TasNetworks
Delivering your power

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18 September 2014

Ms Lynley Jorgensen
Director
Australian Energy Regulator

By email: TasNetworks@aer.gov.au

Dear Lynley,

Consumer Challenge Panel's submission on TasNetworks' Revenue Proposal

Thank you for forwarding a copy of the Consumer Challenge Panel's (CCP sub-panel 6) submission on TasNetworks' transmission Revenue Proposal, and providing this opportunity to respond.

As you are aware, the AER has received submissions from seven other stakeholders (large customers and customer representatives) on our transmission Revenue Proposal. We have provided a separate response, dated 12 September 2014, to Chris Pattas to those stakeholder submissions.

While there is considerable overlap between the stakeholders' submissions and the CCP sub-panel in terms of the matters raised, we considered it helpful to respond separately to the CCP sub-panel submission, with cross-referencing to our earlier submission as appropriate.

The CCP sub-panel's submission addresses matters relating to the following key areas:

- Consumer engagement and consumer feedback;
- Transmission pricing;
- Cost of capital;
- Capital expenditure;
- Operating expenditure;
- Efficiency benefit sharing scheme; and
- Reliability standards.

We set out our response to each of these topics in the attachment.

If you have any queries regarding this submission, please contact Michael Seddon on 03 6271 6736 in the first instance.

Yours sincerely,

Bess Clark
General Manager Strategy and Stakeholder Relations

1. Consumer engagement and consumer feedback

The CCP sub-panel notes that submissions from directly connected customers indicate that:

- Their views have not been appropriately considered or reflected in the Revenue Proposal.
- TasNetworks' actual and forecast expenditures are excessive.
- There are significant opportunities for efficiency and productivity improvements that are not reflected in the revenue proposal.
- TasNetworks' Revenue Proposal does not fully reflect or respond to the feedback and preferences (e.g. cost/reliability trade-offs) expressed by large customers.
- Norske Skog was not consulted in relation to a proposed capital expenditure project, even though the project is specific to its business.

In relation to our engagement with domestic consumers, the CCP sub-panel expresses concern that the cost implications of alternative reliability options were not presented. As a consequence, the CCP sub-panel concludes that TasNetworks obtained no 'real information' about customers' willingness to pay for reliability improvements. The CCP sub-panel concludes that the AER cannot rely on the results of the consumer consultation in assessing whether the Revenue Proposal reflects consumer preferences.

Customer concerns regarding our engagement approach have already been addressed in our response to the stakeholder submissions, and we refer the CCP sub-panel to that submission[1]. In addition, however, it is worth noting that the feedback was not as universally negative as suggested by the CCP sub-panel. In particular, the EUAA's submission commented as follows:

> *"The EUAA are encouraged by the efforts of Transend and AER to improve engagement with customers in a meaningful way."*[2]

Despite this positive feedback, we acknowledge that there is room for improvement in our consumer engagement processes, and we are working to deliver those improvements. For example, we acknowledge the lack of discussion with Norske Skog on a NCIPAP project, which is specific to them. The project represents an investment of $180,000 to enable dynamic rating of equipment. Nevertheless, we should have consulted with Norske Skog directly.

In relation to the consultation with domestic consumers, we are surprised by the CCP sub-panel's conclusion that no reliance can be placed on the outcomes. It is worth recalling that we engaged Straight Talk, a specialist community engagement consultancy, to assist with the process. Our Revenue Proposal noted two particular findings from the consumer engagement process:

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1 TasNetworks, Submissions in response to TasNetworks' transmission Revenue Proposal, 18 September 2014, pages 2 and 3.

2 Energy Users Association, Submission on Transend's Revenue Proposal 2014-19, 8 August 2014, covering letter.

"Overwhelmingly, consumers connected via the distribution network want to see a reduction in the price of electricity. However, they were sceptical about how much difference a reduction in transmission costs would have for consumers, given that these costs only make up 15 per cent of the overall retail electricity price for the average residential consumers.

In terms of the price and reliability trade-off, there are no clear, unambiguous answers about whether price or reliability—the two major issues for consumers identified through both the telephone survey and the workshops—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."[3]

Contrary to the views expressed by the CCP sub-panel, we consider the above information to be useful feedback, and we sought to reflect that information in our Revenue Proposal. It would not be appropriate for us to disregard this feedback, and it is difficult to imagine what benefit would be obtained if the AER disregarded it, as the CCP sub-panel recommends.

