



DRAFT DECISION

TasNetworks distribution determination 2017–18 to 2018–19

Overview

September 2016

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Invitation for submissions

Energy consumers and other interested parties are invited to make submissions on our draft decision for the TasNetworks electricity distribution determination by **Thursday 1 December 2016**.

We will consider and respond to submissions in our final decisions in late April 2017.

We prefer that all submissions are in Microsoft Word or another text readable document format. Submissions on our draft decision should be sent to:

TasElectricity2017@aer.gov.au.

Alternatively, submissions can be sent to:

Mr Chris Pattas
General Manager
Australian Energy Regulator
GPO Box 520
Melbourne Vic 3001

We prefer that all submissions be publicly available to facilitate an informed and transparent consultative process. Submissions will be treated as public documents unless otherwise requested. Parties wishing to submit confidential information should:

- (1) clearly identify the information that is the subject of the confidentiality claim
- (2) provide a non-confidential version of the submission in a form suitable for publication.

All non-confidential submissions will be placed on our website. For further information regarding our use and disclosure of information provided to us, see the ACCC/AER Information Policy (October 2008), which is available on our website.

We will hold a pre-determination conference on 18 October 2016 from 10am. If you are interested in attending this forum, have any queries about this draft decision or about lodging submissions, please send an email to: TasElectricity2017@aer.gov.au.

Note

This overview forms part of the AER's draft decision on TasNetworks' distribution determination for 2017–19. It should be read with all other parts of the draft decision.

The draft decision includes the following documents:

Overview

Attachment 1 – Annual revenue requirement

Attachment 2 – Regulatory asset base

Attachment 3 – Rate of return

Attachment 4 – Value of imputation credits

Attachment 5 – Regulatory depreciation

Attachment 6 – Capital expenditure

Attachment 7 – Operating expenditure

Attachment 8 – Corporate income tax

Attachment 9 – Efficiency benefit sharing scheme

Attachment 10 – Capital expenditure sharing scheme

Attachment 11 – Service target performance incentive scheme

Attachment 12 – Demand management incentive scheme

Attachment 13 – Classification of services

Attachment 14 – Control mechanisms

Attachment 15 – Pass through events

Attachment 16 – Alternative control services

Attachment 17 – Negotiated services framework and criteria

Attachment 18 – Connection policy

Attachment 19 – Tariff structure statement

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Shortened forms

Shortened form	Extended form
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
augex	augmentation expenditure
capex	capital expenditure
CCP	Consumer Challenge Panel
CESS	capital expenditure sharing scheme
CPI	consumer price index
DRP	debt risk premium
DMIA	demand management innovation allowance
DMIS	demand management incentive scheme
distributor	distribution network service provider
DUoS	distribution use of system
EBSS	efficiency benefit sharing scheme
ERP	equity risk premium
Expenditure Assessment Guideline	Expenditure Forecast Assessment Guideline for Electricity Distribution
F&A	framework and approach
MRP	market risk premium
NEL	national electricity law
NEM	national electricity market
NEO	national electricity objective
NER	national electricity rules
NSP	network service provider
opex	operating expenditure
PPI	partial performance indicators
PTRM	post-tax revenue model
RAB	regulatory asset base
RBA	Reserve Bank of Australia
repex	replacement expenditure

Shortened form	Extended form
RFM	roll forward model
RIN	regulatory information notice
RPP	revenue and pricing principles
SAIDI	system average interruption duration index
SAIFI	system average interruption frequency index
SLCAPM	Sharpe-Lintner capital asset pricing model
STPIS	service target performance incentive scheme
WACC	weighted average cost of capital

1 Introduction

We, the Australian Energy Regulator (AER), are responsible for the economic regulation of electricity transmission and distribution systems in all Australian states and territories, with the exception of Western Australia. TasNetworks owns and operates Tasmania's electricity distribution network. We regulate the revenues that TasNetworks can recover from its customers.

TasNetworks submitted a regulatory proposal for its electricity distribution network on 29 January 2016. The proposal sets out the revenue that TasNetworks proposes to recover from electricity consumers through distribution charges for the period 2017–19. This overview, together with its attachments, constitutes our draft decision on TasNetworks' regulatory proposal.

TasNetworks' 2017–19 regulatory control period is shorter than the usual five year period. The two year regulatory control period will allow TasNetworks to align the regulatory control periods of its distribution and transmission businesses. The AEMC approved TasNetworks' proposed change in the length of the regulatory control period in its final rule determination issued on 9 April 2015.¹

The National Electricity Law (NEL) and National Electricity Rules (NER) provide the regulatory framework governing electricity networks. In regulating TasNetworks, we are guided by the National Electricity Objective (NEO), as set out in the NEL. The NEO is:²

to promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity with respect to—

- (a) price, quality, safety, reliability and security of supply of electricity; and
- (b) the reliability, safety and security of the national electricity system.

1.1 Structure of overview

This overview provides a summary of our draft decision and its individual components. The remainder is structured as follows:

- Section 2 provides a high level summary of our draft decision
- Section 3 provides a breakdown of our draft decision into its key components
- Section 4 sets out our draft decision on the classification of services, control mechanisms and incentive schemes that will apply to TasNetworks for the 2017–19 regulatory control period. These are decisions that we make in addition to the building block revenue determination.

¹ AEMC, *Rule Determination: National Electricity Amendment (Aligning TasNetworks' regulatory control periods) Rule 2015*, 9 April 2015.

² NEL, s. 7.

- Section 5 sets out our decision on TasNetworks' tariff structure statement
- Section 6 explains how we apply the regulatory framework, in particular the NEO, the RPPs and the interrelationships between the constituent components
- Section 7 outlines our consultation process in reaching this draft decision and our view of TasNetworks' consumer engagement undertaken in developing its regulatory proposal
- Appendix A contains the full list of constituent components that make up TasNetworks' proposal and our draft decision on each of them (constituent decisions)
- Appendix B lists the stakeholder submissions received on TasNetworks' regulatory proposal.

In our attachments to this decision we set out detailed analysis of the constituent components that make up our draft decision.

1.2 Our process

This draft decision is one of the key steps in reaching our final decision. Our final decision will be released no later than 30 April 2017. Before that, TasNetworks will have the opportunity to submit a revised proposal in response to this draft decision. Stakeholders will also have the opportunity to make submissions to us on our draft decision and TasNetworks' revised proposal.

Following receipt of the revised proposal and submissions, we will then make our final decision taking into account the revised proposal, submissions and any other relevant information. Table 1.1 lists the key dates and consultation deadlines for the process.

Table 1.1 Key dates and consultation

Task	Date
Regulatory proposal submitted to the AER	29 January 2016
AER released Issues paper	11 March 2016
AER held public forum	17 March 2016
Submissions on regulatory proposal closed	28 April 2016
AER draft decision published	29 September 2016
AER public forum to explain draft decision	18 October 2016
Submissions due on draft decision	1 December 2016
Revised regulatory proposal due to AER	1 December 2016
Further submissions, including on revised proposals	23 December 2016
AER release of final decision	No later than 30 April 2017

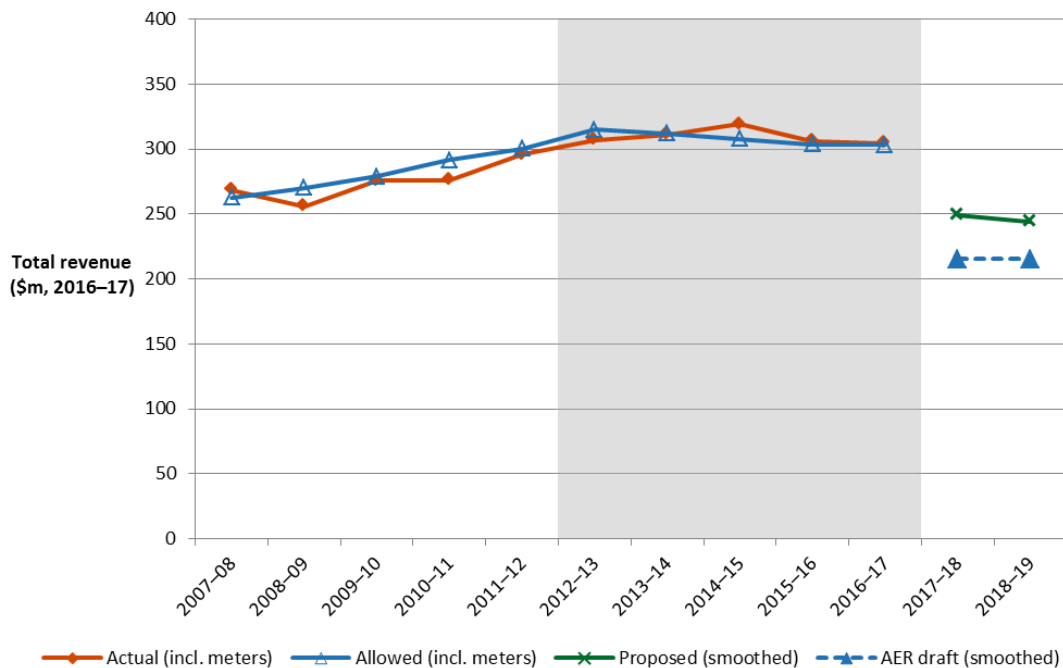
2 Summary of draft decision

Our draft decision is that TasNetworks can recover \$446.6 million (\$ nominal, smoothed) from consumers over the 2017–19 regulatory control period. This is a 12.8 per cent reduction from TasNetworks' proposed revenue allowance of \$511.9 million (\$ nominal).

In coming to our draft decision we have accepted large parts of TasNetworks' regulatory proposal, including its opex and capex forecasts. However, there are areas where we have not accepted TasNetworks' proposal, and TasNetworks has the opportunity to respond to those aspects of our draft decision in its revised proposal. The main differences between our draft decision and TasNetworks' proposal relate to a lower rate of return, gamma and adjustments for the operation of incentive schemes over the last period.

Figure 2.1 compares our draft decision on TasNetworks' revenue for 2017–19 to its proposed revenue and to the revenue allowed and recovered during the two previous regulatory control periods of 2007–12 and 2012–17.

Figure 2.1 TasNetworks' past total revenue, proposed total revenue and AER draft decision total revenue allowance (\$million, 2016–17)



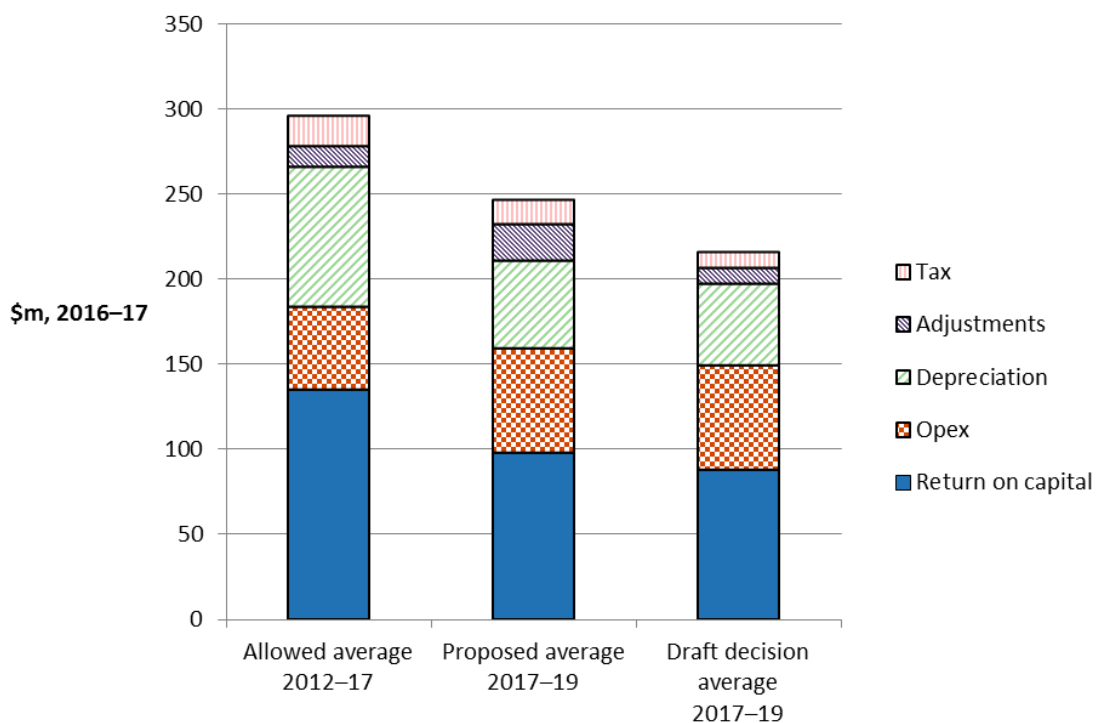
Source: AER analysis.

2.1 What is driving allowed revenue?

Our draft decision approves average annual revenues for the 2017–19 regulatory control period that are \$93.1 million (\$2016–17)—or 30.2 per cent—lower than was approved in our decision for 2012–17 in real dollar terms.³ Our draft decision provides for 12.7 per cent (\$2016–17) less revenue than TasNetworks sought to recover through its regulatory proposal.

Figure 2.2 compares the average annual building block revenue from our draft decision to that proposed by TasNetworks for the 2017–19 regulatory control period, and to the allowed average amount for the 2012–17 regulatory control period.

