Tasmanian Networks Pty Ltd
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27 October 2016

Mr Chris Pattas
General Manager
Networks (Investment and Pricing)
Australian Energy Regulator
GPO Box 520
Melbourne VIC 3001

Dear Chris

TasNetworks' Framework and Approach for the 2019-24 Determinations

I am writing to you in relation to the AER's forthcoming review of our transmission and distribution networks, for the period commencing 1 July 2019. It will be the AER's first combined review of our business' transmission and distribution network services. As such, it presents a number of opportunities to streamline the regulatory process, while ensuring the regulatory requirements within in the National Electricity Rules (**NER**) are met.

TasNetworks' preference is that the AER's review should be conducted in a way that recognises our 'one business' approach. This 'one business' approach enables us to drive efficiency improvements and deliver better outcomes for our transmission and distribution customers.

An important first step in the regulatory review process is the AER's publication of a Framework and Approach paper (the F&A). The purpose of the F&A is to detail the AER's proposed approach to key aspects of the regulatory arrangements, including:

- the classification of distribution network services
- the application of various incentive mechanisms that encourage cost and service efficiencies, including
    - service target performance incentive scheme
    - efficiency benefit sharing scheme
    - capital expenditure sharing scheme
    - demand management incentive scheme
- the AER's application of its expenditure forecast assessment guidelines
- whether depreciation will be based on forecast or actual capital expenditure
- the form of control, being whether revenues or prices are capped
- the duration of the regulatory control period

While Chapters 6 and 6A of the NER set out separate requirements for the regulation of transmission and distribution networks, there is significant overlap between these provisions. In particular, the incentive based building block approach to regulation is essentially the same across both networks. As an integrated transmission and distribution business, a consistent regulatory approach across our transmission and distribution activities is therefore both desirable and achievable, noting that some differences are unavoidable (most notably the components of the service incentive schemes).

As the first combined transmission and distribution review, we consider it appropriate that the AER publishes a new F&A, which captures the AER's regulatory approach in a single document. In doing so, the new F&A will facilitate a better understanding of the AER's regulatory approach to reviewing the merged transmission and distribution business. We therefore request an updated F&A in accordance with clauses 6A.10.1A(c) and 6.8.1(c)(1) of the NER.

In the attachment we set out our preliminary views on the key considerations that should be addressed in the new F&A. We note that implications of the regulatory regime, such as the AER's ring fencing guidelines, have significant issues for our business and our customers, and remain subject to change. We welcome the opportunity to work directly with the AER to find a resolution to ring fencing and service classification matters. In addition, consultation with customers and stakeholders and the final form of the ring fencing guidelines may further shape our views.

We look forward to working with you in developing the new F&A in the coming months. In the meantime, if you have any queries regarding this letter, please contact John Sayers in the first instance on (03) 6271 6469 or by email to john.sayers@tasnetworks.com.au.

Yours sincerely

Bess Clark

General Manager Strategy & Stakeholder Relations
Encl. Submission on Framework & Approach

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Introduction

This submission to the Australian Energy Regulator (**AER**) seeks to replace the current transmission and distribution framework and approach papers (F&A) for Tasmanian Networks Pty Ltd (**TasNetworks**). Our submission is made in accordance with clauses 6A.10.1A(c) and 6.8.1(c)(1) of the *National Electricity Rules* (**NER**); which state:

> *"…no later than 32 months before the end of the regulatory control period that precedes that for which the […] determination is to be made, the […] Network Service Provider may request the AER in writing to make an amended or replacement framework and approach paper in respect of a matter. The request must specify the […] Network Service Provider's reasons for making that request…"*

We set out our reasons for seeking to replace the AER's current F&As for our transmission and distribution networks. The following topics are discussed in this submission:

- alignment of transmission and distribution regulatory control periods for TasNetworks;
- service classification;
- Service Target Performance Incentive Schemes;
- Efficiency Benefit Sharing Scheme;
- Capital Expenditure Sharing Scheme;
- Demand Management Incentive Scheme;
- Expenditure forecast assessment guidelines;
- depreciation;
- duration of the regulatory control period; and
- form of control.

Alignment of the transmission and distribution regulatory control periods

On 1 July 2014 TasNetworks was formed by a merger between Aurora Energy's distribution network and Transend Networks' transmission network.

TasNetworks has been established as an incorporated, State Government-owned fully integrated electricity network business, with complementary activities in telecommunications and energy-related technologies. TasNetworks' two shareholding minsters are the Minister for Energy and the Treasurer.

TasNetworks owns, operates and maintains the transmission and distribution assets that deliver electricity to more than 280,000 Tasmanian customers. Our vision is to be trusted by our customers to deliver today and create a better tomorrow. Our purpose is to deliver electricity and telecommunications network services, creating value for our customers, our owners and our community.

