TasNetworks
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Mr Chris Pattas
General Manager Networks Branch
Australian Energy Regulator
GPO Box 520
Melbourne VIC 3001

Attention: Mr Darren Kearney

Dear Chris

**AER's Framework and Approach for the 2017 Regulatory Control Period**

Thank you for the opportunity to provide comment on the AER's preliminary positions on the framework and approach (F&A) that will apply to TasNetworks for the regulatory control period commencing on 1 July 2017.

Given the changes that have occurred to TasNetworks' operating environment we welcome the AER's decision to replace the F&A and are generally supportive of the preliminary positions proposed by the AER. There are some positions that require further consideration prior to the AER's final decision, in particular TasNetworks proposes:

- the provision of connection services, classified in accordance with chapter 5A of the National Electricity Rules (Rules) as a basic connection service, be classified as alternative control services;
- the provision of public lighting services should be treated as negotiated services;
- the revenue at risk under the AER's service target performance incentive scheme be limited to ±2.5 per cent of allowable revenue;
- an appropriate cost recovery 'safety mechanism' be included for emergency recoverable works where the third party cannot be identified; and
- an appropriate mechanism is put in place to ensure that revenue adjustments arising from the current regulatory control period are smoothed across the 2017 regulatory control period.

We also note that the Australian Energy Market Commission (AEMC) made a final rule determination on 9 April 2015, confirming that TasNetworks' distribution regulatory control period commencing on 1 July 2017 will be for two years only. This will have impacts on the operation of the incentive schemes for the next period and treatment of incentive payments from the present period.

Our detailed comments on the AER's preliminary positions are set out in the following attachment.

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

Yours sincerely

Bess Clark

General Manager Strategy & Stakeholder Relations

# AER's proposed Framework and Approach for the 2017 Regulatory Control Period

## 1. Introduction

On 2 April 2015, the Australian Energy Regulator (AER) released its preliminary positions paper (Position Paper) on the Framework and Approach (F&A). This F&A is intended to apply to the TasNetworks' distribution determination for the 2017 regulatory control period, which commences on 1 July 2017.

The F&A sets out the AER's positions on which services will be regulated and how the AER propose to apply its incentive schemes during the 2017 regulatory control period.

The Position Paper sets the AER's preliminary position on the following matters:

- The distribution service classifications.
- The control mechanisms that will apply to the distribution services.
- The application of the AER's incentive schemes.
- The application of the expenditure forecast assessment guidelines.
- Whether depreciation for establishing the regulated asset base (RAB) at the commencement of the subsequent regulatory control period will be based on forecast or actual capital expenditure.
- Any jurisdictional and legacy issues that must be addressed.

This submission to the AER provides commentary on TasNetworks' considerations relating to the AER's preliminary positions. The submission focuses on areas where TasNetworks proposes that the AER modifies its preliminary positions.

## 2. Background

On 1 July 2014, the operations for the Tasmanian distribution network of Aurora Energy Pty Ltd (Aurora) and the operations for the Tasmanian transmission network of Transend Networks Pty Ltd (Transend) were merged to form a single network business, Tasmanian Networks Pty Ltd (TasNetworks). TasNetworks is registered with the Australian Energy Market Operator (AEMO) as a Distribution Network Service Provider (DNSP) and a Transmission Network Service Provider (TNSP).

A tenet within the recently released Tasmanian Energy Strategy, developed by TasNetworks' shareholders, is ensuring that a framework for predictable and sustainable price outcomes for Tasmanian customers is achieved. This tenet is aligned with the TasNetworks' business strategy and has informed our position on matters discussed in this submission.

In this document, reference to TasNetworks should be read in its capacity as a DNSP.

# 3. Service classifications

Service classification is the process of determining which distribution services are to be subject to economic regulation under the National Electricity Rules (Rules) and the nature of the regulatory oversight that will be applied by the AER to the pricing of those services. Service classification influences the way in which TasNetworks will set and recover the costs of providing distribution services, including whether these costs are recovered directly from those customers requesting the service or from all customers through distribution use of system (DUoS) network tariffs. TasNetworks is supportive of the preliminary positions proposed by the AER with the exception of the following areas where TasNetworks considers that a service classification change is warranted:

- connection services relating to the provision or augmentation of a basic connection service[1];
- public lighting services; and
- emergency recoverable works.

TasNetworks considers that the National Electricity Objective (NEO) will be better served by the proposed changes to these service classifications. These views have been informed by the customer feedback received through engagement programs.

