TasNetworks
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21 April 2017

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

Dear Chris

Preliminary Framework and Approach for the 2019-24 Determinations

I am writing to you in relation to the Australian Energy Regulator's (**AER**) preliminary Framework and Approach (**the F&A**), which was published on 10 March 2017. The F&A will apply to TasNetworks transmission and distribution networks for the regulatory period commencing on 1 July 2019.

TasNetworks notes that the AER intends to adopt a single F&A to reflect our business approach. The merger of the Tasmanian transmission and distribution networks is driving important changes in how we do things, delivering efficiency improvements, and providing better customer outcomes. From TasNetworks' perspective, it is important that the regulatory process mirrors our business focus. We encourage this approach, where practicable, thoroughout the determination process.

By publishing its preliminary F&A, the AER has set out its intended approach to key aspects of the regulatory arrangements, including:

- the classification of distribution network services;
- the application of various incentive mechanisms for transmission and distribution 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 for various services are capped; and

- the duration of the regulatory control period.

In many respects, the AER's intended approach reflects its current regulatory practice, which has been developed through regulatory guidelines, incentive schemes and successive revenue determinations. As such, the approaches outlined in the F&A are consistent with accepted regulatory practice, which TasNetworks strongly supports. In particular, we support:

- The AER's confirmation that revenue caps – as opposed to price caps – should apply to our shared network charges (direct control common distribution services and prescribed transmission services). TasNetworks believes that a revenue cap provides certainty for both the operation of the network, and for end-use customers.
- The AER's application of price caps to alternative control services, which ensures that customers requesting the service pay cost reflective prices. This "user pays" approach is readily understood by customers and ensures that all customers are treated equitably.
- The application of the AER's Expenditure Forecast Assessment Guideline, which describes how the AER will assess TasNetworks' forecast expenditure in accordance with the Rules requirements;
- The continuing application of the AER's suite of incentive schemes, which combine to balance the incentives to reduce expenditure and improve service performance.
- The AER's approach to depreciation, which provides an appropriate incentive to deliver capital expenditure efficiencies.

To a large extent, therefore, TasNetworks supports the AER's preliminary F&A. In the remainder of this submission, we highlight a number of topics where we seek relatively modest changes to the AER's approach.

Service classification

The AER's classification of distribution services has important consequences for how these services are delivered and regulated. In particular, the AER's recently finalised ring-fencing guideline restricts places obligations on distributors in the way they provide unregulated services. In this context, the AER's service classification will affect TasNetworks' potential options when considering compliance with the ring-fencing guideline. As such, service classification is a particularly important aspect of the F&A.

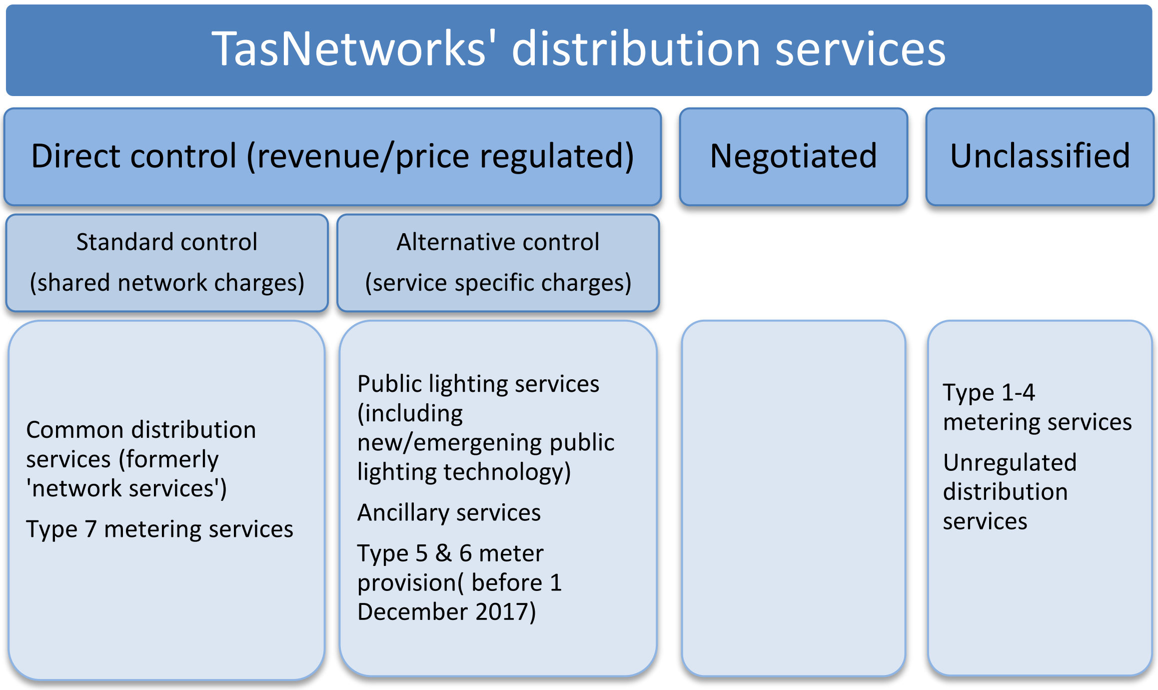
The preliminary F&A notes that the Australian Energy Market Commission (**AEMC**) is currently assessing rule change proposals from the Council of Australian Governments Energy Council and Australian Energy Council on contestability of energy services.[1] The AEMC's deliberations may lead to changes to the distribution services classification process, including:

