09). The Draft Report sets out that Horizon Power's operating costs are predominantly driven by a level of non-controllable operating costs. For example, the cost of purchasing electricity from Independent Power Producers (88 per cent of the electricity sent out in 2009-10). The report explains that the additional energy purchases were made because of delays in obtaining approval for the South Hedland Power project from the State Government.

WACOSS strongly agrees with the Authority that costs due to delays in the budget approval process should not be passed onto residential customers. These costs should be borne by the State Government in the form of a Community Service Obligation (CSO). WACOSS notes that several new generation projects are in the pipeline and suggests that lessons be learnt from project planning and implementation processes to avoid any inefficient cost pass-throughs in the future.

(ii) Controllable costs

WACOSS notes the Authority's analysis of non-controllable operating costs but has concerns about the increase in controllable costs outlined in the report. The Authority comments that the main drivers are costs deemed 'overheads' by Horizon Power. The Authority attributes the clear increase in overhead operating costs to Horizon Power's current practice of the allocation of actual costs at the town/functional level and forecasting the majority of its operating costs at a district level.

The increase in overhead operating costs \$72.7 (real at 30/6/09) in 2009-10 to \$100.5m (real at 30/6/09) in 2010-11 is a cause for concern. WACOSS is aware that the adoption of Horizon Power's decentralised operating model has created an additional layer of district overhead costs. Technical consultants, PB, did not recommend any adjustments but benchmarked Horizon Power's costs and found that they were towards the higher end of the range.

Based on this concern, WACOSS stresses that Horizon Power should strive for efficiencies in controllable operating costs and supports ERA's recommendation to apply an efficiency target of one per cent compounded per annum to effect a reduction of \$105.8m in total across the inquiry period. WACOSS appreciates the comparison with Victorian electricity distribution companies to establish competitive operating costs given the lack of competition in regional WA. WACOSS recommends that the Authority review all WA energy retailer operating costs to enable some level of comparative analysis to be undertaken of those operating costs. Given the lack of contestability in electricity retail in WA's residential customer segment, WACOSS recommends that the Authority consider establishing benchmarks for driving efficiencies in controllable operating expenditure.

Capital Expenditure

A comparison of Horizon Power's historical capital spend over the period 2006-07 to 2008-09 with actual and forecast expenditure for the period 2009/10 to 2013/14 shows a significant increase. WACOSS is concerned that there appears to be an absence of information about any cost benefit analyses associated with Horizon Power's generation projects.

WACOSS recommends the systematic publication of cost-benefit analyses for future generation projects and more frequent use of audits. This would enhance transparency, clearly identify investment choices and provide useful lessons for capital investment projects. WACOSS recognises that generation projects are capital intensive and recommends that electricity corporations share information about the cost-benefit analyses of these projects with the Authority or the Government. WACOSS also suggests that the Authority places an emphasis on the importance of strategic decision-making processes at Horizon Power to drive operational cost efficiencies.

Return on Capital

WACOSS recognizes the Authority's impending decision on debt risk premium and that the new approach may change the proposed WACC for Horizon Power's funding arrangements. In this regard, WACOSS would like to direct the Authority's attention to our earlier submission on estimating the debt risk premium made on 7 January 2011. WACOSS presents evidence in relation to a preferred approach to the debt risk premium and suggests that the Authority consider recommendations made in that submission in conjunction with this one.

Tariff Equalisation Contribution (TEC)

Under the State Government's uniform tariff policy, regional WA customers outside the SWIS pay the same tariffs for their electricity as customers in the SWIS. The uniform tariffs are the same even though the costs to provide electricity to regional customers are higher than those in the SWIS. The difference between the cost to supply electricity and the revenue collected from Horizon Power customers is subsidised by the State Government in two ways.

The first is in the form of CSOs, which are funded through general taxation. CSOs can cover the funding of specific projects or programmes. The second is the TEC, which is funded by an additional charge, collected by Western Power as part of the distribution network tariffs. This charge is paid into the Tariff Equalisation Fund (TEF), which ultimately funds the TEC. The TEC ensures that residential customers connected to the SWIS cross-subsidise other customers outside of the SWIS. On the other hand, a CSO implies that the WA population contributes to the subsidy of electricity outside the SWIS rather than customers connected to the SWIS.

The Authority suggests funding the subsidy through a CSO instead of TEC. WACOSS notes that this funding approach would be consistent with the provision of subsidies across other WA essential services, such as water¹. However, WACOSS reserves a position on this recommendation pending the State Government's Tariff and Concession Framework (TCF) Review to explore tariff structures that increase the affordability and accessibility of energy across WA. The TCF Review is being conducted by the Office of Energy in partnership with WACOSS. The TCF Review will investigate options to improve cost-reflectivity arrangements in prices for electricity provision. WACOSS notes that the full effects on residential customers of cost-reflective pricing and current cross subsidies associated with the TEC are not currently fully understood. WACOSS suggests that the ERA's recommendation on the issue of funding arrangements be reconsidered after the TCF Review has been completed.

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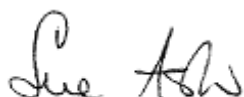
Absence of comment on any portion on the Draft Report or related preceding documents does not imply WACOSS's consent to the matter. No part of this submission is confidential.

Contact

Please contact Amelia Brancato, Senior Policy Coordinator - Essential Services, if you have any queries regarding this submission.

Thank you,

Yours sincerely



Sue Ash
CEO
WACOSS

¹ Electricity Retail Market Review: Final recommendations report, Review of Electricity Tariff Arrangements; Office of Energy Report to the Minister for Energy, January 2009; pp 35