## 3.1 Connection Services

The provision of all basic connection services, and connections requiring augmentation or extension of the distribution network, are currently classified by the AER as direct control, standard control services. As such all costs associated with the provision of these connection services are currently recovered through DUoS tariffs and/or the provision of a capital contribution by the connecting customer.

### 3.1.1 Basic connection services

The provision of a basic connection service can be directly attributed to a single customer and costs can be forecast with reasonable certainty (for example, the provision of a single-phase overhead service wire and service fuse). The majority of these services are currently classified by the AER as a direct control, standard control service. When making its final distribution determination for Aurora in 2012 the AER also classified a number of connection services as alternative control, fee-based services. These services are a basic connection service under the provision of chapter 5A of the Rules and include:

- some supply services;
- all renewable energy connections;
- all temporary builders supplies; and
- all temporary show and carnival connections.

TasNetworks recommends that a single service classification is appropriate to the provision of basic connection services.

[1] As defined in chapter 5A of the National Electricity Rules.

TasNetworks is currently operating under transitional arrangements that will expire at the end of the current regulatory control period. TasNetworks will implement a new Connection Policy developed in accordance with the requirements of Chapter 5A of the Rules and the AER's Connection Charge Guidelines.

As a component of the development of the Aurora Energy connection policy (2012 Connection Policy), a number of changes were made to the way that customers contribute to their costs of providing connection services. The 2012 Connection Policy states that customers requiring the provision of a basic connection service make a capital contribution equal to the full cost of their connection. This connection policy was approved in the AER's final distribution determination and is deemed to comply with the Rules.

The AER's final connection charge guideline contains a provision to undertake an incremental revenue calculation as a component of the capital contributions that should apply to all connecting customers. The 2012 Connection Policy does not contemplate revenue offset for the provision of a basic connection service. A continued classification of these services as direct control, standard control, will mean that the full application of the AER's connection charge guideline should apply and that incremental revenue will apply to this capital contribution. This change will mean that the user-pays signal currently embedded for basic connection services will effectively be removed.

These basic connection services can be linked to an individual customer and it is appropriate to recover the costs of providing these services from the individual customer. TasNetworks therefore proposes that the provision of basic connection services, including associated connection alteration services, is classified as direct control, alternative control services. This will preserve the current user-pays, cost reflective charging mechanism that applies for customers receiving a basic connection service. It also reflects that the service is provided to a particular customer who pays directly for the service.

Prior to the implementation of the 2012 Connection Policy, no connection pricing signals were provided to customers, as the costs associated with connection formed a component of the charges that are levied on all customers as part of the network tariffs. Customers and potential service providers had no benchmark cost for comparison and to date no party in Tasmania has provided basic connection services on a competitive basis. The removal of this user-pays pricing signal will make it more challenging to develop a market where other parties may provide these service.

Electrical contractors are in a position to provide basic connection services as a component of the electrical work they undertake at a customer's premises and a number of these providers have expressed a desire to provide a 'one-stop-shop' to their customers. TasNetworks considers that a competitive market in the provision of connection services, on a user-pays basis for the connection service, would be better supported by a change in service classification for basic connections.

TasNetworks currently offers the following groups of basic connection services:

- connection establishment (6 services);
- connection establishment requiring a 'cross-over' service pole (4 services);
- renewable energy connection (2 services);
- temporary connection (4 services); and
- connection alteration (18 services).

In total there are 34 individual basic connection services currently provided.

The reclassification of all these services to alternative control will also provide administrative savings for TasNetworks and its customers. A single process that establishes cost inputs for each alternative control service, as a component of the revenue determination, will result in price cap that is only adjusted by the control mechanism each year. Prices will then be checked to ensure compliance with the AER's final distribution determination and will provide price transparency for TasNetworks' customers. This will also facilitate competition in provision of services, as alternative service providers will have a longer-term view of the regulated service price for connection services.

The Tasmanian Government recently released its Tasmanian Energy Strategy that notes opportunities to make the connection process more timely and transparent. The strategy states "TasNetworks is considering options to improve connection services, including making connection services contestable". Moving to choice of service providers for basic connection services will be facilitated by the classification of these services as alternative control services.

### 3.1.2 Augmentation and network extension services

The provision of the extension or augmentation of the distribution network, associated with a connection service, is classified as a direct control, standard control service. TasNetworks proposes to preserve the current service classification and charging mechanism with the application of the AER's charging guideline. The AER's revenue offset calculation will apply.

The classification proposed by the AER reflects that these augmentation and network extension services are 'shared' in nature, rather than dedicated to an individual customer. Any related standard connection service will be treated as an alternative control service, reflecting that it is provided for an individual customer. This classification provides a balance between cost reflectivity for dedicated works on one hand, and all customers contributing to the funding of shared services on the other.

