Tasmanian Distribution Revised Regulatory Proposal

Regulatory Control Period
1 July 2017 to 30 June 2019

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Amendments to each version of this document will be tracked through TasNetworks' document management system.

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1 Introduction and Background

1.1 Purpose of this document

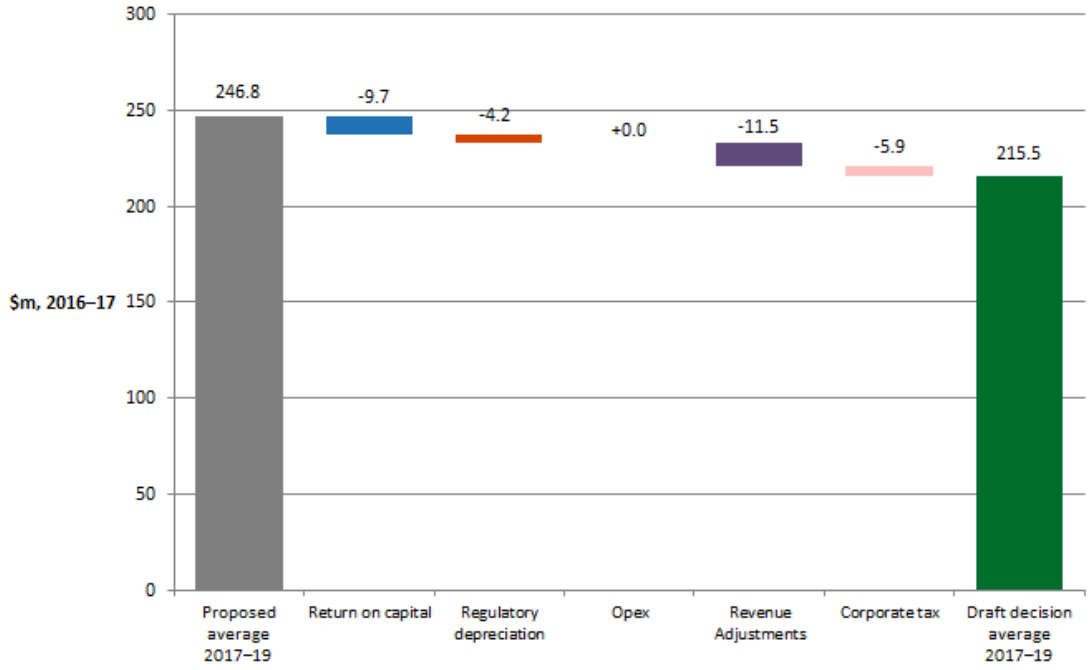
In January 2016, we submitted our electricity distribution Regulatory Proposal for the two year regulatory period commencing on 1 July 2017 and ending on 30 June 2019. On 29 September 2016, the Australian Energy Regulator (**AER**) released its draft decision.

This document sets out our revised Regulatory Proposal in response to the AER's draft decision, and in accordance with clause 6.10.3 of the National Electricity Rules (**Rules**).

1.2 Overview of draft decision

The AER's draft decision did not accept our proposed distribution revenue requirements for the 2017-19 period, and instead set an alternative allowance comprising the adjustments set out below in the figure below[1]:

Figure 1: AER's draft decision adjustments to our proposed revenue requirements ($million, 2016–17)



We accept three of the four adjustments proposed by the AER, being:

- 'return on capital' – which largely reflects updated financial market data, subject to further update;
- 'regulatory depreciation' – which reflects timing changes applied by the AER; and
- 'revenue adjustments' – which reflect different timing assumptions for how the efficiency benefit sharing scheme operates with the operating expenditure forecast.

[1] AER, Draft Decision, TasNetworks distribution determination 2017−18 to 2018−19 Overview, September 2016, Figure 2.3, page 12.

Together these adjustments comprise approximately 80 per cent of the total reduction proposed in the AER's draft decision. We comment briefly on each of these adjustments in turn in sections 1.3 to 1.5 below. We also note that the 'corporate tax' adjustment reflects changes in a number of inputs as well as the value of imputation credits. Our proposal applies the prevailing approach to this calculation.

Section 1.6 outlines the key assumption changes underpinning our revised regulatory proposal. Section 1.7 provides a summary of our engagement approach. Section 1.8 concludes this chapter by outlining the matters that are addressed in this revised Regulatory Proposal.

1.3 Return on capital

The return on capital, or weighted average cost of capital, allowance adopted by the AER reflects updated financial market data which was not available at the time we submitted our original Regulatory Proposal in January 2016. Therefore, the AER's proposed adjustment does not reflect a difference of view regarding the methodology for determining the rate of return. Moreover, the values we adopted for each parameter were consistent with the AER's Rate of Return Guideline.

For the purpose of this revised Regulatory Proposal, we have adopted the AER's cost of capital estimate of 5.48 per cent, as set out in its draft decision. We note that a further update to the cost of capital will be applied in the AER's final decision to reflect updated financial market data, and therefore the revenue requirements presented in this revised Regulatory Proposal will also be updated in light of this information.

1.4 Regulatory depreciation

We accept the AER's proposed adjustment in relation to regulatory depreciation, which reflects the AER's application of a more sophisticated method for depreciating the opening asset base.

The regulatory depreciation amount has also been updated in this revised Regulatory Proposal to reflect our actual capital expenditure in 2015-16. The AER's draft decision calculated our regulatory depreciation allowance based on our earlier estimate. This process of updating expenditure resulted in a reduction to the depreciation allowance, this information is not controversial and we expect the AER to approve the revised regulatory depreciation.

1.5 Revenue adjustments

The 'revenue adjustments' component relates to the calculation of efficiency benefit bonuses. We delivered significant operating expenditure efficiencies in the current regulatory period, leading to lower prices in the forthcoming regulatory period. The regulatory framework rewards these efficiencies through the operation of the Efficiency Benefit Sharing Scheme (**EBSS**).

The AER's draft decision noted the link between the application of EBSS and the base year underpinning forecast operating expenditure and identified an inconsistency in our Regulatory Proposal between:

- the method we used to calculate the efficiency bonus; and
- the method we used to forecast our operating expenditure.

In applying a consistent approach, the AER's bonus calculation is $11.5 million lower than our original calculation. We accept the AER's reasoning and we have updated the calculation for the latest data.

1.6 Key assumptions

There are a number of assumptions that have application to the overall regulatory proposal and apply equally to both capital and operating expenditure. Two assumptions have been amended slightly as a result of discussions with the Tasmanian jurisdiction and the AER on the implementation of metering contestability and embedded networks rule changes.

