

18 September 2014

Mr Chris Pattas
General Manager – Networks Branch
Australian Energy Regulator

Tasmanian Networks Pty Ltd
ABN 24 167 357 299
PO Box 606
Moonah TAS 7009

By email: TasNetworks@aer.gov.au

Dear Chris,

Submissions in response to TasNetworks' transmission Revenue Proposal

As you are aware, the AER received submissions from the following stakeholders in response to our transmission Revenue Proposal:


- Bell Bay Aluminium;
- Energy Users Association of Australia (EUAA);
- Hydro Tasmania;
- Major Energy Users (MEU);
- Norske Skog;
- Nyrstar; and
- Tasmanian Small Business Council (TSBC).

We would like to take this opportunity to respond to a number of common themes raised by stakeholders. The attachment to this letter therefore discusses these themes; provides a short description of the matters typically raised in submissions; and sets out our response. Additionally, we will provide a copy of this submission to each of our customers, and invite them to engage with us further on their areas of concern.

The submission also notes that TasNetworks is currently reviewing its augmentation projections in light of new information, including the latest demand data. This review is not yet complete, however, we will provide the AER with updated project information as soon as this becomes available.

While we recognise that there is no formal regulatory process for lodging this submission, we believe that it will promote further constructive engagement with stakeholders. 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. Key themes raised in submissions

The following themes have emerged from our review of the submissions lodged with the AER in relation to our Revenue Proposal:

- Customer engagement.
- Relevance of previous operating expenditure allowances.
- Proposed expenditure and revenue reductions in the context of historic price increases.
- Efficiency savings from the merger.
- Demand forecasts and stranded asset risk.
- Trade off between capital and operating expenditure.
- Cost of capital.
- Pricing methodology.

We address each of these issues in turn below, by first outlining the issue raised in the submissions and then briefly setting out our response.

2. Customer engagement

2.1 Issues raised

While most submissions welcome TasNetworks' increased focus on customer consultation, a number of submissions also offer some criticism. Norske Skog is particularly critical of Transend's past performance, while the MEU notes that it has not been consulted (although its members have been). The MEU makes the following observation:

*"...TasNetworks has "heard" the concerns but the outcomes, whilst better than in period AA2, still do not go far enough to address the concerns that its customers have. Further, though TasNetworks may have "heard" consumers' views, it still needs to put these into actions."*¹

The Tasmanian Small Business Council also suggests that TasNetworks may not have complied with the Rules requirements and the AER's guidelines for consumer consultation.

2.2 TasNetworks' response

Sections 3.3 and 3.4 of the Revenue Proposal explain our approach to consumer engagement, both in relation to directly connected customers and domestic consumers. It is helpful to recap briefly on the approach adopted.

¹ MEU, page 55 of 83.

We consulted with our directly connected transmission customers in relation to annual publications, such as our corporate plan and Annual Planning Report, in the course of preparing the Revenue Proposal. In addition, we had face-to-face meetings with all our transmission customers. Those customers and representative groups attended a number of other briefing sessions, where information on the Revenue Proposal was provided. For instance, we gave a presentation on our proposal to the Energy Users Association of Australia (EUAA) Tasmanian Forum, at which we also offered to provide further briefings and opportunities for consultation to the EUAA and its members.

In relation to domestic consumers, our Revenue Proposal explains that we commissioned a specialist community engagement consultancy to assist us in designing and implementing an engagement program. In addition to this initiative, our regular engagement with the Office of the Tasmanian Economic Regulator's Customer Consultative Committee also provided an important source of feedback on our plans.

Although we have complied with the regulatory requirements relating to consumer engagement, we also recognise that our practices are still developing, and can be improved further. As already noted, we intend to provide a copy of this submission to each of our customers, and invite them to engage with us further on their areas of concern. In addition, we will continue to build on the improvements in our engagement approach.

3. Relevance of previous operating expenditure allowances

3.1 Issues raised

A number of submissions argued that TasNetworks' operating expenditure allowance for the current period was too generous, and that proposed efficiency savings must be viewed in that context. For example, the Tasmanian Small Business Council makes the following observations:

*"For opex, past reductions are more broadly based, but the generosity of the previous regulatory allowance has made reductions possible without necessarily driving costs down to efficient levels."*²

The MEU's submission also raises its concern that TasNetworks will obtain an efficiency bonus of \$32 million, which it considers TasNetworks 'did not earn'³.