Figure 2.2 AER's draft decision on constituent components of total revenue (\$million, 2016–17)

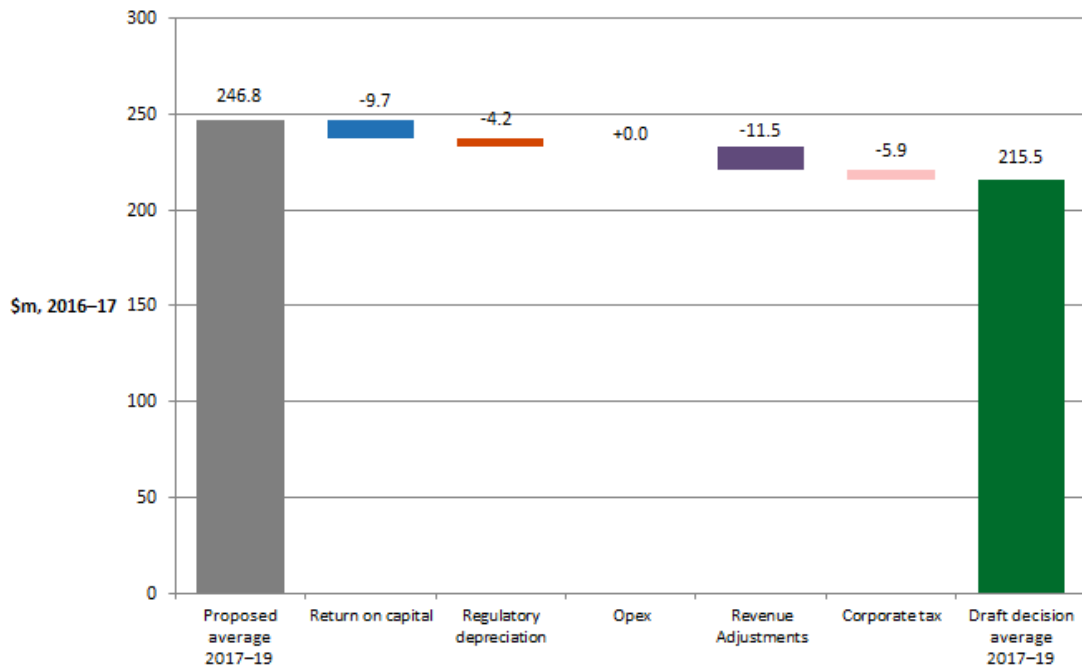


Source: AER analysis.

Figure 2.3 compares our draft decision with TasNetworks' proposal, broken down by the various building block components that make up the forecast revenue allowance. These are annual amounts based on an average over the two year regulatory control period.

³ In nominal dollar terms, our draft decision average annual revenues for the 2017–19 regulatory control period is about \$74.3 million (or 25.0 per cent) less than the average annual revenues approved for the 2012–17 regulatory control period.

Figure 2.3 AER's draft decision and TasNetworks' proposed average annual building block costs (\$million, 2016–17)



Source: AER analysis.

These figures highlight that the return on capital, corporate income tax and other revenue adjustments are the key difference between our draft decision and TasNetworks' proposal. In summary, our draft decision on the allowed rate of return largely drives the difference in the return on capital amounts. Our draft decision on gamma drives a proportion of the difference relating to corporate income tax. Adjustments from the operation of the efficiency benefit sharing scheme over the last period account for some of the difference relating to revenue adjustments.

2.1.1 Allowed rate of return

The allowed rate of return provides TasNetworks with revenue to service the interest on its loans and give a return on equity to its shareholders. It is applied to TasNetworks' capital base to determine the return on capital building block.

We set out our approach to determining the rate of return in the Rate of Return Guideline (Guideline) we published in December 2013. We undertook significant consultation in developing this Guideline. In its proposal, TasNetworks proposed to use the methodology set out in our Guideline. After considering the information before us in TasNetworks' proposal and in submissions, we have accepted the approach proposed by TasNetworks' for calculating the rate of return. Nevertheless, the approach to calculating the rate of return in TasNetworks' proposal requires us to consider prevailing market conditions.

Prevailing market conditions for debt and equity are subject to change and heavily influence the rate of return. Financial market conditions have changed since

TasNetworks submitted its proposal. Interest rates are lower, meaning that the cost of debt and the returns required to attract equity are lower. These factors result in a rate of return lower than TasNetworks proposed in its draft decision.

Our draft decision is for a rate of return of 5.48 per cent (for 2017–18). This compares with TasNetworks' proposed 6.04 per cent in its regulatory proposal and the 8.28 per cent set for the 2012–17 regulatory control period. In our final decision we will update the rate of return again, having regard to the prevailing market conditions at the time we make our final decision and by reference to the averaging periods that TasNetworks nominated in its proposal.

2.1.2 Gamma

We do not accept TasNetworks' proposed value of imputation credits (or gamma) of 0.25. Instead, we adopt a value of imputation credits of 0.4. We consider that the use of a value for imputation credits of 0.4 will result in equity investors in the benchmark efficient entity receiving an ex ante total return (inclusive of the value of imputation credits) commensurate with the efficient equity financing costs of a benchmark efficient entity.

2.1.3 EBSS carryover amounts

We have determined an EBSS carryover amount of \$18.1 million (\$2016–17) from the application of the EBSS during the 2012–17 regulatory control period.⁴ This is \$23.0 million (\$2016–17) less than TasNetworks' proposal. The primary reason for this difference is that TasNetworks' EBSS calculations assume year 4 (2015–16) is used as the base year to forecast opex. However, TasNetworks used year 3 (2014–15) to forecast opex. This inconsistency would effectively reward TasNetworks twice for incremental efficiency gains made in 2015–16: once through the EBSS carryovers and a second time because they are not reflected in its opex forecast.

2.2 Expected impact of decision on electricity bills

The annual electricity bill for customers in Tasmania will reflect the combined cost of all the electricity supply chain components—wholesale energy generation, transmission, distribution, metering, and retail costs. This draft decision primarily relates to the distribution charges for standard control services, which represent approximately 38 per cent on average of a Tasmanian customer's annual electricity bill.⁵

We estimate the expected bill impact by varying the distribution charges in accordance with our draft decision, while holding other components—including the metering component—of the bill constant. This approach isolates the effect of our decision on

⁴ AER, *Electricity distribution network service providers—Efficiency benefit sharing scheme*, June 2008.

⁵ TasNetworks, *Reset RIN template*, TN069, January 2016.

electricity prices, but does not imply that other components will remain unchanged across the regulatory control period.⁶

Based on this approach, we expect that our draft decision will result in the distribution component of the average annual electricity bills for residential customers in Tasmania to decrease over the 2017–19 regulatory control period. The distribution component of the average annual residential electricity bill in 2018–19 is expected to reduce by about \$163 or 9.3 per cent (\$ nominal) below the 2016–17 level.

By comparison, had we accepted TasNetworks' proposal, the expected distribution component of the average annual residential electricity bill in 2018–19 would reduce by about \$95 or 5.4 per cent (\$ nominal) below the 2016–17 level.

Table 2.1 shows the estimated impact of our draft decision on average residential and small business customers' annual electricity bills in Tasmania over the 2017–19 regulatory control period, compared with TasNetworks' proposal. As explained above, these bill impact estimates are indicative only, and individual customers' actual bills will depend on their usage patterns and the structure of their chosen retail tariff offering.

Table 2.1 Estimated impact of draft decision on average Tasmanian residential and small business customers' electricity bills for 2017–19 period (\$nominal)

	2016–17	2017–18	2018–19
AER draft decision			
Residential annual electricity bill	1763 ^a	1582	1600
Annual change ^c		-181 (-10.2%)	17 (1.1%)
Small business annual electricity bill	3225 ^b	2894	2926
Annual change ^c		-331 (-10.2%)	31 (1.1%)
TasNetworks proposal			
Residential annual electricity bill	1763 ^a	1659	1668
Annual change ^c		-104 (-5.9%)	8 (0.5%)
Small business annual electricity bill	3225 ^b	3036	3051
Annual change ^c		-190 (-5.9%)	15 (0.5%)

Source: AER analysis; AER, Energy made easy website; OTTER, *Information paper: Typical electricity customers*, May 2014.

⁶ It also assumes that actual energy demand will equal the forecast in our draft decision. Since TasNetworks operates under a revenue cap, changes in demand will also affect annual electricity bills across the 2017–19 regulatory control period.

- (a) Annual bill for 2016–17 is sourced from the AER's Energy Made Easy website and reflects the average consumption of 6819kWh for residential customers using tariffs 31 (3771kWh) and 41 (3048 kWh) in Tasmania (postcode 7000).
- (b) Annual bill for 2016–17 is sourced from the AER's Energy Made Easy website and reflects the average consumption of 10258kWh for small business customers using tariff 22 in Tasmania (postcode 7000).
- (c) Annual change amounts and percentages are indicative. They are derived by varying the distribution component of 2016–17 bill amounts in proportion to yearly expected revenue divided by forecast energy as proposed by TasNetworks. Actual bill impacts will vary depending on electricity consumption and tariff class.

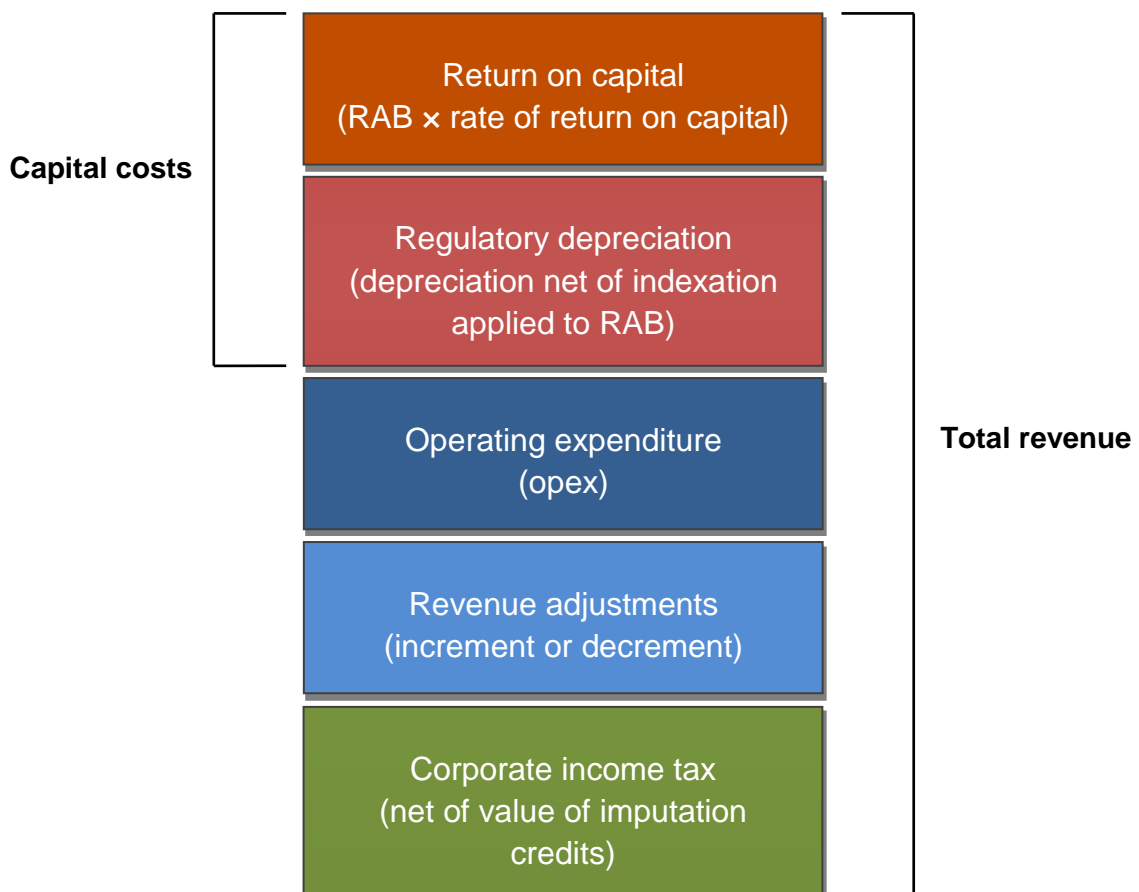
3 Key elements of our draft decision

We use the building block approach to determine TasNetworks' maximum allowed revenue (MAR). The building block approach consists of five costs that a business is allowed to recover through its revenue allowance.

The building block costs are illustrated in Figure 3.1 and include:

- a return on the regulatory asset base (RAB) (or return on capital)
- depreciation of the RAB (or return of capital)
- forecast opex
- revenue increments or decrements resulting from incentive schemes such as the efficiency benefit sharing scheme (EBSS)
- the estimated cost of corporate income tax.

Figure 3.1 The building block approach for determining total revenue



The building block costs are comprised of key elements that we determine through our assessment process. For example, the size of the RAB—and therefore the revenue generated from the return on capital and regulatory depreciation building blocks—is directly affected by our assessment of forecast capex.

This section summarises our draft decision on key elements of the building blocks including:

- RAB (section 3.1)
- Rate of return (section 3.2)
- Imputation credits (section 3.3)
- Depreciation allowance (section 3.4)
- Efficient level of capex (section 3.5)
- Efficient level of opex (section 3.6)
- Forecast level of corporate income tax (section 3.7).

Incentive schemes including the EBSS and CESS are covered in section 4.3. Table 3.1 shows our draft decision on TasNetworks' revenues including the building block components.

Table 3.1 AER's draft decision on TasNetworks' revenues (\$million, nominal)

	2017–18	2018–19	Total
Return on capital	89.2	93.4	182.6
Regulatory depreciation ^a	39.6	59.0	98.6
Operating expenditure ^b	63.8	63.8	127.6
Revenue adjustments ^c	9.7	9.9	19.6
Net tax allowance	7.8	11.0	18.7
Annual revenue requirement (unsmoothed)	210.0	237.1	447.2
Annual expected revenue (smoothed)	220.6	226.0	446.6
X factor ^d	24.72%	0.00%	n/a

Source: AER analysis.

- (a) Regulatory depreciation is straight-line depreciation net of the inflation indexation on the opening RAB.
- (b) Operating expenditure includes debt raising costs.
- (c) Revenue adjustments include the efficiency benefit sharing scheme (EBSS) carry-overs and demand management innovation allowance.
- (d) The X factor for 2018–19 will be revised to reflect the annual return on debt update. Under the CPI–X framework, the X factor measures the real rate of change in annual expected revenue from one year to the next. A negative X factor represents a real increase in revenue. Conversely, a positive X factor represents a real decrease in revenue.

