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Senate Select Committee on Electricity Prices
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Dear Committee Secretary

Submission on the Senate Inquiry on Electricity Prices

Thank you for providing the opportunity for the Economic Regulation Authority (**ERA**) to make a submission to the Senate Select Committee on Electricity Prices.

The ERA is the independent economic regulator for Western Australia. The ERA has two main functions: to act as Western Australia's economic regulator and to be an independent and transparent advisory body to the State Government.

In its regulatory role, the ERA assesses the terms and conditions, including prices, offered by owners of monopoly infrastructure to third parties in the gas, electricity and rail industries. It also licenses providers of gas, electricity and water services and monitors compliance with licensing conditions. The ERA also has a range of responsibilities in gas retailing and surveillance of the State's wholesale electricity market.

'Covered' electricity networks are regulated by the ERA under Western Australia's *Electricity Industry Act 2004* and the subsidiary *Electricity Networks Access Code 2004*. This 'Access Code' is distinct from the National Electricity Rules applying to electricity networks in eastern Australia. Western Power's South West Interconnected System (**SWIS**) is the only covered electricity network in Western Australia. In line with this regulatory role, the ERA recently released its final decision in relation to Western Power's third access arrangement, for the five year period 2012/13 to 2016/17.¹

The retail electricity market operating on the SWIS is only partially contestable. Those customers consuming less than 50 megawatt hours of electricity a year are supplied by a single retailer, Synergy (the Government-owned electricity retailer in the South West of Western Australia). Electricity prices for these non-contestable customers are regulated by the Western Australian Government, under electricity by-laws. All customers outside of the SWIS are contestable and can choose their retailer. However, Horizon Power – an electricity utility that is also owned by the State Government – is the only retailer in many regional areas.

In its advisory role, the ERA is required to inquire into and report on matters referred to it by the State Government. Inquiries, and the reports which follow, generally involve extensive public consultation carried out in an independent and transparent way. Unlike its regulatory

¹ Economic Regulation Authority 2012, *Final Decision on Proposed Revisions to the Access Arrangement for the Western Power Network*, www.erawa.com.au.

role, the ERA is not a decision-maker when undertaking inquiries or preparing reports, but simply makes recommendations to the State Government.

A recent inquiry reference from the State Government related to Synergy's efficient costs of supplying electricity. The ERA was tasked to investigate:

- the efficiency of the costs incurred by Synergy; and
- the efficient level of retail tariffs that electricity consumers in the South West of Western Australia would need to pay if retail tariffs were no longer subsidised by taxpayers.

In response, the ERA published on 5 June 2012 its recommendations on Synergy's retail tariffs for the four year period 2012/13 to 2015/16.² As noted, Synergy's retail tariffs for small non-contestable customers are set by the State Government, and it is anticipated that the ERA's work will inform the State Government's pricing decisions in forthcoming years.

The ERA published a similar report on cost reflective retail tariffs for Horizon Power in 2011.³ In particular, the inquiry examined the level of funding under the 'Tariff Equalisation Contribution' (TEC), which is levied on customers in the SWIS through the network charges, so as to provide for uniform tariffs across Western Australia. The TEC cross-subsidy supports the operations of Horizon Power.

The ERA considers that the findings from the reports referenced above have relevance for the Select Committee's inquiry with regard to the Terms of Reference 1a) and 1b). The findings are briefly summarised below.

The ERA's work is less relevant with regard to Terms of Reference 1c) through 1e). These relate more to matters of policy. The exception would be with regard to Terms of Reference 1 d) iv) and vii), where the ERA has a statutory role to manage licensing of electricity networks, retailers and electricity generators, as well as a requirement to report on the service performance by electricity utilities. The ERA would be willing to provide greater detail on outcomes in these areas should it be required. In the first instance, more information may be found at www.erawa.com.au/1/79/51/electricity_licensing.pm.

Final Decision on Western Power's Proposed Third Access Arrangement

The final decision for the period 2012/13 to 2016/17 is for network tariffs to remain virtually constant in real terms, rising by just 0.1 per cent per annum on average. This flattening off of network tariff increase follows increases averaging 13.6 per cent *per annum* in real terms over the period to 2006/07 to 2011/12.

The anticipated change in trend reflects:

- a levelling out of new capital expenditure, following rapid increases in previous years to support replacement of aging network assets and also significant new growth expenditure (the latter aligned with Western Australia's recent surge in resources related investment);
- a similar flattening of the change in annual operating expenditure, following rapid increases matching the growth in new capital expenditure.