This revised Regulatory Proposal reflects the following updated key assumptions:

- the Metering Contestability Rule change will be implemented in Tasmania on 1 December 2017. The implementation of this rule will require significant investment in our standard control distribution services, including investments in new customer processes and information technology systems. Our proposal reflects a forecast of costs relating to distribution metering compliance; if however, the implementation of metering compliance results in material increases in our costs (over and above our the level we have forecast) we may update our forecasts through a pass through application process; and
- no provision is made for costs arising from the final Embedded Networks Rule change which will be implemented in the National Market on 1 December 2017, as the application of Tasmanian jurisdictional instruments for these changes is not yet determined. If material increases in our costs are required as a result of this Rule, we may update our forecasts through a pass through application process.

1.7 Engagement Approach

We have informed key stakeholders of the outcomes of the AER's draft decision. In particular, we have engaged directly with our customers, interest groups, retailers, and our Pricing Reform Working Group. We also continue to engage with customers through our customer engagement plans.

Our engagement approach should assist stakeholders to participate in the AER's consultation on its draft decision and in responding to this revised Regulatory Proposal.

1.8 Matters addressed in this revised Regulatory Proposal

While we accept the majority of the AER's proposed adjustments to our revenue requirements, there are a number of matters raised by the draft decision that we want to address in this revised Regulatory Proposal. The remainder of this revised Regulatory Proposal is therefore structured as follows:

- Chapter 2 explains our revised operating expenditure forecast;
- Chapter 3 set out our proposed approach to corporate tax;
- Chapter 4 presents the revised revenue requirements for standard control services;
- Chapter 5 sets out our revised proposal in relation to the Service Target Performance Incentive Scheme (**STPIS**);
- Chapter 6 presents our revised proposals on alternative control services;

- Chapter 7 sets out our claims in respect to confidentiality;
- Chapter 8 sets out our certification obligations; and
- Chapter 9 sets out the documents which support our revised regulatory proposal.

In addition to addressing these matters, we submit an updated Tariff Structure Statement and a separate background and explanatory document in response to the tariff strategy issues raised in the AER's draft decision. It should also be noted that we accept the AER's draft decision in relation to our Connection Policy and propose to adopt the amended policy set out in the AER's draft decision.

This revised Regulatory Proposal only focuses on the outstanding issues and therefore does not repeat information previously provided to the AER, which we continue to rely on. By minimising the scope of the revised Regulatory Proposal in this way, we intend to make it as accessible as possible to customers and other stakeholders.

2 Operating expenditure

2.1 Introduction

This chapter explains our revised operating expenditure forecast. It is structured as follows:

- Section 2.2 provides a brief recap of our Regulatory Proposal.
- Section 2.3 provides an overview of the AER's draft decision.
- Section 2.4 comments on the interaction between the Efficiency Benefit Sharing Scheme and our forecast operating expenditure.
- Section 2.5 presents our revised operating expenditure forecast.

2.2 Recap of our Regulatory Proposal

In our Regulatory Proposal we adopted the AER's 'base-step-trend' approach to develop our operating expenditure forecasts. We noted that our operating expenditure forecast was built on the significant efficiencies that we have already achieved since the merger of the transmission and distribution businesses. We also provided benchmarking information to demonstrate that our base year operating expenditure is efficient.

Importantly, our operating expenditure forecast included significant forecast efficiency gains. This reflected our response to feedback from customers, who reasonably expect the merger of the transmission and distribution networks to deliver further cost savings, and that we should be working hard to deliver such savings. For this reason, we considered it appropriate to forecast a productivity gain that would deliver operating expenditure that was flat in nominal terms.

To achieve this outcome, we needed to find cumulative total cost savings of $32.8 million in real terms over the four years from 2015-16 to 2018-19, relative to the 2014-15 efficient base year costs. Our forecast average operating expenditure would need to be 13.1 per cent lower in real terms than our average for the current period. This represented a significant reduction in operating expenditure.

We noted that our approach to assessing productivity growth differed from the approach applied by the AER. Importantly, our Regulatory Proposal noted that by offering additional prospective efficiency gains, we considered our operating expenditure forecast was even lower than the Rules allow. We explained that our operating expenditure forecast contained no 'ambit claims', and highlighted the importance of balancing performance, risk and cost[2]:

> "In forecasting our operating expenditure requirements we must achieve an appropriate balance between the pressure to reduce expenditure and the importance of maintaining service performance and managing network risks. For the reasons set out in this chapter, we believe that we have achieved an appropriate balance, whilst setting challenging but

[2] TasNetworks, Tasmanian Distribution Regulatory Proposal, 1 July 2017 to 30 June 2019, 29 January 2016, page 106.

achievable operating expenditure savings targets for the business over the forthcoming regulatory period."

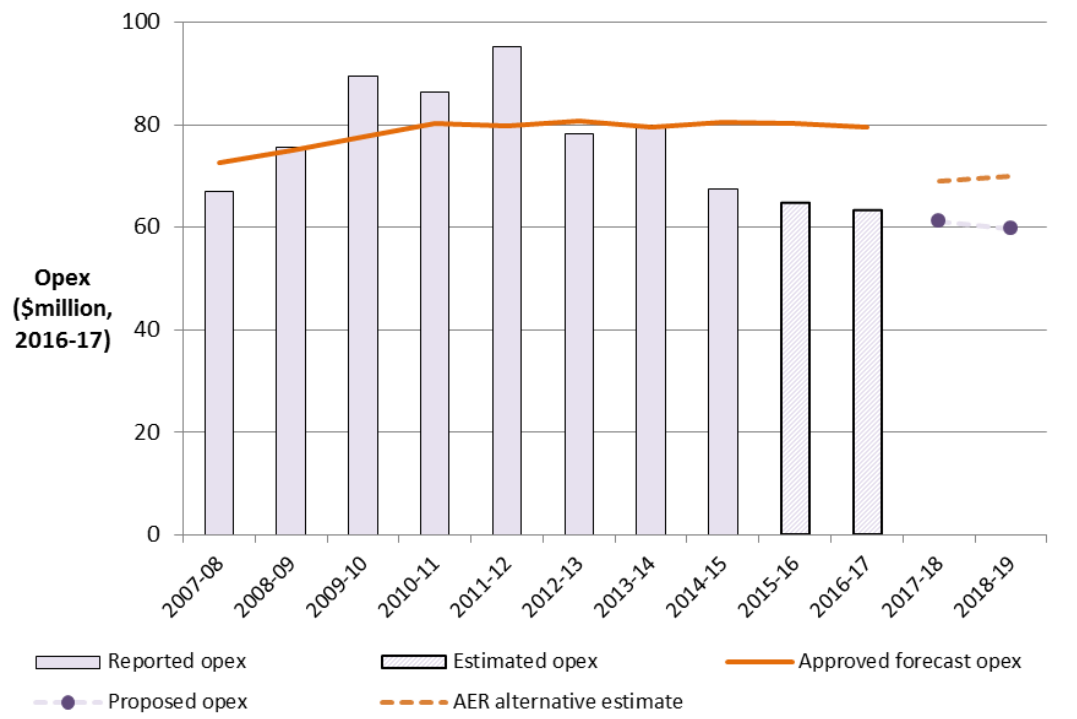
2.3 The AER's draft decision

To assess our proposal, the AER developed an alternative estimate of efficient operating expenditure using its standard 'base-step-trend' approach.

