Australian Energy Regulator

TasNetworks Transmission Revenue Proposal, 2014/15 to 2018/19

Submission

August 2014

Acknowledgements & Disclaimers

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This document has been produced by Goanna Energy Consulting Pty Ltd for the Tasmanian Small Business Council (TSBC). However, the views expressed are those of the TSBC and not the consultants involved.

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Executive Summary

This submission responds to TasNetworks' *Transmission Revenue Proposal, Regulatory Control Period 1 July 2014 – 30 June 2019* lodged with the Australian Energy Regulator (AER). TasNetworks' Proposal will have an important bearing on network charges paid by small business in Tasmania beginning on 1 July this year and feeds into their retail tariffs. The Tasmanian Small Business Council (TSBC) welcomes the opportunity to comment.

The rapid increases in Tasmanian electricity prices are of significant concern to the TSBC and its members. Nominal electricity tariffs for small business increased by 101 per cent from 2000 until 2011. Our interest in TasNetworks' Proposal is heightened by these increases. Our objective is to have transmission prices falling over the next regulatory period.

Consultations with Consumers & Small Business

TasNetworks is required to conduct effective consultations with consumers in developing its regulatory proposals and the AER can consider the quality of these in assessing the Proposal. In our view, there are gaps in what it has done, including in its consultation with small business. TasNetworks has acknowledged that it is coming from a low base in consumer consultations and plans to make improvements in future – which we welcome. TSBC is keen to work with TasNetworks to ensure effective consultation with small business.

TasNetworks' Past Performance

Our submission has assessed TasNetworks' past performance from a small business perspective. Examining trends in capex, opex and revenue over the past two regulatory periods suggests that TasNetworks has been provided with overly generous allowances and was prone to overspending in earlier years. More recently, it has cut back its capex and opex without detriment to its services. When required to, it has been able to do the same with less. A challenge for the next regulatory period is to continue this trend.

We have also examined indicators (ratios) of the productivity and efficiency of TasNetworks' historical cost base. Whilst these need to be qualified, they tend to confirm that TasNetworks' performance worsened in the period to 2010/11. It has recovered some ground since then, but current performance still tends to be below that seen a decade ago.

TSBC welcomes the decisions taken by TasNetworks to reduce its overall capex and opex spending to below the AER regulatory allowances and notes that this has had an impact in moderating transmission price increases in recent years. Capex reductions appear to reflect mainly stagnant electricity demand and falls in industrial load. Whilst not absent, achieving greater efficiency appears to be less of an influence. We are also concerned that some elements of capex were actually overspent. For opex, past reductions are more broadly

based, but the generosity of the previous regulatory allowance has made reductions possible without necessarily driving costs down to efficient levels.

TasNetworks has presented the results of capex and opex benchmarking of its past performance in its proposal. We welcome this but will place more weight on the results of the AER's benchmarking when this is released. Whilst we welcome that some of these results show TasNetworks performing well, others show the opposite and a number have been heavily influenced by TasNetworks' decisions to reduce spending due to stagnant demand for electricity rather than achieving greater efficiency.

Forecast Capex

TasNetworks has proposed a substantially reduced capex program for its next regulatory period. Capex of $275.9 million is proposed, a reduction of 52 per cent compared to its actual spending in this period. TSBC welcomes this reduction, which is more suited to the economic climate facing TasNetworks and electricity consumers in Tasmania. TasNetworks states that it believes these reductions should give consumers confidence that its capex proposal is efficient. However, we have not yet reached this conclusion.

Forecasts of electricity demand and cost escalators are used to establish TasNetworks' future capex. We query a number of these. Zero or even negative growth seems likely in electricity demand, whilst TasNetworks has forecast of annual growth in excess of 1 per cent. We also question the for labour escalators, reliance on futures markets and forecasts for a range of material input escalators, and support greater reliance on mechanisms to improve the incentives on TasNetworks to keep these costs to a minimum rather than rely on escalators. This suggests that further downward revisions in capex is possible.

Drilling down, we generally support the substantial reductions in Development and Business Support capex compared to current period spending, with core network Renewal/enhancement capex less impacted. Nevertheless, we have raised a number of issues about whether the capex reductions proposed by TasNetworks fall short of what can be achieved without detriment to the network. We have also expressed concern that TasNetworks' capex proposal often lacks detailed justification.

Our issues with a number of the individual projects proposed by TasNetworks are set out in Table 2 of this submission. These total $55 million in capex and removing them in all or part from the Proposal would reduce TasNetworks' capex by up to 20 per cent.

We have questioned that TasNetworks proposes no expenditure on non-network solutions, despite their ability to offset capex. The merger should also make such projects easier to deliver as they extend to both transmission and distribution networks.

Forecast Opex

TasNetworks proposes real controllable opex of $204.8 million. This amounts to an average of $41 million per annum. It is 11 per cent below the average over the current regulatory period and its controllable opex proposal for 2018/19 would be 20 per cent below its actual opex in 2007/08. It is also $12.3 million (5.7 per cent) below the Transitional Proposal. Whilst we welcome these outcomes, it is clear that most of the reduction in opex comes in 2014/15, the first year of the next regulatory period, and $2.5 million of the $3 million reduction in that year comes from the merger. Beyond that, there are limited savings from efficiencies in transmission operations. This is a disappointing aspect of the proposal.

The TSBC submission also queries TasNetworks' view that its base year, 2013/14, to establish opex for the next regulatory period is efficient. TasNetworks' track record on opex over the past decade raises questions as to whether this is the case.

Moreover, other inputs into the calculation of an efficient base year require verification: new regulatory obligations must be efficiently performed and costed, labour escalation factors appear to be high and efficiencies from the merger appear to be lower than forecast.

Efficiency Incentive Schemes

Our submission supports the schemes to be applied to promote greater efficiency in TasNetworks' opex and capex over the next regulatory period, albeit with some reservations. It also queries the ability to carry over reductions in opex below the allowance for this regulatory period where these are responses to overly optimistic forecasts in electricity demand which were not realised.

Regulatory Asset Base

We welcome that TasNetworks' Regulatory Asset Base (RAB) will grow closely aligned with forecast inflation. But, notwithstanding capex spending below its allowance and stagnant demand, TasNetworks' RAB has still grown by nearly 50 per cent over the current regulatory period. This large increase will find its way into the opening RAB for the next regulatory period and consequently transmission prices.

Regulatory Depreciation

TasNetworks has reduced regulatory depreciation by $13 million over the next regulatory period compared to the Transitional Determination based on a reassessment and lengthening of asset lives. We welcome this change in approach, which will have a tangible impact in keeping electricity prices lower for Tasmania's electricity consumers.

Rate of Return

TasNetworks has proposed a rate of return of 7.58 per cent and has adopted the AER's parameters (after proposing different parameters in two areas in its Transitional Proposal. We welcome this change, which will flow through into lower transmission prices. Even so, we have reservations with two of the AER's parameters, believing that they are overly generous, especially to government owned networks like TasNetworks (see Section 8.2).

Cost Pass Throughs

TasNetworks has proposed that it be permitted to apply to pass through the costs of events related to terrorism, natural disasters and insurance caps. TSBC has a general concern that pass through events are asymmetrical in their impact in only ever increasing costs. We also mention concerns about the specific pass through events sought, including their inconsistency with competitive markets and the high costs that terrorism and natural disaster events may expose consumers to. We believe that the State Government, as owner, should take responsibility.

Service Targets and Incentives

We generally support the application of service targets performance incentives to TasNetworks, noting that a more extensive and stronger regime will be applied in future.

Revenue

TasNetworks' Proposal results in a revenue requirement (unsmoothed, nominal) of $973 million for the next regulatory period. This is a reduction of $37 million (4.6 per cent) compared to actual revenue recovered in the current regulatory period of $1,020 million. This is welcome and reflects the expenditure, rate of return and depreciation reductions in the Proposal. Nevertheless, we believe scope exists for further reductions.

Transmission Prices and Small Business

Tasmanian transmission charges increased by 27 per cent in real terms from 2004/05 to 2013/14. TasNetworks' Proposal involves a welcome nominal transmission price reduction of 16 per cent, or 18 per cent in real terms, in 2014/15. This is followed by a nominal price increase of 5.3 per cent for the rest of the regulatory period (a 4.7 per cent reduction in real prices). An average small business would get a price reduction of $91 in 2014/15, followed by price increases totally $25 over the following four years.

Whilst the TSBC welcomes the price path and recognises that it recovers some of the large increases in transmission prices seen over the past decade, we believe that TasNetworks could have gone further with its proposals. Small business believes there is scope for price reductions in each of the next five years.

1 Introduction

This submission responds to TasNetworks Pty Ltd's (TasNetworks) *Transmission Revenue Proposal, Regulatory Control Period 1 July 2014 – 30 June 2019* (the Proposal) lodged with the Australian Energy Regulator (AER) on 31 May 2014. TasNetworks' proposal will have an important bearing on network charges paid by small business in Tasmania beginning over the term of the next regulatory control period and feed directly into their retail tariffs. The Tasmanian Small Business Council (TSBC) welcomes the opportunity to comment on the important matters raised in the Proposal.

In preparing this submission, we also considered various other related information, including the AER's *Framework and Approach Paper* (January 2014), the AER's *Issues Paper TransGrid, TasNetworks (Transend) and DirectLink* (released in July 2014), other documents provided by TasNetworks as part of its proposal and released by the AER, and presentations to and other information gained from the AER's public forum held in Hobart on 9 July 2014.

1.1 Background to Tasmanian Small Business & the TSBC

Small business is the 'engine room' of the Tasmanian economy. There are more than 37,000 small businesses in Tasmania, 30,000 of which are employers, employing over 70,000 full and part-time people. Numerically, they make up in excess of 96 per cent of all businesses in Tasmania and the sector provides more than half of the State's private sector employment. Understanding the small business sector, its aspirations and needs is of vital importance to the enterprises themselves, as well as Government and regulators as decision-maker. The resources to address the future needs of the state can only come from the generation of new wealth and healthy, vibrant small businesses are critical to this.

The Tasmanian Small Business Council (TSBC) is an "association of [small business] associations", each of which represents their market grouped industry sector. The TSBC seeks to provide the representative voice of small business in Tasmania. The TSBC's role in facilitating meetings of and forums for these trade associations, whose members are predominately small businesses, is paramount to providing informed insights and advice to governments and regulators. An obvious difficulty for owners of small and micro businesses is the absolute necessity to spend their time working "in the business", while those with larger numbers of employees take a more managerial role and begin to spend some of their time working "on the business". Small business is therefore even more reliant on groups such as the TSBC to develop and put forward informed policy positions to Government and regulators that truly represent their interests.

1.2 TSBC's Interest in TasNetworks' Proposal

Electricity is important to the health and vibrancy of the Tasmanian small business sector. Tasmanian small businesses have a need for competitively priced electricity that supports their competitive advantage *vis-à-vis* larger competitors in the local market, inter-state firms providing goods and services in Tasmania and international competitors (where they sell into export markets or compete against imports). Small businesses are also important input and labour suppliers to larger firms and provide support to them. Many of the competitors to Tasmanian small businesses have access to cheaper energy and to competitive energy offers. Tasmanian small businesses therefore suffer a disadvantage in these respects and the TSBC supports policy and regulatory steps to help redress this.[1] Having access to network prices that truly reflect efficient costs and therefore contribute to the provision of competitively priced electricity to Tasmanian businesses is important to the health of the Tasmanian economy.