² Economic Regulation Authority 2012, *Synergy's Costs and Electricity Tariffs*, www.erawa.com.au.

³ Economic Regulation Authority 2011, *Inquiry into the Funding Arrangements of Horizon Power: Final Report*, www.erawa.com.au.

Western Power's network tariffs contribute 40 per cent of current retail electricity tariffs in the South West of Western Australia. It follows that the sharp increases in network tariffs have been strong contributors to increases in retail electricity prices in recent years on the SWIS. Equally, with network tariffs now set to remain constant in real terms, there should be no upward pressure on retail prices from network charges over the next five years.

The ERA is reasonably confident that Western Power's capital base is not gold plated. In this context, the ERA's powers under the Electricity Networks Access Code allow it to exclude capital expenditure from Western Power's regulatory asset base that it considers inefficient. This power, which extends to forecast investment (*ex ante*), and to *actual investment* (*ex post*), has helped to ensure that capital expenditure is efficient.⁴ By way of example, \$261 million (\$ as at 30 June 2009) of incurred capital expenditure from the first access arrangement was disallowed in the second access arrangement decision.

This capital expenditure monitoring has contributed to Western Power improving its strategic planning, delivery and compliance processes. Nevertheless, the ERA considers that Western Power still has areas of weakness, particularly in relation to risk management and asset information, which potentially may lead to inefficient investment decisions.⁵

With regard to operating expenditure, the ERA noted in its final decision that benchmarking by its technical consultant suggests that Western Power's performance is relatively poor compared with its eastern States counterparts.⁶ The ERA concluded that significant efficiency gains were possible. To drive improved efficiencies, the ERA applied a 2 per cent efficiency requirement for operating expenditure for the third access arrangement period.

Synergy's Costs and Electricity Tariffs

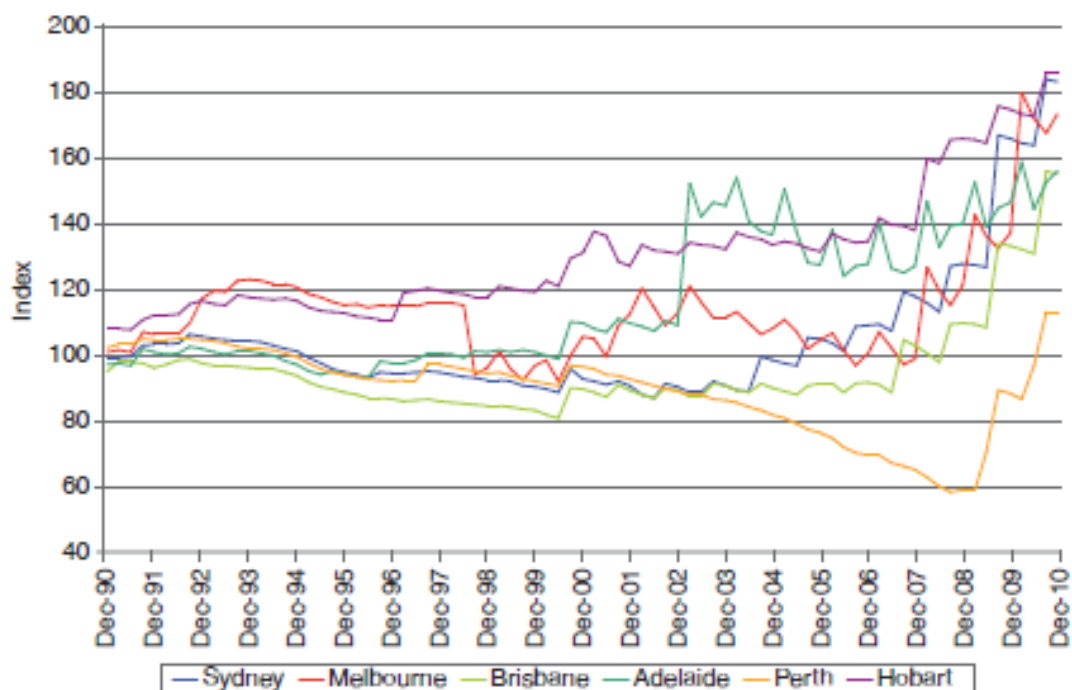
As noted above, residential electricity tariffs in Western Australia are set by the State Government. For ten years, between 1997 and 2007, the State Government had a policy of keeping tariffs unchanged. As a result, tariffs did not even keep pace with inflation, which increased by around 47 per cent during this period (Figure 1).

⁴ It is worth noting here that Western Power can request pre-approval for expenditure to reduce risk of adverse *ex post* review.

