Division 25: Economic Regulation Authority, $2 328 000 —

Mr P.B. Watson, Chairman.

Mr C.C. Porter, Treasurer.

Mr L.G. Rowe, Chairman.

Mr G.P. Watkinson, Chief Executive Officer.

[Witnesses introduced.]

The CHAIRMAN: The member for Cannington has a question.

Mr W.J. JOHNSTON: I refer to page 314 of budget paper No 2. Down the bottom in the little table it says "The efficient, safe and equitable provision of utility services in Western Australia." I ask whether the Economic Regulation Authority has given consideration to the appropriate rate of return on the assets employed by the electricity companies and what advice ERA might have on that topic.

Mr C.C. PORTER: As the member would be aware, the draft report suggested three per cent is the appropriate return. I will have Mr Rowe speak to that, but a draft report suggested a rate of return. Obviously, as we discussed earlier today, much hinges upon what is the appropriate rate of return. That determines the gap between the price and cost and what the cost reflective price is. It has implications for the budget in terms of dividends and tax equivalent payments returned. It is a very important issue. I am happy for Mr Rowe to speak directly to it.

Mr L.G. Rowe: I am happy to take the actual figure on notice. We have calculated rates of return for the two electricity utilities, Western Power and Synergy. The rate of return for Western Power was in our draft decision. On a real pre-tax basis, it was 4.73 per cent in the draft decision. On a real post-tax basis, it was 3.87 per cent. I need to emphasise of course that that is a draft decision. Submissions on that draft decision actually closed yesterday, so the authority will be considering those submissions on that draft decision with the aim of bringing out a final decision on that probably towards the end of July or early August. The other utility that we have put a rate of return on is Synergy. We have released a draft report on Synergy, in which Synergy was given the same rate of return as Western Power. The draft report was released some time ago now. The final report is due to the Treasurer on Friday this week.

[4.40 pm]

Mr C.C. PORTER: I cannot wait!

Mr L.G. Rowe: That report will become a public document in due course and the rate of return we determine will be in that report.

Mr W.J. JOHNSTON: The ERA also regulates a number of privately held assets. Does the rate of return that the ERA suggests for Western Power and for Synergy reflect the rate of return for those private assets that the ERA also regulates?

Mr C.C. PORTER: I will have Mr Rowe answer that directly. I would imagine that the ERA is looking at comparative private assets and what is a reasonable expectation for return on capital, but I am sure there is a more specific answer than that.

Mr L.G. Rowe: Traditionally, when regulators look at organisations, they do not differentiate between whether they are private or public. They tend to look at the benchmark rate of return. One of the crucial issues is the benchmark credit rating for the company concerned. In the case of other private companies that we regulate, in gas in particular, we have used a credit rating of BBB+. In the cases of both Synergy in the draft report and Western Power in the draft decision, we have used a credit rating of A-. That is based on an assessment of, in Western Power's case, for example, what we think is a comparative rate of return for distribution companies in the eastern states. It is done on the basis of a benchmark company.

Mr E.S. RIPPER: The government has instituted efficiency dividends in the government trading enterprises and I am wondering how that interacts, if at all, with the ERA's assessment of efficient costs for the GTEs. Perhaps the Treasurer or Mr Rowe could comment on that issue.

Mr C.C. PORTER: I will invite Mr Rowe to comment in a moment. From the government's perspective, we made a determination that GTEs were not operating at an efficient cost, so we slapped a five per cent efficiency dividend on them. The first round of that will return net debt benefits of $520 million. It was a relatively simple process; all the ministers communicated with the GTEs, the GTEs sent up plans and they were approved by the ministers. The only difficulties so far have arisen, to the extent that they are difficulties, with Verve. If it comes down to a ministerial direction, that will be the result.

I suggest that there was an operational level of fat on the GTEs, which is going to be cleaned out to a certain extent by the five per cent efficiency dividend followed by the 2.5 per cent and 1.5 per cent dividends. I am sure that Mr Rowe takes into account that all the GTEs are being subjected to this process in looking at the cost-effective operation of those GTEs.

Mr L.G. Rowe: The easiest way to illustrate it is, again, with Western Power. In our draft decision, we have assumed a two per cent efficiency dividend on Western Power's operational expenditure. We are still in the process of considering our final decision on Western Power. The ability of Western Power to respond to a five per cent efficiency dividend from government is something that we will take into account in that final decision.

Mr E.S. RIPPER: What is the impact on the government's take from the GTEs if the government has a five per cent efficiency dividend and the ERA assumes a two per cent efficiency dividend?

Mr C.C. PORTER: I will again get Mr Rowe to make some comments about that, because when Mr Rowe says he has assumed a two per cent dividend, I do not know exactly whether that refers to the first round of efficiency dividends, which was five per cent, or the second round, which is 2.5 per cent and then 1.5 per cent. The five per cent happened in last year's budget so it is underway. It has largely been achieved and the savings are already starting to flow.