Although we accept that our consumer engagement processes can be improved further, it does not follow that our actual or forecast expenditure is excessive. On the contrary, our Revenue Proposal explains that our recent expenditure and revenue recovery have been below the amounts set by the AER. Looking forward, our forecast expenditures reflect robust efficiency improvement targets, that require us to identify new sources of efficiency over the course of the forthcoming regulatory period.

2. Transmission pricing

The CCP sub-panel notes the concerns raised by a number of large customers regarding TasNetworks' pricing methodology. The CCP sub-panel requests the AER to review the issues raised and ensure that the pricing methodology allocates costs to all tariffs on a cost-reflective and equitable basis.

TasNetworks understands the issues raised by large customers and we are open to proposals that would improve the current pricing methodology. It is important to note, however, that the rules in relation to transmission pricing are relatively prescriptive. As explained in the Revenue Proposal, TasNetworks' proposed methodology complies with these rule requirements.

3. Cost of capital

The CCP sub-panel raises a number of concerns regarding the AER's approach to estimating the cost of capital in the recent transitional determination. In broad terms, the CCP sub-panel suggests that the AER is inappropriately exercising its discretion by:

- ignoring data from overseas regulators;
- setting parameter values at the top end of the AER's range; and

3 TasNetworks, Tasmanian Transmission Revenue Proposal 2014-19, 31 May 2014, page 36.

- disregarding relevant information such as the RAB multiples implied by recent capital market transactions.

The CCP sub-panel comments that "Tasmanian customers would have been better off under the old rules". It concludes that the long-term interests of consumers would be best served by the AER selecting the lowest end of the range for each cost of capital parameter.

TasNetworks notes that the transitional determination established a placeholder revenue by conducting a high-level review of our revenue requirements. The rules required the AER to set a placeholder revenue in a manner that minimises the price variations between the current period, the transitional year and the subsequent regulatory period. In relation to setting the cost of capital, given the more limited scope of the transitional revenue setting process, the AER explained that it was applying the foundation model, rather than the comprehensive approach set out in the AER's cost of capital guidelines:

> *"In order to minimise the risk of future price variations, we have applied a WACC of 8.1 per cent, which is the top of our indicative range. This estimate process is not a full application of the rate of return guideline, which is not possible in the timeframe of the transitional review. However, it does give priority to sources of evidence and point estimates that we consider are appropriate for this high level process. While we recognise that the final WACC estimate could be higher or lower than this estimate, we have taken account of current market conditions in preparing this estimate."*[4]

In light of the above clarifying information, the CCP sub-panel's criticism of the AER's WACC decision in the transitional determination is misplaced. More broadly, we do not agree with the CCP sub-panel's contention that customers' long-term interests are best served by setting the cost of capital at the lowest point of a reasonable range.

Instead, we take the view that providing incentives for efficient investment in long lived assets requires the AER to exercise caution by ensuring that the regulated cost of capital is not lower than the actual cost of capital. It is also important to note that there is substantially more downside risk to customers' long-term interests if the allowed cost of capital is set too low, as opposed to being too high.

As explained in our Revenue Proposal, we consider our cost of capital estimate to be consistent with the AER's guidelines. Furthermore, it appropriately balances the interests of consumers and our shareholder by recognising, in particular, the importance of putting downward pressure on our transmission revenue requirements at a time when many of our larger customers face strong competitive pressures in local and international markets.

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4 AER, TransGrid and Transend, Transitional transmission determinations 2014–15, March 2014, pages 26 and 27.

4. Capital expenditure

The CCP sub-panel raises a number of issues in relation to TasNetworks' capital expenditure forecasts, including:

- the accuracy of our demand projections, especially given AEMO's forecasts and our previous forecasting errors;
- the reasonableness of our expenditure forecasts; and
- the need for increased project scrutiny and possible re-categorisation of some projects as contingent projects.