3.2 TasNetworks' response

The AER determined our regulatory allowances for the 2009-14 regulatory period in accordance with the Rules. The expenditure allowances that were set for the current regulatory period reflected the best available information at that time, following a review by the AER that included a detailed consideration of:

- the company's expenditure and service standard proposals;
- submissions lodged by stakeholders; and
- independent reports from the AER's consultants.

² TSBC, page 6 of 46.

³ MEU, page 50 of 83.

Given this background, we do not agree that the expenditure allowances in the current regulatory period were 'generous'. However, we have recognised the importance of assisting our customers, especially given the commercial pressures they face in national and international markets. As a consequence, we embarked on a concerted cost reduction program. We also decided not to recover our full revenue allowance in the final two years of the current regulatory period.

In terms of our expenditure forecast for the forthcoming regulatory period, our Revenue Proposal explains the initiatives we are taking to deliver further efficiency improvements. It is appropriate for the AER to consider these proposals on their merits, rather than revisiting previous regulatory decisions.

4. Proposed reductions in the context of historic price increases

4.1 Issues raised

A number of submissions welcome TasNetworks' proposed expenditure and revenue reductions. However, submissions also comment that the reductions must be viewed in the context of historic expenditure and revenue increases over a number of years. When viewed in this context, the submitters argue that the proposed reductions are a step in the right direction, but do not go far enough.

The Tasmanian Small Business Council comments that:

*"average annual opex would be 51 per cent above the average for the previous regulatory period (2004/05 to 2008/09), which is prior to the large increases that took place at the beginning of the current regulatory period."*⁴

The MEU makes the following observation:

*"The MEU considers that the proposal must be seen in the context of the very high transmission prices that TasNetworks' customers currently face. That is, TasNetworks' proposed price reductions are coming off a very high revenue allowance, which in turn reflected the excessively rapid build-up of investment in the regulatory period 2009-14 and earlier."*⁵

The MEU also commented that average prices almost doubled over the last six years from just over \$10/MWh to over \$20/MWh, an increase of over 200 per cent⁶. Norske Skog raised similar concerns regarding the significant historic price increases:

*"We have seen a 175% increase since 2006/7 including a 47% increase during the previous regulatory period. Imposed on our operation have been cumulative year-on-year increases, some 74% higher than CPI over the last 6 years."*⁷

⁴ TSBC, page 38 of 46.

⁵ MEU, page 10 of 83.

⁶ MEU, page 11 of 83.

⁷ Norske Skog, page 7 of 12.

4.2 TasNetworks' response

Changes in transmission charges over the last decade reflected a period of significant investment in the ageing transmission system. This expenditure was essential to maintain reliability standards and meet area specific load growth. The changes also reflected increased operating costs associated with operation in the National Electricity Market (NEM), and a higher cost of capital as a result of financial market conditions.

Whilst price levels increased, a number of claims made as to 200% transmission price increases are inaccurate. As explained in further detail below, the seven largest transmission customers experienced a doubling (or 100% increase) of their charges in real terms over the period from 2006-07 to 2011-12 (an increase of 128% in nominal terms). Concerted cost saving efforts and a lower cost of capital in recent years have led to transmission charges moderating and now reducing: the forecast 2014-15 charges for the seven largest customers are less in nominal terms than their charges were in 2011-12. Transmission charges to our distribution customers have also fallen.

Comparisons of Tasmanian transmission charges with those experienced elsewhere by our customers should also be considered with some restraint. The design of the Tasmanian transmission system has been driven by the relatively decentralised nature of hydro generation and load. Comparisons with systems elsewhere can therefore be misleading. What should be considered in a more holistic discussion is the full delivered energy cost rather than just the cost of the transmission component.

The circumstances now facing the Tasmanian transmission network are markedly different to previous years, and our proposed expenditure plans and revenue requirements reflect this change. The Revenue Proposal and the company's forward expenditure plans should be assessed in this context.