Looking across the small business sector overall, electricity is a middle sized cost of production, typically making up between 3-5 per cent of total costs, although within some sectors, such as Tasmanian Independent Retailers, it can be substantially more. This, in itself, makes electricity important. However, its importance to small businesses in Tasmania is elevated by:

- The need to have access to a reliable source of supply, as many small businesses are heavily dependent on a continuous supply of electricity.
- The fact that some small businesses have energy costs well in excess of the average and, for them, access to competitively priced energy is particularly important.
- The recent large increases seen in Tasmanian electricity prices, which have affected small businesses. Many have been unable to pass on these cost increases due to the very competitive markets in which they operate and cannot access competing suppliers due to a lack of retail competition, making their competitive disadvantage worse.

As mentioned earlier, TasNetworks' transmission charges for 2014/15 will have an important bearing on network charges which will be passed on by retailers in their charges. Whilst transmission charges make up 15 per cent of small business electricity costs they are still important (e.g., the retail component and green charges together comprise a similar proportion). Moreover, TasNetworks' transmission charges have been one of the largest

[1] The Tasmanian Government has a timetable to implement Full Retail Contestability by 1 July 2014. However, the lack of retail competition will continue to impact on Tasmanian small businesses.

components of higher electricity prices in Tasmania over the past decade (see Section 0) and the TSBC is keen to see this end with the forthcoming AER transmission determination.

1.3 Electricity Price Trends in Tasmania

The rapid rate of increase in Tasmanian electricity prices is of significant concern to the TSBC and its members. Our interest in TasNetworks' Proposal has been heightened by this.

As the final report of the Tasmanian Electricity Industry Expert Panel (Expert Panel) shows:

- Electricity tariffs for small business increased by 101 per cent in nominal terms from 2000 until 2011, or by around 6 per cent per annum.
- The average annual increase was 3 per cent in real terms, or roughly double the rate of inflation.
- Increases were particularly pronounced in 2010/11 and 2011/12.
- Network charges accounted for half of the increase and wholesale charges for 40 per cent.

Analysis by Goanna Energy shows that transmission charges contributed around 30 per cent of the total increase in regulated Tasmanian electricity prices between 2009/10 and 2011/12, almost double its share of electricity bills.

Network price increases, including for transmission, have moderated in more recent years and the steps that TasNetworks has taken to ensure this are welcome. Nevertheless, we desire to see that this continues over the next regulatory control period and that network prices reflect the outcomes of an efficient and productive transmission system.

1.4 Outline of This Submission

The remainder of this submission comments on specific aspects of TasNetworks' *Revenue Proposal*. It covers the consultations that TasNetworks has undertaken in preparing its regulatory proposal (section 2), an assessment of its past performance (section 3), its forecast capex and opex (sections 4 and 5 respectively), expenditure incentive schemes (section 6), the Regulatory Asset Base (section 7), the return on and of capital (section 8), cost pass throughs and service incentives (section 9) and revenue and transmission prices (section 10).

2 TasNetworks' Consultation with Small Business on Its Proposal

TasNetworks is required to consult with consumers in preparing its Proposal and the AER can take its approach into account in setting TasNetworks' expenditure forecasts. The consumer engagement process requires TasNetworks to identify consumer cohorts and the views of those cohorts. Small businesses are clearly an important consumer cohort in the context of TasNetworks' Proposal. This requirement follows the Australian Energy Markets Commission's (AEMC) 2012 Rule changes which strengthened consumer engagement and the AER subsequent Guideline on consumer engagement by network service providers.

TasNetworks' Proposal commented that:

> *"The information obtained through the engagement process informs our expenditure plans and, more broadly, our strategic direction. We recognise, however, that our consumer consultation practices are still developing and will continue to improve over time, as we work towards embedding better consumer engagement throughout our business." (p. 30)*

We acknowledge the efforts that TasNetworks has made to engage with consumers and to take their comments into account in preparing its Proposal. We also welcome that TasNetworks has committed to improving its approach in future. We recognise that it would be unrealistic to expect that TasNetworks can begin a process of consumer consultation on revenue determinations without the need for further improvements. This being the case, the AER will need to determine if TasNetworks' initial attempts are reasonable and adequately meet the requirements of the AER's Guideline.

2.1 Consultations with the TSBC

TasNetworks' Proposal mentions that they have engaged with the TSBC. Specifically, the following consultations with the TSBC have taken place to date:

- Transend has made numerous presentations to the Consumer Consultative Committee of the Tasmanian Economic Regulator and invited members to provide feedback. TSBC is a member of this Committee, but TSBC representatives were not present at all these meetings.[2]
- Goanna Energy, on behalf of TSBC, initiated a meeting with senior Transend staff in Hobart on 26 March to discuss its Transitional Revenue Proposal, the direction of its full Proposal, general reset issues and issues facing Tasmanian small businesses.

[2] TSBC representatives did, however, receive copies of presentations made by Transend.

- Goanna Energy, on behalf of TSBC, initiated a meeting with senior TasNetworks staff in Hobart on 9 July to discuss its Revenue Proposal following the AER's Public Forum.

TSBC wishes to place on record the usefulness of these various consultations and the willingness of TasNetworks management to participate. This notwithstanding, there are a number of aspects of the consultation process undertaken by TasNetworks with the TSBC that could be improved, namely:

- That all direct consultations with TasNetworks (Transend) have been initiated by the TSBC. We would be concerned if this suggested a lack of priority on the part of TasNetworks for small business issues, though we have not been given this impression in the discussions.
- None of the consultations that have taken place to date have been in advance of TasNetworks' (Transend's) two proposals being lodged such that they would allow timely input of small business priorities. We believe it is important to ensure timely small business input into the Proposal so that small business issues may be adequately reflected in them.

We hope that TasNetworks will address these matters in its future consultations with TSBC and the Tasmanian small business community. We would like to see small business, including the TSBC, become a more 'natural' part of TasNetworks' consultations. In the meantime and consistent with the AER's Guideline, we believe that the AER needs to carefully consider how the matters raised above may have impacted upon the development of the TasNetworks' Proposal.

2.2 Consistency with the Guideline

TasNetworks comments in its Proposal that:

> *Our approach to consumer engagement is consistent with the AER's guideline. (p. 30)*

Whilst we do not doubt that some aspects of TasNetworks' consultations have been consistent with the Guidelines, in other ways they have either not been or leave room for doubt.

Table 1 below elaborates on this and we would urge TasNetworks to consider these comments in developing improvements to its consultations with consumers.

Table 1: TSBC Assessment of Consistency with the Consultation Guidelines

Best Practice Principles of Consumer Engagement	TSBC Comments
Clear, accurate and timely	• We have no reason to believe that TasNetworks' consultations have not been clear and accurate. We welcome the steps it has taken to improve its communications with consumers and their clarity. • TasNetworks (Transend) has not always been timely in its consultations (e.g., see our points above on consultations with TSBC).
Accessible and inclusive	• TasNetworks (Transend) has been approachable and willing to consult but has not always initiated discussions (e.g., see our comments above). • Small business and the TSBC have not always been included in consultations.
Transparent	• TasNetworks (Transend) has been willing to share information with us and been open in discussions. • However, TasNetworks could have been more transparent in demonstrating how engagement with smaller consumers has directly impacted its Proposal. Its comments in this regards are quite general and may partly reflect the limited depth and scope of their engagement with smaller consumers.
Measurable	• TasNetworks has pointed to areas where it has responded to consumer feedback in its Proposal and we acknowledge these. However, the gaps we raised above appear to have limited their ability to respond to small business issues.

2.3 Other Key Attempts at Engaging with Smaller Consumersith Smaller Consumers

The TasNetworks Proposal outlines its other main attempts to engage with smaller consumers more directly, namely by undertaking:

- A telephone survey to reach a wide and representative sample of consumers.
- Two deliberative forums, in Hobart and in Launceston.[3]

We support these initiatives and believe that they have provided some useful insights to assist in developing the TasNetworks' proposal. Nevertheless, there are limitations in their usefulness, a number of which are highlighted in the Proposal and/or in the report from TasNetworks' consultant, Straight Talk.

Box 1 highlights what we believe are some of the more salient points to emerge from this work.

We note than many of the preferences expressed by smaller consumers also align closely with those of the large energy users directly connected to the transmission network but that the latter's preferences are more detailed. For example, they expressed clear preferences for reduced prices, maintaining service, a scaling back of network augmentations given flat demand, greater use of non-network solutions, setting tougher efficiency and cost minimisation targets, a lower rate of return and a lower regulated asset base. The TSBC supports these preferences and believes that both TasNetworks and the AER need to place considerable weight on realising them in this Determination.

2.4 Conclusions

We believe that there are some gaps in TasNetworks' consumer consultations and that they have not completely fulfilled the requirements placed on them by the Rules and the AER's Guideline on Consumer Engagement by Network Service Providers. The AER needs to take this into account when assessing TasNetworks' Proposal and clearly set out how it has done this in its Determination. We endorse the comments by the Consumer Challenge Panel speaker at the AER's Public Forum that:

- Consumers expect the AER to seriously challenge the networks to provide clear evidence of all of their claims regarding consumer preferences, including evidence of consumers' willingness to pay for those preferences; and
- Consumers also expect the AER to assess the value for money of the networks' consumer engagement programs and to outline their expectations regarding improvements to the networks' approaches

Although we recognise that TasNetworks has had limited experience with consumer engagement in the past, has acknowledged this, has taken some useful steps towards

[3] Both of the above were undertaken with the help of a specialist consumer engagement firm, Straight Talk.

consumer engagement and has indicated that it is working to implement further improvements in future, we are not convinced that its efforts have been sufficient.

Box 1: Key Observations from TasNetworks' Direct Engagement with Smaller Consumers

- Surveys and deliberative forums can provide some useful information to help inform TasNetworks' Proposal and we support their use, but their usefulness has its limitations. These include a lack of detailed and technical knowledge by participants, difficulty in dealing with complex and detailed questions, getting people to reveal their true preferences, a lack of understanding of the place of transmission and its charges in the electricity supply chain and drawing numerical inferences from this work, e.g. by how much should prices fall and what does this mean for regulated revenue. A number of these are alluded to by Straight Talk.
- We endorse a number of the findings of this work, which are generalised but still of importance:
    - That price and reliability are the two key aspects of transmission of interest to consumers;
    - That price is the single most important issue due especially to recent large increases in electricity prices;
    - That consumers want to see a reduction in these high prices;
    - That the impact of rising prices is of most concern in relation to small business and those least able to pay;
    - That TasNetworks needs to focus more on consumer communication, engagement and education so that their views are based on a solid understanding of the electricity industry and TasNetworks' Proposal, noting that the former is also an issue for other parts of the industry;
    - That a more in-depth approach is needed in future, e.g., 'consumer panels'. We also note the need for ongoing engagement and welcome the steps TasNetworks has already taken to improve its approach.
- We only partly accept TasNetworks' comment in the Proposal that "there are no clear, unambiguous answers about whether price or reliability should be our primary objective. In particular, the risk of a less reliable service was not accepted as a trade-off for lower prices. By the same token, an increase in reliability was also not supported if it came at a higher price." We note the comment by Straight Talk that it is more likely that "loss aversion" is dominating consumer thinking on these issues (Appendix 4, p. 17). We also note that the question asked of consumers did not allow them to express a preference for both lower prices and improved reliability.