3.1 Regulatory asset base

We make a decision on TasNetworks' opening regulatory asset base (RAB) at 1 July 2017 as part of our revenue determination. We also make a decision on TasNetworks' projected RAB for the 2017–19 regulatory control period.⁷

The RAB roll forward accounts for the value of TasNetworks' regulated assets over the regulatory control period. The size of the RAB substantially impacts TasNetworks' revenue and the price that customers ultimately pay. It is an input into the determination of the return on capital and depreciation (return of capital) building blocks.⁸ Other things being equal, a higher RAB increases both the return on capital and depreciation allowances. In turn, these increase TasNetworks' revenue, and prices for services.

We determine an opening RAB value of \$1629.4 million (\$ nominal) as at 1 July 2017 for TasNetworks. This value is \$17.4 million (or 1.1 per cent) lower than TasNetworks' proposed opening RAB of \$1646.7 million (\$ nominal) as at 1 July 2017.⁹ This is because we have updated the 2015–16 inflation rate with actual CPI for indexation in the RAB roll forward.

To determine the opening RAB as at 1 July 2017, we have rolled forward the RAB over the 2012–17 regulatory control period to determine a closing RAB value at 30 June 2017. This roll forward includes an adjustment at the end of the 2012–17 regulatory control period to account for the difference between actual 2011–12 capex and the estimate approved at the 2012–17 determination.¹⁰

Table 3.2 summarises our draft decision on the roll forward of RAB values for TasNetworks over the 2012–17 regulatory control period.

Table 3.2 AER's draft decision on TasNetworks' RAB for the 2012–17 regulatory control period (\$ million, nominal)

	2012–13	2013–14	2014–15	2015–16 ^a	2016–17 ^b
Opening RAB	1445.2	1486.9	1539.3	1557.0	1606.3
Capital expenditure ^c	89.3	99.8	89.2	114.9	125.7
Inflation indexation on opening RAB ^d	36.2	43.6	20.4	20.4	40.2
Less: straight-line depreciation ^e	83.8	90.9	91.9	85.4	87.6
Closing RAB	1486.9	1539.3	1557.0	1606.3	1684.5

⁷ NER, cl. 6.5.1 and S6.2.

⁸ The size of the RAB also impacts the benchmark debt raising cost allowance. However, this amount is usually relatively small and therefore not a significant determinant of revenues overall.

⁹ TasNetworks, *Regulatory proposal 2017–19*, January 2016, p. 108, Table 9–1.

¹⁰ The end of period adjustment will be positive (negative) if actual capex is higher (lower) than the estimate approved at the 2012–17 determination.

Difference between estimated and actual 2011-12 capex (1 July 2011 to 30 June 2012)	-38.0
Return on difference for 2011–12 capex	-17.2
Closing RAB as at 30 June 2017	1629.4

Source: AER analysis.

- (a) Based on estimated capex provided by TasNetworks. We will update the RAB roll forward for actual capex in the final decision.
- (b) Based on estimated capex provided by TasNetworks. We expect to update the RAB roll forward with a revised capex estimate in the final decision, and true-up the RAB for actual capex at the next reset.
- (c) Net of disposals and capital contributions, and adjusted for actual CPI.
- (d) We will update the RAB roll forward for actual CPI for 2016–17 in the final decision.
- (e) Adjusted for actual CPI. Based on as-incurred capex.

We determine a forecast closing RAB value at 30 June 2019 of \$1753.9 million (\$ nominal). This is \$9.4 million (or 0.5 per cent) lower than the amount of \$1763.2 million (\$ nominal) proposed by TasNetworks.¹¹ Our draft decision on the forecast closing RAB reflects the updated opening RAB as at 1 July 2017, and our draft decisions on the expected inflation rate (attachment 3), forecast depreciation (attachment 5) and forecast capex (attachment 6).

Table 3.3 sets out our draft decision on the forecast RAB values for TasNetworks over the 2017–19 regulatory control period.

Table 3.3 AER's draft decision on TasNetworks' RAB for the 2017–19 regulatory control period (\$million, nominal)

	2017–18	2018–19
Opening RAB	1629.4	1705.7
Capital expenditure ^a	115.9	107.2
Inflation indexation on opening RAB	39.9	41.8
Less: straight-line depreciation	79.5	100.8
Closing RAB	1705.7	1753.9

Source: AER analysis.

- (a) Net of forecast disposals and capital contributions. In accordance with the timing assumptions of the post-tax revenue model (PTRM), the capex includes a half-WACC allowance to compensate for the six month period before capex is added to the RAB for revenue modelling.

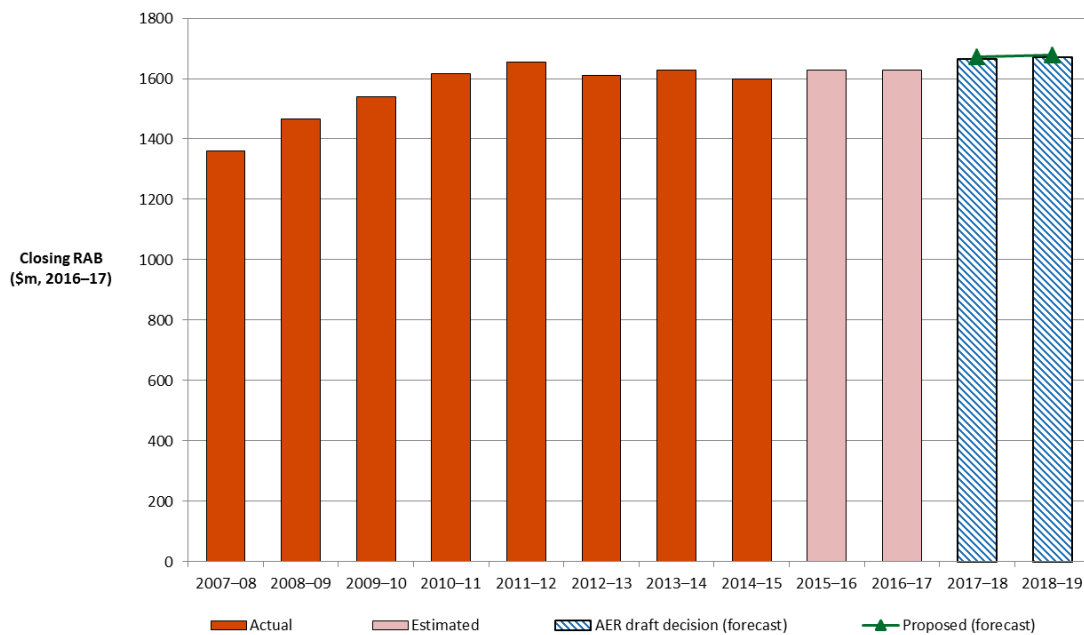
We accept TasNetworks' proposal that the forecast depreciation approach (instead of an actual depreciation approach) is to be used to establish the opening RAB at the

¹¹ TasNetworks, *Regulatory proposal 2017–19*, January 2016, p.109, Table 9–2.

commencement of the 2019–24 regulatory control period.¹² We consider this approach will provide sufficient incentives for TasNetworks to achieve capex efficiency gains over the 2017–19 regulatory control period. TasNetworks is not currently subject to a capital expenditure sharing scheme (CESS). As explained in section 4.2, we will apply the CESS to TasNetworks for the 2017–19 regulatory control period.

Figure 3.2 compares our draft decision on TasNetworks' forecast RAB to TasNetworks' proposal and actual RAB in real dollar terms.

Figure 3.2 TasNetworks' actual RAB, proposed forecast RAB and AER draft decision forecast RAB (\$ million, 2016–17)



Source: AER analysis.

Further detail on our draft decision in regards to TasNetworks' RAB is set out in attachment 2.

3.2 Rate of return (return on capital)

The allowed rate of return provides a DNSP a return on capital to service the interest on its loans and give a return on equity to investors. The return on capital building block is calculated as a product of the rate of return and the value of the RAB.

We are satisfied that the allowed rate of return of 5.48 per cent (nominal vanilla) we have determined achieves the allowed rate of return objective (ARORO).¹³ That is, we are satisfied that this allowed rate of return is commensurate with the efficient financing

¹² NER, cl. 6.12.1(18).

¹³ NER, cl. 6.5.2(b).

costs of a benchmark efficient entity with a similar degree of risk as that which applies to TasNetworks in providing standard control services.¹⁴

This allowed rate of return of 5.48 per cent will apply to TasNetworks for 2017–18. A different rate of return value will apply to TasNetworks for the 2018–19 regulatory year. This is because we will update the return on debt component each year to partially reflect the prevailing debt market conditions. We discuss this annual update further below.

Our allowed rate of return is a weighted average of our return on equity and return on debt estimates determined on a nominal vanilla basis that is consistent with our estimate of the value of imputation credits. We are to determine the allowed rate of return such that it achieves the ARORO. Also, in arriving at our decision we have taken into account the revenue and pricing principles (RPPs) and are also satisfied that our decision will or is likely to contribute to the achievement of the National Electricity Objective (NEO).

We have determined our rate of return based on the methodology set out in our Rate of Return Guideline (Guideline). TasNetworks adopted our Guideline approach in its regulatory proposal,¹⁵ but noted it does not endorse our methods.¹⁶

We have accepted TasNetworks' proposal to apply our Guideline (although components have been updated to account for prevailing market conditions). Table 3.4 sets out our rate of return and TasNetworks' proposed rate of return.

Table 3.4 AER draft decision on TasNetworks' rate of return (% nominal)

	AER previous decision (2012–17)	TasNetworks' proposal (2017–18)	AER draft decision (2017–18)	Allowed return over 2017–19 regulatory control period
Return on equity (nominal post-tax)	8.69	7.30	6.50	Constant (6.5%)
Return on debt (nominal pre-tax)	8.00	5.20	4.79	Updated annually
Gearing	60	60	60	Constant (60%)
Overall rate of return (nominal, vanilla)	8.28	6.04	5.48	Updated annually for return on debt
Forecast inflation	2.60	2.50	2.45	Constant (2.45%)

¹⁴ NER, cl. 6.5.2(c).

¹⁵ TasNetworks, *Tasmanian Distribution Regulatory Proposal Regulatory Control Period 1 July 2017 to 30 June 2019*, 29 January 2016, pp. 114, 116.

¹⁶ TasNetworks, *Tasmanian Distribution Regulatory Proposal Regulatory Control Period 1 July 2017 to 30 June 2019*, 29 January 2016, pp. 114, 116.

Source: AER analysis; TasNetworks, *Tasmanian Distribution Regulatory Proposal Regulatory Control Period 1 July 2017 to 30 June 2019*, 29 January 2016, p. 117; AER, *Final Distribution Determination: Aurora Energy Pty Ltd 2012-13 to 2016-17*, April 2012, p. 29.

Our return on equity estimate is 6.5 per cent. This rate will apply to TasNetworks in each regulatory year. Our return on debt estimate for the 2017–18 regulatory year is 4.79 per cent. This estimate will change each year as we partially update the return on debt to reflect prevailing interest rates over TasNetworks' debt averaging period in each year. Our return on debt estimate for future regulatory years will be determined in accordance with the methodology and formulae we have specified in this decision. As a result of updating the return on debt each year, the overall rate of return and TasNetworks' revenue will also be updated.

We accept TasNetworks' application of our Guideline return on equity approach. We have applied this approach and updated it for prevailing market conditions. Our return on equity point estimate and the parameter inputs are set out in Table 3.5.

Table 3.5 AER draft decision on TasNetworks' return on equity (nominal)

	AER previous decision (2012–17)	TasNetworks proposal (2017-19) ^(a)	AER draft decision (2017–19)
Nominal risk free rate (return on equity only)	3.89%	2.75%	1.95%
Equity risk premium	5.20%	4.55%	4.55%
Market risk premium	6.50%	6.50%	6.50%
Equity beta	0.8	0.7	0.7
Nominal post-tax return on equity	8.69%	7.3%	6.50%

Source: AER analysis; TasNetworks, *Tasmanian Distribution Regulatory Proposal Regulatory Control Period 1 July 2017 to 30 June 2019*, 29 January 2016, p. 117; AER, *Final Distribution Determination: Aurora Energy Pty Ltd 2012-13 to 2016-17*, April 2012, p. 29.

(a) TasNetworks used an indicative averaging period of 20 business days to 30 September 2015.

We accept TasNetworks' application of our Guideline return on debt approach and of our proposed transitional trailing average approach used in our most recent decisions.¹⁷ That is to:

- estimate the return on debt using an on-the-day approach (that is, based on prevailing market conditions near the commencement of the regulatory period) in the first year (2017–18) of the 2017–19 regulatory period, and

¹⁷ TasNetworks, *Tasmanian Distribution Regulatory Proposal Regulatory Control Period 1 July 2017 to 30 June 2019*, 29 January 2016, pp. 114–117.

- gradually transition this approach into a trailing average approach (that is, a moving historical average) over 10 years.¹⁸

This gradual transition occurs through updating 10 per cent of the entire return on debt each year to reflect prevailing market conditions in that year (a full transition).¹⁹

In the Guideline, we proposed to use one or more third party data series to estimate the return on debt.²⁰ At that time, however, we had not formed a view on which data series to use. Our April 2014 issues paper outlined how we would make this choice and sought submissions from service providers.²¹ Following our recent decisions, TasNetworks, used a simple average of the RBA and Bloomberg data series.²²

Consequently, the return on debt in each regulatory year is estimated with reference to:

- a benchmark credit rating of BBB+
- a benchmark term of debt of 10 years
- independent third party data series—specifically, a simple average of the broad BBB rated debt data series published by the Reserve Bank of Australia (RBA) and Bloomberg, adjusted to reflect a 10 year estimate and other adjustments²³
- an averaging period for each regulatory year of between 10 business days and 12 months (nominated by the service provider), with that period being consistent with certain conditions that we proposed in the Guideline.²⁴

It is worth noting that the Tribunal recently reviewed several aspects of our approach to estimating the allowed return on debt in recent decisions for ActewAGL, Jemena Gas Networks and Networks NSW. Specifically, the Tribunal was asked to review:

¹⁸ This draft decision determines the return on debt methodology for the 2017-19 regulatory period. This period covers the first two years of the 10 year transition period. This decision also sets out our intended return on debt methodology for the remaining eight years. However, we do not have the power to determine in this decision the return on debt methodology for those years. Under the NER, the return on debt methodology must be determined in future decisions that relate to that period.

