TasNetworks
Delivering your power

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6 January 2015

Mr Chris Pattas
General Manager, Networks
Australian Energy Regulator
Level 35 The Tower
360 Elizabeth Street
Melbourne Central
MELBOURNE VIC 3000

Dear Chris

Re: AER's Draft Decision and TasNetworks' revised transmission Revenue Proposal

Following the AER's publication of its draft decision on TasNetworks' transmission determination for the 2015-19 regulatory control period, we are pleased to submit our revised transmission Revenue Proposal and response to the draft decision.

TasNetworks notes that the AER has largely accepted TasNetworks' proposal (as amended). As the AER's draft decision makes no material changes from TasNetworks' proposal, we are pleased to accept the AER's draft decision.

If you have any queries regarding this matter, please contact John Sayers on (03) 6271 6469 or by email to RevenueReset@tasnetworks.com.au.

Yours sincerely

Wayne Tucker
Acting Chief Executive Officer

Encl.

TasNetworks

Tasmanian Revised Transmission Revenue Proposal
(Regulatory control period 1 July 2015 - 30 June 2019)

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Revised transmission Revenue Proposal

1. AER's Draft Decision and TasNetworks' revised Revenue Proposal

On 27 November 2014, the AER published its draft decision on TasNetworks' determination for the 2015-19 regulatory control period. The AER's draft decision is an important milestone in a number of respects because it reflects the benefits of:

- The merger of the transmission and distribution businesses in Tasmania; and
- The application of the new National Electricity Rules (the Rules) for the regulation of electricity network companies in Australia.

The draft decision recognises that our Revenue Proposal put forward a significant reduction in revenues compared to the current regulatory control period. This reduction in revenue reflects important changes in our business and in the broader commercial environment.

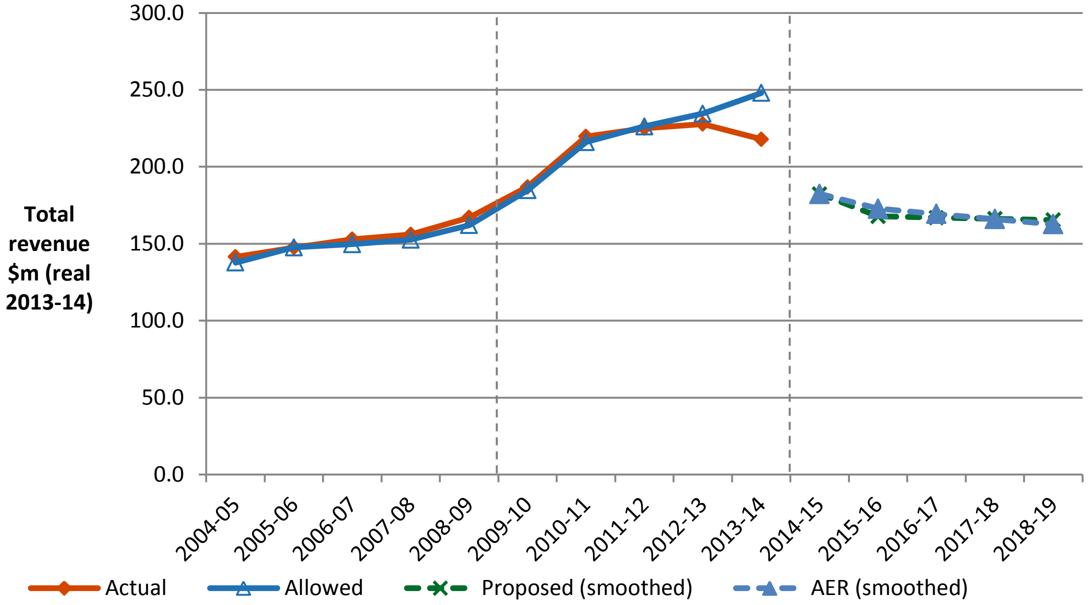
Central to these changes are our customers – who are changing the way they use electricity in response to technological developments and financial pressures, both domestically and internationally. In preparing our Revenue Proposal we responded to customer feedback by proposing significant cost savings without compromising network safety and reliability.