3 Assessment of TasNetworks' Past Performance

This section provides TSBC's assessment of TasNetworks' past performance as Tasmania's transmission network services provider (TNSP). It covers both the current (2009/10 to 2013/14) and previous (2004/05 to 2008/09) regulatory periods. We believe that it is important to view TasNetworks' performance beyond just the current regulatory period.

3.1 Historical Trends in Expenditures and Revenues

We have examined TasNetworks' past performance in terms of historical trends in capex, opex and revenue. The results are presented and discussed below.

Figure 1 shows TasNetworks' capex. Whilst capex has fallen in recent years, as pointed out in the Proposal, this followed a period of unprecedented growth from 2004/05 to 2009/10. It is also clear that over this period TasNetworks overspent its regulatory capex allowance in 4 of the six years, two of which involved substantial overspends. TSBC is concerned about this historical performance, noting that the significant increases and overspends in capex are still finding their way into TasNetworks' RAB, revenue allowances and prices. It is also of note that TasNetworks has found ways to significantly reduce its capex in recent years, having underspent its allowance in three of the past four years without hindrance to service.

Figure 1: TasNetworks' Historical Capex

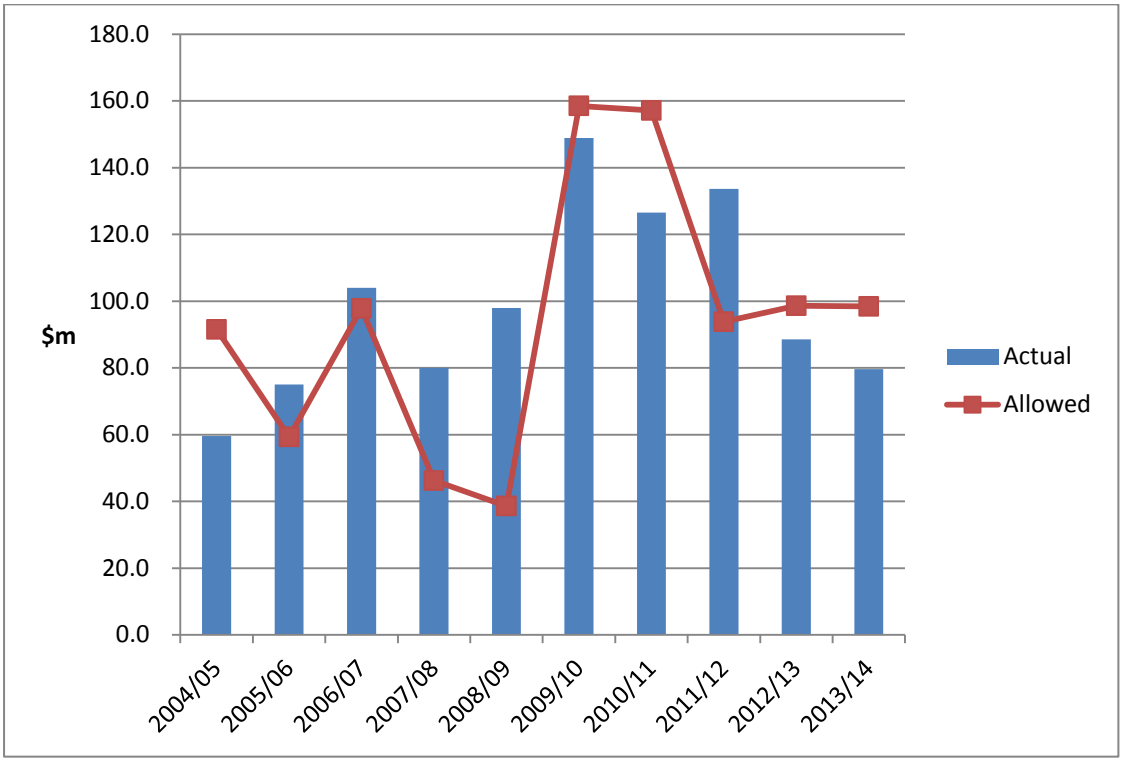


Figure 2 shows TasNetworks' opex. Again, whilst opex has fallen in recent years, prior to this there was a period of substantial increase, which continued unabated for 6 years. In five of those years TasNetworks also overspent its allowed opex, substantially so in three of these years. These matters are of concern to TSBC given the importance of opex in TasNetworks' revenue and prices. Whilst TasNetworks has reduced opex and significantly underspent its allowance in the last two years, that allowance was probably inflated in the first place. Moreover, opex is now 40 per cent higher than it was a decade ago and has grown at over 4 per cent per annum. Before the recent declines it had grown by over 60 per cent with an annual growth rate of over 10 per cent. Whilst we welcome the recent reductions in opex and appreciate the internal challenges this has presented for TasNetworks, we are not convinced, based on the above, that TasNetworks opex is yet efficient suggesting their proposed opex for the next regulatory period could still be reduced without any detriment to operations.

Figure 2: TasNetworks' Historical Opex

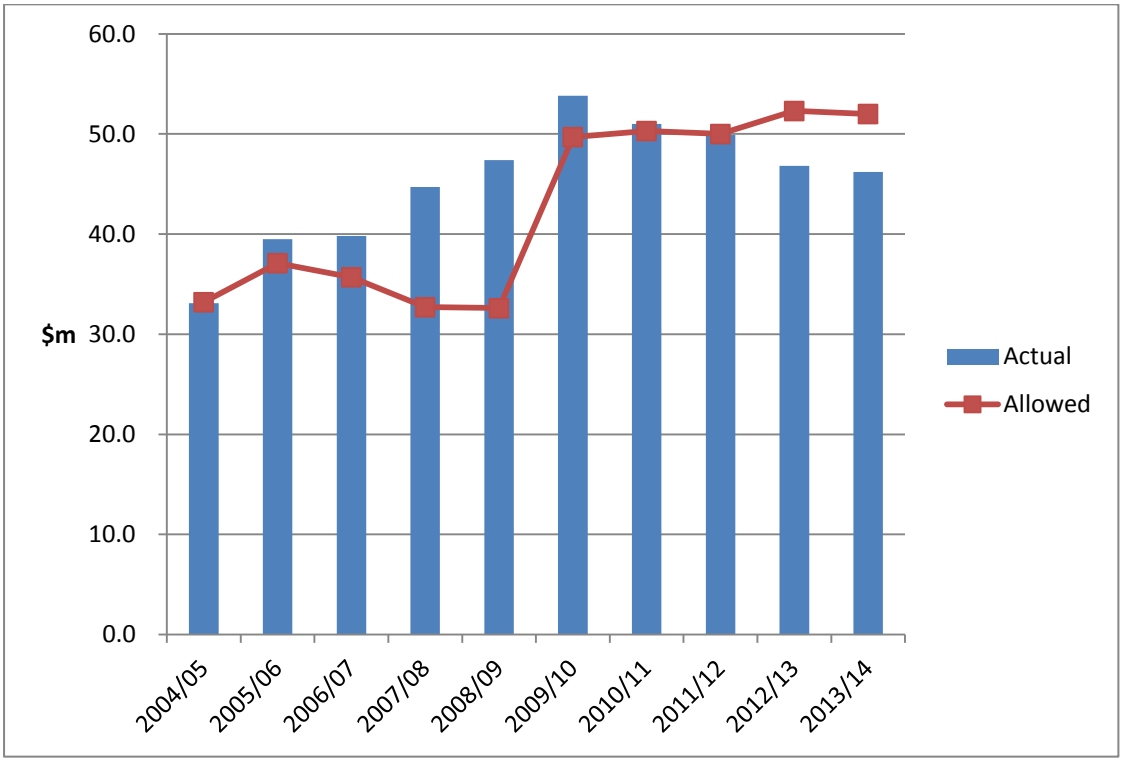
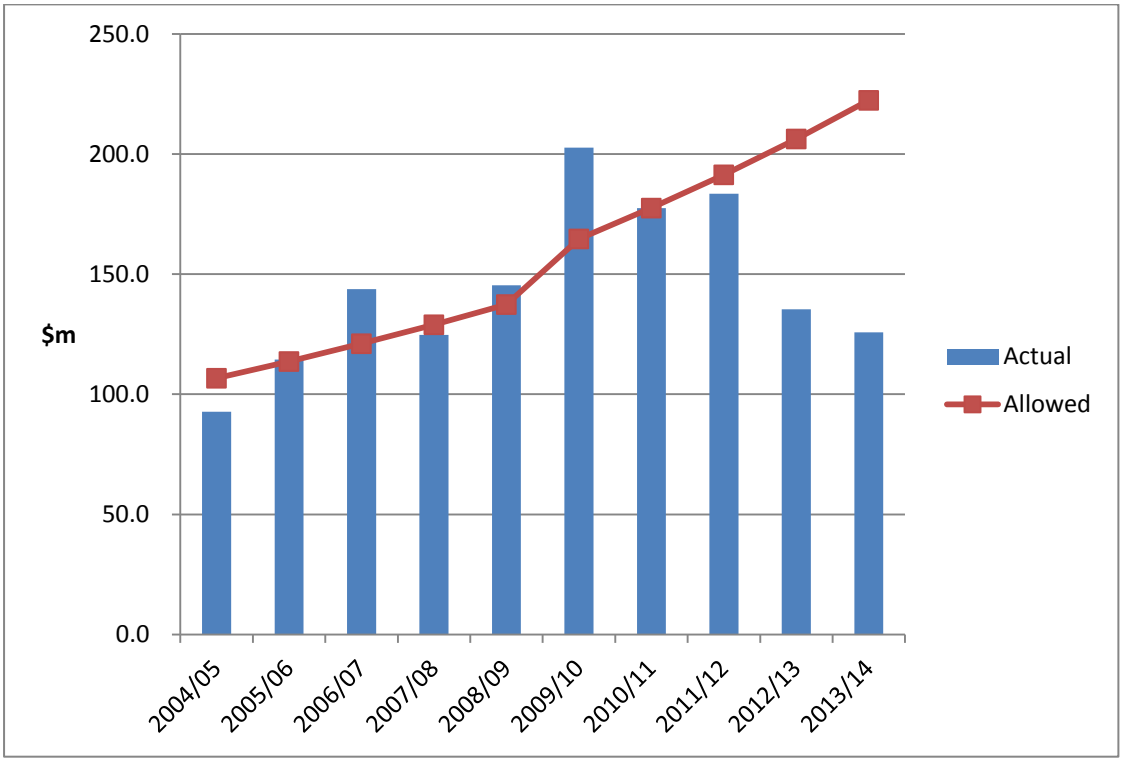


Figure 3 shows historical trends in TasNetworks' revenue. Most apparent is the large growth in revenue from 2004/05 to 2009/10, reflecting the opex allowances, growth in the RAB and high rate of return, the incline in the regulatory allowance, and the significant reductions and underspends since 2009/10. The latter support that TasNetworks was treated too generously in the past two regulatory determinations and is able to operate

perfectly well with a lot less revenue. This would be the case even allowing for the fall off in demand since 2011/12.

Figure 3: TasNetworks' Historical Revenue



The AER needs to ensure that consumers do not continue to pay for past errors in the next regulatory determination.