[1] AEMC, *Consultation paper, National Electricity Amendment (Contestability of energy services) Rule 2016 (COAG), National Electricity Amendment (Contestability of energy services - demand response and network support) Rule 2016 (Australian Energy Council)*, 15 December 2016.

- requiring the AER to produce a service classification guideline;
- allowing for the possibility of reclassifying a service within a regulatory period; and
- providing an easier path to changes in service classification over time.

As the AEMC has publicly stated it intends that the first phase of the rule change would apply to the current round of determinations, including TasNetworks, this creates potential uncertainty. Evidently, these developments in the regulatory framework create some concern regarding the final form of the AER's distribution service classification for TasNetworks. At this stage, however, TasNetworks concurs with the AER's proposed high-level service classification, which is reproduced below[2].

Figure 1: AER proposed approach to classification of TasNetworks' distribution services



Source: AER

There are two features of the above classification that TasNetworks particularly welcomes:

- The AER's proposed introduction of the term "common distribution services" to describe services that are intrinsically tied to the monopoly characteristics of the distribution network. Therefore, it is appropriate that these services, such as emergency recoverable works, are regulated as standard control services.
- The AER's proposed treatment of "unregulated distribution services" as "unclassified", therefore aligning service classification with the obligations under the ring-fencing guideline.

In addition to the above high-level classification, the AER has provided a more detailed analysis of the distribution service classification in the table provided in appendix B of its

[2] Preliminary framework and approach TasNetworks electricity transmission and distribution, Regulatory control period commencing 1 July 2019, March 2017, Figure 1-1, page 12.

preliminary F&A. TasNetworks proposes a number of changes to the AER's table, primarily to clarify the AER's service description or rationale for its proposed classification.

For example, the AER classifies "Network Safety Services", which include the provision of traffic control services by the distributor, as "alternative control (potentially contestable)". TasNetworks agrees with the proposed classification for Network Safety Services, but the safety aspects of this service means that it is not "potentially contestable". A similar issue arises in relation to "Facilitation of generator connection and operation on the network".

TasNetworks also considers that any metering services we provide in support of Aurora Energy's Pay As You Go (**PAYG**) product, should be classified as an alternative control service, rather than being unclassified as proposed by the AER[3]. Our suggested classification means that these services will continue to be provided by TasNetworks' regulated business, rather than being subject to functional separation under the ring-fencing guideline.

We have therefore proposed a small number of amendments to the AER's service classification table, which is provided in Attachment A. TasNetworks would welcome further dialogue with the AER on these issues prior to the finalisation of the F&A.

Quoted Services

Services that are classified as direct control services, and regulated as alternative control services, are priced according to either a published fee or a customer-specific quotation. A customer-specific quote is appropriate for services where the scope of work and the costs of the service are uncertain.