Mr L.G. Rowe: Our role is to assess the proposal that Western Power puts to us. The base year of assessment for operational expenditure was 2010–11. Based on that base year starting point and based on what Western Power put to us, we have indicated in the draft decision that we want a two per cent efficiency dividend on operational expenditure over the next five years for the access arrangement starting on 1 July this year. As I said, we are still in the throes of reviewing the submissions we received in response to the draft decision. We will take this matter into consideration.

If Western Power is able to do better than our two per cent under that five-year period, that would be a benefit to Western Power and ultimately to the government in dividends, but we would then reassess the starting point for an efficient level of operational expenditure at the next access arrangement, taking into account the efficiency gains it had achieved.

Mr E.S. RIPPER: I am seeing a scenario in which Western Power is allowed to charge prices on the basis of, say, a two per cent efficiency dividend, which would result in a higher price than if it were subject to a five per cent dividend. If the government were to then come in with a five per cent efficiency dividend, that would increase the government's revenue take from utilities while at the same time delivering nothing to consumers.

Mr C.C. PORTER: I thought the member's question was to suggest that a body such as Western Power was in effect being squeezed twice—once by the ERA, at least theoretically, and once by government.

Mr E.S. RIPPER: No. Western Power is allowed a price level, which consumers have to bear, based on a certain efficiency dividend, but that body is then subject by the government to a higher or different efficiency dividend, which, had that been applied in the first instance, would have benefited consumers, but, being applied in the second instance by the government, benefits government revenues.

Mr C.C. PORTER: The point to note is that the efficiency dividend applied to an organisation such as Western Power—this question was asked earlier by the member for Victoria Park—is a percentage calculation of a portion of Western Power's budget, which is its discretionary expenditure budget. The two per cent that the ERA looks at is somewhat broader.

Mr L.G. Rowe: I need to stress that the two per cent is in our draft decision, so the member will have to wait for the final decision.

Mr E.S. RIPPER: I have heard that.

Mr L.G. Rowe: In a sense, the member is right. It would also be the case that that would apply only for the length of this access arrangement. We would then expect to base the next access arrangement on the basis of an efficient level of cost at the end of that access arrangement. To the extent that Western Power can achieve significant efficiency gains, it may benefit from that in the short term and the consumer would benefit in the longer term.

Mr W.J. JOHNSTON: There is some comment that AA3 starts on 1 July, but it does not come down until September. Is there any impact from the delay in the final decision?

Mr C.C. PORTER: I am not aware that there is.

Mr L.G. Rowe: We had a request from Western Power to adjust its tariffs from 1 July this year. The authority released a notice saying we refused that. Current tariffs will continue until such time as our final decision is in place, at which stage, if an increase is required, that will be made up in tariffs.

Mr W.J. JOHNSTON: This is a general question, but I refer to "Relationship to Government Goals" on page 314. Has the Treasurer referred any economic or regulatory issue for advice to the ERA in addition to the Synergy referral?

Mr C.C. PORTER: They are the sorts of general referrals on matters of policy. Water Corporation was another issue that was referred. There are also general referrals on policy. We are in the process of developing some terms of reference for a somewhat broader look at microeconomic reform issues in Western Australia, which is probably an area that has been a little underdone in recent years. The insurance market and household insurance issue also will be subject to the reference.

[4.50 pm]

Dr M.D. NAHAN: I refer to the heading "Relationship to Government Goals" on page 314 of the budget papers. In terms of the Economic Regulation Authority, how far are current electricity prices from cost reflectivity?

Mr C.C. PORTER: I will have Mr Rowe give a response in a moment. As we discussed earlier, that depends on the rate of return on capital that is expected to apply. The draft report that Mr Rowe and the ERA released was based on those pre-tax and post-tax assumptions of 4.8 per cent and 3.7 per cent. Based on those assumptions, Mr Rowe can give the member a figure in a moment. That is not the figure that the planning is around at the moment, because Treasury has relied on a somewhat older figure. The final report will be critical, because when it determines the actual rate of return, that will determine the gap between the price and the cost. I think the answer that Mr Rowe is likely to give now is based on the preliminary report and the two pre-tax and post-tax return rates on capital.

Mr L.G. Rowe: The Treasurer is right. This is based on our draft report. As I indicated earlier, our final report will go to the Treasurer on Friday. I also need to preface the figures I am going to give by saying that we were asked to identify Synergy's efficient costs and therefore what would be cost-reflective tariffs reflecting on those efficient costs. The authority took the view that the tariff equalisation contribution is not an efficient part of the electricity business; it is a government decision. The impact of the TEC is not included in the figures I am about to give. I will give the member two sets of figures. One figure we gave is for the overall impact on regulated tariffs across all regulated customers and the other figure, in which there is more interest, is for the impact on households. According to our draft decision, the impact on regulated tariffs was 15.8 per cent and the impact on residential customers was 23.1 per cent.