3.2 Historical Trends in Productivity and Efficiency

We have also examined TasNetworks' historical productivity performance as part of this submission. The results are presented below with reference to a number of ratios that provide insights into this. For all these ratios, an increase is indicative of declining performance and a decrease indicates improved performance.

Figure 4 shows the ratio of capex to energy sales and line kilometres (line length). Whilst there have been improvements in both in recent years (i.e., since 2009/10), this was preceded by a six year period of almost unabated and significant worsening performance. Moreover, the improvements have not yet offset the years of worsening performance in these ratios. In fact, the ratio of capex to energy sales was 30 per cent higher (worse) in 2013/14 than it was in 2004/05, whilst the ratio of capex to line length was 36 per cent higher (worse).

Figure 4: Capex Ratios

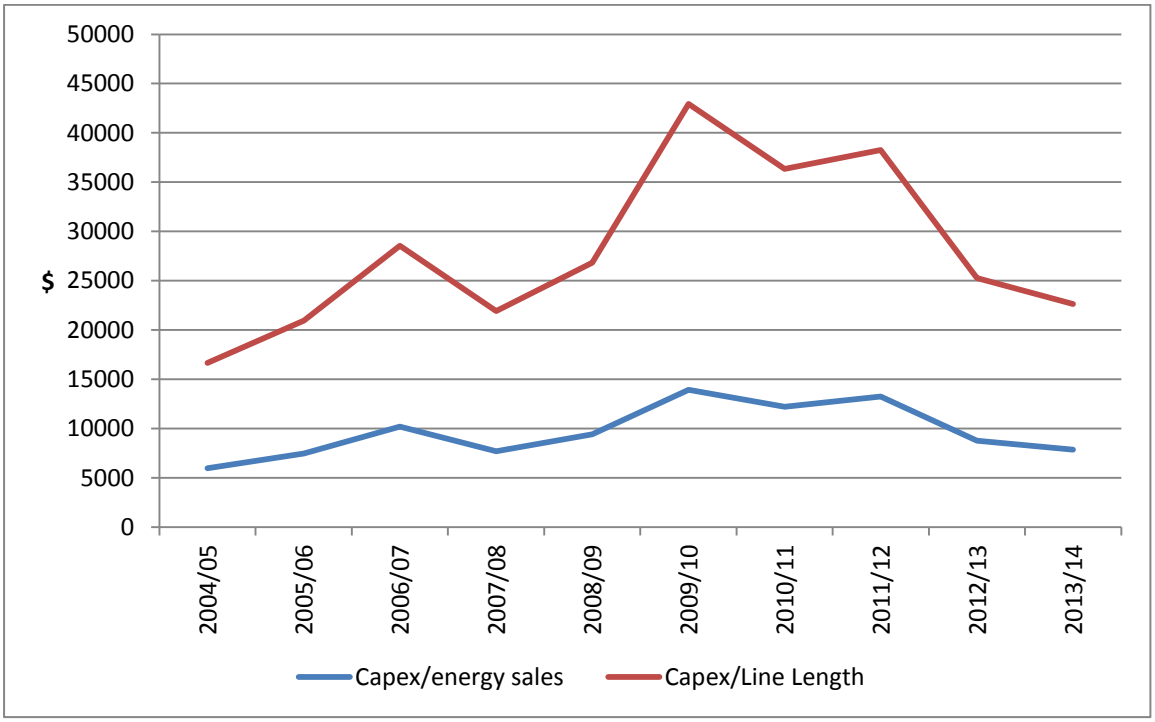
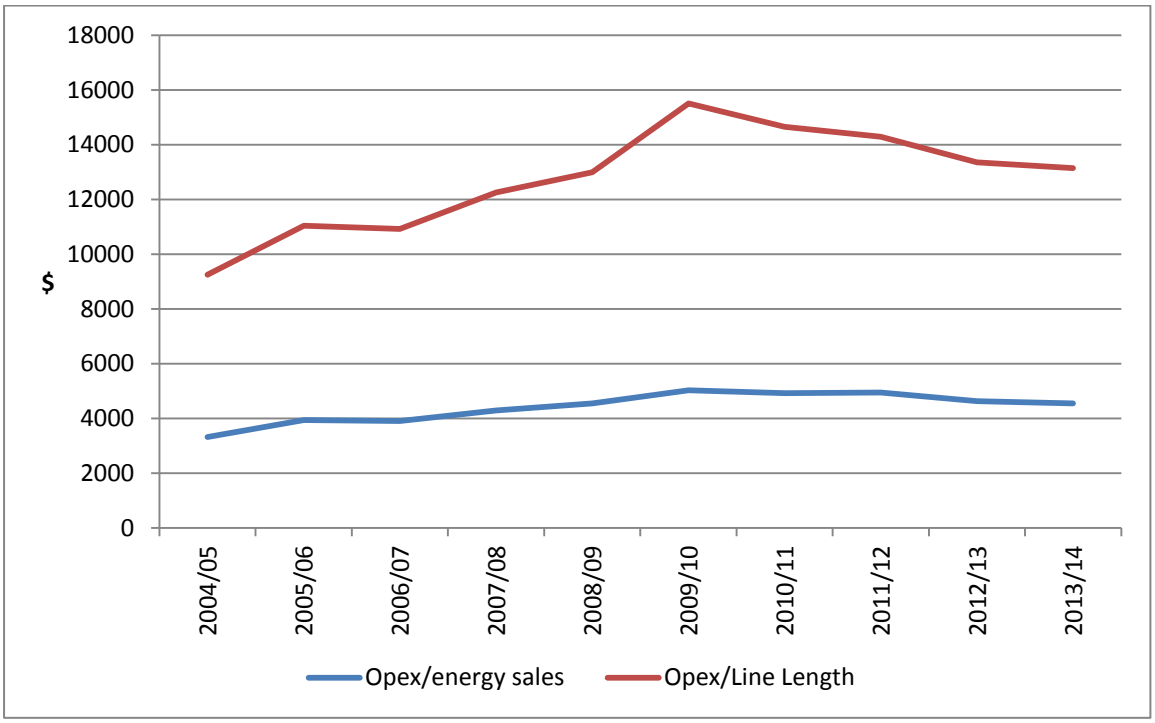


Figure 5: Opex Ratios



The picture is similar for opex as shown in Figure 5 above. Both ratios have improved since 2009/10 but worsened by even more prior to that. The upshot is that the ratio of opex to

energy sales is 37 per cent higher (worse) in 2013/14 than it was in 2004/05, whilst the ratio of opex to line length is 42 per cent higher (worse).

Figure 6 shows the ratios of capex and opex to the Regulatory Asset Base (RAB). This shows an improved trend over the decade under review. We welcome this, whilst noting that it largely reflects deliberate decisions by TasNetworks to reduce its opex and defer a significant amount of its allowed capex after 2009/10. The capex ratio, in particular, has also been influenced by TasNetworks not undertaking development capex related to growth in demand which did not eventuate. Given our comments earlier in this section, these results add to our concerns that despite the reductions, TasNetworks' opex is not yet efficient.

Figure 6: Capex and Opex to RAB

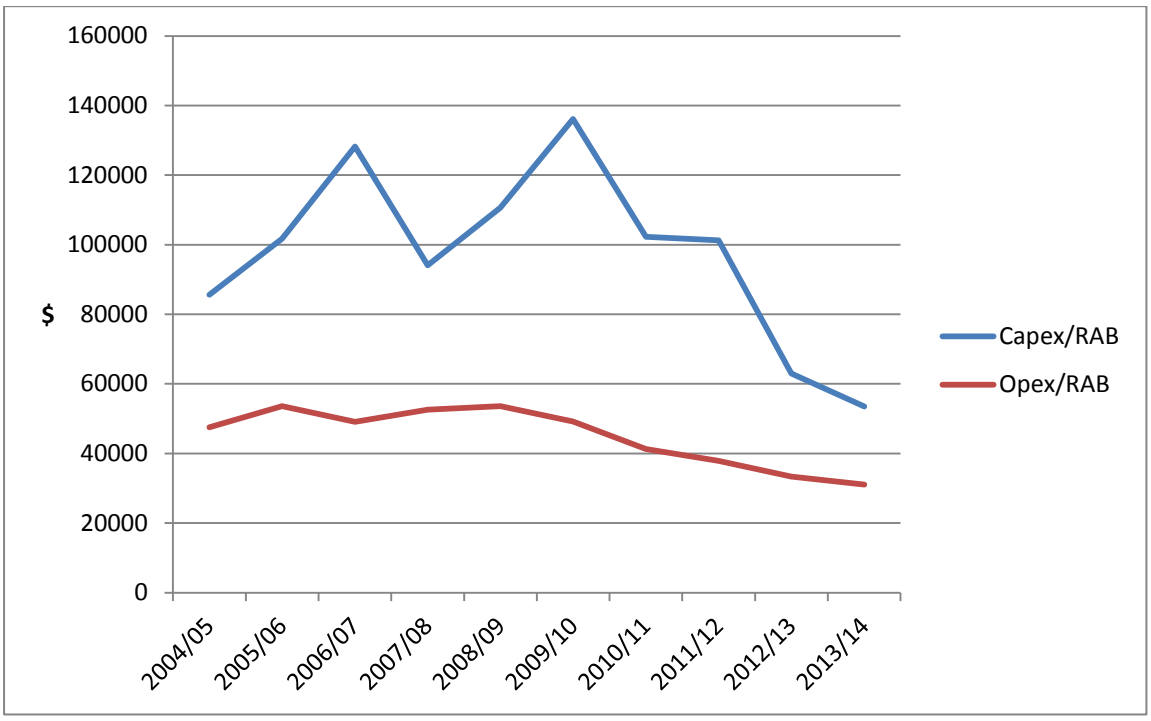
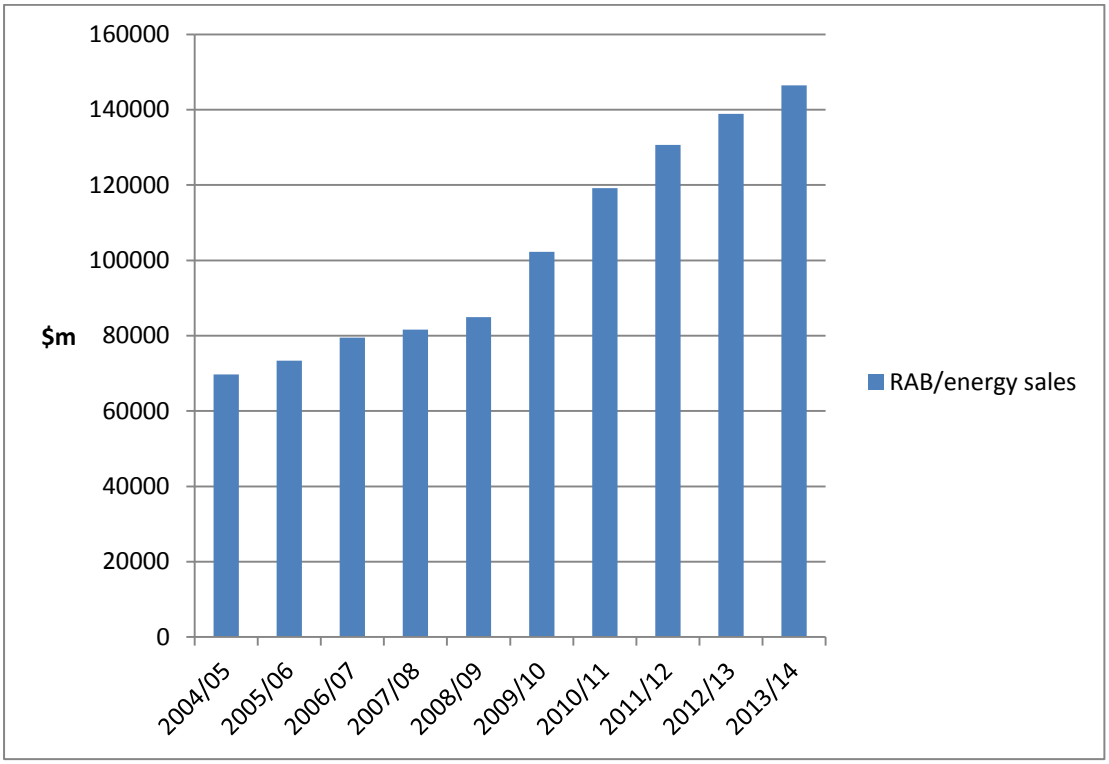


Figure 7 shows that there has been a continuing growth in this ratio notwithstanding the fact that energy sales have been stagnant since 2010/11. This indicates that TasNetworks has continued to expand its regulated asset base notwithstanding that the market it serves with electricity transportation services has not grown and is unlikely to in the foreseeable future.

