CONSULTATION

Draft Decision on Western Power's Proposed Revised Access Arrangement for the Western Power Network

INVITATION FOR SUBMISSIONS

The Economic Regulation Authority has today published on its website a draft decision on Western Power's proposed revised access arrangement for the Western Power Network.

The Authority's draft decision has not approved Western Power's proposed changes to its network access arrangements.

The Authority's draft decision sets a cap of $6.8 billion[1] on the revenue Western Power can earn over the next five years. The Authority's cap on the allowed revenue is 34 per cent below the amount Western Power requested.

The Authority's draft decision results in average annual real tariff reductions for network services of around 0.4 per cent for the period from 1 July 2012 to 30 June 2017. In comparison, Western Power's proposed real increases of 16.4 per cent in 2012/13 followed by real increases of approximately 11 per cent for each of the following four years.

Network charges make up approximately 40 per cent of total electricity costs for residential customers.

The main differences to the cap on revenue between the Authority's draft decision and Western Power's proposal relate to a reduced weighted average cost of capital (i.e. the rate of return it receives on its assets), a lower allowance for capital and operating expenditure, and a longer period to recover revenue deferred from the second access arrangement period.

The detailed reasons for the Authority's decision are outlined in the draft decision document, together with 80 amendments the Authority requires to enable it to approve Western Power's revisions to the proposed access arrangement for the period from 1 July 2012 to 30 June 2017. An overview of the draft decision is provided in the attached explanatory memorandum.

INVITATION TO MAKE A SUBMISSION

Interested parties are invited to make submissions on the Authority's draft decision by **4:00 pm (WST) on Tuesday, 1 May 2012**.

[1] The forecast target revenue includes $906.9 million relating to the Tariff Equalisation Contribution (TEC) which is required to be paid by Western Power but does not fall within the Authority's approval process other than to ensure it may be recovered.

Submissions should be marked to the attention of Tyson Self, Manager Projects Access

Postal address: PO Box 8469, PERTH BC WA 6849
Office address: Level 4, Albert Facey House, 469 Wellington Street, Perth WA 6000
Email address: publicsubmissions@erawa.com.au

Confidentiality

In general, all submissions from interested parties will be treated as being in the public domain and placed on the Authority's website. Where an interested party wishes to make a submission in confidence, it should clearly indicate the parts of the submission for which confidentiality is claimed, and specify in reasonable detail the basis for the claim. Any claim of confidentiality will be considered in accordance with the provisions of the Access Code, sections 14.12 to 14.15.

The publication of a submission on the Authority's website shall not be taken as indicating that the Authority has knowledge either actual or constructive of the contents of a particular submission and, in particular, whether the submission in whole or part contains information of a confidential nature and no duty of confidence will arise for the Authority.

For further information contact:

General Enquiries

Tyson Self
Manager Projects
Ph: 08 6557 7900
Fax: 08 6557 7999

Media Enquiries

Richard Taylor
Riley Mathewson Public Relations
Ph: 61 8 9381 2144
Fax: 61 8 9381 3877

LYNDON ROWE
CHAIRMAN

29 March 2012

EXPLANATORY MEMORANDUM

The purpose of the explanatory memorandum is to provide interested parties with a summary of the Authority's draft decision on proposed revisions to the access arrangement for Western Power's Network. This explanatory memorandum does not form part of the Authority's draft decision or the reasons for the draft decision.

The Decision

The Authority today issued its draft decision on Western Power's proposed access arrangement revisions for the Western Power Network, which distributes electricity to more than one million residential and business customers stretching from Kalbarri to Albany and Kalgoorlie, and including Perth.

The Authority's decision does not approve Western Power's proposed revisions for the third access arrangement period, five years from 2012/13 to 2016/17.

The Authority's reasons have been set out in detail in its draft decision document, together with 80 amendments required for the Authority to approve Western Power's proposed revisions to the access arrangement.

Revenue Cap and Reference Tariffs

The Authority's draft decision allows for reductions in average electricity network charges of 0.4 per cent in each of the five years commencing 2012/13. These reductions, which are expressed in "real" terms, comprise a 10.6 per cent reduction in transmission tariffs and a 2.5 per cent increase in distribution tariffs in each of the five years.

Network charges make up approximately 40 per cent of total electricity costs for residential customers.

The main differences to the cap on revenue between the Authority's draft decision and Western Power's proposal relate to a reduced weighted average cost of capital (i.e. the rate of return it receives on its assets), a lower allowance for capital and operating expenditure, and a longer period to recover revenue deferred from the second access arrangement period.

These differences are summarised in Table 1 below.