The AER's alternative estimate of forecast total operating expenditure over the forthcoming regulatory period, excluding debt raising costs, is $138.9 million (2016–17 dollars). Therefore, the AER's assessment of our efficient operating expenditure requirements is $18 million or 14.9 per cent higher than our original forecast of $120.9 million. As the AER's alternative operating expenditure estimate exceeded our forecast, the AER accepted our forecast.

The figure below[3] presents our historic and forecast operating expenditure alongside the AER's draft decision.

Figure 2: AER draft decision on total forecast opex ($million, 2016–17)



While we and the AER adopted the same 'base-step-trend' forecasting methodology, we assumed higher productivity improvements, as the AER explained[4]:

"We have applied zero productivity growth in our alternative opex forecast.

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3 AER, Draft Decision, TasNetworks distribution determination 2017–18 to 2018–19 Overview, September 2016, Figure 2.3, page 12.

4 AER, Draft Decision, TasNetworks distribution determination 2017–18 to 2018–19, Attachment 7 – Operating expenditure, September 2016, pages 7-15 and 7-16.

> We forecast our change in productivity measure based on our expectations of the productivity an efficient service provider in the distribution industry can achieve. We generally consider past performance to be a good indicator of future performance under a business-as-usual situation.
>
> To reach our best estimate of forecast productivity we have considered the historical change in productivity from Economic Insights' economic benchmarking analysis and whether this reflects a reasonable expectation of the benchmark productivity that can be achieved for the forecast period.
>
> […]
>
> In comparison to our forecast, TasNetworks proposed strong productivity growth over the regulatory control period."

Our review of the AER's draft decision also highlights a difference in our approach to forecasting guaranteed service level (**GSL**) payments. The AER commented that it forecast these payments as the average of GSL payments made by TasNetworks over the most recent five years. The AER explained that it adopted the historical averaging approach to maintain consistency with how GSL payments have been forecast for previous regulatory control periods. In contrast, our GSL payments forecast was more conservative (lower). However expenditure has continued in trend terms to align to the five year average, and we propose to adopt the AER's methodology as it reflects a more cost reflective forecasting approach.

2.4 Interrelationships between operating expenditure and Efficiency Benefit Sharing Scheme

The EBSS provides an incentive for service providers to pursue efficiency improvements in operating expenditure and to share efficiency gains between network service providers and network users. The AER's preferred regulatory approach makes an intrinsic link between the operating expenditure forecasts and the EBSS[5].

As explained in section 1.5 of this revised Regulatory Proposal, the AER concluded that our application of the EBSS was inconsistent with our choice of base year for the purposes of forecasting operating expenditure. In effect, the AER's draft decision seeks to re-establish the intrinsic link between the EBSS and our forecast operating expenditure. In doing so, the AER has updated our calculations, reducing our EBSS payment by $11.5 million, but accepted our forecast operating expenditure.

The AER's draft decision has adjusted one component of our proposal (the EBSS) while accepting the other component (the operating expenditure forecast), while noting that our operating expenditure forecast is lower than the benchmark efficient level. We support the AER's position that there is an intrinsic link between the forecast operating expenditure and EBSS payments. As a result we have updated our efficiency scheme forecast data and calculations, and revisited our operating expenditure forecast. We address our operating expenditure forecast in the next section, given our

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5 AER, Draft Decision, TasNetworks distribution determination 2017−18 to 2018−19, Attachment 9 – Efficiency Benefit Sharing Scheme, September 2016, page 9-9.

most recent actual operating expenditure and the AER's analysis of our operating expenditure forecasts in its draft decision.

2.5 Revised operating expenditure forecast

We have revisited our operating expenditure forecast to incorporate changes required to address matters raised in the AER's reasons for its draft decision, in particular the AER's assessment of an efficient operating expenditure level for our business. The gap between the AER's estimate of our efficient costs and our proposal forecasts is $18 million or 14.9 per cent over the regulatory period.

We are conscious that while there are upward cost pressures faced by our business, our customers expect us to continue to pursue and deliver efficiency savings, particularly as a result of the merger.

At the time of preparing our Regulatory Proposal (in late 2015) we adopted very challenging targets for operating cost savings. We have reassessed these assumptions in light of improved and updated information, including actual 2015-16 revealed costs and a number of changing external factors, including a continuation of higher storm-related costs.

We are working hard to deliver efficiency improvements. Our actual cost information for 2015-16 indicates that the timeframes for achieving the identified future savings are too ambitious, given the range of competing cost increase pressures. Whilst we will deliver efficiency savings, we must balance the pressures to reduce costs against our regulatory and performance obligations.