¹⁹ By entire return on debt, we mean 100% of the base rate and debt risk premium components of the allowed return on debt.

²⁰ AER, *Explanatory statement—Rate of return guideline*, December 2013, pp. 23–24.

²¹ AER, *Issues Paper - Return on debt: Choice of third party data service provider*, April 2014.

²² For example, see AER, *Final decision: AusNet Services determination 2015 -16 to 2019–20, Attachment 3—Rate of return*, May 2016.

²³ For the RBA curve, our draft decision is to interpolate the monthly data points to produce daily estimates, to extrapolate the curve to an effective term of 10 years, and to convert it to an effective annual rate. For the Bloomberg curve, our draft decision is to extrapolate it to 10 years using the spread between the extrapolated RBA seven and 10 year curves (where Bloomberg has not published a 10 year estimate), and to convert it to an effective annual rate. While we do not propose estimating the return on debt by reference to the Reuters curve, we do not rule out including doing so in future determinations following a proper period of consultation.

²⁴ AER, *Rate of return guideline*, December 2013, pp. 21–2; AER, *Explanatory statement—Rate of return guideline*, December 2013, p. 126.

- Whether a benchmark efficient entity would have a credit rating of BBB rather than BBB+. It upheld our decision to define a benchmark credit rating as a BBB+ credit rating.²⁵
- Whether we should estimate the allowed return on debt using the RBA data series alone or a simple average of the RBA and Bloomberg data series. It upheld our decision and found that, 'averaging of the two curves was an acceptable measure of the DRP [debt risk premium]'.²⁶
- Whether we should transition all of the return on debt²⁷ from an on-the-day approach in the first regulatory year to a trailing average by updating 10 per cent of the debt portfolio over 10 years (a full transition). It remitted the determination back to us to make a constituent decision on introducing the trailing average approach in accordance with several reasons outlined in its decision.²⁸ We note the Tribunal's decision in attachment 3 of this decision.

Our formula for automatically updating the return on debt annually is set out in attachment 3 of this decision.

We estimated expected inflation using the RBA's short term inflation forecasts and the mid-point of the RBA's inflation targeting band. This is consistent with the approach we have applied since 2008 and the approach proposed by TasNetworks.

While acknowledging that some matters relating to our Guideline are currently before the Tribunal and Federal Court for consideration, we consider that the rate of return set out in this decision achieves the ARORO and promotes the NEO and RPP.

Further detail on our draft decision in regards to TasNetworks' allowed rate of return is set out in attachment 3.

3.3 Value of imputation credits (gamma)

Under the Australian imputation tax system, investors can receive an imputation credit for income tax paid at the company level.²⁹ These are received after company income tax is paid, but before personal income tax is paid. For eligible investors, this credit offsets their Australian income tax liabilities. If the amount of imputation credits received exceeds an investor's tax liability, that investor can receive a cash refund for the balance. Imputation credits are therefore valuable to investors and are a benefit to investors in addition to any cash dividend or capital gains they receive from owning shares.

²⁵ For example, see Australian Competition Tribunal, *Applications by Public Interest Advocacy Centre Ltd and Ausgrid [2016] ACompT 1*, 26 February 2016, para 993.

²⁶ For example, see Australian Competition Tribunal, *Applications by Public Interest Advocacy Centre Ltd and Ausgrid [2016] ACompT 1*, 26 February 2016, para 983.

²⁷ For clarity, that is 100% of the base rate and debt risk premium components of the allowed return on debt.

²⁸ For example, see Australian Competition Tribunal, *Applications by Public Interest Advocacy Centre Ltd and Ausgrid [2016] ACompT 1*, 26 February 2016, para 1,227. The Tribunal's reasons are set out in paras 870 to 940.

²⁹ *Income Tax Assessment Act 1997*, parts 3–6.

However, the estimation of the return on equity does not take imputation credits into account. Therefore, an adjustment for the value of imputation credits is required. This adjustment could take the form of a decrease in the estimated return on equity itself. An alternative but equivalent form of adjustment, which is employed under the NER, is via the revenue granted to a service provider to cover its expected tax liability. Specifically, the NER requires that the estimated cost of corporate income tax be determined in accordance with a formula that reduces the estimated cost of corporate tax by the 'value of imputation credits' (represented by the Greek letter, γ , 'gamma'). This form of adjustment recognises that it is the payment of corporate tax which is the source of the imputation credit return to investors.

We do not accept TasNetworks' proposed value of imputation credits (or gamma) of 0.25. Instead, we adopt a value of imputation credits of 0.4. We consider that the use of a value for imputation credits of 0.4 will result in equity investors in the benchmark efficient entity receiving an ex ante total return (inclusive of the value of imputation credits) commensurate with the efficient equity financing costs of a benchmark efficient entity.

Estimating the value of imputation credits is a complex and imprecise task. There is no consensus among experts on the appropriate value or estimation techniques to use. Further, with each estimation technique there are often a number of ways these may be applied resulting in different outcomes. Conceptually, the value of imputation credits must be between 0 and 1, and the range of expert views on the value of imputation credits is almost this wide.³⁰

TasNetworks' submission states if the Tribunal determines the AER is correct in regards to gamma in the Ausgrid appeal, it will adopt the Tribunal's findings on gamma in the revised proposal.³¹ However, since the decisions for Ausgrid and others released in April 2015 we have not departed from our 0.4 estimate for gamma. We consider the 0.4 gamma estimate is appropriate for the reasons stated in this draft decision. However, if we are required to, or decide to, use a different gamma estimate as a result of any merits or judicial review proceedings before TasNetworks' final decision is released, the AER will have regard to this in determining the value for gamma to be applied to TasNetworks in its final decision.

In coming to a value of imputation credits of 0.4:

- we adopt a conceptual approach consistent with the Officer framework, which we consider best promotes the objectives and requirements of the NER/NGR. This approach considers the value of imputation credits is a post-tax value before the impact of personal taxes and transaction costs.³² As such, we view the value of

³⁰ The value of imputation credits must be between 0 and 1 because receiving an imputation credit cannot make an investor worse off, nor would an investor value an imputation credit more than its face value.

³¹ TasNetworks, *Tasmanian Distribution Regulatory Proposal*, 29 January 2016, p. 115.

³² Post-tax refers to after company tax and before personal tax.

imputation credits as the proportion of company tax returned to investors through the utilisation of imputation credits³³

- we consider our conceptual approach allows for the value of imputation credits to be estimated on a consistent basis with the allowed rate of return and allowed revenues under the post-tax framework in the NER/NGR³⁴
- we use the widely accepted approach of estimating the value of imputation credits as the product of two sub-parameters: the 'distribution rate' and the 'utilisation rate'. Our definition of, and estimation approach for, these sub-parameters is set out in Table 3.6.

Table 3.6 Gamma sub-parameters: definition and estimation approach

Sub-parameter	Definition	Estimation approach
Distribution rate (or payout ratio)	The proportion of imputation credits generated that is distributed to investors	Primary reliance placed on the widely accepted cumulative payout ratio approach. Some regard is also given to Lally's estimate for listed equity from financial reports of the 20 largest listed firms.
Utilisation rate (or theta)	The utilisation value to investors in the market per dollar of imputation credits distributed ³⁵	A range of approaches, with due regard to the merit of each approach: <ul style="list-style-type: none"> • equity ownership approach • tax statistics • implied market value studies

Source: AER analysis.

Further detail on our draft decision in regards to the value of TasNetworks' imputation credits is set out in attachment 4.

3.4 Regulatory depreciation (return of capital)

Depreciation is the allowance provided so capital investors recover their investment over the economic life of the asset (return of capital). In deciding whether to approve the depreciation schedules submitted by TasNetworks, we make determinations on the indexation of the regulatory asset base (RAB) and depreciation building blocks for

³³ This means one dollar of claimed imputation credits has a post (company) tax value of one dollar to investors before personal taxes and personal transaction costs.

³⁴ In finance, the consistency principle requires that the definition of the cash flows in the numerator of a net present value (NPV) calculation must match the definition of the discount rate (or rate of return / cost of capital) in the denominator of the calculation (see Peirson, Brown, Easton, Howard, Pinder, *Business Finance*, McGraw-Hill, Ed. 10, 2009, p. 427). By maintaining this consistency principle, we provide a benchmark efficient entity with an ex ante total return (inclusive of the value of imputation credits) commensurate with the efficient financing costs of a benchmark efficient entity.

³⁵ In this decision we use the terms theta, utilisation value and utilisation rate interchangeably to mean the same thing.

TasNetworks' 2017–19 regulatory control period.³⁶ The regulatory depreciation allowance is the net total of the RAB depreciation less the inflation indexation adjustment of the RAB.

We do not accept TasNetworks' proposed regulatory depreciation allowance of \$107.2 million (\$ nominal) for the 2017–19 regulatory control period.³⁷ Instead, we determine a regulatory depreciation allowance of \$98.6 million (\$ nominal). This amount represents a reduction of \$8.6 million (or 8.0 per cent) on the proposed amount. In coming to our draft decision:

- We accept TasNetworks' proposed asset classes, its straight-line depreciation method, and the standard asset lives used to calculate the regulatory depreciation allowance. We consider TasNetworks' proposed standard asset lives for its existing asset classes are consistent with those approved at the 2012–17 distribution determination and largely comparable to the standard asset lives used for other distributors.
- We accept TasNetworks' proposal to create a new 'Business management systems' asset class with a standard asset life of 10 years. This asset class will contain asset management IT systems capex incurred from 1 July 2017. We consider the proposed standard asset life of 10 years reflects the nature of the assets in this asset class and is comparable with the standard asset life used by other distributors for a similar asset class. We are satisfied that TasNetworks' proposed standard asset lives would lead to a depreciation schedule that reflects the nature of the assets over their economic lives.³⁸
- We accept TasNetworks' proposal to use the year-by-year tracking method for depreciating its existing assets consistent with the approach we approved in our recent decisions for the Victorian distributors. However, we do not accept TasNetworks' implementation of the approach in its proposed RFM, which is based on the average depreciation method to calculate remaining asset lives at 1 July 2017. We have therefore implemented the year-by-year tracking method to calculate the depreciation for TasNetworks' existing assets in this draft decision. These calculations are made in a separate depreciation model, and the depreciation amounts are substituted directly into the post-tax revenue model (PTRM).
- We made determinations on other components of TasNetworks' proposal that also affect the forecast regulatory depreciation allowance—the opening RAB at 1 July 2017 (attachment 2) and the expected inflation rate (attachment 3).³⁹

Table 3.7 sets out our draft decision on the annual regulatory depreciation allowance for TasNetworks over the 2017–19 regulatory control period.

³⁶ NER, cl. 6.12.1(8).

³⁷ TasNetworks, *Regulatory proposal 2017–19*, January 2016, p. 113.

³⁸ NER, cl. 6.5.5(b)(1).

³⁹ NER, cl. 6.5.5(a)(1).

Table 3.7 AER's draft decision on TasNetworks' depreciation allowance for the 2017–19 period (\$million, nominal)

	2017–18	2018–19	Total
Straight-line depreciation	79.5	100.8	180.4
Less: inflation indexation on opening RAB	39.9	41.8	81.7
Regulatory depreciation	39.6	59.0	98.6

Source: AER analysis.

Further detail on our draft decision in regards to depreciation is set out in attachment 5.

3.5 Capital expenditure

Capital expenditure (capex) refers to the capital expenses incurred in the provision of network services. Forecast capex feeds into the estimates of the return on capital and regulatory depreciation building blocks we use to determine a DNSP's total revenue requirement.

TasNetworks proposed total forecast capex of \$213.4 million (\$2016–17) for the 2017–19 regulatory control period. Our draft decision is to accept TasNetworks' capex proposal which we consider reasonably reflects the capex criteria.

As part of our assessment, we reviewed each of TasNetworks' capex components and their main drivers. We are satisfied with all categories of capex which we found are mostly reducing or in line with longer term trends.

Replacement expenditure (repex) is a significant proportion of total forecast capex and contributes to broadly maintaining overall levels of capex. TasNetworks' repex forecast includes \$18.5 million (\$2016–17) for the continuation of the replacement of the legacy asset management system. This is a project which was initiated by TasNetworks' predecessors, Transend and Aurora, during the current regulatory control period. Our draft decision on this asset management system is in line with our previous decision on TasNetworks (transmission) and has been supported by a thorough business case.

Table 3.8 shows our decision compared to TasNetworks' forecast.