### 3.1.3 Post connection services

At some time in the future, those assets that form a component of a customer's connection to the distribution network will need replacement or require maintenance. These are post connection services. While these post connection services may be linked to a single customer, they will involve the replacement of assets that have either been fully funded by the customer (the 2012 Connection Policy) or included in the shared assets base (prior to the 2012 change).

TasNetworks considers it efficient to treat these replacement and maintenance services as standard control services. In effect, the customer funds its connection to the network directly, as an alternative control service, and then ongoing maintenance and replacement is funded by all customers as part of programs to manage assets across the network.

This reflects that the nature and characteristics of distribution connections change over time, and replacement and maintenance may be undertaken for a range of assets at the same time, making it administratively burdensome to attempt to attribute replacement and maintenance costs to individual customers. The current service classification of direct control, standard control services is therefore appropriate for post connection services, with costs recovered from the general customer base via network tariffs.

## 3.2 Public Lighting

Public lighting services relate to the provision of public and street lighting where costs can be attributed to a single customer (namely councils and other road authorities). Currently, public lighting services are regulated as a direct control, alternative control services.

The current regulatory control period represents the first regulatory period in which the provision of public lighting services has been regulated in Tasmania. Prior to 2012, the jurisdictional regulator, the Office of the Tasmanian Economic Regulator, had determined that the provision of public lighting services by Aurora should be an unregulated activity. The development of the unregulated Aurora prices had been transparent and the final prices developed as part of the AER's distribution determination were little different to those developed by Aurora as an unregulated activity. The AER's final modelling of the prices for these public lights was undertaken with the same modelling techniques that had previously been undertaken by Aurora. The key difference from treating the service as regulated is the inherent inability to negotiate a different service and price outcome with a particular customer.

Technological change and a desire to reduce costs have meant that many recipients of the TasNetworks-provided public lights are investigating the means to undertake the provision of these services in their own right. Some councils and other road authorities are considering new technologies that were not envisaged as recently as three years ago. TasNetworks has already negotiated with two large local government authorities for these authorities to undertake the provision, maintenance and operation of some public lighting services in their areas. Other local government authorities are now seeking to do the same in their areas.

This change has meant that TasNetworks is no longer the sole provider of these services and no longer has a monopoly over the provision of all public lighting services. Public lighting services can be considered an activity where bilateral negotiation can produce more efficient, customer-focussed outcomes. The service classification should reflect this environment and, as an authority is able to negotiate the service model for lights within their area, those services should be treated as negotiated services.

## 3.3 Emergency Recoverable Works

Emergency works relate to repairing the distribution network after damage to restore or maintain the electricity supply to all customers. Emergency recoverable works are those tasks that are undertaken when the damage to the network is caused by, or is a result of the action of a third party. In most instances, this third party is known to TasNetworks and as such, costs of reparation can be recovered from that party. It is generally appropriate for this work to be treated as an unregulated activity.

There is however, instances where a third party has caused damage to the network and the identity of that party are not known to TasNetworks. For example, motor vehicle accidents where the motor vehicle has been stolen and abandoned at the crash site. In these instances, the perpetrator of the damage is not known and TasNetworks has no ability to recover those costs from any other party.

The distribution network is provided for the benefit of all customers, and all customers should bear some risk in the maintenance and operations of that network. Where a third party causes damage to the network, TasNetworks' customers should rightly expect that TasNetworks repair that network and where possible pass on those costs to the party that

causes the damage. Equally, where a third party damages the network and is not identifiable, the network should be repaired by TasNetworks but the costs should be spread across those benefiting from the repair – the general customer base.

TasNetworks proposes that where it is clear that damage to the network has been caused by the actions of a third party that the costs should be recovered from that party and that this activity should not be classified by the AER. The offending parties' ability to pay those costs is a risk borne by TasNetworks and not the general customer base.

Where it is apparent that the damage is likely to have been caused by a third party, but that party is not identifiable, that work should remain as emergency repairs and be classified as a standard control service and included in TasNetworks' forecasts of emergency response expenditure. If this approach is not accepted, then TasNetworks will need to increase its insurance and/or self-insurance coverage and cost as part of the regulatory proposal.

# 4. Control mechanisms

Control mechanisms are the methodologies applied by the AER to the pricing of the services it has classified as direct control. Control mechanisms provide the methodology and formula that is to be adopted by TasNetworks when it recovers the costs of providing its distribution services. There are two basic mechanisms available to the AER: a cap on the revenue that can be earned for the provision of a total service; or a cap on the price that may be charged for the delivery of a particular service.