These matters have been addressed in our response to submissions lodged by large customers, and we refer the CCP sub-panel to that submission for further information. In particular, we explain that in the 2009-14 period several augmentation projects were deferred as a result of the lower-than-expected demand. In addition, we decided not to recover our revenue allowance in the final two years of the current regulatory period. Consequently, customers are no worse off as a result of the demand forecasting error.

It is also worth noting that we were not alone in failing to forecast the downturn in demand following the GFC and the expansion of embedded generation. In fact, AEMO also over-forecast demand during this period.

It is important to take care when comparing AEMO energy and demand forecasts with those of TasNetworks' forecasts for the 2014-19 regulatory period to ensure non-scheduled generation[5] is appropriately taken into account.

In our response to stakeholder submissions, we have also noted that TasNetworks is currently reviewing its augmentation projects in light of new information and the latest demand data.

We note the CCP sub-panel suggestion that augmentation projects may need to be re-categorised as contingent projects. While we are amenable to this type of approach, the projects are not sufficiently material to be classified as contingent projects in accordance with the rules requirements.

In relation to the CCP's concerns regarding replacement capital expenditure, we note that:

- It is not appropriate to base replacement capital expenditure on the average age of the asset base compared to our peers. Where age is correlated with condition, replacement is more appropriately linked to the oldest assets in a group. Our Transmission System Management Plan and Asset Management Plans (provided to the AER and CCP) set out detailed information on asset age profiles.
- Our approach to asset replacement is based on asset condition and risk to people, environment, assets and system performance. It is not age-based, as suggested by the CCP sub-panel.

5 The majority of the non-scheduled generation is hydro generation.

- Detailed justification of projects and detailed information on our assets has been provided to the AER and CCP. We understood that these individual project justifications and asset management plans would be posted on the AER website as we were required to screen all these documents for confidentiality to enable publication.

The CCP sub-panel repeats the submission made by the MEU and others that the average age of network assets does not justify the forecast replacement capital expenditure. However, as already noted in our response to the submissions lodged by stakeholders, the average asset age does not reveal any information regarding the age profile of the assets or how many assets are operating beyond their expected life. Therefore, even if asset age were the primary driver of replacement expenditure (which it is not), a consideration of the average asset age provides practically no useful information regarding future expenditure requirements.

5. Operating expenditure

The CCP sub-panel highlights a number of issues that have been raised in the submissions lodged by large customers. As already noted, we have responded to the issues raised by large customers in our submission dated 18 September 2014, and we refer the CCP sub-panel to that submission.

In addition, the CCP sub-panel focuses on labour escalation rates, commenting that:

> *"The Sub-Panel finds it extremely difficult to accept that an industry that is in contraction due to declining demand for its services can credibly claim Labour price pressures in excess of CPI."*[6]

In our view, it is an exaggeration to describe the industry as being in contraction due to declining demand for its services. Setting aside this issue, however, it is not the case that labour prices only increase in real terms in those sectors that are growing. Instead, improvements in labour productivity mean that labour prices tend to increase at rates faster than CPI. There is no reason to suppose labour productivity cannot increase even if an industry were contracting.

In any event, our Revenue Proposal makes it clear that we are proposing efficiency gains that negate the impact of labour escalation and step changes (on which the CCP sub-panel also expresses concern). In particular, the Revenue Proposal explains:

> *"This [efficiency improvement] target will require us to find savings that offset forecast cost increases, including future labour cost movements, and the $0.8 million additional expenditure required to fund known new obligations imposed by the AER Better Regulation program and the AEMO operating agreement."*[7]

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6 AER Consumer Challenge Panel on Transend's Revenue Proposal, 4 September 2014, page 12.

7 TasNetworks, Tasmanian Transmission Revenue Proposal 2014-19, 31 May 2014, page 87.

The CCP sub-panel also draws the AER's attention to a quotation from the CEO of NSW Networks, which comments (amongst other things) that:

> *"Public ownership, politically powerful unions and amenable management have all combined to deliver union agreements to drive higher labour costs and higher electricity bills.* [8]

We note that this quotation refers to the industry in NSW, not Tasmania. It should also be noted that the EBA relating to TasNetworks will deliver a cost saving in the first year of the forthcoming regulatory period, which has been factored into the Revenue Proposal. The quotation referenced by the CCP sub-panel, therefore, has little relevance to TasNetworks' current circumstances and experience.