Table 3.8 AER draft decision on total net capex (\$million, 2016–17)

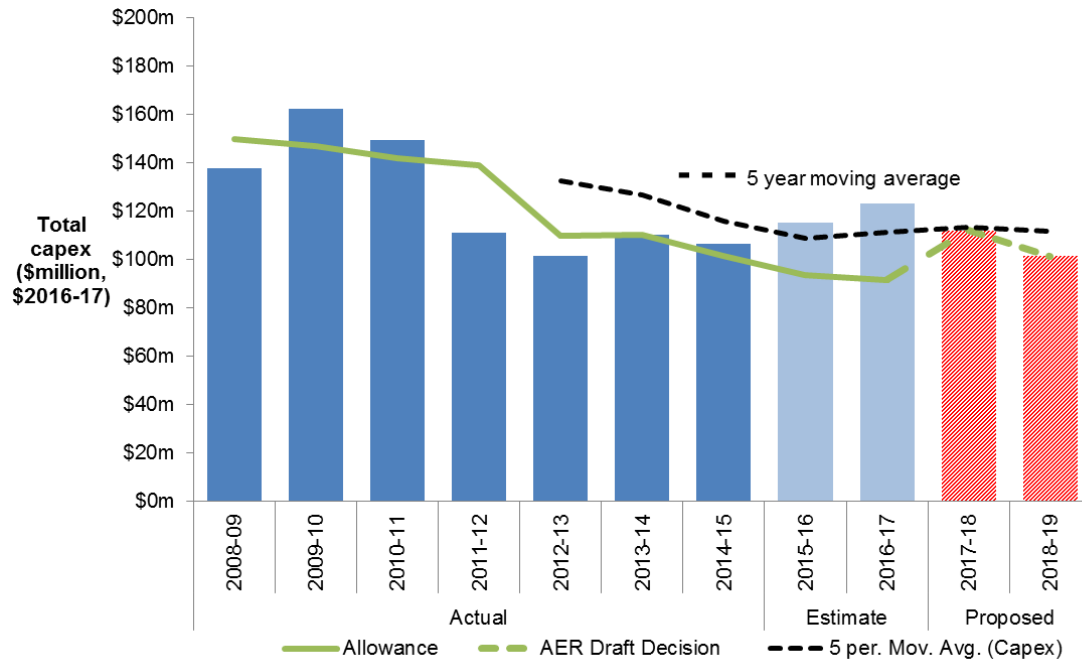
	2017–18	2018–19	Total
TasNetworks' proposal	112.0	101.4	213.4
AER draft decision	112.0	101.4	213.4
Difference	0	0	0
Percentage difference (%)	0	0	0

Source: AER analysis

Note: Numbers may not total due to rounding.

Figure 3.3 shows our capex decision compared to TasNetworks' proposal, its past allowances and past actual expenditure.

Figure 3.3 TasNetworks total actual and forecast capex 2008–2019



Further detail on our draft decision in regards to capex is set out in attachment 6.

3.6 Operating expenditure

Operating expenditure (opex) is the forecast of operating, maintenance and other non-capital costs incurred in the provision of distribution network services.

Our draft decision is to accept TasNetworks' opex forecast of \$123.1 million (\$2016–17) over the 2017–19 regulatory period. TasNetworks' proposal is 14.5 per cent lower (in real terms)⁴⁰ than its annual opex spend over 2012–17. Stakeholder submissions were broadly supportive of TasNetworks' proposal.

To assess TasNetworks' proposal, we developed an alternative estimate of efficient opex using our standard 'base-step-trend' approach.⁴¹ This involves assessing whether the business' past expenditure is an efficient starting point for our estimate, and allowing for forecast growth in prices, output and productivity over the regulatory period.

⁴⁰ Excluding debt raising costs.

⁴¹ AER, *Better Regulation—Expenditure Forecast Assessment Guideline for Electricity Distribution*, November 2013.

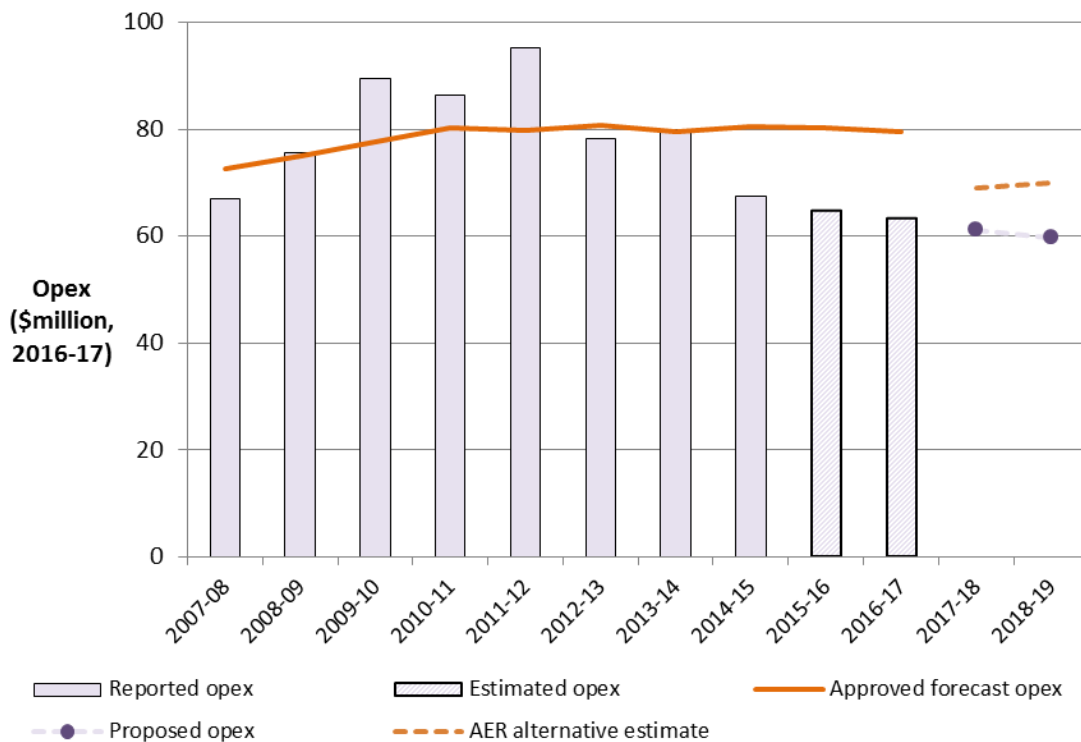
Our benchmarking results indicate TasNetworks is operating efficiently relative to other businesses in the National Electricity Market (NEM). Our alternative estimate of forecast total opex is \$140.6 million (\$2016–17).⁴² This is \$17.5 million higher than TasNetworks' proposal, which we accept.

The key differences between our estimate and TasNetworks' forecast are:

- different approaches to calculating the change in opex between the base year (2014–15) and the final year of the current regulatory control period (2016–17).
- different assumptions about productivity growth over 2017-19. TasNetworks forecast higher productivity growth of 2.2 per cent compared to our estimate of zero productivity growth. TasNetworks expects the merger of the transmission and distribution networks in Tasmania to deliver further costs savings over 2017–19. Our estimate was based on our expectations of the productivity an efficient service provider in the industry can achieve, and takes into account the industry's past performance.

Figure 3.4 shows our alternative estimate compared to TasNetworks' proposal, its past allowances and past actual expenditure.

Figure 3.4 AER draft decision on total forecast opex (\$million, 2016–17)



Source: AER analysis.

⁴² Including debt raising costs.

Further detail on our draft decision in regards to opex is set out in attachment 7.

3.7 Corporate income tax

We make a decision on the estimated cost of corporate income tax for TasNetworks' 2017–19 regulatory control period as part of our revenue determination.⁴³ It enables TasNetworks to recover the costs associated with the estimated corporate income tax payable during the regulatory control period.

We do not accept TasNetworks' proposed cost of corporate income tax allowance of \$30.9 million (\$ nominal). Our draft decision on the estimated cost of corporate income tax is \$18.7 million over the 2017–19 regulatory control period. This represents a reduction of \$12.1 million (or 39.3 per cent) from TasNetworks' proposal.

The reduction reflects our amendments to some of TasNetworks' proposed inputs for forecasting the cost of corporate income tax, including the opening tax asset base, standard tax asset lives and remaining tax asset lives. It also reflects our draft decision on the value of imputation credits—gamma—(attachment 4). Our adjustments to the EBSS carryover amounts (attachment 9), the return on capital (attachments 2 and 3) and the regulatory depreciation (attachment 5) building blocks affect revenues, which in turn impacts the tax calculation. The changes affecting revenues are discussed in attachment 1.

Table 3.9 shows our draft decision on the estimated cost of corporate income tax allowance for TasNetworks over the 2017–19 regulatory control period.

Table 3.9 AER's draft decision on TasNetworks' cost of corporate income tax allowance over the 2017–19 regulatory control period (\$million, nominal)

	2017–18	2018–19	Total
Tax payable	13.0	18.3	31.2
Less: value of imputation credits	5.2	7.3	12.5
Net corporate income tax allowance	7.8	11.0	18.7

Source: AER analysis.

Further detail on our draft decision in regards to corporate income tax is set out in attachment 8.

⁴³ NER, cl. 6.4.3(a)(4).

4 Service classification, control mechanisms, and incentive schemes

A range of factors, in addition to the building blocks, affect TasNetworks' revenues. These include service classification, control mechanisms and our approach to services charged to individual customers, and incentive schemes to promote efficiency. This section explains our approach to each of these.

4.1 Classification of services

Service classification is inherently linked to the type of economic regulation, if any, to apply to specific distribution services. Classification is important to customers as it determines which network services are included in basic electricity charges, the basis on which additional services are sold, and those services we will not regulate. Our decision on service classification reflects our assessment of a number of factors, including existing and potential competition to supply these services.

Services are classified as either 'direct control', 'negotiated' or 'unregulated' services.

- (1) Direct control services are services where we directly control prices by setting a revenue cap or the prices a distributor may charge. These services can be further split by 'standard control' and 'alternative control' services. Our decision on the forms of regulation to apply to standard control and alternative control services is outlined in the following section.

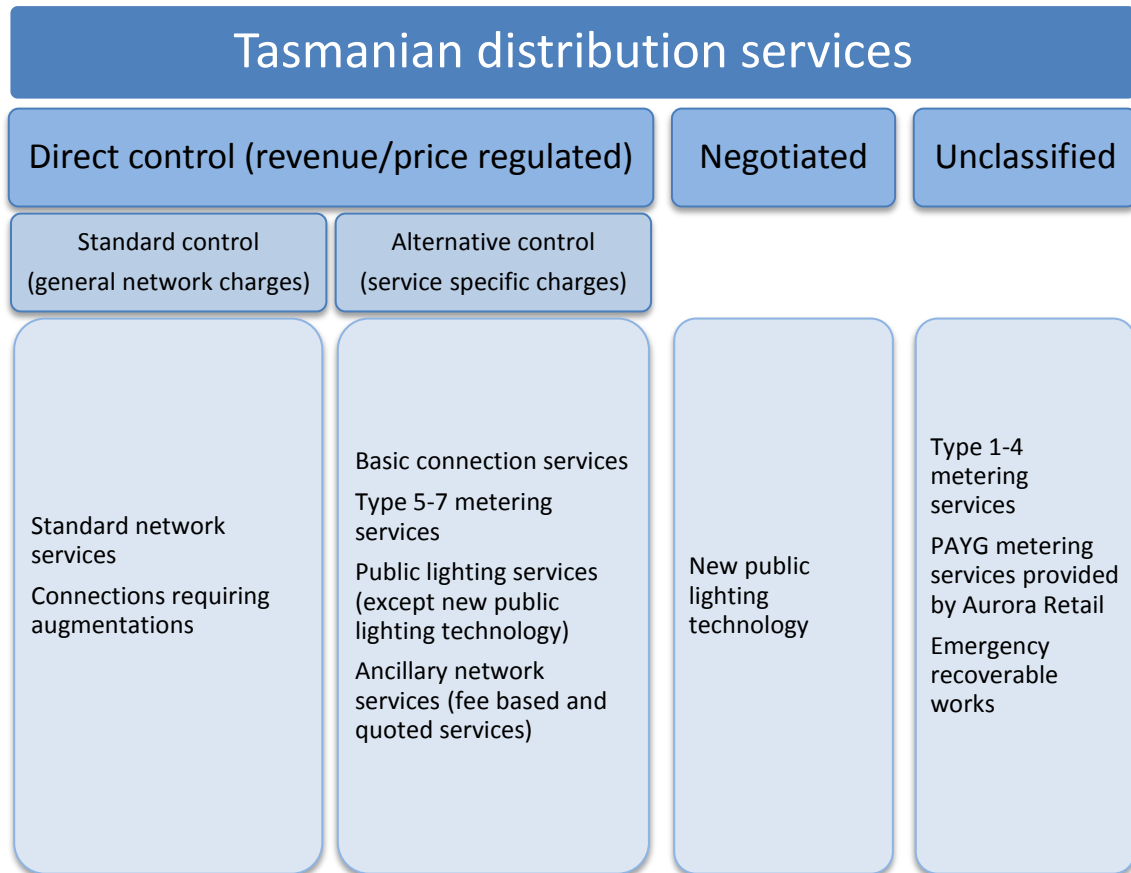
Standard control services are services that are central to electricity supply and therefore relied on by most (if not all) customers.

Alternative control services are customer specific or customer requested services.

- (2) Negotiated services are services that require a less prescriptive regulatory approach because the relevant parties have sufficient market power to negotiate the provision of those services. Distributors and customers are able to negotiate prices, and we are available to arbitrate if necessary.
- (3) Unregulated services are services that are not distribution services, or services that are contestable and therefore do not need to be regulated. We have no role in regulating these services.

Figure 4.1 summarises our draft decision on service classification for TasNetworks for the 2017–19 regulatory control period.

Figure 4.1 AER draft decision on 2017–19 service classification for TasNetworks



4.2 Regulatory control mechanisms

This section sets out our draft decision on the type of regulation to apply to standard control services (section 4.2.1) and alternative control services (4.2.2).

4.2.1 Standard control services

We have decided TasNetworks will be subject to a 'revenue cap' form of control for standard control services over the 2017–19 regulatory control period. This decision is consistent with our final framework and approach (F&A).⁴⁴

The control mechanism, which describes how the revenues will vary from year to year, is discussed in attachment 14. The control mechanism for standard control services is

⁴⁴ The F&A is the first step in our determination of a business' allowable revenue. The F&A determines, amongst other things, which services we will regulate and the broad nature of the regulatory arrangements. AER, *Framework and approach for TasNetworks Distribution for the regulatory control period commencing 1 July 2017*, July 2015, p. 43.

described in mathematical terms and reflects all possible adjustments that might be made to the revenue cap.

4.2.2 Alternative control services

Alternative control services (ancillary network services, public lighting and metering) do not form part of a business' revenue cap. Rather, the prices of these services are generally set individually.

Our draft decision does not accept TasNetworks' proposal for ancillary network services. We consider specific aspects of the cost-build up method to develop final fee based service prices are either overstated or have not been sufficiently justified. We also consider some fee based services should be quoted services.

