Economic Regulation Authority

Notice

20 September 2018

Proposed revisions to the Western Power network access arrangement 2017/18 to 2021/22

Release of final decision

The Economic Regulation Authority has not approved Western Power's proposed access arrangement for 1 July 2017 to 30 June 2022.

The ERA's final decision sets target revenue of $7.3 billion that Western Power can earn over the five-year period. This is 6.7 per cent lower than the amount requested in Western Power's revised proposal.

The access arrangement is required under the *Electricity Networks Access Code 2004*, and sets out the terms and conditions, including prices, for third parties seeking to access the network.

The ERA has reviewed Western Power's access arrangement to ensure the network is operated and managed efficiently, for the benefit of all users in the South West of the State.

This decision will allow Western Power to raise network charges broadly in line with inflation. These charges are paid by electricity retailers, electricity producers, and industrial power users to access the network.

Network charges make up about 40 per cent of household power prices, so the flow-on effect to households is likely to be minor.

The State Government sets household power prices, and this small increase to network charges will be something it considers the next time prices are reviewed.

The ERA's final decision document details 66 amendments it requires for the access arrangement to be approved. There is an explanatory statement at the end of this notice

Further information

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EXPLANATORY STATEMENT

This explanatory statement provides interested parties with a summary of the ERA's final decision on proposed revisions to the fourth access arrangement for Western Power's network (AA4). This summary does not form part of the ERA's final decision or the reasons for the final decision.

The final decision

The ERA's final decision is to not approve Western Power's proposed revisions to the access arrangement for its network. The ERA requires 66 amendments to be made before it will approve the revised access arrangements.

Detailed reasons for the required amendments are outlined in the final decision document.

Table 1: Comparison of Western Power's proposals, and the ERA's draft and final decisions[1]

	Western Power original proposal	ERA draft decision	Western Power revised proposal	ERA final decision
Target revenue	$7,817 million	$7,380 million	$7,861.8 million	$7,333.3 million
Weighted Average Cost of Capital	6.09%	6.00%	6.12%	5.87%
Capital base at the beginning of AA4	$8,967 million	$8,917 million	$8,940.9 million	$8,907.0 million
Forecast capital base at the end of AA4	$10,414 million	$9,962 million	$10,260.0 million	$9,954.3 million
Capital expenditure	$3,515 million	$3,048 million	$3,388.4 million	$3,014.6 million
Operating expenditure	$1,805 million	$1,696 million	$1,830.5 million	$1,756.1 million

Next steps

Under the Access Code, Western Power submit an amended access arrangement proposal within 20 business days of this final decision, that is, by 19 October 2018.

The ERA will consider this amended proposal (if received) before making a further final decision to approve or not approve the revised access arrangement. If the ERA decides not to approve the proposed revisions, it must draft and approve its own revised access arrangement within 20 business days of publishing its further final decision.

Background to the final decision

This access arrangement covers the period 1 July 2017 to 30 June 2022.

1 All figures $ real June 2017.

The preparation and assessment of AA4 was delayed by the previous government's proposed changes to Western Australia's electricity market, which included transferring regulation of the Western Power network to the Australian Energy Regulator.

Legislation to enact the changes was introduced to State Parliament in June 2016, but it then became clear this legislation would not pass before the March 2017 election.

Consequently, Western Power continues to be subject to State-based regulation by the ERA.

To provide Western Power with sufficient time to prepare its submission, the Minister for Energy amended the Access Code to extend Western Power's submission deadline to 2 October 2017.

Western Power's third access arrangement (AA3) remains in effect until AA4 is approved.

The ERA released its draft decision on 2 May 2018, which was to not approve the proposed revisions to the access arrangement, with 91 required amendments. Following the decision, the ERA received submissions from 17 interested parties, as well as a revised access arrangement proposal from Western Power.

On 17 August 2018, the ERA published a notice advising of new information that could affect Western Power's rate of return, and commenced a new, limited round of public consultation. Submissions were received from three parties.

Target revenue

The ERA's draft decision set target revenue of $7.38 billion that Western Power can earn over the access arrangement period. This was 5.6 per cent below the amount requested by Western Power. The ERA also required Western Power to review its overall revenue smoothing profile (how it proposes to recover its target revenue over the whole access arrangement period) to avoid price shocks.

Western Power accepted these amendments "in principle", but proposed a different value for target revenue based on other changes to its revised proposal.

The ERA has not accepted Western Power's revised proposal, and set target revenue of $7.3 billion across the transmission and distribution network. This was 6.7 per cent lower than Western Power's revised proposal.

The Access Code requires an access arrangement to include a service standard adjustment mechanism, which details how the provider's performance against service benchmarks are treated at the next access arrangement review. The mechanism sets rewards/penalties for achieving/not achieving set levels of service.

