

ERM Power Ltd

**Submission to the Economic
Regulation Authority on the Issues
Paper on Western Power's Proposed
Revisions to the Access Arrangement
for the Western Power Network**

December 2011

1 Introduction

This document has been prepared in response to the Economic Regulation Authority (ERA) Issues Paper on Western Power's Proposed Revisions to the Access Arrangement for the Western Power Network 7 November 2011 (Issues Paper) and the Access Arrangement Information for 1 July 2012 to 30 June 2017 with supporting documents submitted by Western Power (AA3 Information).

2 ERM Power Ltd

ERM Power Ltd is an active participant in Western Australia's Wholesale Electricity Market (WEM) as well as in the National Electricity Market (NEM). In WA, ERM activities include:

- operator of NewGen Kwinana 320MW combined cycle gas turbine power station;
- part owner and operator of NewGen Neerabup 330MW open cycle gas turbine power station; and
- electricity retailer to commercial and industrial customers through ERM Sales.

ERM has a substantial presence in both the WEM and NEM, and therefore has experience with the daily operation of both markets. ERM frequently provides retail products to customers with operations in multiples states and our experience of market mechanisms and outcomes is regular and clear.

General comments

The rationale for charging generators a proportion of total network costs, eg 20% of TUOS, as carried through into the current approved AA pricing, is not discussed in the AA3 Information on which comment is sought. It is submitted that, in practice, this charge leaves generators exposed to open-ended changes in G-TUOS that are not quantifiable at the time of a power station investment decision. The total network costs to be imposed on generators needs to be limited to charges and on-going fees that are quantifiable, constituting efficient locational signals to intending generation investors, and that subsequent changes to network costs due to subsequent transmission developments should be precluded from being charged to existing generators, if not precluded from being charged to all generators.

There are fundamental considerations about G-TUOS which have been considered in depth in the development of the NEM, and which have led to G-TUOS being avoided for cost-inefficiencies, and to expressly avoid unnecessary electricity supply price impacts of upstream cost pass-through uncertainties, and rejected by the AEMC to the present day.

1. The recovery of TUOS from generators is economically inefficient because a generator will need to pass the cost to retailers, and then on to end-customers, and it has been argued in NEM considerations that end-consumers (who inevitably pay all the costs of electricity generation, distribution and supply) would end up paying the G-TUOS component with interest.
2. A component of network costs could be defined for generators as a standard fee, and the generator would account for such costs in the contractual arrangements it enters into upon commitment to the construction and commissioning of the new generation facility. By contrast, an open-ended and undefined variable charge cannot be hedged, creating uncertainty for new investors, and if this was to be the interpretation of the network charging, then new generators would not only contract to recover G-TUOS with interest, but with a greater risk premium for the uncertainty of future levels of G-TUOS that might be charged to cover greatly expanding network development, as is occurring in the SWIS at present.
3. The existence of the potentially expanding G-TUOS charges does not fund network augmentations for new entrant generators.

Comments on specific items in the Issues Paper

4.1 Recovery of Deferred Revenue from AA2

Submissions are invited from interested parties on the appropriate time period over which deferred revenue from AA2 should be recovered from network users.

ERM supports the ERA's stated preference for an appropriate time period for recovery of revenue over the life of the asset. The AA3 Information does not provide sufficient justification to use a shorter time period.

4.2 Rate of Return Issues

The Weighted Average Cost of Capital (WACC) proposed for AA3 is 8.82% compared to 7.98% in the last period. The parameters affecting the WACC and their proposed contributions are summarized in Table 76 of the AA3 Information. ERM did not find the supporting AA3 Information to provide compelling justification for the proposed increase in the WACC as the values proposed for some of the parameters are either too high or inappropriate.

The ERA has determined in a recent review that an appropriate rate of return for another monopoly infrastructure supplier with regulated assets, DBP, was 7.16% not the 10.76% sought.

ERM believes the ERA could critically review all aspects of the proposed WACC in the AA3 Information. Specific comments are provided below on some of the WACC parameters mentioned in the Issues Paper.

4.2.1 Benchmark Credit Rating

Submissions are invited from interested parties on the most appropriate benchmark credit rating for electricity transmission and distribution service providers in Western Australia.

See below.