Table 1 Comparison of Western Power's proposal and Draft Decision

	Western Power Proposal	ERA Draft Decision
Present value of target reference service revenue	$7,899.1 million	$6,133.1 million
Capital Expenditure previously disallowed as inefficient (real)	$244 million	$0
WACC[2]	8.82%	4.73%
Opening Capital Base for AA3 (real)	$7,098.0 million	$6,525.2 million
Forecast Capital Base for AA4 (real)	$10,414.8 million	$9,016.3 million
Capital Expenditure (real)	$5,079.8 million	$4,138.6 million
Operating Expenditure (real)	$2,713.6 million	$2,191.8 million
Present value of deferred revenue recovered	$756.0 million	$413.8 million
Forecast average network tariff increase on 1 July 2012	CPI + 16.4%	CPI - 1.0%
Forecast average network tariff increase on 1 July 2013	CPI + 11.1%	CPI - 0.7%
Forecast average network tariff increase on 1 July 2014	CPI + 11.2%	CPI - 0.4%
Forecast average network tariff increase on 1 July 2015	CPI + 11.4%	CPI - 0.1%
Forecast average network tariff increase on 1 July 2016	CPI + 11.5%	CPI + 0.2%

The details of amendments to be made to the access arrangement by Western Power are set out in the Authority's draft decision. However, key elements of the Authority's draft decision are summarised below.

Western Power's performance during the second access arrangement period

Western Power's total capital expenditure during the second access arrangement period 1 July 2009 to 30 June 2012 is estimated to be 39 per cent ($1.2 billion) lower than the $3.1 billion approved by the Authority. The major areas of under expenditure have been capacity expansion and customer driven capital expenditure, particularly on the transmission network. Notwithstanding this, Western Power has met or exceeded 34 of the 38 service level benchmarks over the first two years of the second access arrangement and, over this time, network service levels have shown an improvement from earlier years.

While there are a number of reasons for this underspend, including the impact of the global financial crisis on electricity demand and reduced new customer connections, the fact that Western Power still exceeded its service level targets in spite of substantial capital expenditure reductions indicates there was some inefficiency in its approved capital expenditure forecast for the second access arrangement period.

In previous access arrangement reviews the Authority has identified serious weaknesses in relation to Western Power's planning, design and governance of investment expenditure and inefficiencies in cost estimation processes. These findings led to the Authority excluding $261 million ($ as at 30 June 2009) of capital expenditure incurred in the first access arrangement period from Western Power's capital base.

Western Power notes in its proposed revised access arrangement that, in response to the criticism of the Authority and the Authority's technical adviser, it "sharpened" its focus on

[2] Western Power proposed a real pre-tax WACC, whereas the Authority's Draft Decision is on a real post-tax basis. The Authority has determined a real post tax WACC of 3.87%. To be comparable with Western Power's proposed WACC, the pre-tax equivalent of 4.73% has been shown in Table 1.

initiatives to improve strategic planning, delivery and compliance processes.[3] As a result, a number of capital projects included in the forecasts for the second access arrangement period were deferred or cancelled.

The Authority's technical consultant has observed that processes for managing the development and implementation of capital expenditure and operating expenditure projects and programs have improved since the second access arrangement review. Whilst the Authority notes the improvements in processes identified by its technical consultant, it is concerned that the technical consultant has identified there are still areas of weakness, particularly in relation to risk management and asset information. Potentially these weaknesses may lead to inefficient investment decisions.

Capital Expenditure for the Third Access Arrangement Period

Capacity Expansion and Customer Driven Expenditure

The Authority's technical adviser has identified $464.5 million in Western Power's forecasts for capacity expansion and customer driven expenditure which it considers is potentially overstated. The reasons for this include:

- specific projects which could be deferred;
- inefficiencies in specific projects;
- forecast increases compared to historical levels which are not adequately supported; and
- reductions in the demand forecast since the expenditure forecasts were prepared that would enable capacity expansion projects to be deferred.

Capacity expansion and customer driven capital expenditure, are subject to an investment adjustment mechanism which ensures that Western Power's target revenue is adjusted at the next access arrangement review for any forecasting error in relation to such expenditure. Expenditure higher than forecast can be recovered provided that it is demonstrated to be efficient expenditure.

Given that any capacity expansion or customer driven capital expenditure overspend that meets efficiency requirements can be recovered in the fourth access arrangement period, and given the significant capital underspend compared to forecast during the second access arrangement period, the Authority considers it prudent for the approved capital expenditure for the third access arrangement to be conservative. There will therefore be less likelihood that customers will be asked to pay more during the third access arrangement than needed to fund the actual capital expenditure requirement, and the incentive on Western Power to deliver only an efficient level of capital expenditure is likely to be greater as actual capital expenditure will be subject to more intense ex post scrutiny if it is higher than the forecast approved by the Authority.