In the draft decision, the ERA required the removal of rewards and penalties under the mechanism to ensure that customers would not be exposed to higher service costs in AA4.

In the final decision, the ERA has reinstated the rewards and penalties and set target levels of performance to ensure that Western Power has a firm incentive to maintain existing levels of service. The ERA made this decision after reviewing public submissions and expert advice which raised concerns that standards would fall without penalties.

Western Power's customers have said they are generally satisfied with existing levels of service performance and are not willing to pay more for a higher standard of service performance. Customers also did not want service performance to decline.

The ERA considered the approach used by the Australian Energy Regulator in similar schemes, and has set limits on rewards and penalties to ensure Western Power maintains service performance and does not over-invest in higher levels of service performance that customers do not want.

Price control

The Access Code requires an access arrangement to include a "price control", which determines how target revenue is to be recovered through tariffs.

Under Western Power's current price control, any difference in energy consumption or customer numbers compared with forecasts affect the tariffs paid by network users. This is because any under (or over) recovery of revenue compared to the target is passed through as adjustments to user tariffs in the following year's charges.

In its draft decision, the ERA considered that this placed all demand risk on users, and did not meet the Access Code requirements of enabling users to predict the likely changes in tariffs and avoid price shocks.

The ERA required amendments to remove the correction factor for over or under recovery of target revenue, and to ensure that the forecasts used to calculate Western Power's Price List each year are consistent with those used in the AA4 decision.

Western Power did not accept these amendments, and maintained its original position of retaining its current form of price control. Western Power and the Public Utilities Office questioned whether the draft decision would affect Western Power's ability to recover the Tariff Equalisation Contribution (TEC) costs, which Western Power pays to Horizon Power to subsidise the cost of providing electricity in regional areas.

Under the ERA's required amendments, the TEC will continue to be included as a separate factor in the price control formula. Each year the target revenue that Western Power can collect through its tariffs will be updated to reflect the gazetted TEC.

In its final decision, the ERA has maintained its requirement that the correction factor for over or under recovery of target revenue is removed, and that the forecasts used to calculate Western Power's Price List each year are consistent with those used in the AA4 decision.

Capital expenditure for AA4

In its draft decision, the ERA lowered Western Power's proposed capital expenditure by:

- 5.48 per cent for the distribution network
- 31.51 per cent for the transmission network

Western Power accepted some of the ERA's required amendments, and provided more information, including updated forecasts based on 2017 demand and customer numbers, to support its original proposal.

Advanced metering infrastructure

In its original proposal, Western Power proposed to bring in advanced metering infrastructure (smart meters), and a communications system to operate these meters. The ERA did not approve the communications expenditure in its draft decision.

Western Power did not accept this, and revised its proposal. However, Western Power still has not demonstrated that the proposal meets the new facilities investment test required by the Access Code. The test seeks to ensure that only efficient investment, which benefits all users of the network, is recovered through regulated tariffs. Only capital expenditure that meets the test can be recovered through regulated tariffs.

The ERA has decided that the communications expenditure in Western Power's advanced metering proposal does not meet the new facilities investment test and must be removed from the access arrangement proposal.

Operating expenditure for AA4

Under the Access Code, the ERA is required to review Western Power's forecast operating expenditure, to ensure it is efficiently minimising costs.

In its original submission, Western Power proposed operating expenditure of $1.805 billion ($695 million less than that approved for AA3). In its draft decision, the ERA set operating expenditure at $1.695 billion, removing some planned expenditure on business transformation and data asset replacement projects.

Western Power did not accept this amendment, and submitted a revised operating expenditure proposal of $1.83 billion.

In its final decision, the ERA set operating expenditure at $1.756 billion. Expenditure not approved included $28.3 million for Western Power's business transformation program.

Return on regulated capital base

The rate of return, based on a weighted average cost of capital, provides Western Power with a return on the capital it has invested in is business.

In its draft decision, the ERA did not approve Western Power's proposed rate of return of 6.09 per cent, instead, setting a nominal after-tax rate of return of 6 per cent.

In its revised proposal, Western Power argued that its rate of return should be 6.12 per cent, higher than its original proposal. While it accepted most of the ERA's draft decision, Western Power did not agree with the ERA's approach to calculating the market risk premium, which compensates an investor for the systematic risk of investing in a fully diversified portfolio.

In their submissions to the draft decision, ATCO Gas Australia and the Western Australian Major Energy Users also disagreed with the ERA's approach to both the market risk premium and the calculation of value of imputation credits (known as gamma), which accounts for the reduction in the corporate taxation generated by the distribution of franking credits to investors.

The ERA considered all submissions received from stakeholders, as well as new information released since the draft decision was published in May.

In its final decision, the ERA revised its approach to the market risk premium and gamma, including a minor correction to the debt risk premium parameter and set a rate of return at 5.87 per cent.

Further details on this decision are available in Appendix 5 to the final decision.