6. Efficiency benefit sharing scheme (EBSS)

The CCP sub-panel comments that it supports incentive schemes that deliver genuine efficiency improvements, but it is clear from the EBSS outcomes to date that the AER is consistently setting operating expenditure allowances well above the efficient level. As a consequence, the CCP sub-panel urges the AER to review the outcomes of the EBSS, and discontinue it if the scheme cannot be refined to deliver genuine efficiency improvements.

We agree with the CCP sub-panel's view that the EBSS should provide bonuses in relation to genuine efficiency improvements. The CCP sub-panel's concerns reflect its view that the operating expenditure allowances in the current regulatory period were 'too generous'. We have addressed this issue in our response to stakeholders' submissions, and we refer the CCP sub-panel to that response.

In addition, it is worth noting that the regulatory framework set out in chapter 6A and the National Electricity Law requires the AER to ensure that network service providers have a reasonable opportunity to recover at least the efficient costs of providing network services. As the CCP sub-panel is aware, Chapter 6A has recently been subject to an extensive review to ensure that it appropriately balances the interests of shareholders and customers, particularly in relation to setting operating and capital expenditure allowances. There is no basis to support the proposition that operating expenditure allowances were systematically 'too generous' in the past or will be so in the future.

The design of the EBSS ensures that network service providers face consistent incentives throughout the regulatory period to drive efficiency improvements. An efficiency improvement is defined in relation to the allowance set by the AER, and the company's own performance during the regulatory period. In particular, to obtain an efficiency benefit in relation to year 3 of the scheme, for example, the company must outperform the AER's operating expenditure allowance by more than its out-performance in the previous year.

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8 Ibid.

This design characteristic of the EBSS has important implications for the hypothetical example where the AER's operating expenditure allowances were too generous. In particular, a network company would only benefit in relation to the first year of the scheme, and not in relation to subsequent years. In other words, even if the AER's allowance were systematically 'too generous' in each of the five years of a regulatory control period, the network company would only obtain a bonus in relation to the first year as a result of this error. This is because bonuses in subsequent years would require relative outperformance compared to the company's actual performance in prior years, not the regulatory expenditure allowances.

In TasNetworks' case, the amount by which the company outperformed the AER's allowance increased throughout the current regulatory period. This indicates genuine efficiency improvements over time, which is supported by the initiatives that the company undertook during the regulatory period to drive costs down.

In relation to the long-term interests of consumers, discontinuing the EBSS would be a retrograde step. In particular, it would create an environment in which network companies have a diminished incentive to drive efficiency improvements as the regulatory period progresses. The design of the EBSS not only corrects this potential problem, but it also provides a stronger incentive to deliver efficiency improvements, which are ultimately returned to customers through lower prices.

7. Reliability standards

The CCP sub-panel comments that TasNetworks is consistently receiving bonuses under the Service Target Performance Incentive Scheme (STPIS). The CCP sub-panel highlights that various submissions by large energy users have indicated that they do not support further reliability driven expenditure. Instead, these large users are keen to explore trade-offs between service standards and capital expenditure.

Contrary to the CCP sub-panel's submission, the company's service performance in 2011 resulted in a penalty for that year, while transformer circuit availability has also been below target for several years of the current regulatory period. A summary of our service performance it set out in figure 4.3 of the Revenue Proposal.

The design of the STPIS is based on targets which will be set according to average performance over the previous five years. The company's capital and operating expenditure forecasts must also be based on maintaining current levels of reliability. In this context, TasNetworks notes that the clear message from consumers is their concern about rising electricity prices and the importance of maintaining existing service levels. We have taken this feedback on board by delivering lower costs whilst at least maintaining existing service levels.

In relation to directly connected customers, TasNetworks remains open to addressing their particular preferences in relation to price and reliability through bilateral discussions and negotiations. It should be noted, however, that TasNetworks must comply with the current reliability standards and its regulatory obligations.

8. Concluding comments

This submission has sought to address a number of the concerns raised by the CCP sub-panel. We welcome ongoing dialogue with the CCP sub-panel and other stakeholders as the AER works towards its draft and final determinations. In particular, if further clarification is required in relation to any of the matters raised in the submission, we would be pleased to meet with the CCP sub-panel at its convenience.