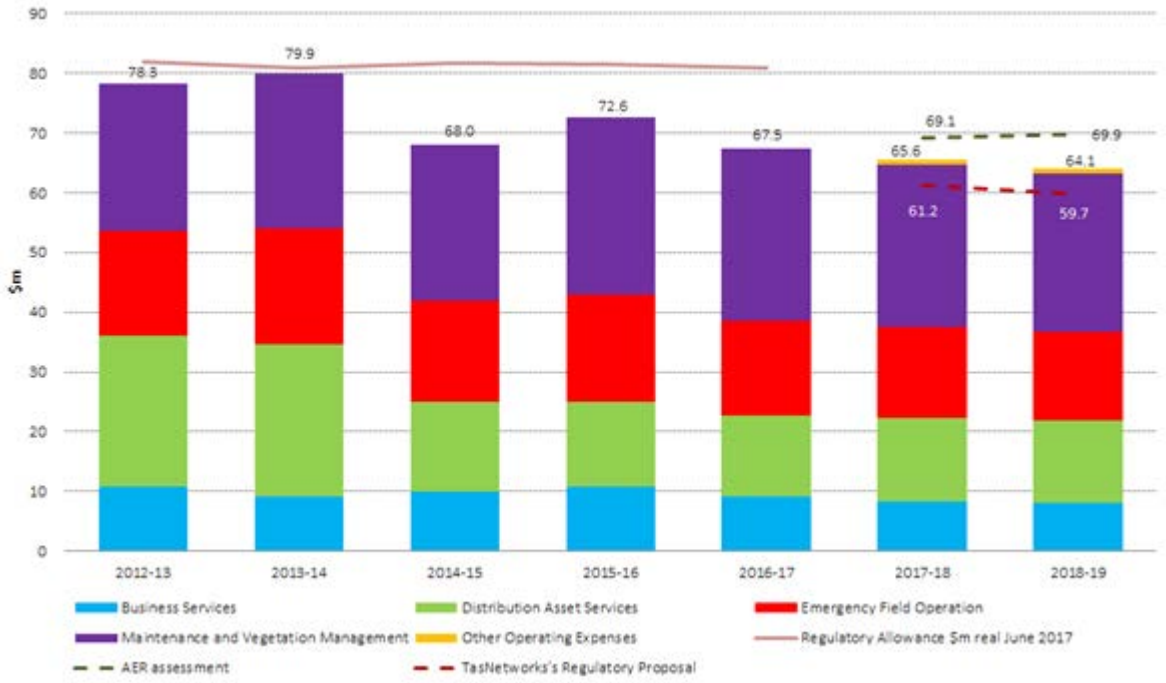
In light of the AER's assessment of an efficient operating expenditure level for our business and our updated cost information, our revised Regulatory Proposal includes changes to our productivity savings targets, and extends the period over which we expect to achieve these savings. Our forecast still includes productivity savings that see operating costs falling in real, constant dollar terms.

We have also reviewed and amended our GSL estimates to reflect the AER's alternative estimate. We have made this assessment in light of our increased costs associated with storms and the related increase in GSL payments in recent years and the year to date.

We have not amended our forecasting methodology or changed the base year from 2014-15, even though 2014-15 costs are substantially lower than 2015-16 – now the most recent audited year.

The figure below shows our revised operating expenditure forecast alongside the AER's alternative forecast of efficient operating expenditure. Our actual expenditure and the regulatory allowance for the current period are also shown.

Figure 3: Revised operating expenditure forecast ($million, 2016-17)



Our revised operating expenditure forecast excluding debt raising costs for the forthcoming regulatory period totals $129.7 million (in 2016-17 dollars), compared to the AER's alternative estimate of $139 million.

Our revised forecast is $9.3 million (or 7 per cent) lower than the AER's alternative estimate. The AER's estimate reflects the "benchmark operating expenditure that would be incurred by an efficient provider over the forecast period"[6]. On this basis, we regard our revised operating expenditure forecast as an appropriately challenging target for our business.

6 AER, Draft Decision, TasNetworks distribution determination, 2017−18 to 2018−19, Attachment 7 – Operating expenditure, September 2016, page 7-23.

3 Forecast allowance for corporate tax

3.1 Introduction

This chapter sets out information on our calculation of the allowance for the cost of corporate tax. It is structured as follows:

- Section 3.2 recaps on the method we have applied for calculating the corporate income tax allowance.
- Section 3.3 discusses the value of imputation credits (gamma) and how the outstanding issues should be addressed in the AER's final decision.
- Section 3.4 provides information on our forecast of depreciation for corporate tax purposes.
- Section 3.5 provides an overview of our calculation of the corporate tax allowance.

3.2 Method for calculating corporate income tax allowance

Our calculation of the cost of corporate income tax for each year (ETC_t) of the forthcoming regulatory period is in accordance with clause 6.5.3 of the Rules, which requires the following formula to be applied:

$$ETC_t = (ETI_t \times r_t)\ (1 - \gamma)$$

where:

ETI_t is an estimate of the taxable income for that *regulatory year* that would be earned by a benchmark efficient entity as a result of the provision of *standard control services* if such an entity, rather than the *Distribution Network Service Provider*, operated the business of the *Distribution Network Service Provider*, such estimate being determined in accordance with the *post-tax revenue model*;

r_t is the expected statutory income tax rate for that *regulatory year* as determined by the *AER*; and

γ is the value of imputation credits.

3.3 Imputation credit value (gamma)

As explained in our original Regulatory Proposal, the value of imputation credits (gamma) is an important input to the calculation of the corporate income tax allowance.

For the purpose of this Regulatory Proposal, we continue to seek the application of the estimation method and input values adopted by the Australian Competition Tribunal in its 2011 findings in appeals relating to gamma[7]. Under this approach - which is also consistent with that set out in the AER's Rate of Return Guideline[8] - gamma is estimated as the product of:

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7 *Application by Energex Limited (Gamma) (No 5)* (2011) ATPR 42.

8 AER, Better Regulation - Rate of Return Guideline, December 2013, section 7.3.

- the 'distribution rate', being the extent to which imputation credits that are created when companies pay tax, are distributed to investors; and
- the 'utilisation rate' (also referred to as 'theta'), being the value of distributed imputation credits to investors who receive them.

In its 2011 decision, the Tribunal said[9]:

> "Taking the values of the distribution ratio and of theta that the Tribunal has concluded should be used, viz 0.7 and 0.35, respectively, the Tribunal determines that the value of gamma is 0.25."

Our Regulatory Proposal recognised that our proposed value for theta is a departure from the Guideline, which estimates a value of 0.7. However, we considered that a value of theta of 0.35 is the best estimate, for the reasons specified by the Tribunal.

We also noted that at the time of our lodging our Regulatory Proposal, the Australian Competition Tribunal was considering an appeal lodged by PIAC and the ACT and NSW distributors in relation to (among other things) the AER's gamma estimate. We commented that we would adopt the Tribunal's findings on gamma if the Tribunal concluded that the AER was correct.[10]

In February 2016, the Tribunal set aside the AER's decision in relation to gamma and ordered the AER to remake its revenue determinations with reference to an estimated cost of corporate income tax based on a gamma of 0.25. The AER has decided to challenge the Tribunal's decision and maintain a gamma estimate of 0.4.

We respect the AER's right to challenge the Tribunal's decision. Equally, we believe that the outcome of that challenge should be reflected in our revenue determination. The AER's draft decision indicates that the Full Federal Court's decision will only be reflected in our determination if it is available in time. In our view, the better approach is to implement the findings of the Full Federal Court, whenever that decision is made.