4.2.2 Credit Rating for Government-Owned Public Utilities in Western Australia

Submissions are invited from interested parties on whether a benchmark credit rating should be applied to Western Power given the different risks faced by government owned public utilities, such as Western Power, in Western Australia.

ERM believes that the appropriate credit rating for Western Power should be that of the WA State Government rather than a benchmark against corporate bond rates as this better reflects the level of risk faced by holders of debt against WA Treasury Corporation.

4.2.3 Treatment of Taxation

Submissions are invited from interested parties on the most appropriate method of incorporating taxation liabilities in a service provider's revenue requirement.

ERM Power believes that the ERA could move to request information for NFIT applications to use post-tax nominal WACC as this better enables estimates of the actual return from the asset base.

4.2.4 Equity Beta

Submissions are invited from interested parties on the appropriate range or value for the equity beta for Western Power.

ERM believes that the ERA is well suited to investigate and determine whether the change in equity beta proposed can be supported or rejected.

4.2.5 Equity Raising Costs

Submissions are invited from interested parties on whether equity raising costs should be included in Western Power's revenue requirement and if so what is the appropriate methodology for calculating these costs.

ERM believes that the ERA is well suited to investigate and determine equity raising costs for Western Power and whether any can be justified for inclusion in revenue as a 100% State Government owned organisation utilizing the WA Treasury Corporation.

4.3 Investment from Prior Periods

Submissions are invited from interested parties on whether this investment from AA1 should be considered as 'speculative investment' and if so, should it be added to the AA3 capital base.

The AA3 Information does not provide sufficient information to justify the inclusion of \$244.4 million in the opening capital base for AA3 from capital expenditure during the AA1 period. In Appendix C of the AA3 Information the ERA is stated as having received additional confidential information. It also states that the Mid-West Energy Project is now proceeding whereas the ERA draft determination is to not approve its NFIT.

ERM believes the ERA could investigate and determine if the evidence provided by Western Power is compelling enough to reverse previous ERA determinations and the additional capital items now completely satisfy the NFIT and can be added to the capital base for the AA3 period.

4.3.1 Service Standards Adjustment Mechanism

Submissions are invited from interested parties on proposed revisions to the access arrangement to allow adjustments to target revenue in the next access arrangement period for the service standard adjustment mechanism proposed by Western Power.

AA3 Information contains proposals to change Western Power's Service Standards and hence its potential revenue. There is very little comparison of the current or proposed Service Standards to similar standards in Australia or overseas. One of the few comparisons in Figure 15 showed performance below the NEM average. AA3 Information would be improved by a comparison with best practice in Australia and overseas.

It is proposed to include a service standard relating to Western Power's call centre performance. Whilst this is an important service consideration it is not considered appropriate for inclusion as a separate revenue incentive target as it is not a good indicator for management of the asset base.

4.4.1 Mid-year Capital Expenditure Timing

Submissions are invited from interested parties on Western Power's proposed mid-year timing assumption for new facilities investment (capital expenditure), including:

- the appropriateness of a change in timing assumption from the historically (AA1 and AA2) approved approach for the current AA2 period and the future AA3 period; and*
- the impact of differences existing between the capital expenditure timing assumptions, depreciation timing assumptions and revenue collected timing assumptions.*

ERM believes that the ERA is well suited to investigate and determine whether the proposed change to mid-year capital expenditure timing can be supported or rejected.

4.4.2 Tax on Capital Contributions

Submissions are invited from interested parties on whether an amount for tax on capital contributions should be allowed to be recovered from all network users.

AA3 Information includes around \$240 million in target revenue from net tax costs associated with forecast capital contributions and gifted assets provided by Western Power customers. That is, all customers will be required to contribute to costs associated with assets that have been subject to specific requirements agreed between Western Power and the contributor. This does not seem the most efficient or appropriate means of cost recovery. ERM supports the view of the ERA that the contributor and Western Power should make arrangements that cover these costs rather than have all network users contribute to the costs.

4.4.3 Working Capital

Submissions are invited from interested parties on the need to include an allowance for a return on working capital.