The AER is currently reviewing our distribution network revenue requirements for the two year period 2017-2019, rather than the usual five years. The shorter regulatory period was adopted to allow alignment of the transmission and distribution reviews from 1 July 2019 onwards. We strongly support the combined transmission and distribution review because it:

- is consistent with our 'one business' philosophy, which promotes the achievement of efficiency and performance improvement across the whole business, supported by an aligned customer engagement program;
- facilitates a simplified regulatory process and improved customer understanding; and
- will reduce regulatory costs and duplication for TasNetworks, our customers and the AER.

In our view, the merged regulatory process should commence by the adoption of a new F&A that covers the regulatory arrangements for TasNetworks in a single document while addressing the relevant NER requirements.

Service classification

The various distribution services we provide are subject to classification by the AER. The service classification affects the form of regulation that may apply, including whether the AER:

- directly controls revenues and prices and sets performance targets; or
- allows parties to negotiate services and prices and arbitrates if any disputes arise; or
- does not regulate the service at all.

While the same spectrum of regulatory control also applies to transmission services, the Rules define prescribed, negotiated and unregulated services in a way that does not require the AER's formal classification. The new F&A should therefore provide a classification of distribution services, but not transmission services.

The table below provides an overview of the different classes of distribution services and the associated regulatory arrangements.

Table-1: Distribution services classifications and regulatory approach

Classification		Description	Regulatory approach
Direct control service	Standard control service	Services such as building and maintaining the shared distribution network that are central to electricity supply and therefore relied on by most (if not all) customers. Most distribution services are classified as standard control.	The AER regulates these services by determining prices or an overall cap on the amount of revenue that may be earned for all standard control services. The costs associated with these services are shared by all customers.
	Alternative control service	Customer specific or customer-requested services. These services may also have potential for provision on a competitive basis rather than by the local distributor.	The AER sets service specific prices to enable the distributor to recover the full cost of each service from customers using that service.
Negotiated service		Services that the AER considers require a less prescriptive regulatory approach because all relevant parties have sufficient countervailing market power to negotiate the provision of those services.	Distributors and customers are able to negotiate prices according to a framework established by the Rules. The AER arbitrates if necessary.
Unclassified service		Services that are not distribution services or services that are contestable.	The AER has no role in regulating these services.

We support the AER's current service classification in its recent draft decision for our 2017 Distribution Determination. The AER has highlighted the importance of considering service classifications in the context of the ring fencing guidelines. In this regard, TasNetworks notes that the final ring fencing guideline may have implications for the service classification. TasNetworks therefore reserves the right to seek amendments to the proposed classification to address any issues arising from the ring fencing guidelines.

Service Target Performance Incentive Scheme

The AER's Service Target Performance Incentive Scheme (STPIS) provides a financial incentive to network service providers to maintain and improve service performance. The STPIS aims to safeguard service quality for customers that may otherwise be affected as network service providers seek cost efficiencies. Separate schemes apply to transmission and distribution networks, which recognise the relevant measures of network performance and their impact on customers.

In September 2015, the AER published a revised STPIS (version 5) for transmission networks. Compared to version 4 of scheme (which is currently specified in our transmission F&A), version 5:

- introduces financial incentives for the forced outage service component sub parameters;
- makes the market impact component symmetrical (±1 per cent of maximum allowed revenue) compared to the current reward-only scheme; and
- amends the incentive arrangements relating to the network capability component.

In relation to the transmission STPIS, we consider it appropriate for the AER to specify Version 5 in our F&A for the forthcoming regulatory period, instead of Version 4 that currently applies.

For distribution networks, the AER's STPIS (November 2009) applies in relation to network reliability and customer service (in the form of telephone answering). This scheme rewards the distributor for bettering the targets set by the AER, and applies a penalty if performance falls short of the targets. The size of the reward or penalty is proportional to the magnitude of the variation from the target, capped at a level determined by the AER.

The AER adopted the November 2009 STPIS in our current F&A for our distribution network. The guaranteed service level (GSL) component of the STPIS does not apply because we are subject to a jurisdictional GSL scheme, and therefore the STPIS GSL would duplicate the incentive arrangements already provided by the jurisdiction.

The distribution STPIS applies a standard revenue at risk of ±5 per cent of the annual smoothed distribution revenue. While this is the standard revenue at risk, clause 2.5(b) of the scheme allows the distributor to propose a different revenue at risk where this would better satisfy the objectives of the scheme.

In the new F&A, we propose that:

- the AER continues to apply the November 2009 distribution STPIS, excluding the GSL component;
- we continue to consult with our customers on whether a penalty and reward mechanism of +/-5 per cent is appropriate or another amount should apply;
- financial incentives apply to TasNetworks' distribution momentary interruption performance for the first time;
- we investigate the various approaches adopted by other DNSPs in reporting against momentary interruptions (ie. MAIFI and MAIFIe) and identify TasNetworks' preferred approach;
- we review transmission loss of supply event thresholds to ensure they continue to remain relevant, in line with changing historical performance;
- we review any other issues regarding the detailed application of the schemes, in consultation with our customers, including parameter values and exclusions.