We propose that the AER gives effect to the Full Federal Court decision by amending the definition of X_t in the revenue control formula, which is currently defined in the draft decision as follows:

> "X_t is the X factor for each year of the 2017–19 regulatory control period as determined in the PTRM, and annually revised for the return on debt update in accordance with the formula specified in attachment 3—rate of return—calculated for the relevant year."

In effect, the X factor will be updated in any event to incorporate annual adjustments to the Post Tax Revenue Model (**PTRM**) to reflect updated cost of debt information. Therefore, a change to the definition of the X factor could easily be made to address any change in the AER's determination of gamma, following the conclusion of the court proceedings. The adjustment to X_t to reflect the gamma outcome could be defined as follows:

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9 *Application by Energex Limited (Gamma) (No 5)* (2011) ATPR 42-356 at [42].

10 Tasmanian Distribution Regulatory Proposal, Regulatory Control Period 1 July 2017 to 30 June 2019, 29 January 2016, page 121.

> "The revenue adjustment in relation to gamma must remove the revenue impact of any difference between the value of gamma specified in the AER's determination and the value subsequently determined by the AER in accordance with the conclusion of the court proceedings relating to the merits review sought by ActewAGL Distribution, Ausgrid, Endeavour Energy, Essential Energy and Jemena Gas Networks. The revenue adjustment should apply from the commencement of the regulatory period and should recognise the time value of money."

Subsequent to our proposal, and the AER's draft decision, the Tribunal has considered, and made a decision in relation to the South Australian Power Networks proposal relating to gamma. As the Tribunal's South Australian Power Networks decision is that the value of gamma should be 0.4, it seems appropriate to adopt this value for the purpose of our determination. However, by including the proposed definition of X_t, if the Full Federal Court determines a different value, our revenue will be adjusted accordingly. We note that the outcome determined by the Full Federal Court will be consistent with the National Electricity Objective.

We believe that our proposed approach to addressing the current uncertainty is preferred to the approach proposed in the draft decision, because it will ensure that the court's decision is implemented, regardless of the timing of that decision.

3.4 Forecast regulatory tax depreciation

The calculation of the corporate tax allowance requires a forecast of tax depreciation to be made. TasNetworks has calculated tax depreciation in accordance with the tax law and with the methodology contained within the PTRM. In accordance with the PTRM, TasNetworks has calculated tax depreciation on a straight line basis, using applicable straight line tax depreciation rates.

3.5 Calculation of corporate income tax allowance

We have derived the forecast of our corporate income tax allowance pursuant to clause 6.5.3 of the Rules, using the PTRM in accordance with the AER's preferred method.

The formula set out in section 3.2 assesses the benchmark entity's effective tax rate and calculates the income tax allowance for each year. An adjustment is then made to reduce the tax allowance for the benchmark value of imputation credits.

We have made no amendment to the corporate tax allowance, although we continue to seek the application of the value determined as a result of the New South Wales appeals as explained in section 3 of this submission.

The table below shows the resulting regulatory allowance for tax.

Table 1: Revised forecast tax allowance from 1 July 2017 to 30 June 2019 ($million, nominal)

	2017-18	2018-19
Benchmark income tax payable	12.8	18.1
Imputation credit	-5.1	-7.3
Corporate tax allowance	**7.7**	**10.9**

4 Revised revenue requirements and customer outcomes

4.1 Introduction

This chapter sets out information on the calculation of our revised revenue requirements.

We have updated our revenue requirements for the forthcoming regulatory period to reflect our response to the AER's draft decision and updated information. In summary, the changes in our revenue requirements reflect:

a) updated information on actual capital expenditure incurred in 2015-16;

b) our acceptance of the AER's approach to depreciation, which adopted a different approach to depreciating the opening asset base;

c) our acceptance of the Weighted Average Cost of Capital (**WACC**) allowance of 5.48 per cent adopted by the AER for the purpose of its draft decision, noting that the WACC allowance for the determination will be updated to reflect updated financial market data;

d) our updated regulatory asset base, which is affected by (a) and (b) above;

e) our amended operating expenditure forecasts, as detailed in section 2 of this revised proposal; and

f) no amendment to the corporate tax allowance, although we continue to seek the application of the value determined as a result of the New South Wales appeals explained in section 3 of this submission.

The remainder of this chapter is structured as follows:

- Section 4.2 presents information on our updated opening regulatory asset base value.
- Section 4.3 sets out information on our updated forecast regulatory asset base value.
- Section 4.4 provides details of our revised revenue requirements and X factors.
- Section 4.5 concludes the chapter by providing an indication of outcomes for customers under our revised proposal.

4.2 Updated opening regulatory asset base

The table below shows the derivation of our updated regulatory asset base (**RAB**) value as at 1 July 2017 (that is, the closing RAB as at 30 June 2017). The updated opening RAB value reflects the following revisions to the values contained in our Regulatory Proposal:

- We have updated our capital expenditure information to reflect our actual expenditure for 2015-16, which was 6 per cent lower than the forecast we adopted in our Regulatory Proposal. This difference reflects minor differences in the timing of forecast and actual expenditure for 2015-16.
- We have applied actual inflation for 2015-16 to index the opening RAB for that year. Actual inflation tuned out to be lower than the forecast we adopted in the Regulatory Proposal.

The combined effect of these two revisions is to reduce the opening RAB value from

$1,646.7 million (in our Regulatory Proposal) to $1,621.2 million in this revised proposal.

Table 2: Revised roll forward of regulatory asset base from 1 July 2012 to 30 June 2017 ($million, nominal)

	2012-13	2013-14	2014-15	2015-16	2016-17
Opening RAB	1,445.2	1,486.9	1,539.3	1,557.0	1,597.0
Net capital expenditure	89.3	99.8	89.2	104.9	125.7
Inflation on opening RAB	36.2	43.6	20.4	20.4	39.9
Straight-line depreciation	-83.8	-90.9	-91.9	-85.4	-86.2
Closing RAB	1,486.9	1,539.3	1,557.0	1,597.0	1,676.3
Add difference between actual and forecast net capital expenditure for the period					-38.0
Add return on difference in net capital expenditure for the period					-17.2
Closing RAB					**1,621.2**

Note: Numbers may not sum exactly due to rounding

4.3 Revised forecast regulatory asset base values

The table below shows our revised forecast RAB values, which reflect the updated opening RAB and the revised depreciation allowance. It should be noted that the nominal capital expenditure in the table below excludes capital contributions. The customer initiated capital expenditure included in the RAB is the gross expenditure minus customer capital contributions.