Turning to a more detailed examination of the claims made in submissions regarding historic increases in transmission charges, we note that a number of factors affect the comparison of rates of increase in charges over time. These need to be clarified before reasonable comparisons can be made:

- Some of the customers increased their contract demand during the period. Comparison of \$/MW is therefore a more reasonable basis for comparing price increases, rather than comparing total charges.
- Selection of the years over which charges are compared can have a significant impact on the rate of increase. For example:
 - The 2006-07 year included correction of a significant over-recovery of revenue⁸ from prior years, thereby creating a reduction in charges for that year.
 - TasNetworks (Transend at the time) under-recovered part of its revenue allowance in 2012-13 and 2013-14 to reduce the impact of rising transmission charges on customers.
 - Therefore, choosing 2006-07 as the starting year and 2011-12 as the finishing year to calculate the rate of increase in charges results in the maximum apparent rates of increase.

⁸ Greater than 10 per cent of the revenue requirement.

In light of the above factors, comparing the \$/MW price between 2005-06 and 2013-14 provides a more valid analysis of price increases. On this basis, we calculate the following increases over the period:

- The overall average nominal increase for the seven largest customers is 101 per cent (63 per cent in real terms); and
- The maximum increase experienced by any one customer is 125 per cent (82 per cent in real terms).

As already noted, we expect charges for 2014-15 for the largest customers to be less than those in 2013-14. We recognise the increases described above are significant, however they were driven by necessary increases in capital investment and maintenance expenditure, the additional costs of Tasmania's entry into the NEM, and a higher cost of capital over the period of the Global Financial Crisis. These increases are substantially less than the 175 to 200 per cent increases that are sometimes quoted.

5. Efficiency savings from the merger

5.1 Issues raised

A number of submissions suggest that TasNetworks' savings from the merger are too modest. For example, Nyrstar comments:

*"The TasNetworks proposal does not incorporate a stretch for synergy benefits which should arise from the merger of Aurora distribution and Transend. An ambitious but realistic synergy benefit target should be included in the opex allowance. It is not inconceivable that synergy benefits of 15% of the combined opex of the merged entities could be used as a stretch target."*⁹

The TSBC also queried whether TasNetworks' proposal included an appropriate allowance for the merger savings:

*"We note that TasNetworks has identified \$2.5 million in merger related savings in 2014/15. We therefore seek further information on the extent of TasNetworks' savings beyond this to achieve at least \$8 million per annum in total and when these will be realised?"*¹⁰

5.2 TasNetworks' response

The merger of the transmission and distribution networks has led to a significant reduction in staff numbers, which has been incorporated in the Revenue Proposal. We are committed to delivering further efficiencies during the forthcoming regulatory period. Although the sources of these efficiencies have not yet been identified, our expenditure plans have anticipated that they will be achieved.

⁹ Nyrstar, page 1 of 4.

¹⁰ TSBC, page 36 of 46.

In particular, the Revenue Proposal explains that:

- We forecast an immediate operating expenditure saving of \$2.5 million in 2014–15.
- Further efficiency gains will be achieved over time as the new company rationalises duplicate systems and finds better ways of delivering services to its customers. The detailed plans to realise these savings are still to be developed.
- In the absence of these efficiency improvement plans, a performance objective has been set to achieve continued operating cost reductions beyond 2014–15.
- TasNetworks' operating expenditure forecasts reflect the achievement of \$7.9 million worth of annual efficiency gains by 2018-19, the last year of the forthcoming regulatory period (as shown in table 6.6 of the Revenue Proposal).
- The target reductions will require us to find savings that offset forecast cost increases, including future labour cost movements, and \$0.8 million of additional expenditure required to fund known new obligations imposed by the AER Better Regulation program and the AEMO operating agreement.
- The total value of the efficiency gains built into our operating expenditure forecast is \$29.8 million over the regulatory period.

It should also be noted that the \$8 million annual efficiency gain (referred to by the TSBC) is the combined transmission and distribution saving expected from the merger.

In these circumstances, we regard our efficiency targets as reasonable, and we do not agree that a further 'stretch' target should apply.

