



# WA ELECTRICITY MARKET REVIEW

Response to Discussion Paper  
12 September 2014

## CONTENTS

Executive summary .....	1
Background.....	1
Energy Networks Association.....	1
Electricity network context in Western Australia.....	2
Removing distortions in the electricity market .....	2
Competition .....	3
Contestable Metering framework.....	3
Full retail competition .....	3
Regulation of networks in WA region .....	3
Investment incentives for networks .....	3
National economic regulator and framework.....	6

## EXECUTIVE SUMMARY

The Steering Committee's Discussion Paper for the Electricity Market Review in Western Australia highlights some of the big challenges faced by governments across Australian States and Territories, about ensuring market structures are right, and that consumers have choice and competition in the market to empower them.

The Energy Networks Association (ENA) welcomes the clear recognition evident in the review's processes to date that in Western Australia the electricity networks have delivered reliable and safe supply at a cost which compares favourably in cost terms with networks across the National Electricity Market (NEM) jurisdictions.

The Discussion Paper raises issues of the sustainability and design of the range of government subsidies. The ENA considers there is a need for reform in the existing arrangements, which is critical to ensuring consumers and taxpayers interests continue to be protected into the future. The ENA considers that the primary focus of reforms in this area should be on developing a transition path to allow for removing of the Tariff Adjustment Payment.

In relation to the competition in provision of metering services, the ENA supports in principle a framework for contestable metering which facilitates service quality and supports customer choice. However, it is crucial that the framework for metering contestability does not jeopardise efficient delivery of services or network-level outcomes, which provide value to all electricity customers.

The ENA also considers that taking further reform steps to enable introduction of full retail competition are critical for delivering efficient consumer outcomes and choice. Full retail competition has resulted in significant innovation and cost savings to consumers in other Australian markets. In addition, competition, along with electricity and gas prices that better reflect the final delivered cost of energy, better enable users to make the right choices between the two fuel sources.

Another positive in the Discussion Paper has been a clear-eyed recognition of the fact that the right investment incentives and regulatory environment is critical to delivering efficient network investment over time. The Steering Committee's Discussion Paper acknowledges that a regulatory framework that offers poorer investment incentives, such as rates of return that are systematically below the efficient financing costs, represents a deterrent to efficient investment and potentially adds to a long term under-investment challenge that the Steering Committee discusses. Consideration needs to be given that the fact that

regulated entities must compete for investment finance with other infrastructure projects, both domestically and internationally.

It is a challenge that will need to be addressed. The ENA is of the view that there is a strong case for the same regulatory bodies and regulatory rules to cover electricity networks across all of Australia's States and Territories. The existing divergence in regulatory regimes represents a source of uncertainty and undermines the emergence of regulatory best practice. The difference in regulatory regimes also imposes unnecessary regulatory burden and has the potential to distort investment between individual jurisdictions. In this regard, the ENA considers that the requirements of chapters 6 and 6A of the National Electricity Rules should be extended to apply to electricity transmission and distribution networks in Western Australia and the regulatory function transferred from the Economic Regulation Authority (ERA) to the Australian Energy Regulator (AER). These reforms will complete the objectives of the Australian Energy Market Agreement with respect to promoting investment certainty and achieving greater national consistency.

## BACKGROUND

### ENERGY NETWORKS ASSOCIATION

The Energy Networks Association is the national industry association representing the businesses operating Australia's electricity transmission and distribution and gas distribution networks. Member businesses provide energy to virtually every household and business in Australia. ENA members own assets valued at over \$100 billion in energy network infrastructure.

The ENA welcomes the opportunity to make a submission to the Steering Committee's Discussion Paper for the Electricity Market Review in Western Australia, which was released on 25 July 2014. The Electricity Market Review is tackling some fundamental issues for the electricity market in Western Australia, primarily focusing around wholesale electricity market arrangements. This submission provides the perspectives of network businesses on the issues raised by the Steering Committee in its Discussion Paper.