AA3 Information includes a proposal to continue an allowance for a return on working capital as approved for AA1 and AA2. It was not mentioned that the ERA noted in its decisions for AA2 that other Australian regulators were questioning this allowance and that recently both the AER and the ERA had determined that monopoly service providers would only be likely to have working capital related issues if the organisation was not efficiently managed. ERM supports the view that an allowance for a return on working capital is not warranted.

4.5 Applications and Queuing Policy

Submissions are invited from interested parties on

- *the operation of the applications and queuing policy in the current access arrangement period;*
- *the revisions proposed by Western Power; and*
- *whether any revisions to this policy, in addition to those proposed by Western Power, are required to meet the requirements of the Access Code.*

ERM has experience with the existing Applications and Queuing Policy (AQP) and has reviewed the revised AQP proposed for the AA3 period. Whilst many of the changes could make general improvements to the current situation, where over 7,000 MW is currently in application on a network where annual growth is generally around 150MW, some specific comments are offered for consideration.

Where an applicant is prepared to proceed on the basis of an applicant-specific solution, the applicant will want some certainty around how long the process might take and there could therefore be appropriate time limits in the provisions as follows:

1. Clause 20.3(c) could require objectors to lodge their objections with 20 business days otherwise it will be deemed there are no objections.
2. Clause 20.3(d) allows Western Power 40 business days to consider objections and this does not seem efficient, so it is proposed that 20 business days be provided.
3. Clause 20.3(e) could, in the event that there are no objections, require Western Power to make an access offer within a period of 20 business days.

To allow technical disputes to go to arbitration as well, Clause 20.4 could be amended so that dispute resolution is available for applicants against a decision by Western Power.

5.1.2.2 Operating Expenditure

Submissions are invited from interested parties on the level of actual operating expenditure for AA2, and whether or not the actual costs are consistent with a service provider efficiently minimising costs.

Submissions are also invited from interested parties on the level of underspend in operating expenditure in the distribution network from the forecast in AA2.

Submissions are also invited from interested parties on the forecast operating expenditure for AA3, the methods used by Western Power to derive its forecasts, whether the forecasts should include an amount for efficiency gains in base operating expenditure, and the adequacy of Western Power's supporting information for this forecast.

It is noted that Western Power has not assumed any efficiency gains on base operating costs in its forecasts. This does not appear to align with the gains identified elsewhere in the AA3 Information nor with best practice management practices generally. ERM believes that performance standards that result in increases in efficiency are required and that these could be agreed with independent persons.

5.1.2.3 Opening Capital Base for AA3

Submissions are invited from interested parties on Western Power's calculation of the capital base values at the start of AA3 and, in particular, on whether Western Power has adequately demonstrated that new facilities investment in AA2 meets the requirements of the Access Code to be added to the capital base.

ERM believes that the ERA is well suited to investigate and determine whether the opening capital base proposed can be supported or rejected including whether the evidence provided by Western Power is compelling enough to reverse previous ERA determinations and the additional capital items now completely satisfy the NFIT and can be added to the capital base for the AA3 period.

5.1.2.4 Forecast Capital Base for AA3

Submissions are invited from interested parties on whether information provided by Western Power in the revised access arrangement information is sufficient for the Authority to be satisfied that the forecast capital expenditure may be reasonably expected to meet the new facilities investment test.

Submissions are also invited as to Western Power's proposed management plan and expenditure on pole replacements and reinforcements to reduce a public safety risk.

It is noted that the pole replacement program does not identify what proportion of the pole replacement program is for transmission services rather than distribution services.

ERM believes that the ERA is well suited to investigate and determine whether the forecast capital expenditure is likely to meet an NFIT and what parts of the proposal can be supported or rejected and in particular if any should be assigned to connected generators.

5.1.2.6 Return on Regulated Capital Base

Submissions are invited from interested parties on the rate of return (WACC), and various parameters, proposed by Western Power.

Please see earlier comments on 4.2 Rate of Return issues.

5.2.3 Reference Services

Submissions are invited from interested parties on whether the set of reference services included in the current access arrangement have proven to meet the requirements of users, and the requirements of section 5.2 of the Access Code.

Submissions are also invited from interested parties on the proposed revisions to the list of reference services and the proposed new non-reference service.