⁵ This was illustrated by the approach of Western Power to planning for augmentation for the Perth CBD, where the ERA disallowed expenditure in its draft decision, and Western Power came back with a completely revised project plan, which was subsequently accepted in the final decision (see Economic Regulation Authority 2012, *Final Decision on Proposed Revisions to the Access Arrangement for the Western Power Network*, www.erawa.com.au, p. 184).

⁶ Geoff Brown & Associates 2012, *Technical Review of Western Power's Comments on the Economic Regulation Authority's AA3 Draft Decision*, www.erawa.com.au, p. 41.

Figure 1 Index of Real Residential Electricity Prices in Australian Capital Cities



Source: Office of Energy 2011, *Tariff and Concessions Framework Review: Issues Paper*, p. 9.

Consequently, regulated retail electricity prices have had to increase sharply in recent years in Western Australia, in order to catch up to costs of supply. Since 2008, electricity prices have increased by 57 per cent for residential customers. The additional ten per cent increase over and above inflation addresses, in part, other cost pressures such as:

- higher costs of gas and coal, which are used as fuels for electricity generation;
- increases in the costs of operating Western Power’s network (see above), following a period of substantial underinvestment in that network;
- significant increases in the subsidy to Horizon Power, the electricity provider in the regional and remote parts of Western Australia – this subsidy is paid for by users of Western Power’s distribution network and is the result of the State Government’s policy of having uniform electricity tariffs across Western Australia for households and small businesses; and
- increases in the costs of complying with the Commonwealth and State Government’s renewable energy policies.

These cost pressures are subsiding. Efficient wholesale electricity costs are estimated to increase in only modest nominal terms over the period to 2015/16, which is equivalent to a forecast decline in real terms (Table 1).

Table 1 Efficient Wholesale Electricity Cost (\$/MWh, nominal) 2012/13 to 2015/16

	2012/13	2013/14	2014/15	2015/16
Wholesale electricity cost (incl. Capacity)	117.10	116.81	117.17	122.06
Carbon	16.95	17.76	18.61	21.10
RECs	10.81	7.76	7.79	8.57
Total	144.87	142.34	143.57	151.72

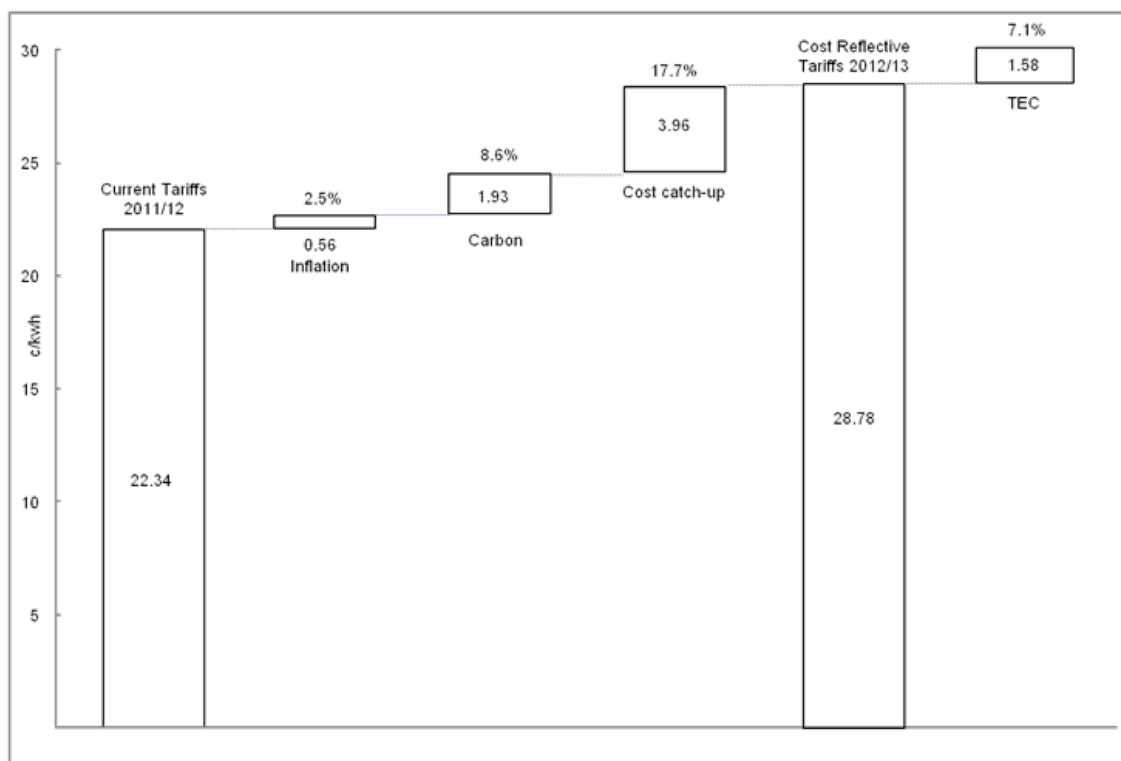
Source: Economic Regulation Authority 2012, *Synergy's Costs and Electricity Tariffs*, www.erawa.com.au, p. 61.