Our draft decision is to apply price caps as the forms of control to all the alternative control services which are set out in attachment 16. They are consistent with our final F&A.⁴⁵

4.3 Incentive schemes

Incentive schemes are a component of incentive-based regulation and complement our approach to assessing efficient costs. The incentive schemes that will apply to TasNetworks are:

- the efficiency benefit sharing scheme (EBSS)
- the capital expenditure sharing scheme (CESS)
- the service target performance incentive scheme (STPIS)
- demand management incentive scheme (DMIS).

Our incentive schemes encourage network businesses to make efficient decisions. They give network businesses an incentive to pursue efficiency improvements in opex and capex, and to share them with consumers. Incentives for opex and capex are balanced with the incentives under our STPIS. The incentive schemes encourage businesses to make efficient decisions on when and what type of expenditure to incur, and meet service reliability targets.

4.3.1 Efficiency benefit sharing scheme (EBSS)

The efficiency benefit sharing scheme (EBSS) provides an additional incentive for service providers to pursue efficiency improvements in operating expenditure (opex).

To encourage a service provider to become more efficient, under an ex ante framework, a service provider retains any efficiency gains it makes until the end of the

⁴⁵ AER, *Final framework and approach paper for TasNetworks Distribution—Regulatory control period commencing 1 July 2017*, July 2015, pp. 56–57.

regulatory control period when its opex forecast is reset. The EBSS allows the service provider to retain any efficiency gains it makes for a total of six years, regardless of the year in which the gains are made.⁴⁶ This provides a continuous incentive for service providers to pursue efficiency gains over the regulatory control period. It also discourages a service provider from incurring opex in the expected base year to receive a higher opex allowance in the following regulatory control period.

During the 2012–17 regulatory control period, TasNetworks operated under the Electricity distribution network service providers' EBSS released in June 2008.⁴⁷

We have determined an EBSS carryover amount of \$18.1 million (\$2016–17) from the application of the EBSS during the 2012–17 regulatory control period.⁴⁸ This is \$23.0 million (\$2016–17) less than TasNetworks' proposal. The primary reason for this difference is that TasNetworks' EBSS calculations assume year 4 (2015–16) is used as the base year to forecast opex. However, TasNetworks used year 3 (2014–15) to forecast opex. This inconsistency would effectively reward TasNetworks twice for incremental efficiency gains made in 2015–16: once through the EBSS carryovers and a second time because they are not reflected in its opex forecast.

Our draft decision for the EBSS carryover amounts from the 2012–17 regulatory control period is outlined in Table 4.1.

Table 4.1 AER's draft decision on TasNetworks' EBSS carryover amounts (\$million, 2016–17)

	2017-18	2018-19	Total
TasNetworks' proposed carryover	20.6	20.6	41.1
Draft decision	9.0	9.0	18.1

Source: AER analysis, TasNetworks, *Regulatory proposal 2017–19*, January 2016. Totals may not add up due to rounding.

In our final decision we will update estimated opex with actual opex for 2015–16. This may change the carryover amount we determine in the final decision.

Looking forward, our draft decision is to apply version two of the EBSS to TasNetworks in the 2017–19 regulatory control period.⁴⁹ This is consistent with our Final framework and approach paper and TasNetworks' proposal.⁵⁰

⁴⁶ The service provider keeps any efficiency gains in the year it makes them. The service provider then keeps those gains for the length of the carryover period. The carryover length is usually five years so the service provider keeps efficiency gains for a total of six years.

⁴⁷ AER, *Electricity distribution network service providers—Efficiency benefit sharing scheme*, June 2008
AER, *Aurora, distribution determination 2012–17 - attachments, final decision*, April 2012, p. 273.

⁴⁸ AER, *Electricity distribution network service providers—Efficiency benefit sharing scheme*, June 2008.

⁴⁹ AER, *Efficiency benefit sharing scheme for electricity network service providers*, November 2013.

⁵⁰ AER, *Final Framework and approach for TasNetworks*, July 2015, pp. 65-69 ;
TasNetworks, *Regulatory proposal*, January 2016, p. 123.

Attachment 9 sets out our draft decision on the target opex for the EBSS (total opex less excluded categories) that we will use to calculate efficiency gains in the 2017–19 regulatory control period.

Further detail on our draft decision in regards to the application of the EBSS, including proposed expenditure items to be excluded, is set out in attachment 9.

4.3.2 Capital expenditure sharing scheme (CESS)

The CESS provides an incentive for service providers to pursue efficiency improvements in capex. Similar to the EBSS, the CESS provides a network service provider with the same reward for an efficiency saving and the same penalty for an efficiency loss regardless of which year they make the saving or loss.

Under the CESS a service provider retains 30 per cent of the benefit or cost of an underspend or overspend, while consumers retain 70 per cent of the benefit or cost of an underspend or overspend. This means that for a one dollar saving in capex the service provider keeps 30 cents of the benefit while consumers keep 70 cents of the benefit. Conversely, in the case of an overspend, the service provider pays for 30 cents of the cost while consumers bear 70 cents of the cost.

We will apply the CESS as set out in version 1 of the capital expenditure incentives guideline to TasNetworks in the 2017–19 regulatory control period.⁵¹ This is consistent with the proposed approach we set out in our final F&A.⁵²

4.3.3 Service target performance incentive scheme (STPIS)

The STPIS is intended to balance a business' incentive to reduce expenditure with the need to maintain or improve service quality. It achieves this by providing financial incentives to businesses to maintain and improve service performance where customers are willing to pay for these improvements.

Businesses can only retain their rewards for sustained and continuous improvements to the reliability of supply for customers. Once improvements are made, the benchmark performance targets will be tightened in future years.

Our draft decision is to continue to apply the national STPIS to TasNetworks in the 2017–19 regulatory control period. We will not apply the guaranteed service level

⁵¹ AER, *Capex incentive guideline*, November 2013, pp. 5–9.

⁵² AER, *Framework and approach for TasNetworks Distribution for the Regulatory control period commencing 1 July 2017*, July 2015, p. 15.

(GSL) component as TasNetworks is subject to a jurisdictional GSL scheme.⁵³ This is consistent with our final F&A.⁵⁴

The STPIS parameters applied in our draft decision are set out in attachment 11.

4.3.4 Demand management incentive scheme (DMIS)

The demand management incentive scheme (DMIS) includes a demand management innovation allowance (DMIA). The DMIA is a capped allowance for distributors to investigate and conduct broad based and/or peak demand management projects.

We have determined to continue Part A of the DMIS for TasNetworks in the 2017–19 regulatory control period (that is, the DMIA component). We will not apply Part B of the DMIS to TasNetworks for the 2017–19 regulatory control period because the revenue cap form of control will continue. This is consistent with our final F&A.⁵⁵

An innovation allowance amount of \$0.4 million (\$June 2017) per annum will be applied in the 2017–19 regulatory control period.

Attachment 12 sets out our draft decision on TasNetworks' DMIS.

⁵³ OTTER, *Guideline - Guaranteed Service Level Scheme*, December 2007.

⁵⁴ AER, *Final framework and approach paper for TasNetworks Distribution—Regulatory control period commencing 1 July 2017*, July 2015, p. 15.

⁵⁵ AER, *Framework and approach for TasNetworks Distribution for the Regulatory control period commencing 1 July 2017*, July 2015, p. 73.

5 Tariff structure statement

A distributor's tariff structure statement proposal must comply with the distribution pricing principles and other applicable requirements in the NER.⁵⁶⁵⁷

Our draft decision is to not approve TasNetworks proposed tariff structure statement. We do not consider TasNetworks has demonstrated reasonable consideration of the impact of the proposed increases in fixed charges on high voltage business customers.⁵⁸ Therefore we are not satisfied TasNetworks proposed tariff structure statement complies with the distribution pricing principles.

TasNetworks proposed to rebalance its tariffs, such that there is more emphasis on the fixed service charge and less on consumption based charging.

We consider the increase in fixed charges can signal the fixed nature of network costs and therefore contributes to the achievement of compliance with the distribution pricing principles. However, we consider TasNetworks has not demonstrated reasonable consideration of the proposed increases for high voltage business customers.

We require TasNetworks revised tariff structure statement provide further analysis and reasoning to demonstrate reasonable consideration of the impact on these customers.

However, there are elements of TasNetworks proposal we do approve.

We approve of the introduction of time of use demand tariffs for small and low voltage business customers. Demand based tariffs are more cost reflective compared to existing consumption based tariffs. Demand tariffs better reflect a distributor's forward looking costs which are driven by building network capacity to alleviate network congestion and provide a safe and reliable network during periods of peak demand.

Furthermore, we approve the introduction of the time of use demand tariffs to customers on an opt-in basis and that legacy tariffs will continue in their current structure for at least the 2017–19 regulatory control period. Both TasNetworks and stakeholders considered this to be a prudent approach, to avoid any sudden price shocks for customers.

We approve the proposed time of use demand charging windows for the demand tariffs. The peak demand charging windows reflect times of network stress. The proposed times are also wide enough to aid in avoiding customers shifting load and creating new peaks.

We approved the realignment of specific tariffs to remove long standing subsidies between customer groups. Removing the cross subsidies is a movement along the

⁵⁶ NER, cl. 6.18.5.

⁵⁷ NER, cl. 6.12.3(k).

⁵⁸ NER, cl. 6.18.5(h).

cost reflectivity spectrum and contributes to the achievement of compliance with the distribution pricing principles.

6 The regulatory framework

The NEO is the central feature of the regulatory framework. The NEO is to:

- promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity with respect to—
- (a) price, quality, safety, reliability and security of supply of electricity; and
 - (b) the reliability, safety and security of the national electricity system.⁵⁹

Energy Ministers have provided us with a substantial body of explanatory material that guides our understanding of the NEO.⁶⁰ The long term interests of consumers are not delivered by any one of the NEO's factors in isolation, but rather by balancing them in reaching a regulatory decision.⁶¹

In general, we consider that we will achieve this balance and, therefore, contribute to the achievement of the NEO, where consumers are provided a reasonable level of safe and reliable service that they value at least cost in the long run.⁶² We have also considered the quality and reliability of services provided to consumers. For example, opex allowances have been set so TasNetworks may meet existing and new regulatory requirements. Replacement expenditure (repex) allowances take into account the age and condition of assets. Our capex allowance is based on a contemporary estimate of the value of customer reliability. The STPIS encourages maintenance, and indeed improvement of, service quality.

The nature of decisions under the NER is such that there may be a range of economically efficient decisions, with different implications for the long term interests of consumers.⁶³ At the same time, however, there are a range of outcomes that are unlikely to advance the NEO, or advance the NEO to the degree that others would.

For example, we do not consider that the NEO would be advanced if allowed revenues encourage overinvestment and result in prices so high that consumers are unwilling or unable to efficiently use the network.⁶⁴ This could have significant longer term pricing implications for those consumers who continue to use network services.

⁵⁹ NEL, section 7.

⁶⁰ Hansard, *SA House of Assembly*, 9 February 2005, pp. 1451–1460; Hansard, *SA House of Assembly*, 27 September 2007, pp. 963–972; Hansard, *SA House of Assembly*, 26 September 2013, pp. 7171–7176.

⁶¹ Hansard, *SA House of Assembly*, 26 September 2013, p. 7173.

⁶² Hansard, *SA House of Assembly*, 9 February 2005, p. 1452.

⁶³ *Re Michael: Ex parte Epic Energy [2002] WASCA 231* at [143].

Energy Ministers also accept this view – see Hansard, *SA House of Assembly*, 26 September 2013, p. 7172.

AEMC, *Rule determination, National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006 No. 18*, 16 November 2006, p. 50.

⁶⁴ NEL, s. 7A(7).

Equally, we do not consider the NEO would be advanced if allowed revenues result in prices so low that investors are unwilling to invest as required to adequately maintain the appropriate quality and level of service, and where customers are making more use of the network than is sustainable. This could create longer term problems in the network⁶⁵ and could have adverse consequences for safety, security and reliability of the network.

The NEL also includes the revenue and pricing principles (RPP),⁶⁶ which support the NEO. As the NEL requires,⁶⁷ we have taken the RPPs into account throughout our analysis.

The RPPs are:

A regulated network service provider should be provided with a reasonable opportunity to recover at least the efficient costs the operator incurs in—

- providing direct control network services; and
- complying with a regulatory obligation or requirement or making a regulatory payment.

A regulated network service provider should be provided with effective incentives in order to promote economic efficiency with respect to direct control network services the operator provides. The economic efficiency that should be promoted includes—

- efficient investment in a distribution system or transmission system with which the operator provides direct control network services; and
- the efficient provision of electricity network services; and
- the efficient use of the distribution system or transmission system with which the operator provides direct control network services.

Regard should be had to the regulatory asset base with respect to a distribution system or transmission system adopted—

- in any previous—
- as the case requires, distribution determination or transmission determination; or
- determination or decision under the National Electricity Code or jurisdictional electricity legislation regulating the revenue earned, or prices charged, by a person providing services by means of that distribution system or transmission system; or

⁶⁵ NEL, s. 7A(6).

⁶⁶ NEL, s. 7A.

⁶⁷ NEL, s. 16(2).

– in the Rules.

A price or charge for the provision of a direct control network service should allow for a return commensurate with the regulatory and commercial risks involved in providing the direct control network service to which that price or charge relates.

Regard should be had to the economic costs and risks of the potential for under and over investment by a regulated network service provider in, as the case requires, a distribution system or transmission system with which the operator provides direct control network services.

Regard should be had to the economic costs and risks of the potential for under and over utilisation of a distribution system or transmission system with which a regulated network service provider provides direct control network services.