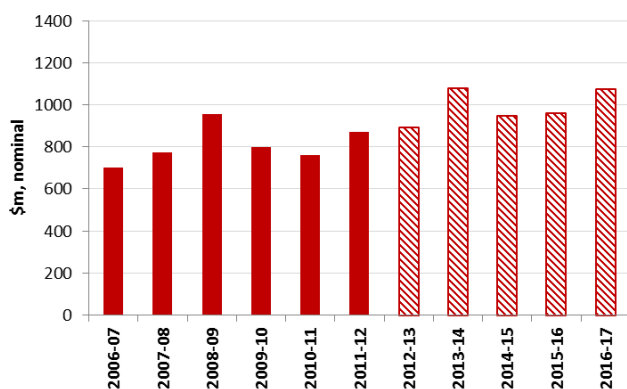
## ELECTRICITY NETWORK CONTEXT IN WESTERN AUSTRALIA

The Discussion Paper clearly recognises that in Western Australia the electricity networks have delivered reliable and safe supply at a cost which compares favourably to the rest of the country.

The Sapere’s analysis presented in the Discussion Paper identifies that network costs in Western Australia account for 37 per cent (including the TEC) of the final electricity bill.<sup>1</sup> This is below the national average despite the relatively low level of customer density on Western Australia’s electricity networks. The analysis also shows that when the network cost component is adjusted to remove the subsidy, Western Power’s prices are some of the lowest in the country.<sup>2</sup>

Western Power’s electricity network is currently facing high demand for investment, which is evident from the Economic Regulation Authority’s recent decision on the capital expenditure allowance for the third access arrangement. It is estimated that Western Power will need to invest \$6 billion (nominal) over the next 5 years. This capital funding requirement for Western Power comes in a context where it is already the State’s single largest borrowing entity and the State is seeking to regain a ‘AAA’ credit rating from independent rating agencies.

**Figure 1** Past and future capital expenditure<sup>3</sup> (nominal, \$m)



**Source:** ERA, Final Decision on Proposed Revisions to the Access Arrangement for the Western Power Network

The Discussion Paper points to the challenge for a capital-constrained owner to fund the approved capital expenditure. Electricity networks’ assets typically have useful

<sup>1</sup> WA Electricity Market Review Discussion Paper, p.27.

<sup>2</sup> WA Electricity Market Review Discussion Paper, p.28.

<sup>3</sup> ENA has converted the ERA’s final decision capital expenditure to nominal values using 2.1 per cent inflation assumption.

lives of more than 40 years. Investments in electricity infrastructure are also amongst the longest term investments made in an economy. Therefore, it is important to ensure sufficient investor confidence in the regulatory framework that provides for cost recovery, including commercial returns on invested capital, over the medium-term.

## REMOVING DISTORTIONS IN THE ELECTRICITY MARKET

The current level of subsidy in the electricity market is unsustainable, and there is a need for reform in these arrangements to avoid adverse outcomes for consumers and taxpayers into the future.

The Tariff Adjustment Payment (TAP) artificially constrains increases in retail electricity costs, thereby effectively discriminating against gas as a competitive supply source. The ENA considers that energy policies should be fuel neutral; otherwise they become an inefficient distortion in the market which harms the long-term interests of consumers.

Subsidised electricity tariffs also send incorrect price signals to consumers, which weakens incentives for energy efficiency, distorts investment signals to energy users and undermines efficient utilisation of both electricity and gas networks. The ENA considers that the reforms in this area should focus on developing a transition path to allow for removing the TAP.

The Discussion Paper stresses that the TAP paid to Synergy serves as a barrier to retail competition. The ENA shares this concern and considers it is important for the TAP to be delivered in a competitively neutral manner while it remains in place. There needs to be a clear process to transition away from general subsidies from taxpayers to energy users which may require a more targeted approach to the delivery of customer hardship measures where they are needed most.

In relation to the Tariff Equalisation Contribution, the ENA’s policy position is that consistent with competition policy objectives and policies in place across the Australian infrastructure sector this subsidy should be funded from the Community Service Obligation transparently funded from consolidated revenue rather than imposed on electricity customers in the South West Interconnected System.

# COMPETITION

## CONTESTABLE METERING FRAMEWORK

Should the network operator be subject to competition in the provision of metering and other services?

The ENA supports a framework for competition in provision of metering services, which facilitates service quality and supports customer choice. The framework for metering contestability, however, should not jeopardise efficient delivery of services or network-level outcomes, which provide value to all electricity customers. In addition, the network operator should be allowed to provide metering services to ensure that the objective of competitive tension is achieved.

There are significant network-related benefits of smart meters. These benefits include (but are not limited to) reduced network costs, service quality improvement (for example, by management of power quality and voltage fluctuations to safeguard customer appliances as well as network equipment) and improved safety and reliability of supply. Therefore, the framework for metering contestability needs to ensure that smart meters have functionality to support network services, as well as enable efficient and cost-effective network access to smart meter services. In addition, network businesses should be able to roll out smart meter infrastructure where it is the most efficient option (such as to delay or off-set network augmentation) and in the best interests of consumers.

