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

28 January 2011

Dear Sir

**Submission: Economic Regulation Authority's draft report on the inquiry into funding arrangements of Horizon Power**

The Funding Inquiry (the Inquiry) of the Economic Regulation Authority (ERA) will assess the efficient cost of supply of electricity in regional and remote Western Australia. As part of the Inquiry, the ERA will build up the tariff cost stack to reflect the elements of Horizon Power's cost of supply. This includes materials and labour expenses, electricity purchases, fuel, interest, depreciation, return on capital etc.

In the Draft Report released just before Christmas 2010, the ERA indicated that in its opinion Horizon Power's approach of escalating materials and non-labour costs by the Building Cost Index (BCI) was excessive and that the Consumer Price Index (CPI) was more appropriate.

This submission by KPMG focuses solely on this one issue and is based on our general business and commercial experience as financial advisors and consultants operating extensively in servicing companies operating in remote and regional Western Australia, in particular in the Pilbara region.

In Western Australia the outlook for the Pilbara region is extremely positive, off the back of continued strong growth in China fuelling sustained demand for commodities mined and exported from the Pilbara.

By way of illustration, we attach an extract from a paper prepared by the Chamber of Minerals and Energy of Western Australia (CME) on "Infrastructure to support Western Australia's Growth". The extract, section 7.2, refers to Pilbara infrastructure needs and highlights the intense level of activity and construction expected over at least the upcoming decade in the region. Figure 29 on page 59 illustrates the rapid increase in housing costs in Port Hedland.

Strong economic growth is forecast for the Pilbara (in particular) and a likelihood that this is going to lead to increased pressure on price levels. CPI being a metro-based index, is not likely

to be sufficient for pricing growth in labour and materials costs in the foreseeable future given base costs are much higher in regional WA.

We also attach an extract relating to the Pilbara from another paper prepared by CME titled "Developing a Growth Outlook for WA's Minerals & Energy Industry". This extract illustrates the expectation that increased activity in the minerals and energy sector (from iron ore, copper, gold, molybdenum and oil and gas projects) will drive a 40% increase in the resident population of the Pilbara.

Indeed, the ERA recognises that regional prices have probably risen at a faster rate than the eight capital cities' CPI in the past. The ERA notes that no reliable measure of regional prices over time exists.

CPI does not reflect the underlying inflation Horizon Power faces in the markets within which it operates. In the North West of the State, Horizon Power is competing with the resources sector and other industry sectors servicing the resources industry for labour and materials. Naturally, this drives up prices. The remoteness of the location also adds to increased prices due to the cost of landing and transporting goods in the region. The adverse variation in the prices of goods in regional Western Australia compared to Perth is generally recognised by ERA.

This is evidenced by the publication of a Regional Prices Index in 2007 by the Department of Local Government and Regional Development, and since 1983, Rawlinson's publishing has produced the Australian Construction Handbook which lists regional indices for all states. The Rawlinson's handbook, we understand, recommends a significant uplift for cost bases in regional and remote WA.

**KPMG has not formed any views on the appropriateness of BCI or any other index, but would have reservations with CPI being used as a basis to measure the expected increase in labour costs, material costs and non-labour costs in the Pilbara region in the upcoming decade and would recommend an independent study be undertaken to identify the most appropriate index to apply.**

Duncan Calder, the author of this letter, is a partner of KPMG. He was the Chairman of KPMG's Energy and Natural Resources Group W.A. for over a decade and has sat on the Infrastructure and Economics Committee of CME for close to a decade. He is also the President of the Australia China Business Council W.A. and often speaks at public seminars and conferences on the future of China and its implications for Australia.

Yours faithfully



Duncan Calder  
Partner