Consistent with Energy Ministers' views, we set revenue allowances to balance all elements of the NEO and consider each of the RPPs.⁶⁸ For example:

- In determining forecast opex and capex that reasonably reflects the opex and capex criteria, we take into account the revenue and pricing principle that should provide TasNetworks with a reasonable opportunity to recover at least efficient costs. (Refer to capex attachment 6 and opex attachment 7).
- We take into account the economic costs and risks of the potential for under and over investment by a network service provider in our assessment of TasNetworks' forecast capex and opex proposals. (Refer to capex attachment 6 and opex attachment 7).
- We consider the economic costs and risks of the potential for under and over utilisation of TasNetworks' distribution network in our demand forecasting (Refer to capex attachment 6).
- Our application of the EBSS, CESS, and STPIS in this draft decision provide TasNetworks with effective incentives which we consider will promote economic efficiency with respect to the direct control services that TasNetworks provides throughout the regulatory control period. (Refer to attachments 9, 10 and 11).
- We have determined TasNetworks' opening RAB taking into account the RAB adopted in the previous distribution determination. (Refer to attachment 2, regulatory asset base).
- The allowed rate of return objective reflects the revenue and pricing principle in s. 7A(5) of the NEL. We have determined a rate of return that we consider will provide TasNetworks with a return commensurate with the regulatory and commercial risks involved in providing direct control services. (Refer to attachment 3, rate of return).

⁶⁸ Hansard, *SA House of Assembly*, 27 September 2007, p. 965; Hansard, *SA House of Assembly*, 26 September 2013, p. 7173.

- Our financing determinations provide the DNSP with a reasonable opportunity to recover at least the efficient costs of accessing debt and capital. (Refer to attachment 3, rate of return).

In some cases, our approach to a particular component (or part thereof) results in an outcome towards the end of the range of options that may be favourable to the businesses. While it can be difficult to quantify the exact revenue impact of these individual decisions, we have identified where we have done so in our attachments. Some of these decisions include:

- selecting at the top of the range for the equity beta
- setting the return on debt by reference to data for a BBB broad band credit rating, when the benchmark is BBB+
- the cash flow timing assumptions in the post-tax revenue model.

We take into account the RPPs when exercising discretion about an appropriate estimate. This requires a recognition that for the long term interests of consumers, the risk of under compensation for, or underinvestment by, a service provider may be less desirable than the risk of overcompensation or overinvestment. However, the AER is also conscious of the risk of introducing an inherent bias towards higher amounts where estimates throughout the different components of the determination are each set too conservatively.⁶⁹ The legislative framework recognises the complexity of this task by providing the AER with significant discretion in many aspects of the decision-making process to make judgements on these matters.

Chapter 6 of the NER provides specifically for the economic regulation of DNSPs. It includes rules about the constituent components of our decisions. These are intended to contribute to the achievement of the NEO.⁷⁰

6.1 Achieving the NEO to the greatest degree

Electricity distribution determinations are complex decisions and must be considered as such. In most instances, the provisions of the NER do not point to a single answer, either for our decision as a whole or in respect of particular components. They require us to exercise our regulatory judgement. For example, chapter 6 of the NER requires us to prepare forecasts, which are predictions about unknown future circumstances. As a result, there will likely always be more than one plausible forecast.⁷¹ There is substantial debate amongst stakeholders about the costs we must forecast, with both sides often supported by expert opinion. As a result, for certain components of our decision there may be several plausible answers or several plausible point estimates.

⁶⁹ AEMC, *Rule determination, National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006 No. 18*, 16 November 2006, p. 52.

⁷⁰ NEL, s. 88.

⁷¹ AEMC, *Rule Determination: National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006*, (16 November 2006), 52.

When the constituent components of our decision are considered together, this means there will almost always be several potential, overall decisions. More than one of these may contribute to the achievement of the NEO. Where this is the case, our role is to make an overall decision that we are satisfied contributes to the achievement of the NEO to the greatest degree.⁷²

We approach this from a practical perspective, accepting that it is not possible to consider every permutation specifically. Where there are choices to be made among several plausible alternatives each of which would result in an overall decision that contributes to the achievement of the NEO, we have selected what we are satisfied would result in an overall decision that contributes to the achievement of the NEO to the greatest degree. This is our role under the NEO.

In coming to this draft decision we considered TasNetworks' regulatory proposal. We have examined each of the building block components of the proposal and the incentive mechanisms that would apply across the 2017–19 regulatory control period. We considered the submissions we received and conducted our own analysis to help us better understand if and how TasNetworks' proposal contributes to the achievement of the NEO. We also considered how our constituent decisions relate to each other, the impact that particular constituent decisions have on other constituent components of our decision, and have described these interrelationships in this draft decision. We have undertaken an extensive and consultative regulatory review process to ensure we have canvassed stakeholder issues and made as much of this information publicly available as practicable. We have had regard to and weighed up all the information assembled before us in making this draft decision.

We are satisfied that among the options before us our draft decision on TasNetworks' distribution determination for the 2017–19 regulatory control period contributes to the achieving the NEO to the greatest degree.

6.2 Interrelationships between constituent components

Examining constituent components in isolation ignores the importance of the interrelationships between components of the overall decision, and would not contribute to the achievement of the NEO. As outlined by Energy Ministers, considering the elements in isolation has resulted in regulatory failures in the past.⁷³ Interrelationships can take various forms, including:

- underlying drivers and context which are likely to affect many constituent components of our decision. For example, forecast demand affects the efficient levels of capex and opex in the regulatory control period (see attachment 6 and 7).
- direct mathematical links between different components of a decision. For example, the level of gamma has an impact on the appropriate tax allowance; the benchmark

⁷² NEL, s. 16(1)(d).

⁷³ SCER, *Regulation impact statement: Limited merits review of decision-making in the electricity and gas regulatory frameworks*, Decision paper, 6 June 2013, p. 6

efficient entity's debt to equity ratio has a direct effect on the cost of equity, the cost of debt, and the overall vanilla rate of return (see attachments 3, 4 and 8).

- trade-offs between different components of revenue. For example, undertaking a particular capex project may affect the need for opex or vice versa (see attachments 6 and 7).
- trade-offs between forecast and actual regulatory measures. The reasons for one part of a proposal may have impacts on other parts of a proposal. For example, an increase in augmentation to the network means the DNSP has more assets to maintain leading to higher opex requirements (see attachments 6 and 7).
- the DNSP's approach to managing its network. The DNSP's governance arrangements and its approach to risk management will influence most aspects of the proposal, including capex/opex trade-offs (see attachment 6).

We have considered interrelationships, including those above, in our analysis of the constituent components of our draft decision. These considerations are explored in the relevant attachments.

7 Consultation

Stakeholder participation is important to informed decision making under the NEL and NER. It allows us to take a range of views into account when considering how a proposal or decision contributes to the NEO. Effective consultation and engagement provide confidence in our processes and are good regulatory practice. This is reflected in the consultation process set out in the NER, under which we have:

- published TasNetworks' regulatory proposal and supporting material
- published an issues paper identifying preliminary issues with the regulatory proposal
- invited written submissions on the regulatory proposal
- held a public forum on the regulatory proposal
- published this draft decision.

We also sought advice from the AER's Consumer Challenge Panel (CCP) on TasNetworks' regulatory proposal. Both the CCP and TasNetworks met with the AER Board to discuss this review.

This process builds on consultation we undertook with a broad range of stakeholders as part of the Better Regulation program. Following changes to the NER in 2012, we spent much of 2013 consulting on and refining our assessment methods and approaches to decision making. We referred to this as our Better Regulation program. The Better Regulation program was designed to be an inclusive process that provided an opportunity for all stakeholders to be engaged and provide their input.⁷⁴

This gives us confidence the approaches set out in our various guidelines, which we have applied in this decision, will result in outcomes that will or are likely to contribute to the achievement of the NEO to the greatest degree. Our Better Regulation guidelines are available on our website⁷⁵ and include:

- Expenditure forecast assessment guideline
- Expenditure incentives guideline
- Rate of return guideline
- Consumer engagement guideline for network service providers
- Shared assets guideline
- Confidentiality guideline.

⁷⁴ AER, *Overview of the Better Regulation reform package*, April 2014, pp. 4 & 7–13.

⁷⁵ www.aer.gov.au/better-regulation-reform-program

The guidelines provide businesses, investors and consumers predictability and transparency of our approach to regulation under the new rules.

7.1 Consumer engagement

Recent changes to the NER provide further support for consumer involvement in the regulatory process, and enable us to engage more productively with energy consumers and businesses.⁷⁶ Chapter 6 of the NER was amended to, among other things, require:

- DNSPs to submit an overview with their proposal which describes how they have engaged with consumers and sought to address any relevant concerns identified by that engagement⁷⁷
- the AER to publish an issues paper after receiving the DNSP's proposal.⁷⁸ The purpose of the issues paper is to assist consumer representative groups to focus on the key preliminary issues on which they should engage and comment⁷⁹
- the AER, when determining capex and opex allowances, to have regard to the extent to which the forecast includes expenditure to address the concerns of consumers as identified by the DNSP in the course of its engagement with the consumers.⁸⁰

Our Better Regulation Consumer engagement guideline sets out our expectations of how network businesses should engage with their customers. We expect the network businesses to demonstrate a commitment to ongoing and genuine consumer engagement on issues relevant to consumers. We want to see businesses being more accountable to their consumers.⁸¹ We also understand the businesses may need some time to develop and implement robust and comprehensive engagement strategies and approaches.⁸²

As set out in the guideline, we monitor consumer engagement activities through the CCP and our ongoing engagement with stakeholders. We may publicly comment in our decisions on any shortcomings that we identify from an expenditure proposal that reflect weaknesses in consumer engagement.⁸³

We have considered the material presented in TasNetworks' proposal (section 7.2), and stakeholder views presented to us in submissions (section 7.3) to form a view of

⁷⁶ AEMC, *Rule determination, National Electricity Amendment (Economic Regulation of Network Service Providers)*, Rule 2012.

⁷⁷ NER, cl. 6.8.2(c1)(2).

⁷⁸ NER, cl. 6.9.3(b).

⁷⁹ AEMC, *Rule determination, National Electricity Amendment (Economic Regulation of Network Service Providers)*, Rule 2012.

⁸⁰ NER, cll. 6.5.6(e)(5A) and 6.5.7(e)(5A).

⁸¹ AER, *Better Regulation: Consumer engagement guideline for network service providers*, November 2013, p. 5.

⁸² AER, *Better Regulation: Consumer engagement guideline for network service providers*, November 2013, p. 12.

⁸³ AER, *Better Regulation: Consumer engagement guideline for network service providers*, November 2013, p. 12.

its progress in implementing improved engagement strategies and approaches (section 7.4).

7.2 TasNetworks' consumer engagement activities

In its regulatory proposal, TasNetworks has outlined its consumer engagement strategy as summarised below:⁸⁴

- TasNetworks is committed to engaging with, informing and educating its customers about its activities and plans for the future.
- TasNetworks' customer strategic goal is to 'understand its customers and make them central to all it does', with the ultimate aim of improving price, service and reliability outcomes for customers.
- TasNetworks must understand and respond to each of its customer segments in order to deliver service propositions that meet their varied needs.
- TasNetworks has developed a 'Voice of the Customer Program' to sharpen its focus on delivering quality service outcomes for its customers.
- Through its Voice of the Customer program, focus on customers will
 - help TasNetworks to provide quality service outcomes for our customers
 - enable the successful achievement of its vision, which is: to be trusted by its customers to deliver today and create a better tomorrow.⁸⁵

7.2.1 TasNetworks' reset engagement plan

TasNetworks submitted that to inform its revenue reset activities, it gathered information and feedback from its customers and other stakeholders in a variety of different ways. The key milestones of its customer engagement activities under the plan are outlined below.⁸⁶

- First round of customer engagement workshops held in October 2014
- Workshop with a number of stakeholder groups held in October 2014
- Established a Tariff Reform Working Group
- Participated in Agfest rural symposium in May 2015
- Quantitative research - telephone and online surveys were conducted by an external facilitator in May 2015
- Second round of customer engagement workshops held in June 2015

⁸⁴ TasNetworks, *Regulatory proposal*, January 2016, pp. 36–41.

⁸⁵ TasNetworks, *Regulatory proposal*, January 2016, pp. 36–41.

⁸⁶ TasNetworks, *Regulatory proposal*, January 2016, pp. 37–40.

- System planning engagement held with representatives of developers, customers and external planning bodies from April to December 2015
- Direction and priorities consultation paper - insights collected through TasNetworks' engagement activities, along with its knowledge of the network, future trends and regulatory obligations.

7.2.2 Summary of customer feedback

TasNetworks submitted that it has undertaken a range of activities to gather feedback, and to understand the issues and concerns that are important to its customers. The key messages emerging from the customer engagement as outlined in TasNetworks' regulatory proposal are summarised below:⁸⁷

- TasNetworks is meeting most customers' needs from an overall performance perspective.
- Its most valued services include reliability and restoration of supply, followed by the management of the network to safely and reliably deliver electricity.
- Overall satisfaction with current reliability levels is quite high. The majority of customers support TasNetworks' proposed strategy to maintain reliability rather than investing more to improve it.
- While improvements in reliability and outage response could strengthen satisfaction, customers are not willing to pay higher prices for these improvements.
- Cost is the greatest concern and lower prices – without reducing service quality – would lead to the greatest uplift in satisfaction.
- Customers recognise that technology is changing the electricity industry, particularly in relation to solar PVs, battery storage and electric vehicles.

In relation to areas for improvement, customers highlighted the following issues:

- providing services at lower cost without compromising service quality
- providing customers with better information about restoration times
- addressing meter reading concerns
- addressing quality of supply issues such as voltage complaints
- ensuring that customers or stakeholders have sufficient information to make informed decisions on TasNetworks' future plans and network pricing reform
- improving the way TasNetworks' communicate with its stakeholders on how it is innovating and considering new technologies

⁸⁷ TasNetworks, *Regulatory proposal*, January 2016, pp. 40–41.

- using more responsive and modern communication tools (for example SMS automatic messaging for outage updates) and improved online communication, especially for outages.