The AER's formula for regulating quoted services allows the distribution business to recover the full costs of any external contractors. In particular, the AER defines contractor services to include overheads and indirect costs[4]:

> "*Contractor Services* reflect all costs associated with the use of external labour including overheads and any direct costs incurred. The contracted services charge applies the rates under existing contractual arrangements. Direct costs incurred are passed on to the customer."

Similarly, the AER's definition of "materials" is appropriately broad, and allows for the inclusion of storage, logistics on-costs and overheads. However, the broad scope of this cost category is not reflected in the AER's definition of "*materials*", which implies a much narrower scope. To avoid any customer confusion, TasNetworks therefore proposes the following changes to the definition of materials[5]:

[3] Preliminary framework and approach TasNetworks electricity transmission and distribution, Regulatory control period commencing 1 July 2019, March 2017, page 23.

[4] Preliminary framework and approach TasNetworks electricity transmission and distribution, Regulatory control period commencing 1 July 2019, March 2017, page 49.

[5] Ibid.

> *"Materials and other costs* reflect the cost of materials directly incurred in the provision of the service, and other costs, including material storage and logistics on-costs and overheads." (additions underlined)

While this is a minor change, it ensures that the AER's formula reflects current pricing practice, which provides for cost reflective pricing for quoted services.

Service Target Performance Incentive Scheme

TasNetworks has previously raised the possibility of the AER amending the reporting requirements for the STPIS schemes so that the transmission and distribution networks both 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 understanding service performance across the combined networks.

In relation to this issue, TasNetworks is disappointed with the AER's response in the preliminary F&A[6]:

> "Since TasNetworks' proposal relates to the scheme design of STPIS. This issue will be considered when we review the scheme in due course. If the scheme is modified at a later stage in this regard, TasNetworks' reporting arrangements will be changed accordingly."

TasNetworks does not regard the proposed change as a modification to the design of the scheme. In TasNetworks' view, the proposed change is not controversial and would simplify the reporting of the schemes, which would benefit TasNetworks and its customers.

TasNetworks therefore requests that we are provided with an opportunity to develop arrangements to transition the STPIS scheme for transmission to financial year reporting. These transitional arrangements could be presented in our Revenue Proposal.

Demand management incentive scheme and innovation allowance mechanism

On 20 August 2015, the AEMC published its Demand Management Incentive Scheme Rule Determination and accompanying Rule changes. In accordance with these Rule changes, the AER is currently developing a new Demand Management Incentive Scheme (**DMIS**) and Demand Management Innovation Allowance mechanism (**DMIA**). The AER's preliminary F&A proposes that the new DMIS and DMIA currently being developed will apply to TasNetworks.

TasNetworks lodged a submission to the AER's consultation paper on the development of the DMIS and DMIA, which raised significant concerns in relation to two of the options under consideration. We remain concerned that these options are unlikely to deliver efficient outcomes.

While TasNetworks accepts the AER's position that the new DMIS and DMIA arrangements should apply in the forthcoming regulatory period, it exposes us to some uncertainty. In

[6] Preliminary framework and approach TasNetworks electricity transmission and distribution, Regulatory control period commencing 1 July 2019, March 2017, page 57.

particular, should the AER ultimately adopt a significantly different DMIS scheme, then TasNetworks' ability to plan its forward program of works is likely to be impacted. In this context, we ask that the AER gives particular consideration to the concerns that we have raised in relation to the design of the DMIS and DMIA.

Benchmarking

The AER noted that we have previously raised concerns regarding the AER's benchmarking methodology[7], and invited us to comment on these matters in relation to the application of the current Expenditure Forecasting Assessment guideline.

TasNetworks recognises that benchmarking is a challenging task, particularly as Australian networks have widely diverse characteristics. As such, TasNetworks will continue to analyse the AER's benchmarking results and provide commentary as part of our Revenue Proposal.

Next steps

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

Yours sincerely

Bess Clark
General Manager Strategy & Stakeholder Relations

[7] Preliminary framework and approach TasNetworks electricity transmission and distribution, Regulatory control period commencing 1 July 2019, March 2017, page 72.