The Australian Energy Market Commission is currently considering a rule change request that seeks to establish arrangements that would promote competition in the provision of metering services in the NEM. The ENA made a submission to this rule changes process that details its position. The submission is supplemented by a report from Energeia that identifies the potential network benefits of smart metering. The ENA's submission is available [here](#).

## FULL RETAIL COMPETITION

Should the retail electricity market be opened to FRC and should all retailers also be able to retail gas?

Full retail competition is critical for delivering efficient customer outcomes and choice and has resulted in significant innovation and cost savings to consumers in other Australian markets.

For example, in its *2013 Residential electricity price trends* report the Australian Energy Market Commission found that

electricity consumers in New South Wales and Victoria could save \$190 and \$240 respectively by switching from a standing offer to a market offer in 2012-13.<sup>4</sup> Consumers could make even greater savings by switching to the most competitive offer that was available in the market.

The ENA also notes that, competition, along with electricity and gas prices that better reflect the final delivered cost of energy, better enable users to make the right choices between the two fuel sources. Therefore, introduction of full retail competition in Western Australia's electricity market has the potential to reduce energy market distortions that disadvantage electricity against gas, without benefits to consumers.

## REGULATION OF NETWORKS IN WA REGION

### INVESTMENT INCENTIVES FOR NETWORKS

Regulatory outcomes in Western Australia currently offer poor investment incentives and potentially add to the long-term under-investment challenge identified in the Discussion Paper. Over time, poor investment signals (or a constrained capacity of public owners to recover the efficient cost to finance new capital investments) have the potential to adversely impact on the long term interests of electricity consumers across Western Australia.

The following characteristics of regulatory regime are required to ensure that sufficient investment flows in networks:

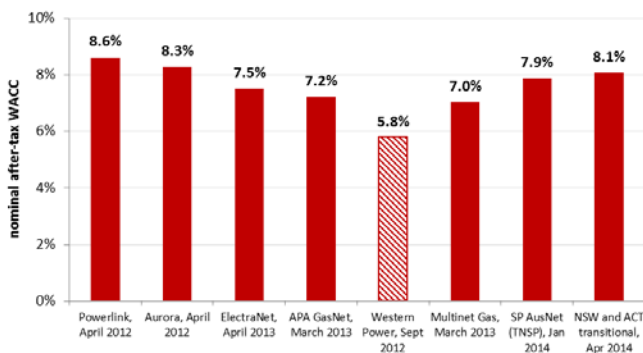
- » stability and predictability of regulatory outcomes,
- » adequate rate of return allowance, and
- » a capacity to access merits review process to allow for the correction of regulatory errors, and to strengthen the quality and accountability of regulatory outcomes.

The ERA provides the lowest rate of return allowance when compared to the AER's decisions made at around the same time.

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<sup>4</sup> AEMC, 2014 Retail Competition Review, p.102, p.154.

Figure 2 Cost of capital allowances (AER and ERA)



Source: AER and ERA regulatory determinations

The ENA also observes the ERA's aggressive application of the *ex post* prudency test in past access arrangement decisions for Western Power.<sup>5</sup> During the second access arrangement review for Western Power, the ERA's application of the *ex post* prudency test resulted in an across the board disallowance of 15 per cent of the capital expenditure incurred in the previous period.<sup>6</sup> There are no recent comparable precedents in the energy sector of such *ex post* disallowances, and regulatory rules (such as the National Electricity Rules) have generally constrained the scope for such extraordinary regulatory interventions due to the well-recognised effect of such actions on investment incentives.

Past regulatory decisions have long-term implications for the regulated industry. The established trends in the regulator's approach serve as a critical information source for future potential investors when they conduct assessment of investment options, as the treatment of past capital investment signals to investors the likely treatment of future capital investment.

The ENA notes that *Electricity Networks Access Code* (the code) does not unduly restrict the ERA's discretion in relation to determining the rate of return (in fact, the opposite is true). Similarly, the Code provides little guidance as to how the *ex post* prudency test should be applied. It is arguable that regulator's implementation of the Code has not contributed to enhancing investment certainty in Western Australia. Thus, it can also be concluded that the Code does not achieve the right balance between flexibility and certainty of regulatory outcomes.

<sup>5</sup> Under the *Electricity Networks Access Code* the ERA is required to undertake *ex post* reviews of capital expenditure to ensure that only efficient capital expenditure is added to the regulatory asset base.