TasNetworks has recognised that there are many opportunities for it to improve the way it engage and communicate with its customers.⁸⁸

7.3 Consumer submissions

The CCP and other consumer submissions welcome TasNetworks' customer engagement strategy, processes and endeavours. The CCP and other stakeholders considered that TasNetworks has exhibited a proactive commitment to its consumer engagement and that it will seek continuous improvement in this. In particular, CCP member's noted TasNetworks' 'customer first' culture that it seeks to implement and considered that this should be introduced by all network service providers in the NEM. All submissions spoke highly of TasNetworks' engagement efforts and its openness and transparency.⁸⁹

Submissions received by the AER noted that TasNetworks' customer engagement has identified two recurring messages:⁹⁰

1. Cost of services is of greatest concern to customers
2. Customers are not willing to pay higher prices for reliability improvements.

While TasNetworks has been applauded for its 'Voice of the Customer' program, various submissions noted that these two areas have not been identified in the program definitions. Stakeholders considered that these two areas should be the core focus of the Voice of the Customer program.⁹¹

Stakeholders were also concerned that TasNetworks' customer focus groups were held in metropolitan areas of the state where network reliability tends to be good. Although survey instruments were also employed, stakeholders believe that

⁸⁸ TasNetworks, *Regulatory proposal*, January 2016, p.41.

⁸⁹ TasCOSS, *Submission on TasNetworks' revenue proposal for 2017–19*, 28 April 2016, p. 2; Tasmanian Small Business Council, *TasNetworks' electricity distribution regulatory proposal, 1 July 2017 to 30 June 2019 and tariff structure proposal submission*, May 2016, pp. 17-18; CCP (David Headberry), *Response to the proposal from Tasmania's electricity distribution network service provider for a revenue reset for the 2017–2019 regulatory period*, 4 May 2016, pp. 5–9; CCP (Jo De Silva), *Submission to the AER on TasNetworks' distribution regulatory proposal 2017–19*, April 2016, pp. 13–15.

⁹⁰ Tasmanian Small Business Council, *TasNetworks' electricity distribution regulatory proposal, 1 July 2017 to 30 June 2019 and tariff structure proposal submission*, May 2016, p. 17; CCP (David Headberry), *Response to the proposal from Tasmania's electricity distribution network service provider for a revenue reset for the 2017–2019 regulatory period*, 4 May 2016, p. 6; CCP (Jo De Silva), *Submission to the AER on TasNetworks' distribution regulatory proposal 2017–19*, April 2016, p. 12.

⁹¹ Tasmanian Small Business Council, *TasNetworks' electricity distribution regulatory proposal, 1 July 2017 to 30 June 2019 and tariff structure proposal submission*, May 2016, pp. 17–18; CCP (David Headberry), *Response to the proposal from Tasmania's electricity distribution network service provider for a revenue reset for the 2017–2019 regulatory period*, 4 May 2016, p. 6.

TasNetworks should proactively seek the views of consumers who live in more regional areas.⁹²

7.4 Our view of TasNetworks' consumer engagement

Overall we consider that TasNetworks has taken important steps to engage with its customers. We agree with stakeholder comments that TasNetworks has exhibited a proactive commitment to its consumer engagement. We consider that this is very positive and it is encouraging to see positive comments from stakeholders. We consider that the consumer engagement undertaken by TasNetworks to date has continued to improve and has built on the engagement program undertaken by TasNetworks for its transmission network.

We accept that there are some concerns from stakeholders regarding TasNetworks' customer engagement program. We note, however, that customer engagement is a relatively new aspect undertaken by network service providers and TasNetworks has committed to improving this process over time. In particular, TasNetworks has submitted that, on the basis of feedback it has received, it intends to engage in a way that ensures customers from regional areas have more opportunities to be heard in the future.⁹³

We expect that TasNetworks will take into account the issues raised by stakeholders in further developing its future customer engagement activities.

⁹² TasCOSS, *Submission on TasNetworks' revenue proposal for 2017–19*, 28 April 2016, pp. 2–3; Tasmanian Small Business Council, *TasNetworks' electricity distribution regulatory proposal, 1 July 2017 to 30 June 2019 and tariff structure proposal submission*, May 2016, p. 18; CCP (David Headberry), *Response to the proposal from Tasmania's electricity distribution network service provider for a revenue reset for the 2017–2019 regulatory period*, 4 May 2016, p. 8.

⁹³ TasNetworks, *Regulatory proposal*, January 2016, p. 41.

A Constituent decisions

Our draft decision on TasNetworks' distribution determination includes the following constituent components:⁹⁴

Constituent decision

In accordance with clause 6.12.1(1) of the NER, the following classification of services will apply to TasNetworks for the 2017–19 regulatory control period (listed by service group):

- Standard control services include network services, and connection services requiring augmentation
- Alternative control services include basic connections, type 5–7 metering services, public lighting services (except new public lighting technology), ancillary network services (fee based and quoted services)
- Negotiated distribution services include new public lighting technology
- Unregulated services include type 1 to 4 metering services, PAYG metering services provided by Aurora Retail, emergency recoverable works.

Attachment 13 of the draft decision discusses classification of services.

In accordance with clause 6.12.1(2)(i) of the NER, the AER does not approve the annual revenue requirement set out in TasNetworks' building block proposal. Our draft decision on TasNetworks' annual revenue requirement for each year of the 2017–19 regulatory control period is set out in attachment 1 of the draft decision.

In accordance with clause 6.12.1(2)(ii) of the NER, the AER approves TasNetworks' proposal that the regulatory control period will commence on 1 July 2017. Also in accordance with clause 6.12.1(2)(ii) of the NER, the AER approves TasNetworks' proposal that the length of the regulatory control period will be 2 years from 1 July 2017 to 30 June 2019.

In accordance with clause 6.12.1(3)(i) and acting in accordance with clause 6.5.7(c), the AER accepts TasNetworks' proposed total forecast capital expenditure of \$213.4 million (\$2016–17). This is discussed in attachment 6 of the draft decision.

In accordance with clause 6.12.1(4)(i) and acting in accordance with clause 6.5.6(c), the AER accepts TasNetworks' proposed total forecast operating expenditure inclusive of debt raising costs and exclusive of DMIA of \$123.1 million (\$2016-17). This is discussed in attachment 7 of the draft decision.

In accordance with clause 6.12.1(4A)(i) the AER determines that there are no contingent projects for the purposes of the distribution determination.

TasNetworks did not include any proposed contingent projects in its regulatory proposal for the 2017–19 regulatory control period. Therefore,

⁹⁴ NER, cl. 6.12.1.

- in accordance with clause 6.12.1(4A)(ii), the AER has not made an assessment of whether the capital expenditure proposed in the context of each contingent project reflects the capital expenditure criteria and factors
- in accordance with clause 6.12.1(4A)(iii), the AER does not specify any trigger events in relation to contingent projects
- in accordance with clause 6.12.1(4A)(iv), the AER does not determine that any proposed contingent project is not a contingent project.

In accordance with clause 6.12.1(5) the AER's draft decision on the allowed rate of return for the first regulatory year of the regulatory control period in accordance with clause 6.5.2 is to not accept TasNetworks' proposal of 6.04 per cent. Our draft decision on the allowed rate of return for the first regulatory year of the regulatory control period is 5.48 per cent as set out in attachment 3 of the draft decision. This rate of return will be updated annually because our draft decision is to apply a trailing average portfolio approach to estimating debt which incorporates annual updating of the allowed return on debt.

In accordance with clause 6.12.1(5A) the AER's draft decision is that the return on debt is to be estimated using a methodology referred to in clause 6.5.2(i)(2) which is set out in attachment 3 of the draft decision. For the purposes of clause 6.5.2(L), our draft decision is that the resulting change to TasNetworks' annual building block revenue requirement is to be effected through:

- the automatic application of the return on debt methodology specified in this section
- using the return on debt averaging periods specified in attachment 3 of the draft decision
- implemented using the control formulas specified in attachments 14 and 16 to the draft decision, and
- implemented using TasNetworks' final determination post-tax revenue model (PTRM) in accordance with the AER's PTRM handbook.

In accordance with clause 6.12.1(5B) the AER's draft decision on the value of imputation credits as referred to in clause 6.5.3 is to adopt a value of 0.4. This is discussed in attachment 4 of the draft decision.

In accordance with clause 6.12.1(6) the AER's draft decision on TasNetworks' regulatory asset base as at 1 July 2017 in accordance with clause 6.5.1 and schedule 6.2 is \$1629.4 million (\$ nominal). This is discussed in attachment 2 of the draft decision.

In accordance with clause 6.12.1(7) the AER does not accept TasNetworks' proposed corporate income tax of \$30.9 million (\$ nominal). Our draft decision on TasNetworks' corporate income tax is \$18.7 million (\$ nominal). This is set out in attachment 8 of the draft decision.

In accordance with clause 6.12.1(8) the AER's draft decision is to not approve the depreciation schedules submitted by TasNetworks. Our draft decision substitutes alternative depreciation schedules in accordance with clause 6.5.5(b) and this is set out in attachment 5 of the draft decision.

In accordance with clause 6.12.1(9) the AER makes the following draft decisions on how any applicable efficiency benefit sharing scheme, capital expenditure sharing scheme, service target performance incentive scheme, demand management and embedded generation connection incentive scheme or small-scale incentive scheme is to apply:

- The AER's draft decision is to apply version two of the EBSS to TasNetworks in the 2017–19 regulatory control period. This is set out in attachment 9 of the draft decision.

- We will apply the CESS as set out in version 1 of the Capital Expenditure Incentives Guideline to TasNetworks in the 2017–19 regulatory control period. CESS is discussed in attachment 10 of the draft decision.
- We will apply our Service Target Performance Incentive Scheme (STPIS) to TasNetworks for the 2017–19 regulatory control period.
- We will apply the System Average Interruption Duration Index (SAIDI) and System Average Interruption Frequency Index (SAIFI) reliability of supply parameters. We will also apply the customer service telephone answering parameter. We will not apply a guaranteed service level scheme as TasNetworks must comply with an existing jurisdictional guaranteed service level scheme.
- A beta of 2.5 will be used to calculate the major event day boundary.
- Our draft decision on the SAIDI and SAIFI incentive rates and performance targets to apply to TasNetworks for the 2017–19 regulatory control period are set out in attachment 11 of the draft decision.
- Our draft decision on the customer service incentive rate and performance target are set out in attachment 11 of the draft decision.
- The revenue at risk for TasNetworks will be capped at ± 5.0 per cent. Within this there will be a cap of ± 0.5 per cent on the telephone answering parameter for performance.
- Note: The meaning for year "t" under the price control formula for this determination is different to that in Appendix C of STPIS. Year "t+1" in Appendix C of STPIS is equivalent to year "t" in the price control formula of this draft decision.
- The AER has determined to continue Part A of the Demand Management Innovation Scheme (DMIS) for TasNetworks in the 2017–19 regulatory control period (that is, the DMIA component). DMIS is discussed in attachment 12 of the draft decision.

In accordance with clause 6.12.1(10) the AER's draft decision is that all appropriate amounts, values and inputs are as set out in this determination including attachments.

In accordance with clause 6.12.1(11) the AER's draft decision on the form of control mechanisms (including the X factor) for standard control services is a revenue cap. The revenue cap for TasNetworks for any given regulatory year is the total annual revenue calculated using the formula in attachment 14 plus any adjustment required to move the DUoS under/over account to zero. This is discussed at attachment 14 of the draft decision.

In accordance with clause 6.12.1(12) the AER's draft decision on the form of the control mechanism for alternative control services is to apply price caps for all services. This is discussed in attachment 16 of the draft decision.

In accordance with clause 6.12.1(13), to demonstrate compliance with its distribution determination, the AER's draft decision is TasNetworks must maintain a DUoS unders and overs account. It must provide information on this account to us in its annual pricing proposal. This is discussed in attachment 14 of the draft decision.

In accordance with clause 6.12.1(14) the AER has approved the following nominated pass through events to apply to TasNetworks for the 2017–19 regulatory control period in accordance with clause 6.6.1(a1)(5):

- terrorism event

- insurance cap event
- natural disaster event.

These events have the definitions set out in Attachment 15 of the draft decision.

In accordance with clause 6.12.1(14A) the AER's draft decision is to not approve the tariff structure statement proposed by TasNetworks. Our draft decision requires TasNetworks to demonstrate reasonable consideration of the impact of the proposed increases in fixed charges on high voltage business customers. This is discussed in attachment 19 of the draft decision.

In accordance with clause 6.12.1(15) the AER's draft decision is to approve TasNetworks' proposed negotiating framework. The negotiating framework that is to apply to TasNetworks is set out in attachment 17 of the draft decision.

In accordance with clause 6.12.1(16) the AER's draft decision is to apply the negotiated distribution services criteria published in February 2016 to TasNetworks. This is set out in attachment 17 of the draft decision.

In accordance with clause 6.12.1(17) the AER's draft decision on the procedures for assigning retail customers to tariff classes for TasNetworks is set out in attachment 14 of the draft decision.

In accordance with clause 6.12.1(18) the AER's draft decision is that the depreciation approach based on forecast capex (forecast depreciation) is to be used to establish the RAB at the commencement of TasNetworks' regulatory control period as at 1 July 2019. This is discussed in attachment 2 of the draft decision.

In accordance with clause 6.12.1(19) the AER's draft decision on how TasNetworks is to report to the AER on its recovery of designated pricing proposal charges is to set this out in its annual pricing proposal. The method to account for the under and over recovery of designated pricing proposal charges is discussed in attachment 14 of the draft decision.

In accordance with clause 6.12.1(20) the AER's draft decision is to require TasNetworks to maintain a jurisdictional scheme unders and overs account. It must provide information on this account to us in its annual pricing proposal as set out in attachment 14 of the draft decision.

In accordance with clause 6.12.1(21) the AER's draft decision is to not approve the connection policy proposed by TasNetworks. We have modified TasNetworks' proposed connection policy as set out in attachment 18 of the draft decision.

B List of submissions

We received 5 submissions in response to TasNetworks' regulatory proposal. These are listed below.

Submission from	Date received
Consumer Challenge Panel member Jo De Silva	April 2016
Consumer Challenge Panel member David Headberry	4 May 2016
Tasmanian Council of Social Service (TasCOSS)	28 April 2016
Tasmanian Small Business Council	May 2016
Vector	28 April 2016