A major reference service item not discussed in the AA3 Information is a proposal for charging arrangements for constrained network connections. Moving away from a model of unconstrained network connection offers to constrained connections was an important part of Western Power's submission to the Office of Energy's Strategic Energy Initiative. It is an essential part of increasing the efficient utilisation of the network assets. ERM believes provision for these services needs to be addressed in the current information so that these services are available as soon as possible during the AA3 period.

5.3.3 Price Control - Proposed Revisions

Submissions are invited from interested parties on the changes proposed by Western Power to the side constraint on year-to-year changes in reference tariff components.

Western Power's AA3 Information proposes an increase in average transmission reference tariff of 12.9% for the first AA3 year followed by real increases of 4.5% for the remaining pricing years. This can be compared to the proposed increase in transmission operating expenditure which declines by 2.4% in the first AA3 year and then increases by 7.8% average over the remaining years. Figure 99 in the AA3 Information shows that the largest component towards the intended increase in tariff is the proposed return on investment which has been set too high as discussed at Section 4.2 above.

ERM believes that the ERA is well placed to critically review the proposed increases and advise what amounts have been adequately justified.

5.5.3.2 Service Standard Benchmarks - Proposed Revisions to Transmission Reference Services

Submissions are invited from interested parties on Western Power's proposed revisions to the service standard benchmarks, including:

- *the level of service standard benchmarks proposed by Western Power for AA3;*
- *the proposed exclusions for the measures of SAIDI, SAIFI, circuit availability and call centre performance; and*
- *whether the supporting information provided by Western Power is sufficiently detailed to enable users or applicants to determine the value represented by the reference service at the reference tariff.*

Submissions are also invited on whether Western Power's revised service standards are reasonable, given the levels of actual and forecast expenditures for AA2 and AA3.

AA3 Information proposes to amend the current service standards for Transmission services by:

1. decreasing the level of circuit availability from 98 to 97.3 % of total time;
2. removing five performance standards for the transmission network; and
3. replacing the above with customer service initiatives.

ERM believes it is unacceptable to replace network performance standards with a customer management plan.

5.6.3.2 The D factor scheme

Submissions are invited from interested parties on proposed revisions to the access arrangement to allow adjustments to target revenue in the next access arrangement period, including by:

- *the proposed gain sharing mechanism; and*
- *the “D factor scheme”.*

No comment.

5.7.3 Proposed Revisions

Submissions are invited from interested parties on any practical issues and/or difficulties experienced with the electricity transfer access contract during the current access arrangement period, and whether interested parties foresee any potential issues arising from the revisions proposed by Western Power to the electricity transfer access contract for AA3 that:

- *may impact on a commercially workable access contract, or*
- *might present difficulties for a user or applicant in determining the value represented by the reference service at the reference tariff.*

Among the changes proposed for AA3 related to ETACs are modifications to security requirements. It is proposed to amend the ETAC through the introduction of a new clause requiring users, on request, to provide updated security when the previous security provided is no longer equal to the charges for two months services. The principal of keeping current the amount of two months security can generally be supported provided this does not become a frequent administrative burden. To avoid this, a request could only be generated when the security amount falls below one month service charge. It is noted that a security is supposed to be a nominal amount and is not a guarantee to cover lost revenue.

A new clause is proposed in the ETAC (Clause 9(d)), which requires replacement security to be provided if the security is called on or if that security ceases to be enforceable for any reason (including as a result of the expiry of the security). ERM believes that a security is generally called upon in circumstances of hardship and an additional burden of replacing the security would not be welcome and may not be successful. If the security ceases to be enforceable then a remedy ought to be found and it is unlikely this will just be providing a replacement security.

A new clause is proposed in the ETAC (Clause 9(e)), which requires a user to provide alternative security when it has provided a parent company guarantee but its parent company ceases to have the resources to meet the user's obligations under the ETAC. A decline in the credit position of the parent company providing a guarantee is an example of where this may occur. ERM believes this could be supported provided there is no ongoing administrative burden. For example the parent company could have the obligation to advise Western Power rather than Western Power initiate a process that might result in ongoing annual assessments for example.

5.8.3 Proposed Revisions

Submissions are invited from interested parties on the operation of the contributions policy during the current access arrangement period and on Western Power's proposed revisions to the contributions policy.

ERM believes the ERA is well suited to investigate and determine the effect of the changes proposed to the contributions policy and that any potential cost increases have supporting justification.