Figure 7: RAB to Energy Sales



3.3 TasNetworks' Assessment of Its Past Performance

We comment below in those aspects of TasNetworks' Proposal that relate to its past performance. It is worth noting at the outset that the lack of sufficient historical context to its assessment was a shortcoming that leaves consumers less informed. Some of TasNetworks' past performance cannot be adequately assessed by merely looking back at the current regulatory period. A longer time series would provide a better picture.

3.3.1 Capex

We provide the following comments on TasNetworks' recent past capex performance:

- We note that total capex over the current regulatory period will be $115 million (17 per cent) below the AER's regulatory allowance. We support the decisions that TasNetworks has taken to keep its capex well below the regulatory allowance and believe that it would have been inappropriate for TasNetworks to spend its

allowance given that the demand forecasts that underpinned this allowance have turned out to be wrong and that the regulatory proposals put to the AER by TasNetworks in its last reset were above what could be considered reasonable.[4]

- We note that development capex (augmentation, connection, and land and easements) was reduced to $132 million (34 per cent) below the AER's allowance. Hence, this has been responsible for more than the total reduction in capex. It is appropriate that this category has been reduced given that forecast increases in demand on which a significant proportion of it was based did not eventuate, and that a number of industrial sites closed or did not go ahead.
- Renewal/enhancement capex was $24.7 million (9 per cent) higher than TasNetworks' allowance. We are concerned both about this outcome and the lack of adequate explanation in the Proposal for it, and believe that TasNetworks should have taken steps to also curtail its spending in this area. The environment facing TasNetworks and its customers in the current regulatory period is not one where overspends are appropriate.
- Of the remaining elements of capex, information technology was $12.7 million (two-thirds) below the allowance[5], which we welcome but business support was $5.8 million (30 per cent) higher than the allowance (for which no explanation appears to have been provided). We are surprised by the latter outcome given that it would be partly related to the total quantum of capex, which was lower than allowed.
- On the timing of TasNetworks' capex spending, we note that there was a pattern of higher spending in the early years of the regulatory period, especially in the case of underspent items such as augmentation and connection. We would be concerned if this early spending was inappropriate given the circumstances that faced TasNetworks, including a collapse in forecast demand and lower industrial demand.

3.3.2 Opex

In relation to TasNetworks' recent opex, we provide the following comments:

- We welcome the steps that TasNetworks has taken to reduce its opex to below the allowance it was provided and believe that this outcome is more consistent with the circumstances facing TasNetworks and Tasmanian electricity consumers in the current regulatory period. It also better reflects the fact that expenditure proposals put forward by the businesses, including TasNetworks, at the last reset were well

[4] This problem was subsequently acknowledged by the AER and lead to a range of regulatory reforms.
[5] We note that some of the items have been deferred and appear in TasNetworks' Proposal for the next regulatory period.

known to be above what could be considered reasonable (let alone efficient). It is expected that TasNetworks' spending on opex will be $39.5 million (14 per cent) below its allowance. The bulk of this (94 per cent) comes from Field Operations and Maintenance, which is responsible for $19.1 million (48 per cent), Business Support, $6 million (16 per cent), Asset Management, $4.3 million (11 per cent), Transmission Operations, $4.1 million (10 per cent) and Transmission Services, $3.7 million (9 per cent). This outcome is also more consistent with the subsequent regulatory reforms designed to minimise the scope for exaggerated opex claims in future. However, we are not convinced that TasNetworks' actual opex spend for the current regulatory period will adequately reflect these factors (see Section 5).

- We also welcome that all categories of opex listed in Table 4.3 of the Proposal are shown as being either underspent or matching the allowance.
- TasNetworks has provided some information as to the decisions it has taken to achieve this underspending (Table 4.5). It has provided some useful specific examples of where it has reduced Field Operations and Maintenance spending and some of these are clearly efficiency based but has provided only generalised information for the other main categories of opex, which makes an informed assessment of its decisions more difficult. It is also difficult to establish from the information provided what scope there may have been for further opex savings.
- It is also a concern to TSBC that in its previous regulatory proposal TasNetworks was, at the time, unable to outline tangible productivity or efficiency savings in its opex claim, a gap subsequently reflected in the AER's allowance. That it has subsequently been able to underspend its opex by a significant amount is welcome, as mentioned above, but is hardly conducive to establishing confidence in TasNetworks processes for forecasting opex.

3.3.3 Service Performance

We note that TasNetworks generally met or bettered its service performance targets over the current regulatory period, whilst also mentioning that the regime applied to TasNetworks is not as challenging as some newer versions of the AER's Service Target Performance Incentive Scheme (STPIS). TasNetworks' comments that its "loss of supply performance in 2011 was unsatisfactory" (p. 48). The reasons outlined for this include human error, low transformer oil levels, wildlife incursion during planned work and unknown causes. It is possible that some of these reflect poor practices or avoidable mistakes, though this is difficult to confirm from the information provided. There is also no information about how TasNetworks has dealt with these problems to minimise the risks of re-occurrence. We note that the AER will be applying the latest version of the STPIS to TasNetworks in the next regulatory period, which will provide sharper incentives, though whether these will avoid the 2011 problems is unclear.

3.3.4 Results of TasNetworks' Benchmarking

The TSBC is strongly supportive of the use of benchmarking to assist the AER in determining efficient levels of future capex and opex. As part of its Proposal, TasNetworks commissioned Huegin to benchmark its past opex and capex performance. The results are generally complimentary of its performance once unique aspects of its transmission network are taken into account. TSBC provides the following observations:

- The uniqueness of an organisation is often mentioned as influencing benchmarking results and no doubt does have some impact. We accept that TasNetworks' transmission system is characterised by certain factors that can have an impact on its opex and capex. However, there is also a risk that organisations may seek to use this as an excuse for less than efficient performance. Techniques to overcome such limitations should be used by regulators to establish robust outcomes.
- The results of opex benchmarking presented in TasNetworks' Proposal shows that its opex to RAB has historically been higher than its Australian peers, including Electranet its closest comparator (Figure 4.4 of the Proposal). This also shows that TasNetworks' opex to RAB has improved for much of the period shown, to a level where it may now be approaching that of its peers, though a lack of peer data from 2010/11 onwards leaves this unknown. Nonetheless, this also shows that despite the relative disadvantages claimed by TasNetworks, it is still capable of lifting its efficiency to nearer that of its peers.
- TasNetworks' Proposal also shows the results of peer benchmarking for a range of partial productivity indicators of opex at a point in time (Figures 4.5 to 4.9). TSBC welcomes TasNetworks' position at or towards the most efficient end of the scale for a range of indicators of its maintenance opex, whilst also noting that this presumably reflects large reductions in this opex category during the current regulatory period. We also note that for the other three categories of opex – corporate, transmission services and asset management – TasNetworks is at or near the least efficient end of the scale. This is ascribed to its small scale, though these elements of opex did not decline significantly during the current regulatory period.
- For total capex, TasNetworks is shown to be at or towards the higher end compared to its peers for all the ratios shown (Figure 4.11). This is notwithstanding that they spent substantially less than their allowance over the current regulatory period. Partial capex indicators are also shown for augmentation, replacement and IT, with TasNetworks in the middle or towards the more efficient end of the scale. We note that these outcomes appear to correlate to decisions made by TasNetworks to either spend below or above its capex allowances for these categories during the current regulatory period.

- TasNetworks' consultants also undertook an econometric analysis to compare TasNetworks' actual opex to its predicted level based on their model. We have not examined the model in detail but do not agree with the comment in the proposal that "our [TasNetworks'] actual Controllable operating expenditure is lower than that predicted by the econometric model (as shown in the Figure 4.15). This is another indicator of the efficiency of our Controllable operating expenditure." (pp. 53-4, Proposal) The chart clearly shows that actual opex was higher than predicted in five of the nine years shown and that it has only trended below the model prediction following decisions made by TasNetworks to reduce its opex significantly below its regulatory allowance during the current regulatory period. However, the model continues to predict a higher level of opex.
- Huegin conclude that "there is nothing to suggest that Transend is inefficient compared to its peers." (p. 53, Proposal) TSBC has some doubts about this conclusion based on the results and the comments above.
- Whilst information about TasNetworks' past opex and capex performance is of interest, the regulatory determination is largely a forward looking process and it is information about the efficiency of its forecast opex and capex that is most important.
- The study commissioned by TasNetworks is useful, up to a point, but TSBC will put more weight on the benchmarking work of the AER given its more independent and arms length basis.

Finally, the comment made in the Proposal that "we [TasNetworks] expect to see further improvements in our benchmarked performance during the next regulatory period" (p. 54) is welcome and we expect the AER to reflect this in its allowances.

4 Forecast Capex

This section comments on the forecast capital expenditures outlined in the Proposal.

4.1 Key Variables and Assumptions

TasNetworks has based its forecast capex for the next regulatory period on certain key variables and assumptions. We comment on these below.

4.1.1 Load Forecast Methodology

The TasNetworks' Proposal outlines its load forecasting methodology. PB was also engaged to review this and TasNetworks comments that:

> *"PB stated that both Transend and Aurora [now merged as TasNetworks] have significantly improved their forecasting processes since our previous revenue cap review in 2008. The report concluded that the current forecasting approach is reasonable and likely to produce realistic forecasts." (p. 59, our parenthesis)*

Nevertheless, the PB report (Appendix 9 to the Proposal) also provides a qualification in that:

> *"PB notes that this is a conclusion on the reasonableness of the model process and methodology, not on the forecasting results as such." (p. ii)*

Ultimately, it is the forecasts themselves which are used to establish capex and the AER will need to ensure not only that the model is reasonable but also that its forecast results are robust. In this regard, they would be aware of recent problems in accurately forecasting demand in the NEM, with AEMO needing to continually revise downwards its forecasts of demand, which is has done again this year. Even AEMO's low growth scenarios have proved to be too optimistic and have been subsequently revised downwards. The AER needs to consider that there could be further downward revisions over the next regulatory period and ensure that the forecasts are reasonable bearing this possibility in mind. Overly optimistic forecasts will set a higher capex allowance than is needed – even allowing for the large reductions proposed by TasNetworks – and this will be reflected in its revenues and prices going forward. The environment now is such that consumers should be protected from risks of unnecessary transmission price increases.