Table 3: Revised regulatory asset base roll forward 1 July 2017 to 30 June 2019 ($million)[11]

	2017-18	2018-19
RAB (start period) - nominal	1,621.2	1698.7
Nominal capex	116.0	107.2
Inflation on opening nominal RAB	39.7	41.6
Nominal straight-line depreciation	78.1	99.4
RAB (end period) - nominal	1,698.7	1,748.2
RAB (end period) - $ June 2017	**1,658.1**	**1,665.6**

[11] The data in this table is expressed in nominal terms, with the exception of the final row which is expressed in 2016-17 dollars.

4.4 Revised revenue requirements and X factors

The table below summarises the revenue building block calculation for the forthcoming regulatory period.

Table 4: Summary of revised Building Block Revenue Requirement ($million, nominal)

	2017-18	2018-19	Total
Return on Capital	88.8	93.0	181.8
Regulatory Depreciation	38.4	57.8	96.2
Operating expenditure (incl. Debt Raising)	68.3	68.4	136.7
Revenue Adjustments	12.6	12.9	25.6
Benchmark cost of corporate income tax	7.7	10.9	18.6
Total Revenue Requirement (unsmoothed)	**215.7**	**243.0**	**458.8**

Note: Numbers may not sum exactly due to rounding

As our regulatory control period is only two years, there is limited scope to adopt an X factor to smooth revenues. We have proposed revised X factors of 22.76 per cent for 2017-18 and 0 per cent for 2018-19, which mean that our revenue will be reduced by approximately 23 per cent in real terms in 2017-18 and remain constant in real terms in 2018-19.

Our revised X factors ensure that:

- our allowed revenues do not increase in real terms over the regulatory control period; and
- our building blocks costs remain closely aligned in 2018-19, as required by the Rules. We note that our proposed approach will smooth prices changes over time and is consistent with the application of the X factor in the AER's draft decision.

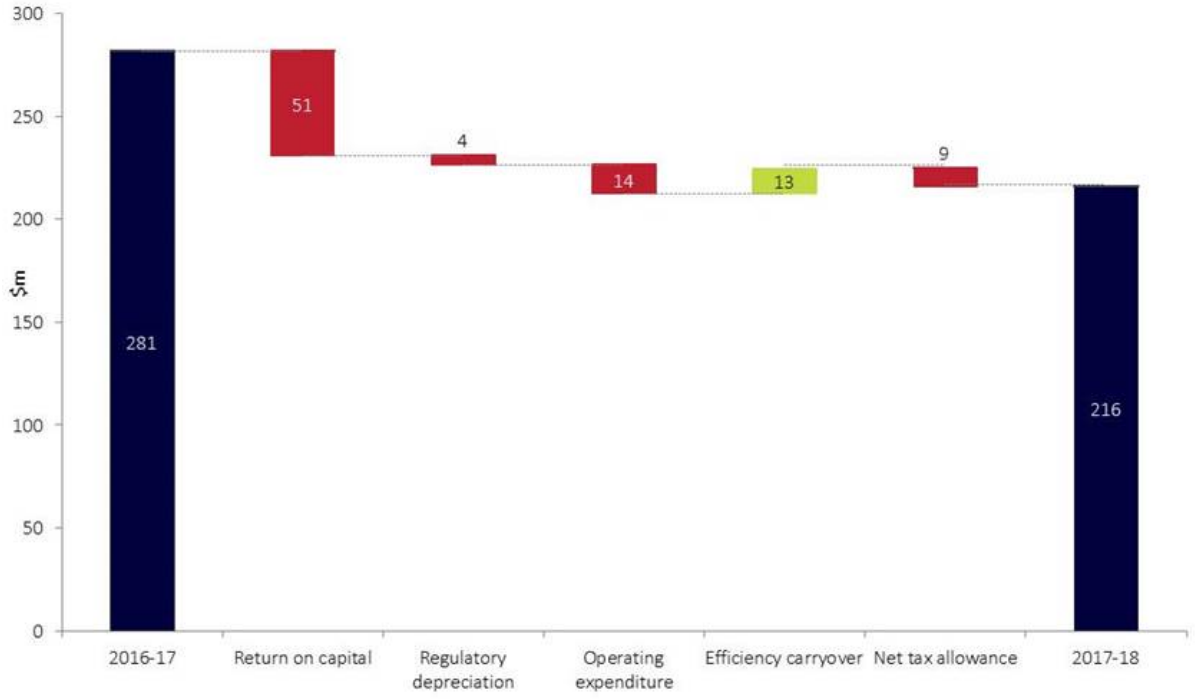
The table below shows our revised unsmoothed and smoothed revenue requirement for the forthcoming period. Our revised total revenue over the period is approximately 4 per cent above the level proposed by the draft decision.

Table 5: Revised unsmoothed and smoothed revenue 2016–17 to 2018–19 ($million, nominal)

	2016–17	2017–18	2018–19	Total revenue
Annual building block revenue requirement (unsmoothed)	281.4	215.7	243.0	**458.8**
Maximum allowed revenue (smoothed)	286.0	226.3	231.9	**458.2**
X factor		22.76%	0%	

The figure below explains the movement in our revised unsmoothed revenue from the final year of the current regulatory period (2016-17) to the first year of the forthcoming regulatory period (2017-18).

Figure 4: Changes in our revised unsmoothed revenue from 2016-17 to 2017-18 ($m, nominal)



