Economic Regulation Authority
Promoting fair prices, quality services and choice

PUBLICATION

Inquiry into the Funding Arrangements of Horizon Power

FINAL REPORT TABLED IN PARLIAMENT

The Treasurer, the Hon. Christian Porter has released the Economic Regulation Authority's final report on its inquiry into the funding arrangements of Horizon Power. The inquiry followed a request from the Treasurer, on 17 May 2010, for the Authority to establish the efficient level of costs to supply electricity to regional Western Australia. The Authority was not required to provide advice on the level of actual retail electricity tariffs.

In the final report, the Authority has sought to determine the efficient levels of costs which would be incurred by a prudent regional electricity service provider acting efficiently and in accordance with good industry practice. This has required the Authority to determine, for the duration of the five year inquiry period (2009/10 to 2013/14), values for Horizon Power's:

- return of capital (or depreciation);
- rate of return on capital; and
- operating and maintenance costs.

From these elements, the Authority calculated Horizon Power's efficient annual cost to supply electricity to regional Western Australia and also the cost-reflective tariffs for Horizon Power's 34 electricity supply networks. The cost-reflective tariffs produced in the final report range from $0.28 per kWh for Lake Argyle in East Kimberley to $1.47 per kWh for Menzies in the Mid West. The cost-reflective tariff for the North West Interconnected System (NWIS) is $0.32 per kWh and $0.38 per kWh for Horizon Power as a whole. These compare to an equivalent figure of $0.19 per kWh for the South West Interconnected System (SWIS).

For the purpose of calculating cost-reflective tariffs, the Authority's key final recommendations are that:

- an inflation-adjusted historical cost asset valuation of $388.7 million be used for Horizon Power's capital base at 1 July 2009;
- a compounding efficiency target of one per cent per year be applied to the 2009/10 adjusted level of controllable operating costs per connection. This reduces Horizon Power's total forecast operating costs by $72.6 million over the five year inquiry period from $1,646.7 million to $1,574.1 million;
- Horizon Power's forecast capital expenditure programme be reduced by $43.4 million over the five year inquiry period, from $841.6 million to $798.2 million; and
- A real pre tax rate of return of 7.23 per cent be applied to Horizon Power's capital base.

All of the values above are real as at 30 June 2009.

From this information the Authority has also calculated the amount of the Tariff Equalisation Contribution (TEC), which is the subsidy paid to Horizon Power to fund the additional costs it faces in supplying electricity throughout regional Western Australia. The TEC is funded from network tariffs paid by electricity customers in the more densely populated areas of the State.

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The Authority made two recommendations that relate to the TEC. These are how the Authority considers the TEC should be funded and why and, if the TEC is to be retained in its current form, then how the TEC should be calculated. These recommendations are as follows:

- The TEC be funded by a Customer Service Obligation (CSO) payment direct to Horizon Power. This has the benefits of:
  - lower distribution network tariffs in the SWIS;
  - removing price distortion in the competitive markets that exist within the SWIS;
  - an earlier timeframe to achieve full retain contestability in the SWIS;
  - greater transparency around the overall level of subsidy for Horizon Power; and
  - being consistent with how other utilities are subsidised.
- Should the Government continue to subsidise Horizon Power through a TEC payment funded by SWIS network customers, the TEC should be calculated using a return on capital that reflects Horizon Power's actual cost of debt. This will provide for the lower TEC to be passed through to lower distribution network tariffs in the SWIS. The Authority notes that using a lower return on capital to calculate TEC will result in a shortfall in funding from the cost reflective revenue requirement for Horizon Power and suggests that this shortfall could be covered by an additional Government subsidy.

The recommendations result in a net present value saving of $44.5 million (for the period 2009/10 to 2011/12) compared to the TEC values published in the *Government Gazette*.

The Authority also recommended that another inquiry be undertaken in three years to enable a further review of Horizon Power's actual costs and to set new efficiency targets.

In preparing the final report, the Authority conducted two rounds of public consultation and overall received 23 public submissions.

A copy of the final report is available on the Authority's website.

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