Mr E.S. RIPPER: I refer to the third dot point from the bottom of page 315, which refers to new funding regulations to increase the proportion of regulatory costs recovered by the authority from industry. I assume that this means that both government-owned utilities and the private sector will be paying more to the ERA. I want to know how much more and whether the additional revenue is incorporated in the forward estimates.

Mr C.C. PORTER: I am informed that it is. It is about $4.8 million.

Mr W.J. JOHNSTON: Is that over the forward estimates?

Mr C.C. PORTER: That is on an annual basis.

Mr E.S. RIPPER: Of that $4.8 million annually, how much would be paid by government-owned utilities?

Mr C.C. PORTER: I will get Mr Rowe to answer.

Mr L.G. Rowe: The $4.8 million is made up of two aspects. One is a levy on Western Power for the work of the ERA as a regulator of Western Power, and the other is to recoup the cost of licence fees across electricity, gas and water. I cannot give the member the figure for the break-up of government enterprises on the licences. Those issues are still being worked on. I am told that the impact on Western Power is around $1.5 million.

Mr C.C. PORTER: If the member wants to seek that information as supplementary information, we can provide that.

Mr E.S. RIPPER: Yes, I would like to seek that as supplementary information. We know that the total is $4.8 million. I assume that the Treasurer stands by that figure. I am looking for how much more government-owned utilities will be paying across the forward estimates as a result of these changes.

Mr C.C. PORTER: We will take that as a supplementary question.

[*Supplementary Information No B25.*]

Mr B.S. WYATT: I come back to the question asked by the member for Riverton. I think Mr Rowe referred to the three or four per cent efficient rate of return in the draft report. I think it was suggested earlier that Treasury is assuming seven per cent. This may become public when the final report becomes public. Has Treasury always had, and has it submitted to the ERA, a view that that should be seven per cent, not the two figures that Mr Rowe said—either three or four per cent?

Mr C.C. PORTER: The submissions to the final draft that determine that rate of return on the capital closed yesterday. The government did not make a submission. I considered this in detail and liaised with the Premier's office. We want the most accurate answer. There is a tendency inside Treasury to look at this issue in terms of its budgetary implications, not that they are particularly positive whether or not it is for a high rate of return on capital, in which case the gulf between cost and price increases and the direct subsidies increase. If the return rate is determined to be lower than we have previously estimated, the gulf between price and cost is lower and the direct subsidies decrease, but so do the dividends and tax equivalent payments coming in, because the organisation is ultimately earning less profit as it is receiving less return on its capital. We did not make a submission. Treasury based its estimates on the previous best estimates. The Department of Finance made a submission.

Mr B.S. WYATT: Again, when the ERA looks at these figures, does it look at similar organisations? I am curious about how it gets to that efficient rate of return.

Mr C.C. PORTER: I think it is complicated.

Mr L.G. Rowe: How long does the member have! The first comment I should make is that the figures that we gave are real. I suspect that the figures that Treasury is using are nominal. Our four per cent could become seven per cent very easily on that basis. It is a complicated process whereby we look at a reasonable return on equity and a reasonable cost of debt for a benchmark firm, and then average that across on the basis of 60 per cent debt and 40 per cent equity within the company. The short answer to the question is: yes, it is done on the basis of a benchmark firm. The crucial issue with the cost of debt goes to the credit rating for that particular benchmark company.

Mr W.J. JOHNSTON: I have one further question, and I use that desired outcome as the hook for it. I have talked to different people in the regulated utility space, and people have commented about the approach that the ERA takes to its regulatory decision making. I wonder whether the Treasurer and the chairman perhaps could make a comment. At the moment, all the regulatory process is done effectively on the papers. Does the ERA have a view about holding a public hearing, as I understand is done by some other regulators, so that the last step before the ERA made a decision on the draft report would be an interchange between the regulator and the asset owner?

Mr C.C. PORTER: I do not have a view. I am not aware that there is a prevailing government view about the adequacy of the present process or the desirability of processes that other states engage in. If advice was given to me by Mr Rowe, we would consider it. I do not know whether Mr Rowe has a view.

Mr L.G. Rowe: There is no reason why we could not hold public hearings under our act. We could do that. We tend not to. We have often held public forums after the access arrangement is first lodged with us to give other participants an opportunity to understand it. Usually, those public forums are as much about the provider explaining to potential customers what is in the access arrangement than anything else. The comment I would make is that if we were to hold a public forum, it would not be, in my view, simply a public forum between the ERA and the provider. That paints a picture of our role that I take some objection to. Our role is not to counter the provider; our role is to independently assess the balance of issues between a fair and reasonable return for the provider and a fair and reasonable price for the consumer. The principles of fair justice would require that to be a forum that would be open to anybody who wanted to participate. We have not done it to now. It is within our ability to do so if we decide to do it.

[5.00 pm]

The appropriation was recommended.