4.5 Outcomes for customers

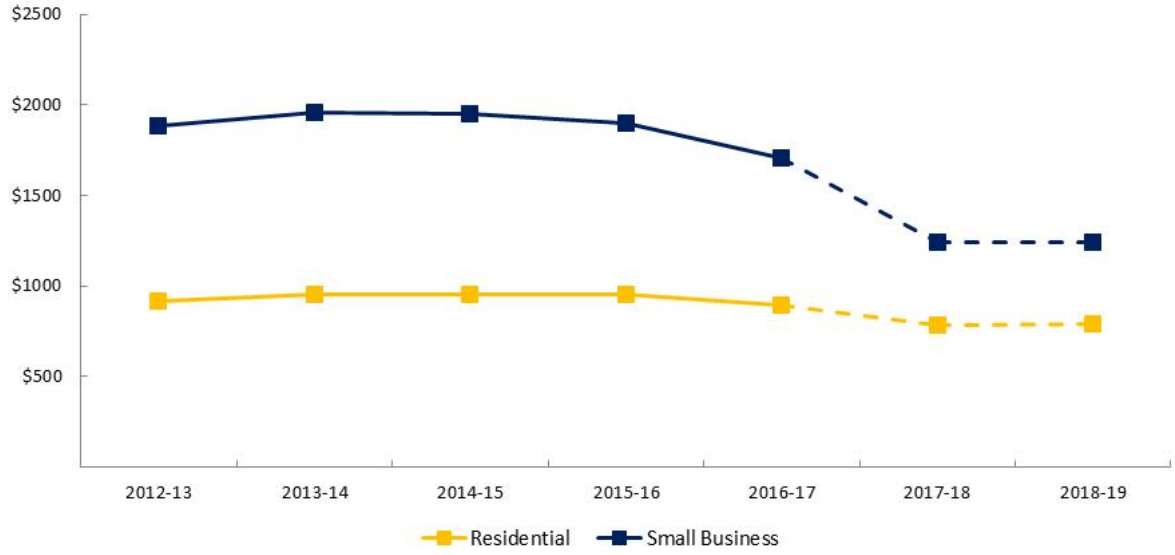
Transmission and distribution network costs presently make up around 50 per cent of the average Tasmanian residential and small business customer retail electricity bill[12]. TasNetworks was established as an integrated network business to drive efficiencies in the transmission and distribution networks and to deliver better outcomes for Tasmanian customers.

In our first year of operation (2014-15) we achieved an unprecedented outcome in our transmission revenue determination, with the AER accepting our proposal, resulting in lower prices for our transmission customers. This has already delivered value to our customers and our revised distribution Regulatory Proposal seeks to build on that positive outcome.

Our revised proposed distribution revenue, based on the AER's cost of capital estimate of 5.48 per cent (which will be updated in the final decision), together with our current transmission revenue allowance, results in the indicative average annual total network charges for residential and small business customers shown below.

12 Source: Office of the Tasmanian Economic Regulator, based on 2014-15 standing offer prices.

Figure 5: Indicative average annual total network charges for customers ($2016-17)



Most network tariffs presently have a large element of consumption based pricing, so we forecast future energy consumption for customers in order to set our network tariffs. Therefore network charging outcomes, to a large degree, reflect our revenue requirement as well as forecast consumption levels for different types of customers. If consumption turns out to be lower than we presently forecast, network charges may be higher. Conversely, if consumption is higher than forecast, network charges may be lower.

In addition, to simplify the presentation of this information, we have assumed no under-recoveries or incentive payments from the current regulatory period. Our forecasts of total network charges (shown above) for residential and small business customers are therefore indicative only.

The AER's draft decision has accepted our tariff strategy for residential and small business customers. The changes will involve rebalancing most of our existing network tariffs, by increasing the emphasis on service charges and reducing the variable consumption based component. The prices of some network tariffs will also be realigned over time, to unwind some long-standing cross subsidies between different tariffs and different customer groups.

Together with the decrease in our revenue allowance we anticipate that average residential and small business customers will experience a network price decrease in 2017-18 followed by no real network price increases in 2018-19. In accordance with our tariff strategy to make network charges more cost-reflective, the decrease for small business customers in 2017-18 will be more significant than for residential customers. Further information on our tariff proposals for the forthcoming regulatory period are set out in the document titled "Tariff Structure Statement – background and explanation", which accompanies this revised Regulatory Proposal.

5 Service Target Performance Incentive Scheme (STPIS)

5.1 Introduction

The STPIS operates as part of the building block determination and is applied via the control mechanism. Through the S-factor component of the STPIS, distributors are penalised or rewarded for diminished or improved service performance compared to predetermined targets. It ensures that cost savings are not achieved at the expense of service performance.

The STPIS includes reliability measures (System Average Interruption Duration Index (**SAIDI**) and System Average Interruption Frequency Index (**SAIFI**)) and customer service targets for telephone calls answered within 30 seconds, known as the telephone Grade of Service (**GOS**).

In our original Regulatory Proposal, we proposed targets and incentive rates in accordance with the AER's STPIS scheme (November 2009) and the definitions set out in that scheme. We also proposed that the revenue at risk should be reduced to ±2.5 per cent rather than the standard scheme design of ±5.0 per cent, on the basis of customer feedback regarding reliability improvements and annual price volatility.

5.2 Draft Decision

The AER did not accept our proposal to reduce the revenue at risk.

In relation to the STPIS parameter values, the AER:

- set targets for SAIDI, SAIFI and customer service for telephone calls answered within 30 seconds, which is referred to as the telephone Grade of Service (**GOS**); and
- set incentive rates in accordance with clause 3.2.2 and using the formulae provided as appendix B of the National STPIS.

The AER also noted that we raised data accuracy issues in relation to historical performance data previously provided to the AER. The AER commented that we should clarify this matter in our revised proposal. The AER highlighted the importance of undertaking a transparent process and ensuring that adequate time is allowed to submit properly verified data to it.

5.3 Revised targets and incentive rates

In this revised Regulatory Proposal, we accept the AER's decision in relation to the revenue at risk. We have also updated our targets (including the customer service component), and incentive rates to include 2015-16 performance, and our proposed smoothed revenue.

We acknowledge the AER's concern in relation to our historic data. To address this matter, we have engaged GHD to undertake a thorough audit of historic data to ensure that the historic data is appropriately verified. This audited information forms the basis of our revised targets and incentive rates and is provided to the AER as part of our revised Regulatory Proposal.

6 Alternative control services

6.1 Introduction

This chapter sets out our response to various matters arising from the draft decision on alternative control services. These services include public lighting, metering and ancillary network services. We accept the AER's draft decision in relation to public lighting and metering, and these matters are not discussed further.

Ancillary network services share the common characteristic of being non-routine services provided to individual customers on an 'as needs' basis. Examples include customer requested appointments or after hours service provision.

Ancillary network services are sub-divided into fee-based and quoted services.

Fee based services are largely homogenous in nature, so that the cost inputs involved in providing these services do not involve significant variations between customers. Given these characteristics, fee based services can be priced according to a tariff, which is set for the duration of the regulatory period, subject to an annual CPI-X escalation.

By contrast, the scope of quoted services may vary significantly depending on the scope of the customer's specific requirements. Accordingly, quoted services are priced according to the labour, materials and other direct costs required to meet the customer's service request.

The remainder of this chapter is structured as follows:

- Section 6.2 provides an overview of the AER's draft decision.
- Section 6.3 addresses the issues raised by the AER in relation to fee based services; and
- Section 6.4 sets out our response in relation to quoted services.