As a consequence, the AER's draft decision reflects an unprecedented degree of alignment with our Revenue Proposal. The draft decision explains that:

> "…the differences between our draft decision and TasNetworks' proposal are relatively slight. The 7 per cent difference in revenue proposed and allowed is predominately the result of small adjustments to the allowed rate of return and a revised capital expenditure program which TasNetworks itself has proposed."

The figure below shows our proposed reductions in revenue compared to historic levels, and the further modest reductions in the draft decision. As noted by the AER, these additional savings include the impact of our amended capital expenditure forecasts, following updated projections of electricity demand.

TasNetworks' past total revenue, proposed total revenue and AER draft decision revenue allowance ($ million, 2013–14)[1]



2. Our response to the draft decision

The Rules provide us with an opportunity to submit a revised Revenue Proposal in response to the AER's draft decision[2]. From a compliance perspective, we ask the AER to regard this submission, together with our original Revenue Proposal, as comprising our revised Revenue Proposal.

In our review of the draft decision, we have identified the following matters as raising important points of principle:

a) Rate of return and taxation;

b) Treatment of provisions; and

c) Benchmarking.

Each is discussed in the following pages.

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1 This figure is based on adjustment of the AER's Figure 1-1, Draft decision, TasNetworks transmission determination 2015-16 to 2018-19, Overview, November 2014, page 8. Historical allowed data has been adjusted to account for actual CPI; approved pass through amounts; performance incentive payments; and the outcome from the 2009-14 merits review, and the proposal data has been updated to reflect the draft decision WACC.

2 Clause 6A.12.3. It should be noted that version 53 of the National Electricity Rules applied in relation to this determination given the transitional arrangements in clause 11.58.4.

a. Rate of return and taxation

It is essential that network companies earn a reasonable rate of return in order to encourage efficient augmentation and asset renewal.

As part of its Better Regulation reform program, the AER established a new guideline for estimating the rate of return[3]. The guideline and the AER's accompanying explanatory statement set out values for several parameters that are used to estimate the rate of return. In addition, the guideline included a value for 'gamma', which is used to estimate an allowance for company taxation.

Our Revenue Proposal explained that we engaged independent experts to review the AER's proposed parameter values. We submitted copies of these independent expert reports in our Revenue Proposal (Appendix 20). The experts concluded that there is strong evidence to support a higher cost of equity than the estimate using the AER's parameter values. The experts also raised concerns regarding the AER's value for 'gamma'.

Our views on the cost of equity are unchanged from those expressed in the Revenue Proposal. In particular, while we accept the independent experts' conclusions, we must also consider the impact on our customers of a higher cost of equity and tax allowance. We remain particularly mindful of the commercial pressures currently facing our customer base in Tasmania.

With these broader considerations in mind, our Revenue Proposal adopted the parameter values in the AER's Rate of Return Guideline and the explanatory statement. The AER's draft decision has confirmed these values for the purpose of determining the weighted average cost of capital, and updated our estimates to reflect more recent market data, as was always intended.[4]

While TasNetworks accepts the AER's draft decision in relation to the rate of return and taxation, the views expressed by the independent experts remain valid. In future determinations, it will be important to revisit these issues to ensure that TasNetworks earns a reasonable return on its assets and obtains an appropriate tax allowance.

b. Treatment of provisions

The AER's draft decision makes adjustments to our regulatory asset base and our actual operating expenditure to remove the effect of changes in accounting provisions. The AER explains its approach in the following terms:

> "TasNetworks' proposed actual capex for 2008–09 to 2013–14 included capitalised provisions. Provisions are expenditures that TasNetworks anticipate but have not yet paid (incurred). Examples of provisions include environmental provisions, superannuation and other employment entitlements such as annual leave and long service leave. […] we consider that a TNSP should not treat capitalised provisions as capex incurred when rolling forward its

3 AER, Rate of Return Guideline, December 2013.

4 AER, Draft decision TasNetworks transmission determination 2015-16 to 2018-19, Overview, November 2014, page 34. In the draft decision, the AER revised its value for gamma which impacts on the tax allowance.