However, the ERA's report concludes that further increases would be required to achieve cost reflective electricity tariffs for small customers. Specifically, overall revenue from regulated customers, on average, would have to increase by approximately 21 per cent to achieve cost reflectivity, after allowing for the additional cost associated with the carbon pricing regime that took effect from 1 July this year. Figure 2 illustrates the estimated required movement from current tariffs to cost reflective tariffs, averaged across all customer categories (shown in c/kwh).

Horizon Power Costs and Electricity Tariffs

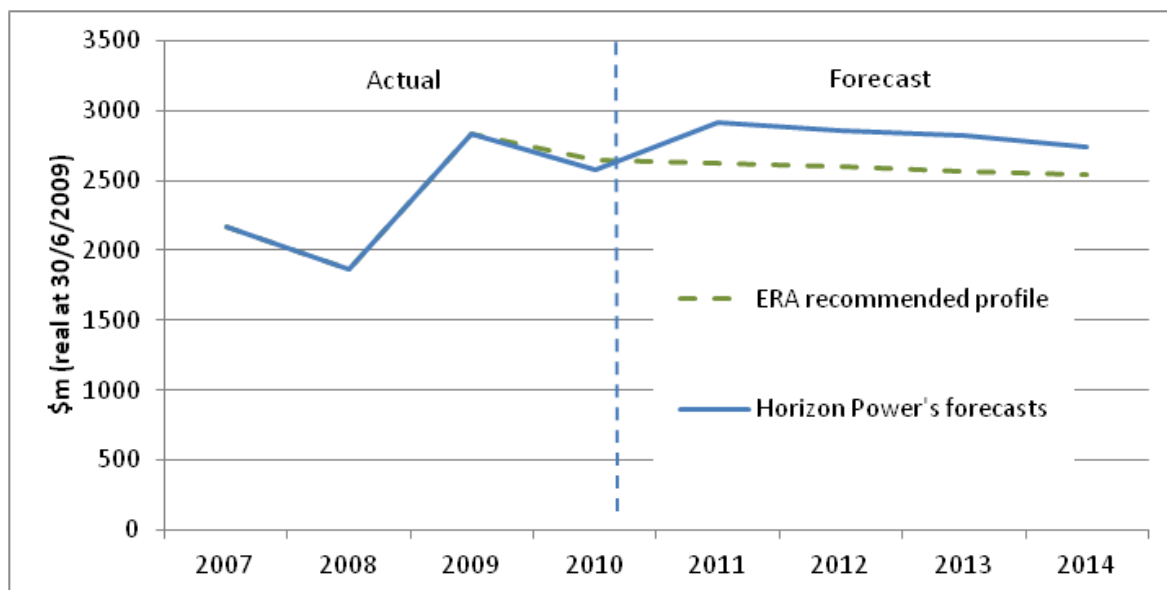
The ERA found that Horizon Power has faced similar cost pressures to Synergy. Nevertheless, as with Synergy, these cost pressures are levelling out (Figure 3).

Figure 2 Gap between Current Tariffs and Cost Reflective Tariffs in 2012/13 Averaged across all Customers



Source: Economic Regulation Authority 2012, *Synergy's Costs and Electricity Tariffs*, www.erawa.com.au, p. 11.

Figure 3 Final report – trends in controllable unit costs per connection based on Horizon Power’s forecasts and ERA’s revised recommendations (\$m real at 30/6/2009)



Source: Economic Regulation Authority 2011, *Inquiry into the Funding Arrangements of Horizon Power: Final Report*, www.erawa.com.au, p. 74.

Conclusions

Three recent reports produced by the ERA have found that the cost pressures for increases in retail electricity prices in Western Australia should subside over the medium term. This is in contrast to the sharp increases in costs in recent years. However, there is still some way to go before prices become fully cost reflective for all classes of customers.

Yours sincerely

LYNDON G. ROWE
CHAIRMAN

21 / 9 / 2012