The AER has proposed that a revenue cap is applied to the provision of standard control services and that a price cap is applied to the provision of any alternative control service.

TasNetworks supports the application of the AER's proposed control mechanisms with one small adjustment for the provision of standard control services. We propose that a revenue smoothing mechanism is allowed in the final determination that will allow TasNetworks to smooth any total revenue under-recovery for the current regulatory control period across the 2017 revenue control period. This mechanism should be similar in operation to that allowed in the current determination.

Under present tariff arrangements, where changes in consumption can materially affect recovered revenues and prices, TasNetworks may have a large under-recovery of allowable revenue at the end of the current regulatory control period. Unless explicitly provided for, this revenue would be recovered as a component of the allowable revenue for the 2017-18 financial year. Such adjustments in allowable revenue can lead to price shocks.

Volatility in electricity tariffs is not consistent with the national electricity objective or the revenue and pricing principles. Price volatility is detrimental to both customers and TasNetworks as it impairs the efficient use of the distribution system. We therefore support the AER using its discretion to allow for a revenue smoothing mechanism for standard control services.

# 5. Incentive schemes

The AER has proposed that it will apply the following schemes to TasNetworks:

- service target performance incentive scheme (STPIS);
- efficiency benefit sharing scheme (EBSS);
- capital expenditure sharing scheme (CESS); and

- demand management incentive scheme (DMIS).

We support the application of these schemes. The AER's standard schemes assume a five year regulatory control period; the 2017 regulatory control period for TasNetworks will be two years in duration. We commit to work with the AER to ensure an appropriate application of the intended schemes over the 2017 regulatory control period.

We will also work with the AER to consider the appropriate revenue treatment of any incentive payments from the present period. The following schemes have applied during the current regulatory control period:

- STPIS;
- EBSS; and
- DMIS.

The finalisation of the current EBSS assumes that efficiency outcomes will be applied to the full five years of the next regulatory control period. As the 2017 period will only be two years in duration, we propose that the efficiency outcomes form the EBSS are applied to the two years of the 2017 regulatory control period and the first three years of the regulatory control period beginning on 1 July 2019 as if the two regulatory control periods were a single period. This approach will also need to be considered in the context of the EBSS payments or penalties applicable from 2017-18 and 2018-19 outcomes.

With respect to the STPIS, we consider that the revenue at risk is too high, and results in unnecessary customer price volatility. This is discussed further below.

## 5.1 Service target performance incentive scheme

The STPIS is intended to focus a distributor's attention on the service that it provides to its customers. The proposed service measures relate to network reliability and customer service (in the form of telephone answering). TasNetworks will be rewarded for bettering the targets set by the AER, and penalised for failing to meet 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 proposes to apply the STPIS with the revenue at risk cap being ±5.0 per cent of the annual smoothed revenue.

A range of customer consultation activities conducted by TasNetworks indicates that customers are generally not seeking improvements in the current levels of reliability and are happy with the service/price trade-off they are receiving. They also support measures to reduce annual price volatility.

The current STPIS operation, with 5% of revenue at risk, contributes to price volatility.

The first two years of the current distribution determination have resulted in rewards (+3.85 per cent) for the 2012-13 year and penalties (-2.95 per cent) for the 2013-14 year. It is likely that TasNetworks will achieve a reward outcome that is close to 2.75 per cent for 2014-15. The volatility of these outcomes is largely driven by externalities to TasNetworks' operations such as weather related events.

The present incentive framework results in a downward revenue adjustment of approximately $20 million, followed by an upward adjustment of approximately $17 million, on a base of $300 million per annum. Whilst the AER has made provision for a banking mechanism to limit customers' exposure to such volatile pricing outcomes, the banking mechanism does not mitigate the impacts of highly volatile annual outcomes.

At a recent Energy Users Association of Australia conference, Consumer Challenge Panel member Hugh Grant noted that the present incentive allowances are far too large, and proposed that they be removed. TasNetworks is proposing a more moderate position, where service incentives are retained but the revenue at risk is reduced.

We consider that a ±2.5 per cent cap retains the appropriate service incentive while reducing pricing volatility for customers.

# 6. Jurisdictional and legacy issues

## 6.1 Dual function assets

We confirm that there are no dual function assets within the TasNetworks' networks and as such, the AER will not be required to make any determination regarding dual function assets.

## 6.2 Regulatory control period

The AEMC made a final rule determination on 9 April 2015, which confirmed that TasNetworks' distribution regulatory control period commencing on 1 July 2017 would be for two years[2].

We have outlined some of the consequences of this rule change and our position concerning these matters in our previous comments.

[2] Section 11.80 of the National Electricity Rules.