RAB, because a TNSP has not yet paid out (incurred) the expenses to which the provisions relate."[5]

"An adjustment to TasNetworks' actual opex for movements in provisions. Provisions are accounting adjustments which reflect estimates of future costs a business expects to incur. They are not actual costs. We do not consider estimates of future costs should be subject to the EBSS [Efficiency Benefit Sharing Scheme]. To reward or penalise a service provider for changes in provisions would reward or penalise it for changes in assumptions, not efficiency improvements. This would be contrary to the aims of the EBSS under the NER."[6]

While we agree with the AER that provisions are "not actual costs" in terms of cash paid, the use of provisions is an accepted accounting convention. Our approach to recording actual operating and capital expenditure complies with accounting standards. Adopting a regulatory approach that differs from the accounting standards imposes additional complexity and costs on our business, which are ultimately borne by customers.

The AER's draft decision also raises an important point of principle because it imposes a retrospective change.

Specifically, in relation to the EBSS the AER's draft decision adjusts our actual expenditure to remove provisions, but does not adjust the operating expenditure targets. As a consequence, the draft decision adopts a definition of efficiency that is inconsistent with the AER's 2009 determination. In our view, the draft decision should have applied the EBSS in a manner that is consistent with the AER's earlier determination.

The effectiveness of incentive based regulation depends, in part, on the regulator adhering to the application of each incentive scheme, even if a scheme is subsequently shown to be imperfect. While the financial impact of the AER's draft decision is modest in this case, it is important that the principle of 'no retrospectivity' is adopted in future determinations.

c. Benchmarking

The draft decision makes the following observations in relation to benchmarking:

"The results of our annual benchmarking report show that TasNetworks' capital efficiency has been slowly, but steadily, decreasing over time. However, its overall expenditure efficiency is better than that of comparable TNSPs." [7]

While we note the AER's conclusion that our expenditure efficiency compares favourably with other TNSPs, we are concerned that the AER understates the inherent limitations of benchmarking. It should be noted that benchmarking in relation to revenue determinations is still in its infancy, and substantial further work is required before it should play a significant role in the AER's decisions.

5 AER, Draft decision TasNetworks transmission determination 2015-16 to 2018-19, Attachment 2, November 2014, page 16.

6 AER, Draft decision TasNetworks transmission determination 2015-16 to 2018-19, Overview, November 2014, pages 45 and 46.

7 AER, Draft decision TasNetworks transmission determination 2015-16 to 2018-19, Overview, November 2014, page 21.

3. Acceptance of draft decision

The Rules require the AER to approve our revised Revenue Proposal if we accept the draft decision[8].

While we have a number of reservations regarding the AER's draft decision, as discussed above, the overall difference between our proposal and the draft decision is modest. We are also conscious that accepting the draft decision will shorten the regulatory process and enable us to focus on providing efficient and reliable network services, as our customers expect us to do.

In light of these considerations, we therefore accept the AER's draft decision and the constituent components set out in Appendix A – Constituent Components of the Draft decision Overview.

We note that the AER's final decision will update various parameters to reflect the latest information. In particular:

- The RAB roll forward will be updated for actual capital expenditure in 2013-14;
- The forecast inflation rate will be updated to reflect the latest information;
- The risk free rate used in estimating the rate of return will be updated to reflect the latest information; and
- The cost of debt will be updated annually to reflect the AER's trailing average approach.

Apart from these adjustments, the AER's final decision will be aligned with the draft decision, as required by the Rules. We look forward to working constructively with the AER during the forthcoming regulatory period to ensure that customers continue to obtain efficient, safe and reliable network services.

[8] Clause 6A.14.3(c) and (h).