Consequently, the Authority has reduced Western Power's capital expenditure forecasts consistent with the technical consultant's advice. If Western Power needs to spend more than the approved forecast then, provided it can be demonstrated to be efficient, the additional capital expenditure will be allowed for at the time of the fourth access arrangement review. Alternatively, the provisions of the Access Code enable Western Power to apply to the Authority at any time for pre-approval of capital expenditure forecasts.

[3] Western Power Access Arrangement Information, p. 62.

Wood Poles Expenditure in the Third Access Arrangement Period

The Authority has accepted Western Power's proposed wood pole expenditure for the third access arrangement period.

The poor condition of its wood pole population poses a high risk for Western Power because of the risk to public safety from unassisted wood pole failures and the potential for such failures to start bush fires that cause extensive property damage. Western Power's wood pole failure rate is significantly higher than other Australian distribution network service providers.

Western Power is proposing to significantly increase its wood pole replacement and reinforcement rates during the third access arrangement period and has included forecast capital expenditure of $748 million. Based on its current assessment of the condition of the wood pole population, Western Power considers it will take 20 years of elevated investment before it can reach a sustainable rate of replacement. Western Power has considered more aggressive timescales but considers the 20 year management plan is the most achievable approach.

In September 2009 Western Power was issued with an Order by EnergySafety which required, amongst other things, that all unsupported rural wood poles which do not comply with required standards be replaced or reinforced by 2015. This Order followed EnergySafety audits into Western Power's management of its distribution wood pole population that were undertaken in 2007 and 2009.

The Authority understands that EnergySafety considers Western Power's proposed wood pole management program is inadequate and that Western Power's preferred investment approach does not fully meet the Order's requirements.

Western Power's unassisted wood pole failure rate has also been the subject of a recent inquiry by the Standing Committee on Public Administration of the Legislative Council of the Western Australian Parliament.[4] The report of the Legislative Council's Standing Committee on Public Administration and the asset management review[5] undertaken for the Authority by GHD were both critical of aspects of Western Power's management of its wood pole replacement program.

The Authority notes that the level of wood pole renewal and replacement required in order to comply with the Safety Order is a matter for Western Power to resolve with the safety regulator, EnergySafety and is not for the Authority to determine.

The Authority's technical adviser considers that improvements in the efficiency with which wood pole inspections are undertaken and wood pole replacements are implemented are available, particularly if Western Power successfully addresses issues related to records management. However, the Authority considers any efficiency improvements should drive an increase in the rate of pole replacement and reinforcement rather than a reduction in the actual expenditure. The Authority therefore accepted Western Power's proposed expenditure on wood poles for the third access arrangement period.

Potentially the investment needed for wood pole management may change as Western Power further develops its understanding of what is required. To ensure that Western Power is incentivised to do this in an efficient manner, the Authority has decided that, for the third

4 Unassisted Failure: Report 14, Standing Committee on Public Administration, Report 14, Legislative Council, Parliament of Western Australia, January 2012.

5 GHD Asset Management System Review Final Report October 2011.

access arrangement period, expenditure relating to wood pole management should be subject to the investment adjustment mechanism. This will then enable efficient expenditure higher than forecast to be recovered and will provide Western Power with a return on that investment from the date it is incurred. Alternatively, the provisions of the Access Code enable Western Power to apply to the Authority at any time for pre-approval of capital expenditure forecasts. All of these provisions ensure Western Power is not constrained to only spend what is allowed in the current forecast.

Capital expenditure previously disallowed as inefficient

As previously mentioned the Authority excluded $261 million ($ real as at 30 June 2009) of capital expenditure incurred in the first access arrangement period from Western Power's opening capital base for the second access arrangement period. This was as a result of weaknesses the Authority identified in relation to Western Power's planning, design and governance of investment expenditure and inefficiencies in cost estimation processes.

Despite the fact that Western Power acknowledged that improvements needed to be made and has since embarked on a process of doing so, it has proposed that $244 million of the expenditure disallowed by the Authority should now be included in its capital base. The Authority's view is that any improvements made by Western Power to its processes since the last access arrangement review will not change the findings of the Authority in relation to past expenditure. Consequently, the Authority does not agree that the $244 million should now be added to Western Power's opening capital base.

Operating expenditure for the Third Access Arrangement Period

As is the case with capital expenditure, Western Power's operating expenditure during the second access arrangement period has been significantly lower than the forecasts approved by the Authority. Western Power's forecasts for the third access arrangement period include significant increases above the actual expenditure during the second access arrangement period.