6.2 AER's draft decision

In its draft decision on our fee-based services, the AER did not accept:

1. Our 'implied administration labour rate' as it exceeded the AER's benchmark rate;
2. The margins we proposed in relation to after hours or same day premium services, as the AER considered that sufficient justification had not been provided;
3. Our estimated task times to perform after hours services, which the AER regarded as inefficient;
4. Our proposal to charge our new design and construction services as fee based services. The AER argued that these services are highly variable and should be treated as a quoted service.

We accept the AER's position in relation to the fourth point, and we propose to reclassify design and construction services as a quoted service. However, as explained in section 6.3, we do not accept the AER's draft decision in relation to the remaining three points.

6.3 Fee-based services

6.3.1 Implied administration labour rate

The AER has derived an implied administration labour rate from our market support costs of $1.47 million and the number of hours attributed to back office activities. This calculation resulted in an 'implied' administration labour rate of $224 per hour.

Contrary to the AER's analysis, our administration labour rate is below the benchmark maximum set by the AER. However, we understand why the AER has derived a higher labour rate from the information that we provided. The AER's analysis revealed that we introduced a modelling inconsistency, in summary:

- We correctly attributed total overheads to ancillary services in accordance with TasNetworks approved Cost Allocation Method; but
- We inappropriately attributed $1.47 million of the overhead cost on a direct basis, being the total costs of Market Support.

We recognise that a smaller cost should have been directly allocated, as Market Support provides a range of services. Therefore, while the total overhead costs were correctly allocated to alternative control fee-based services, a greater proportion of these costs should have been allocated on an indirect basis.

In relation to each labour rate, with the exception of 'administration (implied)', our labour rates are substantially lower than the AER's maximum rates. Our amended model shows that the correct treatment of our overheads costs leads to a substantially lower administration labour rate. Correct modelling treatment has resulted in adjustments to all our proposed fee-based services prices.

We have adjusted our fee-based alternative control services to reflect the updated model, which is submitted to the AER as part of our revised Regulatory Proposal. We are confident that the AER will approve the updated administration labour rate and the updated fees.

6.3.2 Premium services

In our Regulatory Proposal, we proposed higher prices for premium services that are performed outside normal scheduling. While customers value same day services, we incur a loss of efficiency and higher costs as work schedules and priorities are changed, and travel time increases. In particular:

- Additional back office staff time is required to provide premium services, which includes cancelling and rescheduling other services;
- Non-scheduled and premium services are often associated with work extending into after-hours;
- Work cannot be scheduled to minimise travel time; and
- Premium services sometimes require more experienced and costly staff.

The AER argued that the margins we apply to the total direct costs are not supported by substantive evidence. We have considered the AER's feedback and we have revisited our modelling.

In developing our revised cost analysis, we have identified additional premium services costs associated with the factors set out above. Where it is not possible to derive a precise estimate of the

costs involved, we have continued to apply a mark-up or margin to reflect the likely additional costs, however this mark-up is lower than originally proposed. While this approach partially reflects judgment rather than economic analysis, it is appropriate to apply a modest margin to recognise the additional costs of providing premium services.

We are working to improve our data capture and quality which will assist in the ongoing refinement of our prices.

6.3.3 After hours services

In its draft decision the AER argues that our analysis overstated the costs of providing after hours fee based services[13]:

> "We acknowledge that after hours services typically incur higher costs than services performed during standard 'business day' hours (business hours) primarily due to the higher labour costs incurred for after-hours services. However, it does not follow that after hours services have significantly increased task times which is another key input into the final price of the service.
>
> The time taken on-site to perform a service should remain constant regardless of the time of day the service is performed. For example, a meter test performed at 10 am (inside business day hours) should take the same amount of time if performed at 7 pm (after hours) as the task is the same. We note this consideration is supported by the cost build-up of ancillary network services by other distributors which apply the same on-site task times regardless of the time the service in performed."

We accept the logic of the AER's draft decision. In practice, however, we provide very low volumes of after-hours services. As a result these jobs do not benefit from scale, travel and scheduling benefits associated with grouping like activities, including activities in similar geographic areas. Therefore, although the time for the work on site is not dissimilar, the entire cost of service provision after hours is comparatively higher.

We appreciate the importance of cost reflective pricing and we have revisited our modelling. With very low volumes, it is difficult to develop highly robust prices. Nevertheless, our modelling, which is provided as part of this revised Regulatory Proposal, shows that the fees for after hours services should be substantially above those proposed in the draft decision. In light of the further information provided, we consider it appropriate for the AER to approve the revised charges.

We are working to improve our data capture and quality which will assist in the ongoing refinement of our prices.

6.4 Quoted services

As noted in section 6.2, we accept the AER's view that new design and construction ancillary network services should be reclassified as quoted services.

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[13] AER, TasNetworks distribution determination 2017−18 to 2018−19 Attachment 16 – Alternative control services, September 2016, page 16-18.

We note that the AER approved our proposed labour rates for quoted services.

7 Confidentiality

In accordance with the Rules and the AER's Confidentiality Guideline, we have completed a confidentiality template that we have provided to the AER. This template details the matters in our Regulatory Proposal and supporting documents for which we are claiming confidentiality.

8 Certifications

8.1.1 Certification statement

Clauses S6.1.1(5) and S6.1.2(6) of the Rules require us to provide a certification by our Directors about the key assumptions that underlie our revised expenditure forecasts.

The certification statement is provided as an attachment to this Regulatory Proposal (RTN012).

9 Supporting documents

Document ID	Document Title	Confidential
RTN001	Revised Regulatory Proposal Overview Paper	N
RTN002	Alternative Control – Revised Fee Based Services Model	N
RTN003	Tariff Structure Statement	**Y**
RTN004	Tariff Structure Statement Overview Paper	N
RTN005	Tariff Structure Statement – Background and Explanation	N
RTN006	Revised Post Tax Revenue Model (**PTRM**)	N
RTN007	Revised Roll Forward Model (**RFM**)	N
RTN008	Revised Efficiency Benefit Sharing Scheme Model	N
RTN009	Revised Regulated Asset Base and Tax Depreciation Model (Baseline Method)	N
RTN010	STPIS Model Reliability of supply	N
RTN011	STPIS Model Customer Service	N
RTN012	Directors Certification of Key Assumptions for Revised Regulatory Proposal	N
RTN013	Revenue Reset Regulatory Information Notice - STPIS	N