As different STPIS arrangements apply for transmission and distribution, there is currently no scope to apply a single, combined STPIS scheme to TasNetworks' combined activities. However, one area that we would like to explore with the AER is the possibility of aligning the reporting arrangements for transmission and distribution so that both networks report performance on a financial year basis. Currently, transmission performance is subject to calendar year reporting. A common reporting approach will assist all parties in better understanding performance across the combined networks.

Efficiency Benefit Sharing Scheme

The operating expenditure efficiency benefit sharing scheme (EBSS) aims to provide a continuous incentive for network service providers to pursue efficiency improvements in operating expenditure, and provide for a fair sharing of such efficiencies between the network company and its customers. Customers benefit from improved efficiencies through lower regulated prices in the future.

As part of its Better Regulation program, the AER published version 2 of the EBSS. This version of the EBSS currently applies to our transmission and distribution networks. We propose that this scheme continues to apply in the forthcoming regulatory period.

Capital Expenditure Sharing Scheme

The capital expenditure sharing scheme (CESS) provides financial incentives for network service providers to deliver capital expenditure efficiencies. As noted in relation to the EBSS, customers benefit from improved efficiency through lower prices in the future.

As part of its Better Regulation program, the AER published version 1 of the capital expenditure incentive guideline for network service providers, which sets out the CESS. The CESS currently applies to our transmission and distribution capital expenditure. We propose that this scheme continues to apply in the forthcoming regulatory period.

Demand Management Incentive Scheme

The AER has initiated a review to develop a new demand management incentives scheme and innovation allowance mechanism.

The scheme's objective is to provide electricity distribution businesses with an incentive to undertake efficient expenditure on non-network options relating to demand management. The separate innovation allowance mechanism's objective is to provide distribution businesses with funding for research and development in demand management projects that have the potential to reduce long term network costs.

The AER's website notes that the new scheme and allowance mechanism will apply across the NEM, but will be tailored to different distribution businesses.

Our view is that the F&A should provide for the new scheme and incentive allowance to apply to TasNetworks in the forthcoming regulatory period. We see no reason to delay the application of incentive schemes that promote the better outcomes for customers. The new F&A should therefore signal the AER's intention to apply the new scheme from 1 July 2019 or as soon as practicable thereafter.

Expenditure forecast assessment guidelines

As part of its Better Regulation program, the AER published expenditure forecast assessment guidelines for both transmission and distribution networks. The expenditure assessment guideline is based on a nationally consistent reporting framework, which assists the AER to compare the relative efficiencies of network companies. The assessment guideline also includes a suite of assessment/analytical tools and techniques that the AER applies in assessing the network company's expenditure forecasts.

In the current F&As for our transmission and distribution networks, the AER stated that it will apply the information requirements and assessment techniques set out in the relevant guidelines.

We support the continued application of the information guidelines and assessment techniques, with one important caveat. We have previously highlighted discrepancies in the AER's benchmarking approach to transmission and distribution networks, and treatment of some key characteristics of our networks. These benchmarks identify TasNetworks as an efficient transmission company, but as a less efficient distributor. We therefore encourage the AER to continue to refine its benchmarking techniques including consideration of total expenditure analysis.

Depreciation

The regulatory asset base (RAB) is a key component of the building block revenue calculation. It is updated (or 'rolled forward') at the end of a regulatory period to include actual capital expenditure and tto deduct an amount for economic depreciation.

The depreciation to be deducted can either be the amount forecast at the start of the previous regulatory period or the actual depreciation incurred during the period. The actual depreciation will be lower (higher) if the company has underspent (overspent) its capital expenditure allowance.

In recent determinations, the AER has applied forecast depreciation because, in combination with the CESS, it provides a 30 per cent reward for capital expenditure underspends and 30 per cent penalty for overspends. This outcome is broadly consistent with the incentives that apply in relation to operating expenditure. The current F&As for both transmission and distribution apply forecast depreciation.

We propose that the new F&A should confirm that the AER will apply forecast depreciation to establish the RAB at the commencement of the 2019 regulatory control period.

Duration of the regulatory control period

We propose a regulatory control period of five years, from 1 July 2019 to 30 June 2024. This standard regulatory duration provides an appropriate balance between:

- allowing the business sufficient time to implement initiatives to drive efficiency and service improvements; and
- ensuring that savings are passed back to customers as soon as practicable.

Form of control

We propose the continuation of a revenue cap for both our transmission and distribution services.

Conclusion

For the reasons set out in this submission, a new combined F&A should be developed by the AER for the forthcoming regulatory control period. The F&A should adopt the approaches outlined in this submission, as each of the proposed changes will clarify the AER's approach and facilitate better outcomes for our customers.