6. Demand forecasts and stranded asset risk

6.1 Issues raised

Several submissions note that TasNetworks' demand forecasts exceed AEMO's forecast for Tasmania. Submissions also comment that previous demand forecasts have been too high, leading to unnecessary capital expenditure. These submissions argue the case for lower capital expenditure requirements in the next period, and some highlight the risk of asset stranding. For example, the MEU, Norske Skog and EUAA make the following observations:

*"The fact that there was significant investment in connection assets during AA2 when there was effectively a falling demand subsequent to the 2008 peak demand implies that the AA2 period investment in connection assets has "preloaded" the network with greater capacity than is needed for forecast period AA3."*¹¹

*"The extreme levels of development capital employed in the previous regulatory period versus the ongoing reduction in demand has created the situation where assets are both stranded and have had their lives significantly extended."*¹²

¹¹ MEU, page 55 of 83.

¹² Norske Skog, page 3 of 12.

“The EUAA members are concerned that Transend are proposing high levels of re-investment in long life assets in an environment where there is a real possibility of those investments continuing to be heavily under utilised or worse case being stranded.”¹³

A more specific issue of asset stranding has been raised by Hydro Tasmania in relation to TasNetworks’ expenditure on the optical fibre ground wire project (OPGW). Hydro Tasmania argues that this project has not contributed to the provision of prescribed services and should be reviewed by the AER.

6.2 TasNetworks’ response

In relation to historic demand forecasts, we acknowledge that we did not expect the downturn in demand. It is worth noting that the impacts of increased solar PV installation, increased energy efficiency, and the downturn in economic conditions led to reductions in demand across the NEM that took many commentators and forecasters by surprise. The demand forecasting error that occurred in relation to the current regulatory period was therefore common across many organisations, including AEMO.

As explained in section 4.3.1 of the Revenue Proposal, we responded appropriately to the lower-than-forecast demand during the period by reducing and deferring development capital expenditure. Specifically, our total development capital expenditure is approximately \$132 million lower than the AER’s allowance for the period. In view of these and other savings we achieved, we decided to not fully recover our maximum allowed revenue. Under that decision, we have foregone the recovery of \$11 million of allowed revenue in 2012–13, and \$26 million of allowed revenue in 2013–14. Importantly:

- Our actual capital expenditure over the current period was reduced to include only the efficient level of investment required to meet the actual demand conditions that prevailed.
- Savings from our reduced capital expenditure were passed back to customers in 2012-13 and 2013-14 through lower charges, so customers have not paid for planned investment that did not proceed.
- Customers are no worse off as a result of the demand forecasting error.

In relation to the OPGW project undertaken during the current period, we note that this work contributes to the provision of prescribed services by providing lightning protection and communications functionality to support the efficient operation of the transmission system. The portion of the cost of this project which is attributable to prescribed services has been properly allocated to that activity in accordance with our Cost Allocation Manual, and so it is appropriate for that expenditure to be included in the regulated asset base.

¹³

EUAA, page 9 of 13.

Section 5.7.3 of the Revenue Proposal explains the differences between our demand forecasting approach and the approach adopted by AEMO. Since lodging our Revenue Proposal, we have continued to work with AEMO to reconcile the differences in our demand forecasts. Notwithstanding these methodological differences, it should also be noted that AEMO's latest demand forecasts were published after the Revenue Proposal was submitted, and therefore could not be taken into account in the Revenue Proposal.

It is important to take care when comparing AEMO demand forecasts with TasNetworks' forecast for the 2014-19 regulatory period. When non-scheduled generation¹⁴ is appropriately taken into account, the AEMO maximum demand forecast is slightly higher in the initial years and slightly lower in the final years than the TasNetworks' forecasts for the 2014-19 regulatory period.

New information (in terms of recent actual demand and updated customer demand forecasts) has become available since we submitted our Revenue Proposal, and we are reviewing the projected need for network augmentation in light of that information.

We are confident that our capital expenditure forecasts will reflect the efficient level of expenditure required to meet the forecast level of demand, whilst continuing to efficiently manage risk associated with deteriorating assets.