<sup>6</sup> ENA, Response to Draft Determination Economic Regulation of Network Service Providers, p.126.

## Rate of return

A higher WACC would encourage network investment but could lead to an increase in network tariffs. Is this a necessary trade-off to achieve a reliable network?

Systematically lower WACC outcomes (which have been delivered by the ERA across gas and electricity network investments) will tend to discourage long-term investment in Western Australia's electricity network. Western Australia's rates of return are significantly lower than cost of capital determinations made for identical network investments in the NEM jurisdictions.

The Discussion Paper points out that the allowed rate of return for network businesses in the NEM has been an area of significant debate. This is to be expected because:

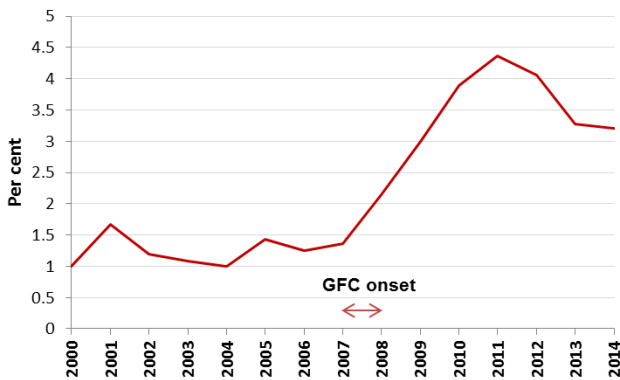
- » cost of capital decisions have substantial commercial implications for network firms,
- » there was a significant increase of equity and debt costs in the context of the Global Financial Crisis; and
- » there were significant errors established by the independent review body (Australian Competition Tribunal) in past AER decisions and analysis with respect to cost of capital.

In relation to the third point, the ENA notes that the *Electricity Industry Act 2004* provides for an appeal mechanism; however, to date the ERA's rate of return decisions for electricity networks have not been subject to appeal.

The Discussion Paper further observes that some industry commentators argued that the allowed rates of return in the NEM have been excessive. The ENA notes that concerns around the allowed rates of return in the NEM jurisdictions being too high were raised following a substantial increase in the cost of finance during the first phases of the Global Financial Crisis. During this period, debt margins effectively doubled and the increase in financing costs flowed through into the AER's electricity distribution determinations made in 2009-10. However, the rates of return approved by the AER in its recent determinations have been substantially lower.

As capital markets continue to recover from the Global Financial Crisis, debt margins have fallen significantly, resulting in substantial downward pressure on the rate of return. As an example of that, in the period of 2008-09 the median cost of capital allowances approved by the AER were in a range of 9.1 to 10.0 per cent. In the recent decisions the AER approved rates of return were around 7.2-8.1 per cent.

**Figure 3 Debt risk premium allowance in Eastern States**



Source: Regulatory determination, AER and former State and Territory regulators

In addition, the *National Electricity Rules* have recently been amended in order to address the perceived deficiencies in the rules, including concerns put forward by electricity users around potential incentives for over-investment. The revised rules provide for:

- » *ex post* assessment of capital expenditure, e.g. the AER has discretion to disallow some or all of the capital expenditure overspend to be included in the regulatory asset base,
- » clarification of the scope of the AER's capacity to accept, reject or amend proposal cost allowances, including through the use of benchmarking analysis, and
- » new provisions around the allowed rate of return, which allow the AER to select an approach it considers appropriate, provided that it considers all relevant information, estimation methods and models.

The revised *National Electricity Rules* provide additional checks and balances over past arrangements designed to significantly reduce the risk of over-investment.

The ENA observes that in its recent draft determination for railway networks, the ERA adopted more favourable assumptions in relation to the cost of capital when compared to the approach taken in electricity and gas access arrangement decisions. For example, the ERA adopted a 10 year term of the risk free rate and the debt risk premium, which compares to 5 year term assumptions adopted in electricity and gas. The ERA's indicative nominal post tax cost of capital is in a range from 6.5 to 12 per cent, depending on a railway network.<sup>7</sup> This outcome is one

example of alternative investment options that are available to investors.

Overall, the rate of return approved for Western Power appears to be too low to reliably attract ongoing private sector investment. As the government seeks to improve its fiscal position, this low rate of return has the potential to undermine the business's ability to fund the required capital expenditure

Establishing a framework in which government-owned businesses have the reasonable opportunity to recover a rate of return commensurate with the risks of the services they provide is also critical for public policy outcomes beyond establishing correct investment incentives.