We note that AEMO's 2014 macroeconomic and energy market variables forecast were not available in time to be included in the development of TasNetworks' 2014 demand forecast,

which therefore requested NIEIR to develop forecasts of these variables. The AER will need to check these against the AEMO forecasts which are now available.

4.1.2 Maximum Demand Forecasts

The winter medium growth, 10 per cent PoE forecast provided by TasNetworks is for an annual average growth rate of 1.26 per cent over the next regulatory period. The low growth scenario is 1.1 per cent. Actual growth over the current regulatory period has been minus 0.06 per cent. Given this and AEMO's continually over optimistic demand forecasts, we doubt that any positive growth in demand for the next regulatory period would be reasonable. Zero or even negative growth seems more likely.

4.1.3 Connection Point Forecasts

We note the connection point forecast approach used by TasNetworks, and that it involves both its major customers and Aurora. We support this. We comment later in section 4.2 on certain aspects of TasNetworks' capex proposals that seem to be based on erroneous or out-of-date network information.

4.1.4 Project Scopes and Estimates

The TasNetworks' Proposal says that these are based on project definitions and supporting information for each project included in the capex program to enable the estimation of efficient project costs, that cost estimates are based on actual costs of recent similar projects or procured assets and that contracts for the delivery of capital projects are established through either formal 'closed' tender or 'open book' negotiations, which reflect competitive prices. Whilst we accept these comments, we note in Section 4.2 that some of the information provided in support of individual projects appears to be limited.

4.1.5 Cost Estimation Risk factors

We recognise that there tends to be an inherent bias for project costs to increase and note the way that TasNetworks proposes to allow for this in its forecasts. However, we would also point out that this should not detract from the need for project costs to be efficient and for TasNetworks to ensure that this happens. The will AER also need to ensure this.

4.1.6 Cost Escalation Rates

TasNetworks and the other network service providers (NSPs) currently under AER review commissioned two consultants to review escalation rates for key inputs into their capex and opex forecasts. We note that the AER has previously queried the value of such forecasts and the effort that goes into preparing them, noting that escalation rates typically contribute 3-5 per cent to regulatory allowances. It has also suggested that perhaps a better approach would be for networks to manage such cost factors through hedging, labour productivity offsets and better timing of purchases. This is typically how businesses have to manage such costs and NSPs should also be required to.

However, CEG one of the consultants, queries whether these strategies would lead to zero escalation. We doubt that this is necessarily what the AER had in mind? Rather they were probably concerned to minimise any escalation and to avoid what has been a problematic approach to forecasting input costs. We believe that the AER's suggestions are also more consistent with the objectives of incentive regulation whereby NSPs are encouraged to seek out greater efficiencies. Moreover, we do not accept a number of the points raised by CEG against the AER's suggestions. They seem to miss the point that NSPs should be encouraged to avoid cost pass throughs and seek more efficient ways to manage costs.

4.1.6.1 Labour

TasNetworks is proposing real costs escalation of 1.15 and 1.3 per cent per annum, on average, for utilities based labour and general labour respectively over the next regulatory period. These rates generally increase over the regulatory period. TSBC doubts that the outlook for the Tasmanian economy is such that it would support such escalations. Moreover, Tasmanian electricity consumers are looking for TasNetworks to control its costs and ensure that they are efficient not simply to pass on 'normal' wage increases.

4.1.6.2 Non-labour Cost Escalation

TasNetworks proposes the following annual average real cost escalations:

- Aluminium, 4.3 per cent
- Copper, -0.22 per cent
- Steel, 0.8 per cent
- Crude oil, 4.6 per cent
- Construction, 0.45 per cent
- Land, 3.4 per cent

These are based on prices from futures markets where possible or otherwise forecasts of how prices in these markets might change over the next regulatory period. As with any forecast, there are inherent uncertainties associated with such methods. Rather than relying purely on forecasts, the AER should, in our view, seek to place greater incentives on TasNetworks to manage these costs so as to minimise them over the next regulatory period. We note that new or improved regulatory mechanisms such as the Capital Efficiency Sharing Scheme (CESS), discussed further in Section 6.2, ex-post reviews of capex and refinements to the Efficiency Benefits Sharing Scheme (EBSS) for opex, discussed further in Section 6.1, should assist in this regard.

4.2 Comments on Capex Program

TasNetworks proposes to spend $275.9 million on capex over the next five years. TSBC welcomes that this is a 52 per cent reduction in TasNetworks' real capex compared to the current regulatory period. We believe that this is more appropriate to the circumstances facing TasNetworks and its customers.

We also note that TasNetworks has reduced its capex compared to its Transitional proposal by a further $28.9 million by removing three reliability projects and a connection project from its transitional proposal on the basis that they are no longer required in the next regulatory period.

It is also pleasing that each of the three main categories of capex – development, renewal/enhancement and non-network – would see significant reductions compared to the current period under the Proposal, with the first and the third categories most impacted. We accept, *a priori*, that renewal/enhancement projects should be reduced by less on the basis that this expenditure is related to the core existing network which needs to be kept in good condition.

However, we have also formed a view that TasNetworks' proposals sometimes lack sufficient detail which makes their justification difficult to support in detail and they lack sufficient transparency. Costs, benefits and risks are mentioned but rarely quantified. The supporting documentation provided also lacks this detail.

We have some concerns about some elements of TasNetworks' capex program including the following:

- Inventory/spares would increase from $9.9 million in this regulatory period to $15.2 million in the next. This is on the basis of the purchase of strategic spare transformers and a mobile sub-station. The only justifications are the comments that it would allow the life of some existing assets to be extended.

- Operational support systems double from $16 million in this regulatory period to $32.6 million in the next. However, aside from mentioning that this includes some deferrals from this regulatory period and listing the items to be purchased, there is no detailed justification for this.
- Renewal and enhancement projects amounting to $145 million are included. Of this, $54 million is allocated to projects with a value of greater than $5 million each and these are set out in Table 5.7 (p. 73). However, these projects are justified mainly on the basis of limited information (e.g., a tick next to the main investment drivers). The remainder ($91 million) is allocated to smaller projects that are mentioned but not discussed or justified.

Our comments on a number of the individual projects proposed by TasNetworks are set out in Table 2 below. These amount to $55 million in capex and removing them in total or part from the Proposal would reduce TasNetworks' capex by up to 20 per cent. Aside from this, the Proposal does not contain sufficient emphasis on the increased use of existing assets. Besides planning for potential 110 kV asset rationalization in the Southern region and consequently increased use of the new 220 kV assets, there are no projects seeking an increased reliance on 11, 22 and 33 kV distribution feeders to defer capex in the transmission network. The fact that the transmission and distribution networks are now merged should make these sorts of options easier to achieve.

The Regulatory Proposal says that a range of initiatives will be used to ensure that the capital program would be delivered prudently and efficiently. We welcome this comment. Nevertheless, it is disappointing that TasNetworks proposes no further initiatives to improve its approach to delivery and we would also expect that the merger of the transmission and distribution arms into a single business would allow some scope to increase efficiencies or rationalise approaches but this is not obvious from the Proposal.

TasNetworks comments that:

> *"The substantial reduction in forecast capital expenditure compared to recent actual levels should provide all stakeholders with confidence that our proposed expenditure is efficient in accordance with the Rules requirements." (p.67)*

However, the issues we have raised above suggest that its proposed capex may not yet be as efficient as suggested and that further reductions may be possible. We also note the importance of applying benchmarking analysis to TasNetworks' capex forecasts before they can be judged to be efficient. This will be an important task for the AER.

Table 2: Comments on Individual Capex Projects

Project	Category	Proposed Expenditure	TSBC Comments
Waddamana-Palmerston 220 kV security augmentation	Augmentation	$21 million	This project is outlined as a reliability augmentation and compliance project. Also, we understand that the existing 110 kV line was originally designed for 220 kV operations and used to be in service as a 220 kV line. The Proposal outlines that this corridor could be affected by bush fires and we are aware that recent bush fires caused damage to an adjacent 110 kV line. TasNetworks provides little information about the magnitude of the risks to frequency operating standards and system black. They also discuss the potential for widespread loss of supply following a double-circuit fault or circuit breaker fail event but acknowledge that "such events are rare". We note that TasNetworks has had discussions with a major industrial customer for network support as explained on pages 34 and 64 of the Proposal. We note that this could provide a potentially more cost effective alternative to the proposal.
Newton-Queenstown security augmentation	Augmentation	$14 million	Copper Mines of Tasmania have recently decided to close and put into care and maintenance their Queenstown mine for at least 3 years. Consequently, TasNetworks' concern for breaching the ESI Regulation requirement of 300 MWh of unsupplied energy should no longer be an issue. Hence, the need for 220/110 kV injection into Queenstown can be avoided unless the mine re-starts. We do support dismantling the 110 kV line (built 1936) from Queenstown to Newton as asset rationalization in the area.
Lindisfarne Substation transformer replacement	Asset Renewal	$7 million	Given that TasNetworks commissioned the Mornington 110/33 kV injection point in the existing reset period, it should transfer load to this and postpone the Lindisfarne transformers replacements.
Strategic mobile 110/33-22-11 kV substation	Inventory/ spares	$7 million	We understand that TasNetworks' spare transformers may offer an alternative to purchasing a mobile substation? What is a risk exposure if this purchase does not go ahead? Are the costs worth the benefits?
Renewal of K-poles on the Triabunna Spur 110 kV transmission line	Asset Renewal	$6 million	We query the need for this. A wood chip mill has closed as the main load at Triabunna and maximum load is only retail load on two 22 kV distribution feeders, amounting to around 5 MW (Aurora 2013 Annual Planning Review). TasNetworks should explore an option of decommissioning the 110 kV supply to Triabunna and examine if this small amount of load can be supplied by the existing 22 kV feeder.

4.3 Other Comments

TasNetworks has proposed no contingent project expenditure for the next regulatory period. TSBC supports this given the stagnant state of electricity demand in Tasmania for the foreseeable future, the challenging state of the economy and the need to avoid putting any upward pressure on electricity prices.

The Proposal comments that TasNetworks' capex forecasting methodology investigates "the scope for more cost effective non-network solutions"(p. 57). These can reduce costs and provide useful solutions to constraints and the like. They may be augmentation or replacement based. However, they also present challenges to networks, which tend to be based on a culture of building assets, and to potential third party providers who must overcome this culture. Disappointingly, TasNetworks has not identified any non-network solutions as part of its proposal but does indicate that it will continue to progress this where credible solutions exist. The AER will need to ensure that TasNetworks gives serious consideration to non-network solutions in the next regulatory period. We also note that with the merger of Tasmania's transmission and distribution networks, TasNetworks should be able to provide both an holistic approach to non-network solutions covering all voltages and a seamless approach covering both transmission and distribution options. Efficiencies from the merger should extend to non-network solutions.