7. Trade off between capital and operating expenditure

7.1 Issues raised

The MEU's submission argues that the average age of TasNetworks' asset base does not justify the proposed level of renewal capex. In addition, it is also argued that renewal capex should produce savings in maintenance expenditure. Bell Bay Aluminium and Nyrstar make the following observations:

*"As the RAB has grown due to Augmentation and Replacement, then why have the maintenance costs not decreased, as the new assets have less maintenance requirements? In this regard, prudent replacement of aging assets should result in lower ongoing maintenance costs and an improvement in reliability. The opposite is reflected in the historical performance, and unless challenged, this trend shall continue in the current RP."*¹⁵

*"TasNetworks have not provided any evidence that past asset renewals/replacements have indeed had a positive impact on operational expenditures."*¹⁶

7.2 TasNetworks' response

Replacement expenditure is driven primarily by asset condition, asset performance and safety. While asset age may be correlated with some of these factors, it is incorrect to assume that age is the principal driver of replacement expenditure. Notwithstanding these observations, even if asset age were the primary driver for replacement expenditure (which it is not), examining the average

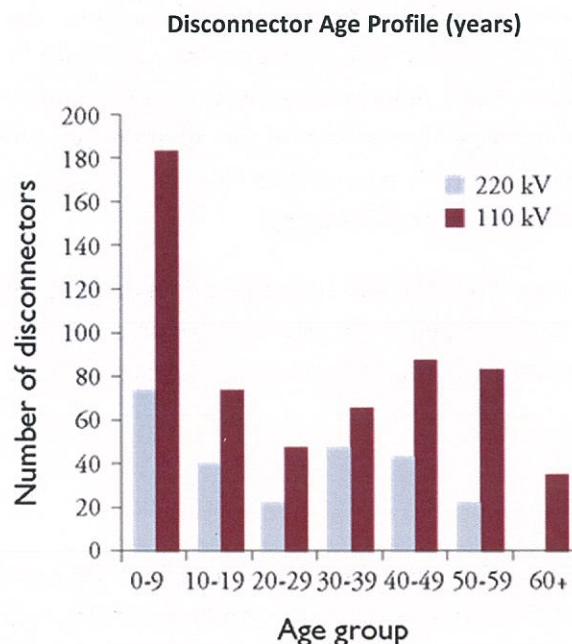
¹⁴ The majority of the non-scheduled generation is hydro generation.

¹⁵ Bell Bay, page 4 of 6.

¹⁶ Nyrstar, page 1 of 4.

asset age provides limited insight into the expenditure requirements. This point is illustrated by considering the example of the age profile for disconnectors.

The figure below shows that the average ages of TasNetworks' 110 kV and 220 kV disconnector populations are 23.4 years and 23.8 years respectively. However, the disconnector age profile shows that 215 units (around one-quarter of the population) are older than their expected life of 40 years. Therefore, while the average is lower than the expected life, a significant proportion of the asset base would be replaced if a mechanistic asset age replacement approach were applied.



Section 4.3.2 of the Revenue Proposal explains that:

- We are coming to the end of a period of relatively high renewal and enhancement capital expenditure.
- Our forecast renewal and enhancement capital expenditure for the forthcoming regulatory period is lower than the current period.
- Replacement of assets at the end of their useful life, determined on the basis of condition and risk - not simply age - continues to be a major expenditure driver for us.

Depending on the asset type and performance, TasNetworks agrees that renewal capital expenditure should deliver maintenance savings. Tables 6.8 and 6.9 of the Revenue Proposal demonstrate that TasNetworks has in fact achieved savings in the relevant expenditure category (Field operations and maintenance) over the current regulatory period, and expects to continue to do so:

- Our actual expenditure in this category was \$80.3 million, compared to the regulatory allowance of \$99.4 million for the period. This represents a reduction of nearly 20% in recurrent operations and maintenance expenditure over the period - a significant saving.

- For the coming regulatory period, our proposed total field operations and maintenance expenditure allowance is \$75.5 million, a further 6% lower than the levels achieved in the current period.

Contrary to some of the suggestions made in the submissions to the AER, these outcomes provide clear evidence that past asset renewals/replacements have indeed had a positive impact on operational expenditures.

As explained in section 5.12 of the Revenue Proposal, the expenditure forecasts consider the interaction between capital and operating expenditure. For example, the Transmission System Management Plan outlines our framework and strategies for optimising the life cycle costs and performance of our assets. Asset-specific management plans set out detailed strategies and actions for achieving optimal costs and asset performance over the asset life cycle. In this context, it would be inappropriate to assume a broad brush relationship between renewal capital expenditure and maintenance for the purpose of expenditure forecasting.

We are confident that our Revenue Proposal and supporting documents demonstrate the efficiency and prudence of our renewals capital expenditure, and that our asset management activities enable us to identify and deliver an optimal mix of capital and operating expenditure.