Under the national competition policy framework, a critical goal of establishing stand alone corporatized businesses, targeting commercially comparable risk adjusted returns was to ensure governments had the capacity to measure and assess the performance of these firms, and be satisfied that the opportunity cost of the resources was properly recognised. The opportunity cost of public resources used to fund Western Power is, effectively, the public use that might otherwise be made of these financial resources (including education, health and public transport related services).

To the extent that the Western Australia's electricity regulatory framework provides an artificially low rate of return for network investment it results in the following outcomes:

- » Western Australia's taxpayers are not compensated for the economic cost of their investment in network infrastructure, reducing the financial capacity to fund other State services,
- » the regime entrenches the need for public funding resources to be directed to electricity network investment by failing to provide adequate incentives for alternative private capital sources, and
- » the corporate performance and accountability of the government-owned business is unable to be fairly assessed as intended by the corporatisation model. For example, limitations on capital investment programs due to macroeconomic or budgetary factors may impact both financial performance measures and be incompatible with a continuous and stable capital works financing program over the medium term.

<sup>7</sup> ERA, Review of the method for estimating the Weighted Average Cost of Capital for the Freight and Urban Railway Networks, p.127.



## NATIONAL ECONOMIC REGULATOR AND FRAMEWORK

Should the WEM adopt the NEM access regime?

The ENA supports that a national approach which sees the same regulatory bodies and regulatory rules cover electricity networks across all of Australia's States and Territories.

Different regulatory arrangements across jurisdictions:

- » contribute to uncertainty of outcomes, potentially deterring efficient investment and operation decisions of market participants,
- » increase the regulatory burden for potential investors and market entrants seeking to understand bespoke Western Australia's regulatory frameworks, and
- » have the potential to distort or deter investment decisions where inconsistent regulatory outcomes arise between Western Australia and other NEM jurisdictions.

These goals are reflected in cl. 2.1 of the Australian Energy Market Agreement<sup>8</sup> and should be addressed as a matter of priority.

Greater consistency should be achieved not only through the application of a common rules framework but its administration by a national economic regulator also. The potential for two regulators to interpret the same rules framework in a different manner was highlighted recently by the parallel development of the Rate of return guidelines by the ERA and the AER under the *National Gas Rules*. This experience demonstrated the potential for different institutional arrangements between jurisdictions to become a source of uncertainty and investment distortions. In their final rate of return guidelines, each regulator adopted a different methodology to estimating the cost of equity and the cost of debt. This difference extends even to the scope of information considered to be relevant in making an estimate of the prevailing cost of equity. Such a divergence in views on the same subject matter and under the same rules framework can not be justified.

The absence of interconnection with the NEM is not a valid reason for differences in regulatory determination process and tests by which the regulator assesses and approves regulated revenues. Administration of a largely duplicative regulatory framework represents an unnecessary cost to Western Australia's taxpayers by preventing economies of scope and scale in regulatory institutions and the emergence of regulatory best practice.

Further, moving towards the same set of regulatory bodies would provide the benefits of the existing institutional

arrangements in the National Electricity Market, e.g. Australian Energy Market Commission as a rule-making body and the Australian Competition Tribunal as a review body. Currently these are only partially captured in the Western Australia's energy market by virtue of the *National Gas Rules* framework being applied, by the ERA.

The Discussion Paper considers an option to move to a NEM gross pool, which would involve adopting all sixteen chapters of the *National Electricity Rules*. This would effectively mean that Western Australia becomes a region of the National Electricity Market. The ENA considers that requirements of chapters 6 and 6A of the *National Electricity Rules*, which guide economic regulation of network service providers, should be extended to apply to electricity distribution and transmission networks in Western Australia irrespectively. This could be the first step of Western Australia moving towards a framework that is built around a set of national rules and institutions.

The ENA stresses that regardless of the regulatory framework adopted; an important success factor for good customer outcomes is the freedom to appeal the regulator's decision. The *Electricity Industry Act 2004* provides for this to happen; however, when the ERA delivered its final decision on Western Power's Access Arrangement in September 2012 the Western Australia's Government issued a directive to Western Power not to appeal the ERA's decision.<sup>9</sup>

<sup>8</sup> Australian Energy Market Agreement, cl. 2.1 (b) (i) – (ii)

<sup>9</sup> Western Power, Amended proposed access arrangement information for the Western Power Network, p.8.