TasNetworks has outlined how it has optimised the trade off that exists between capex and opex. Whilst we accept that it has done this, it is difficult to see from the proposal specifically how it has done so as very little concrete information is provided. Its Proposal also says that growth in its asset base has an impact on opex as new assets need to be maintained. We do not question this, but note the slowdown in both capex and the RAB proposed over the next regulatory period. What is not clear from the proposal is how this has impacted on opex?

5 Opex Forecasts

This section discusses TasNetworks' forecast opex for the next regulatory period.

5.1 Forecasting Controllable Opex

TasNetworks' uses the AER's preferred 'base-step-trend' approach to forecasting opex over the next regulatory period. TSBC expressed doubts about the ability of this approach to reveal an efficient level of costs in its submission on the Transitional Proposal and our national organisation, COSBOA, also did so in the input it provided to the AER's Better Regulation program. This alone makes us doubt the robustness of the opex forecasts provided by TasNetworks as a basis for establishing efficient costs. However, the benchmarking work being undertaken by the AER for use in the determination should improve its ability to establish an efficient level of opex for TasNetworks in the next regulatory period.

We comment next on TasNetworks' key assumptions and variables for establishing its opex.

5.1.1 Base

TasNetworks proposes to use its actual 2013/14 opex as an efficient base for its forecasts. However, we have some reservations with this. It selected this year on the basis that it is the most recent year of audited, actual opex, it most closely represents the costs required to operate the business in the near future and it represents an efficient level of expenditure. TSBC particularly has concerns with this representing an efficient level of expenditure.

On behalf of TasNetworks, Huegin found that: the opex in 2012/13 is the lowest in the current period; it is lower than the long term trend; it is lower than the estimated level of efficient expenditure that was forecast for 2012/13 in the previous determination; and it includes significant reductions in opex in many of the individual expenditure lines reported in the regulatory accounts - several of which are at their lowest level since 2004/5.

Whilst we do not necessarily take issue with these findings, we do not believe that this establishes an efficient level of opex. In the first place, the opex allowances established at the time of the last resets, including for TasNetworks, are known to have been at the top of or above reasonable levels. Moreover, the actual opex for 2013/14 was, in real terms, some 76 per cent higher than for 2004/05 and 33 per cent higher than the average for the previous regulatory period. Even allowing for factors such as growth in demand and in TasNetworks' network over the previous regulatory period, these are large increases in opex.

Moreover, as TasNetworks comments:

> *"Because of the impact of scale economies, some operating cost categories, such as operations and business support, will change more slowly than changes to the asset base." (p. 85)*

The 2013/14 level of opex was also only 3.5 per cent lower than the average annual real opex for the current period.

TasNetworks proposes a real base opex level of $44.4 million per annum – $222.1 million in total – for the next regulatory period. We believe that additional analysis is required to establish an efficient base level of opex for TasNetworks for the next regulatory period, including the use of robust benchmarking.

5.1.2 Step

TasNetworks proposes to include two step changes to its base level opex allowance. First, the cost of its new consumer engagement obligations and the costs of providing data for the AER's benchmarking activities. Secondly, the cost of providing services from transmission customers, previously recovered by AEMO. We do not object to including these two new elements in TasNetworks' opex allowance but TasNetworks and the AER need to establish that the costs included are efficient and prudent. Consumer engagement and benchmarking are new activities so an efficient and prudent base level of costs will need to be set. The services previously undertaken by AEMO were not regulated but set in AEMO's budget from fees levied on NEM participants. AEMO is an unregulated monopoly provider and TasNetworks proposal to recover the same level of costs on the basis that these are prudent and efficient needs to be tested.

This amounts to a proposed $4 million (real) expenditure over the next regulatory period.

5.1.3 Trend

TasNetworks proposes the use of the AER's approach to establishing an allowance for asset growth in its opex allowance. We note that this amounts to a small proposed addition of $0.5 million (real) over the next regulatory period.

The labour cost escalation rates proposed by TasNetworks amount to $5.8 million (real) over the next regulatory period. It also proposes to escalate non-labour rates by CPI. We commented on the proposed escalation factors in the previous section.

5.1.4 Efficiency Improvements

TasNetworks proposes efficiency improvements of $29.8 million (real) over the next regulatory period arising from the merger of the transmission and distribution systems. We welcome these additional efficiencies, and recognise that they are based on some difficult decisions, including redundancies. We also note the comment that:

> *"Further efficiency gains will be achieved over time as the new company rationalises duplicate systems and finds better ways of delivering services to its customers. The new organisation will also develop optimal business processes and practices, with these efficiencies achieved over time." (p. 87)*

Whilst these plans were still being developed, TasNetworks has included a further target of reducing controllable opex by 0.5 per cent per annum (real) over the next regulatory period (excluding cyclical revenue reset costs). Again, we welcome the inclusion of this whilst noting that it is a modest target.

The TasNetworks Proposal comments that these savings will be "challenging to achieve". We have no doubt that TasNetworks will face some challenges in this regard but strongly believe that it is vital that they face such challenges as a business, as consumers expect them to operate with a level of truly efficient costs.

Regarding the efficiencies from the merger, when he announced this, the then Minister remarked that:

> *"In the longer term, we expect that having only one state owned business that is responsible for the transmission and distribution of electricity from power stations to households and businesses will realise annual savings of at least $8 million."*[6]

We note that TasNetworks has identified $2.5 million in merger related savings in 2014/15. We therefore seek further information on the extent of TasNetworks' savings beyond this to achieve at least $8 million per annum in total and when these will be realised?

5.2 Controllable Opex Proposals

TasNetworks has proposed controllable opex of $204.8 million over the next regulatory period ($2013/14). This amounts to an average of $41 million per annum. It notes that this is 11 per cent below the average over the current regulatory period and that its controllable

[6] Bryan Green MP, Deputy Premier and Minister for Energy and Resources, *Energy for the Future*, Ministerial Statement, 15 May, 2012, p. 6.

opex proposal for 2018/19 would be 20 per cent below its actual opex in 2007/08. It is also $12.3 million (5.7 per cent) below the Transitional Proposal.[7] Whilst we welcome these outcomes, it is clear that most of the reduction in opex comes in 2015/15, the first year of the next regulatory period, and $2.5 million of the $3 million reduction in that year comes from the merger. Beyond that, more limited savings are apparent from greater efficiencies in TasNetworks' transmission operations. This is a disappointing aspect of the proposal.

We also observe that Transmission Operation costs are forecast at $5.0 million per annum over the next regulatory period and are therefore virtually unchanged in comparison with the current regulatory period. This is despite the fact that, as we understand it, significant new system software, sophisticated and intelligent devices have been installed to facilitate transmission operations. It would be helpful if TasNetworks could respond to this point.

5.3 Other Opex Proposals

TasNetworks is proposing a regulatory allowance for other (than its controllable) opex of $13.5 million over the next regulatory period. This is made up of:

- Network support, zero dollars (with pass through of actual costs incurred);
- Insurance premiums, $5.2 million;
- Self insurance, $3.5 million; and
- Debt raising costs, $4.8 million.

In relation to network support, we raised some issues about this in the capex section (4.2) and we urge the AER to also consider these in assessing TasNetworks' proposal for a zero allowance for network support opex. Essentially, it may be possible to avoid some capex by making use of more cost effective network support?

On self insurance, we note that these proposals are based on expert advice and are lower than costs incurred over the current regulatory period. We would expect TasNetworks to achieve these outcomes.

We note that TasNetworks proposes debt raising costs based only on the direct (not indirect) costs associated with raising debt. Nevertheless, its proposal results in an increase of $1.5 million on its actual costs incurred for the current regulatory period, even though its debt requirement is presumably impacted by its substantially lower capex and the impact of the GFC has diminished since its last determination? We also have a significant concern that

[7] TSBC commented in its submission on the Transitional Proposal that our assessment was that there existed further scope to reduce opex. We are pleased that TasNetworks' Proposal also recognises this.

TasNetworks, as a Government owned entity, faces substantially lower costs compared to the (benchmark) private sector entity but this seems not to be reflected?

5.4 Conclusions

TasNetworks has proposed total opex of $213.5 million for the next regulatory period (excluding debt raising costs). The Proposal points out that this is a decline of 11 per cent on its actual expenditure in the current regulatory period, which is welcome. We note the significant (well above average) declines in Business Support (Corporate), presumably reflecting in part the merger, in self insurance and in network support (which we have raised some questions about). We also note the increase in debt raising costs.

There are alternative ways to view the efficiency of TasNetworks' opex proposals:

- For example, its average annual opex would be 51 per cent above the average for the previous regulatory period (2004/05 to 2008/09), which is prior to the large increases that took place at the beginning of the current regulatory period.
- Moreover, TasNetworks opex in 2007/08 was near the top of its actual opex for the regulatory period 2004/05 to 2008/09. If we compare its proposed opex at the start of the next regulatory period with that at the start of the previous regulatory period, it is 65 per cent higher.
- Even allowing for growth in demand (now stagnant) and its network, these are still very large increases.

TasNetworks' Proposal says that:

> *"In forecasting our operating expenditure requirements an appropriate balance is struck between the pressure to reduce expenditure and the importance of maintaining service performance and managing network risks." (p. 79)*

This comment provides important reassurance to customers that service performance will not be compromised by the Proposal's opex.

Nevertheless, the AER will need to establish robustly that the opex proposals provided by TasNetworks are as efficient as they can be, including through the use of benchmarking techniques. Some of our comments raise issues for their consideration.

6 Expenditure Incentive Schemes

In this section we set out our views on those aspects of the TasNetworks' Proposal that relate to the opex and capex incentive schemes.

6.1 Efficiency Benefits Sharing Scheme (EBSS)

TSBC supports the application of the Efficiency Benefits Sharing Scheme (EBSS) to TasNetworks' forecast controllable opex. Earlier in this submission, we welcomed the reductions in opex achieved by TasNetworks in recent years and under the EBSS they are entitled to the benefits of an efficiency carryover reflecting this. This amounts to $34.1 million (nominal) over the next regulatory period according to TasNetworks' calculation. Under the EBSS, after this the benefits of these savings accrue to customers.

We note, however, that a share of the opex savings achieved by TasNetworks compared to its regulatory allowance for the current regulatory period relate to demand forecasts which did not eventuate. We have reservations about whether this should be included in an efficiency carryover, given it reflects management decisions in the face of market changes.

In the next regulatory period, the AER will apply a new version of the EBSS to TasNetworks, which includes certain changes intended to improve the scheme's operation and incentive properties. Consistent with our national body COSBOA's input into the consultations on the new scheme, we generally support these but with some reservations noted in the COSBOA submission. Notwithstanding these, we recognise that the AER has determined the new EBSS scheme to apply in the next regulatory period and TasNetworks has applied this.

6.2 Capital Expenditure Sharing Scheme (CESS)

The AER will apply a new CESS incentive scheme to TasNetworks in the next regulatory period to provide sharper incentives for efficiencies in its capex. Under this scheme TasNetworks will retain 30 per cent of its under or over spends, whilst consumers will retain the remaining 70 per cent. However, this will not apply to 2014/15, the transitionary year.

COSBOA supported the application of an efficiency sharing scheme to capex, but expressed some doubts about the details of the scheme to be applied by the AER. In particular, these related to issues such as the symmetric nature of the scheme, the need for more powerful incentives on government owned NSP, such as TasNetworks, to avoid capex overspends and (frustration that) application of CESS incentives would not take effect until the end of this decade.