The Authority's draft decision ensures only an efficient level of base operating expenditure and legitimate increases above that are included in the forecast for the third access arrangement period.

The Authority's review of operating expenditure, which was assisted by its technical adviser, has identified $95.1 million of inefficient expenditure relating to specific items which have been removed from the operating expenditure forecasts.

Benchmarking by the Authority's technical consultant has shown that Western Power's operating expenditure performance is relatively poor compared with its Eastern State counterparts. This would suggest there is significant opportunity to make further efficiency gains. The Authority also notes that Western Power's business case for its proposed strategic program of works, which is expected to cost more than $132 million over a period of five years, was justified on the basis that it would lead to efficiency gains, yet Western Power has not included these efficiencies in its forecast operating costs.

The Authority considers annual operating cost efficiencies of between 2 and 3 per cent could be achieved. For the purposes of the draft decision the Authority has assumed 2 per cent.

Return on Regulated Capital Base

Western Power has proposed a higher weighted average cost of capital (WACC) for its regulated capital base than the WACC approved for the second access arrangement period. The Authority does not consider this to be consistent with the prevailing cost of capital for a business of its type and has adjusted it accordingly.

The Authority has reviewed the debt risk premium and adjusted it to be in line with a credit rating of A- (compared with the previous BBB+) which more accurately reflects an electricity network service provider's risk profile.

The Authority has also adopted a post tax WACC which is consistent with the Access Code requirements and is in line with the practice adopted by nearly all regulators in Australia. The continued use of a pre-tax WACC would have over compensated Western Power for its tax liabilities.

Deferred Revenue

At the second access arrangement review, Western Power proposed an alternative treatment of capital contributions which had the effect of significantly increasing the revenue requirement. In its final decision, the Authority considered that to avoid price shocks (as required by section 6.4(c) of the Access Code) an amount of revenue should be deferred to subsequent access arrangement periods. The revenue was deferred in such a way to ensure it would have a neutral commercial effect on Western Power's business in present value terms.

Western Power has proposed recovering the full amount of deferred revenue over the five year third access arrangement period which would add $967 million to target revenue. For the purpose of this draft decision the Authority has adopted a period of 10 years and will review the recovery period and impact on prices when making its final decision.

Incentives

Incentive mechanisms to encourage Western Power to provide services to customers at an efficient cost form an important part of the regulatory regime. The incentive framework contained in this draft decision is designed to ensure Western Power provides services at an efficient cost. The incentive framework includes:

- the gain sharing mechanism – a mechanism to provide a reward for any out-performance of operating expenditure forecasts included in this draft decision;

- a Service Standard Adjustment Mechanism – a mechanism designed to reward (or penalise) Western Power for out-performing (under-performing) on its service performance against benchmarks;

- an assessment of the efficient capital expenditure during the second and third access arrangement periods; and

- an assessment of the efficient base operating expenditure during the third access arrangement, and the inclusion of a 2 per cent annual efficiency adjustment in operating expenditure during the third access arrangement period.

Tariff Equalisation Contributions

Tariff equalisation contributions (**TEC**) are an impost levied on users of Western Power's distribution network to fund the subsidy to Horizon Power to allow it to provide electricity services at tariffs that are uniform across the State.

The Authority considers the tariff equalisation contribution is not a cost related to the provision of electricity network services to Western Power's customers. However, the Access Code requires that Western Power be able to recover these costs. As Western Power has not yet been required, by a notice made under section 129D(2) of the *Electricity Industry Act 2004*, to pay a TEC into the Tariff Equalisation Fund during the third access arrangement period, Western Power has proposed an estimate of the amount. The Authority has estimated the distribution network reference tariffs on the basis of the approved target revenue plus an allowance for the expected TEC amount.

The Authority notes that if the tariff equalisation contribution was not included in Western Power's costs, network tariffs would be on average 5.7 per cent lower than the current levels.

INVITATION TO MAKE A SUBMISSION

Interested parties are invited to make submissions on the Authority's draft decision by **4:00 pm (WST) on Tuesday, 1 May 2012.**

Submissions should be marked to the attention of Tyson Self, Manager Projects Access

Postal address: PO Box 8469, PERTH BC WA 6849
Office address: Level 4, Albert Facey House, 469 Wellington Street, Perth WA 6000
Email address: publicsubmissions@erawa.com.au

ENDS

LYNDON ROWE
CHAIRMAN

For general queries please contact Tyson Self, Manager Projects Access on +61 8 6557 7900.

For media inquiries please contact Richard Taylor, Riley Mathewson Public Relations on +61 8 9381 2144.