8. Cost of capital

8.1 Issues raised

While several submissions welcome TasNetworks' decision to adopt the AER's parameter values for the cost of capital, it is also argued that these values are too high. For example, the EUAA makes the following observations:

"We welcome that TasNetworks has shifted its position on the equity beta and gamma since its Transitional Proposal and now proposes to apply the AER's Guideline and WACC parameters in order to establish a price path that is sustainable for its customers. [...]"

However, we note two areas where we continue to have significant reservations about the AER's values:

- *In relation to the equity beta, the AER has settled on a value of 0.7. However, we note that this was at the upper end of the range proposed by the AER and supported by its consultants. The expert advice received by the AER would have been consistent with a further reduction in the equity beta to at least 0.6.*
- *The cost of debt established by the AER reflects private sector benchmarks and these are, in our view, inappropriate to a government owned entity such as TasNetworks, which actually sources debt on a substantially more favourable (lower cost) basis and is an isolated monopoly provider with no competitive neutrality issues at play."¹⁷*

¹⁷

TSBC, page 42 of 46.

“We would encourage the AER to re-visit some of the parameters in particular the market risk premium and equity beta to provide a balanced point allocation within the parameter ranges mooted to date by the AER.”¹⁸

8.2 TasNetworks’ response

The AER has published a guideline setting out its proposed approach to estimating the rate of return. As the Revenue Proposal explains, TasNetworks obtained independent expert advice which indicated that the actual cost of capital exceeds the estimate set out in the AER’s guideline. However, given the commercial pressures faced by our customers, we concluded that for the purpose of our next regulatory period, the AER’s estimate for the rate of return should be adopted.

TasNetworks stands by the cost of capital methodology set out in its Revenue Proposal. As noted in the Revenue Proposal, the cost of capital will be updated prior to the Final Decision, to reflect prevailing interest rates.

9. Pricing methodology

9.1 Issues raised

The MEU submission provided detailed comments on a range of matters relating to TasNetworks’ proposed transmission pricing methodology. It stated:

“There is an expectation that prices for the same service should approximate the general trend for changes in the allowed revenue. This allows greater certainty for consumers in year on year changes for the costs of transmission.

The structure and the freedom granted to transmission networks to develop their prices, even under the strictures of the Rules, still results in considerable variation from the general trends implied by the X factor established by the AER at the revenue reset. This freedom is further exacerbated by the ability of the networks to allow low load factor users to pay their transmission charges on an energy basis which does not recover the costs that are incurred to meet the occasional high demands implicit in low load factor usage.”¹⁹

The pricing methodology is unacceptable as it is clearly not cost reflective. The MEU considers that the pricing methodology should be based on the peak usage each user imposes the network rather than using the lower of demand and consumption for non-locational TUoS and common service.”²⁰

9.2 TasNetworks’ response

TasNetworks understands the issues raised by the MEU and we are open to proposals that would improve the current pricing methodology.

¹⁸ EUAA, page 8 of 13.

¹⁹ MEU, page 75 of 83.

²⁰ MEU, page 4 of 83.

We recognise the need for customers - in particular, large customers - to have reasonable certainty regarding network prices. Currently, we are considering commercially negotiated arrangements to reduce the level of uncertainty in transmission prices for some large customers. However, our ability to provide certainty under the regulatory framework is limited because some of the sources of volatility - such as interregional settlements residues - are outside our control, and can have a material impact on transmission prices from year to year. We recognise the current arrangements need to change. It is appropriate for TasNetworks to be able to negotiate prices with customers to provide more predictable and sustainable price paths.

In relation to the proposal now before the AER, it is important to note that the rules governing transmission pricing are relatively prescriptive. As explained in the Revenue Proposal, TasNetworks' proposed methodology complies with these rule requirements.

10. Concluding comments

The purpose of this submission is to respond to a number of common themes that have emerged in the submissions lodged by stakeholders in response to our Revenue Proposal. This submission is not intended to address all of the matters raised by submitters, as some of those issues are relatively complex and more appropriately addressed through bilateral discussions. Nonetheless, it is hoped that this further submission clarifies a number of issues and promotes a constructive ongoing dialogue as the AER works towards its draft determination.