We note that the TasNetworks' Proposal identifies $225 million in capex for CESS purposes in the next regulatory period.

7 Regulatory Asset Base

TasNetworks' Regulatory Asset Base (RAB) will increase only slightly in real terms and grow closely aligned with forecast inflation in nominal terms. We welcome these outcomes. They are what we would expect given the significant cut back in capex forecast by TasNetworks and also the stagnant nature of electricity consumption.

TSBC also takes this opportunity to point out that, notwithstanding capex spending below the AER's allowance for most of the current regulatory period and stagnant demand since 2011/12, TasNetworks' RAB has still increased by nearly 50 per cent over the current regulatory period. This large increase, which arguably was neither prudent nor efficient even allowing for the capex reductions made by TasNetworks, will find its way into the opening RAB for the next regulatory period and consequently transmission prices. Hence, consumers will still be paying for poor past decisions by both TasNetworks and the AER.

8 Return Of and On Capital

In this section we discuss our views on the depreciation (return of capital) and the rate of return (return on capital) proposals submitted by TasNetworks.

8.1 Regulatory Depreciation

TasNetworks has amended its proposed regulatory depreciation allowance from that proposed on its Transitionary Proposal. It explains that:

> *"In reviewing the appropriate remaining lives of our assets, we reassessed the weighted average remaining life of the pre-30 June 2009 transmission line and substation assets, and we have amended the remaining lives of those asset classes accordingly. Compared to the roll forward model calculation, these amendments increase the average remaining lives of these asset classes." (pp. 102-3)*

This reduces regulatory depreciation by $13 million over the next regulatory period compared to the Transitional Determination. TasNetworks then goes on to elaborate:

> *"This proactive adjustment to our depreciation profile results in a reduction in transmission charges over the next five years. While it will take us longer to recover the investment made in our assets, we have accepted this risk in order to reduce customer charges now." (p. 103)*

We welcome this change in approach on the part of TasNetworks, which will have a tangible impact on keeping electricity prices lower and is focused on improved outcomes for Tasmania's electricity consumers.

8.2 Return of Capital

The AER intends to apply an amended approach and parameters to establishing the rate of return for NSPs in their coming regulatory periods. This includes the TasNetworks transmission system. Our national body, COSBOA, supported the thrust of the changes introduced by the AER in its submissions on the rate of return guideline, though it expressed some specific reservations about aspects of the approach and the AER's parameters. The rate of return is critical to setting TasNetworks' transmission revenues and prices as it comprises almost 60 per cent of the proposed revenue for the next regulatory period.

We welcome that TasNetworks has shifted its position on the equity beta and gamma since its Transitional Proposal and now proposes to apply the AER's Guideline and WACC parameters in order to establish a price path that is sustainable for its customers. It is unfortunate that other NSPs currently under review by the AER are not doing so, with the

result that they have proposed rates of return substantially in excess of TasNetworks', to the detriment of consumers in those jurisdictions.

We note that this approach will reduce TasNetworks' WACC substantially from that allowed in the current regulatory period and relative to that proposed by other NSPs under review (e.g., 7.58 per cent compared to 8.83 proposed by TransGrid, on a post tax vanilla basis). TasNetworks' cost of equity reduces from 11.8 per cent to 8.7 per cent. As the Proposal notes, half of this is due to interest rate reductions but we recognise that the remainder would make a significant contribution to fairer transmission charges in Tasmania.

However, we note two areas where we continue to have significant reservations about the AER's values:

- In relation to the equity beta, the AER has settled on a value of 0.7. However, we note that this was at the upper end of the range proposed by the AER and supported by its consultants. The expert advice received by the AER would have been consistent with a further reduction in the equity beta to at least 0.6.
- The cost of debt established by the AER reflects private sector benchmarks and these are, in our view, inappropriate to a government owned entity such as TasNetworks, which actually sources debt on a substantially more favourable (lower cost) basis and is an isolated monopoly provider with no competitive neutrality issues at play.

Unfortunately, Tasmanian consumers will have to pay a significant transmission price premium given the parameters favoured by the AER.

9 Other Issues

In the section we address the issues of cost pass throughs and the service target performance incentives scheme (STPIS).

9.1 Cost Pass Throughs

TasNetworks propose the following additional pass through events:

- Terrorism event
- Natural disaster event
- Insurance cap event

We are sceptical about the need for cost pass through events given their asymmetrical tendency to only add to costs and the unlikelihood of consumers being an effective counterbalancing force to this. The consideration of cost pass through applications also involves little consultation with consumers and attracts little participation from them. This lessens scrutiny and increases the risks of networks applying for and obtaining allowances that are not as efficient as they should be.

Noting these reservations, we provide the following comments on the TasNetworks' three proposals for cost pass through:

- Non-regulated private sector entities can also be susceptible to terrorism attacks yet they have no recourse to regulated cost pass throughs. Shareholders would be responsible for these costs unless the state was willing to contribute. Therefore, we prefer that the Tasmanian Government, as the owner of TasNetworks, should take responsibility. On the basis that the AER permits this pass through, the proposed definition of a terrorism event is acceptable to us on the basis that it is reasonably clear about what constitutes such an event and that it includes a 'materiality' element. We understand that materiality is defined in the Rules as being at least 1 per cent of annual revenue. We also note with some concern that (at the extreme) such an event could conceivably do major damage to a transmission network and consumers could be left with major costs to fund. We understand that the Australian Energy Markets Commission (AEMC) removed terrorism events from the cost pass through Rules on the basis that such events may be more efficiently managed in other ways. TasNetworks has concluded that "it remains the case that a pass through mechanism is currently the most appropriate regulatory approach for addressing the costs arising from a terrorism event." (p. 119) However, the AEMC appears to have come to a different view given that its removal of terrorism

events must have been based on some likelihood of alternatives to pass through. The AER should seek to establish the veracity of TasNetworks' proposal before agreeing to such a pass through.

- Our comments in relation to natural disaster events are similar to those for terrorism events. If the AER permits this pass through, the proposed definition of a natural disaster event would be acceptable to us on the basis that it is reasonably clear what constitutes such an event and that it includes 'serious and significant' provisions. However, the meaning of these two terms is unclear and should be clarified so that the implications for consumers are more transparent. We also note with some concern that (at the extreme) such an event could conceivably do major damage to a transmission network and consumers could be left with major costs to fund, even though they bear little responsibility. This again draws attention to the responsibilities of TasNetworks' shareholder, the State Government. We would also expect that TasNetworks and the AER to ensure that prudent steps are taken to ensure that the risks of such events are minimised. The opportunity for cost pass through could well blunt these incentives.
- Again, we have concerns similar to the above in relation to the inclusion of an insurance cap event as a cost pass through. In this case our concerns also extend to the fact that such a pass through should not preclude TasNetworks from holding a prudent level of insurance given that that they may apply for a pass through. If the AER permits this as a pass through event, the proposed definition and approach outlined in the Proposal seems appropriate, also bearing in mind its past application by the AER.

9.2 Service Target Performance Incentive Scheme (STPIS)

We support the application of the latest version of the STPIS (version 4) to TasNetworks, noting that this extends the scope of the STPIS and sharpens the incentives provided compared to the version applied to TasNetworks in the current regulatory control period. TasNetworks application of the STPIS to its revenue proposal seems appropriate and consistent with the scheme based on its explanation set out in the Proposal.

Whilst we have some reservations about aspects of the STPIS, we do not believe that this submission is the best place to raise them.

10 Transmission Revenue and Prices

Below we discuss our comments on the revenue and price outcomes of the TasNetworks Proposal.

10.1 Revenue

TasNetworks' Proposal results in a revenue requirement (unsmoothed, nominal) of $973 million for the next regulatory period. This compares to actual revenue recovered in the current regulatory period of $1,020 million, a reduction of $37 million (4.6 per cent). This is welcome and reflects the reductions in expenditures that TasNetworks has proposed, its proposed lower rate of return and lower depreciation. We also note that TasNetworks has decided not to recover the $26 million in revenue it under-recovered in 2013/14. In any case, this would have been inappropriate given the reasons for the under-recovery and TasNetworks stated commitment to allaying price pressures on customers. Nevertheless, as pointed out in earlier sections of this submission, we believe that some scope exists to further reduce the proposed revenue requirement and that the AER needs to examine this as part of its draft Determination.

One observation on TasNetworks' proposed revenue path is that there is a clear and significant reduction in 2014/15 but thereafter nominal revenue slowly climbs again (Figure 11.1 of the Proposal), though there are slight reductions in real terms. TSBC has some reservations about this 'steady-as-she-goes' outcome and, as mentioned in the previous paragraph, believes that more is possible and desirable.

We note that the $186.9 million in revenue that TasNetworks proposes to recover in 2014/15 is lower than the $205.1 million set by the AER for that year in its Transitional Determination. We believe that the AER needs to adjust its subsequent Determination to reflect this difference and ensure that consumers are no worse off than TasNetworks' proposal.

10.2 Transmission Prices

For consumers, including small business, transmission price impacts are the single most important outcome of any AER transmission revenue reset. The prices paid for transmission services along with the reliability provided are at the core of consumer interests in the AER's processes. TasNetworks' engagement with consumers as part of formulating its revenue proposal confirms this, with price reductions being shown as a priority.

We welcome TasNetworks' inclusion of a transmission price path in its Proposal to the AER. This is helpful information for Tasmanian electricity consumers, for the TSBC and for consumer advocates participating in this review. We encourage the AER to similarly report on the price impacts of its Transitional and Subsequent Determinations.

Analysis of Tasmanian transmission charges by Goanna Energy shows that these increased by 27 per cent in real terms from 2004/05 to 2013/14, or an annual rate of 3 per cent.

Transend's proposal involves a nominal transmission price reduction of 16 per cent, or 18 per cent in real terms, in 2014/15. This is followed by a nominal price increase of 5.3 per cent for the remainder of the regulatory period (a 4.7 per cent reduction in real prices).

Whilst the TSBC welcomes the price path and sees it as a significant departure from the large increases in Tasmanian transmission prices seen over the past decade, as outlined elsewhere in this submission, we do not accept that TasNetworks has gone far enough with its proposals. Addressing these areas in a robust way would pave the way for further reductions in transmission charges for Tasmanian consumers, without any risk to service levels.

TasNetworks has also drawn attention to a number of factors that could alter its price path including through intra-regional settlement residues, subsequent adjustments to over and under recovery of annual revenue, bonuses or penalties payable under its service incentive scheme, any cost pass throughs and the introduction of inter-regional transmission use of system pricing from 2015–16 onwards. We welcome its helpfulness in drawing attention to these matters and the indicative amounts which TasNetworks has provided where possible. We also recognise that two of these items are outside the AER's Determination.

10.2.1 Small Business Price Impacts

TasNetworks suggests that the impacts of its revenue proposal for small business in Tasmania will be for a $91 reduction in charges on average in 2014/15 followed by modest increases in prices after that (ranging from $2 to $8 per year after that). TSBC welcomes the initial price reduction but is concerned that small business will see price increases after that, albeit modest ones. We believe that the circumstances facing Tasmanian small business are such that annual price reductions in each year of the forthcoming regulatory period would have been warranted, also bearing in mind the significant increases in electricity prices that small business has had to bear over the past decade. We would urge the AER to consider this in its Determination.