



**Tasmanian Small
Business Council**
Uniting Small Business

Australian Energy Regulator

TasNetworks' Electricity Distribution Regulatory Proposal, 1 July 2017 to 30 June 2019 and Tariff Structure Proposal

Submission

Acknowledgements & Disclaimers

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Executive Summary

This submission responds to TasNetworks Pty Ltd's (TasNetworks) *Regulatory Proposal* (the Proposal), for the period 1 July 2017 – 30 June 2019 lodged with the Australian Energy Regulator (AER) and TasNetworks' *Tariff Structure Statement (TSS) Proposal* also lodged with the AER. Both will have important implications for small business electricity price and we welcome the opportunity to respond.

Electricity is important to the health and vibrancy of the Tasmanian small business sector. Tasmanian small businesses have a need for competitively priced electricity.

Tasmanian electricity prices increased rapidly from 2007 until 2012 (well beyond inflation), after which there have been some welcome reductions, although nowhere near enough to offset the increases. Distribution charges make up around half of the electricity bills paid by small business, so they are important to us. They also accounted for 87 per cent of the increase in electricity prices between 2009/10 and 2014/15.

These increases in distribution charges and their underlying causes are of concern to us. Our goal is to ensure significant reductions in distribution charges in future.

In this regard, we welcome TasNetworks' recognition of the challenges currently facing the Tasmanian economy and the importance of delivering the lowest sustainable electricity prices and their acknowledgement that distribution prices have a key role to play in keeping electricity prices low

TasNetworks' Customer Engagement

We welcome TasNetworks' customer engagement activities and their continued improvement. We have made some suggestions in the submission for further improvements and also support the suggestions made by other consumer advocates. It is pleasing that TasNetworks has already responded positively to a number of these.

Planning and Reliability Performance

TasNetworks has outlined its planning processes, which appear reasonable on paper, but are difficult to assess from outside. One important development is that the merger of the Tasmanian transmission and distribution systems is delivering planning efficiencies. TSBC expects that to be clearly identified and fully delivered.

TasNetworks recognise that reliability targets in some low density rural areas have not been met. This is of concern to us and small businesses in affected areas and we welcome that TasNetworks proposes reinforcement programs targeted at the poorest performing areas.

Forecast Demand, Consumption and New Connections

There are grounds to believe that TasNetworks' maximum demand forecasts (1.2 per cent annually in its base scenario) for the next regulatory period is too high. For example, Australian Energy Market Operator (AEMO) forecasts for Tasmania are for zero growth in maximum demand over this period. These forecasts have an important bearing in the capital expenditure invested in the network and need to be set as robustly as possible. AEMO processes include updated forecasts mid-year.

TasNetworks' forecasts for electricity consumption are for 1.2 per cent annual growth. AEMO mid 2015 forecasts are for 0.5 per cent growth (medium scenario) but may be more bearish now given its recently reduced demand forecasts. It will update these in mid 2016.

TasNetworks forecast for new connections – a key driver for its development capex – may be too optimistic given they are derived from the same forecast of Gross State Product (GSP) used in its demand forecasts. The AER needs to establish that these forecasts are robust. Regarding its embedded generation connections forecasts (mainly roof top solar and photovoltaics), TasNetworks has used an arbitrary historical average. It could have sought expert advice to help establish a more robust forecast.

Capital Expenditure Forecast

TasNetworks expect to spend 5 per cent less than the AER's allowance on capex in this regulatory period. They forecast 6.6 per cent less capex over the following five years (\$556.2 million), which includes the next regulatory period. These reductions are welcome but there could be room for further falls as the previous round of AER regulatory determinations contained excessive amounts of capex. The mere fact that a reduction is forecast is not sufficient to establish that the forecast are efficient.

With a total of \$50.6 million forecast to be spent on connection capex over the next regulatory period, this accounts for around 80 per cent of TasNetworks' Development Capex. However, actual GSP growth, a key determinant of this item was 1.6 per cent in 2014/15, which is lower than the forecast outcome used by TasNetworks. Moreover, TasNetworks will face contestability for new connections work in the next regulatory period, which should lower the need for TasNetworks capex. TasNetworks has allowed for this by placing a cap on its capex for this item but the basis for this approach and its value has not been clearly explained. The AER should explore this more deeply.

TasNetworks supported its augmentation capex (augex) forecasts with the results of a commissioned application of the AER's Augex model to these. It claims this report provided "strong support" for the forecasts but the report uses the words "largely support", mentioned certain qualifications and suggested that the AER should not rely solely on its Augex model but use other assessment techniques as well.

Renewal and Enhancement Capex

TasNetworks forecast an increase of \$12.9 million (4.9 per cent) in this item over the five years from 2017/18 due to increased safety and reliability risks from asset age deterioration. However, they have undertaken a substantial asset replacement program over recent regulatory periods and the need to further increase this item is surprising.

TasNetworks commissioned an assessment of its replacement capex (replex) forecast using the AER's replex model. This confirmed that the forecasts were below the AER's benchmarks and *prima facie* efficient but noted several qualifications and suggested that the AER also apply other techniques.

IT and Communications Capex

Although this declines by 9 per cent in the five year forecasts provided by TasNetworks, it remains a significant element of capex at \$74.7 million, representing 13.4 per cent of total capex. The AER should establish that the forecasts are robust and efficient.

Included in this item are expenditures by TasNetworks for implementing Full Retail Competition (FRC) and a Rule change to make metering services competitive (the usefulness of which is still unknown in Tasmania). The TSBC is concerned that these expenses are being incurred when no retail competition exists in Tasmania or is likely.

Benchmarking

We strongly support the use of benchmarking to help establish an efficient level of capex and opex for TasNetworks'. This allows consumers to better assess expenditure proposals and feel more comfortable about the expenditure forecasts. As benchmarking is relatively new in electricity regulation it also needs to be allowed to evolve and develop.

TasNetworks has expressed a concern that the AER's current approach to benchmarking capex shows it as far less efficient than the AER's target benchmark. A key issue it has raised is that its network has unique aspects that need to be considered. The TSBC recognises that some unique aspects of a network may be a valid reason for adjusting benchmarks. However, taken to an extreme this could undermine the discovery of inefficiencies in networks and mute their need to improve their efficiency over time. The AER already has a long list of Operating Environment Factors (OEPs) for opex benchmarking and their application to a number of recent Determinations lead to significant upward

adjustments of 11 to 26 per cent in benchmark scores. Care is needed to ensure this does not begin to erode the efficiency increasing objective of benchmarking.

If the AER's benchmarking confirms the inefficiency of TasNetworks' capex, its forecasts should be adjusted downwards to reflect this and encourage greater efficiency in its capex.

Operating Expenditure Forecast

We welcome the 13.1 per cent reduction in opex in the next regulatory period proposed by TasNetworks. Efficiencies stemming from the merger of the Tasmanian transmission and distribution businesses are the main reason for the reductions. We are pleased to see TasNetworks delivering these.

TasNetworks has applied the AER's 'base-step-trend' approach to its opex forecasts.

It proposes to use 2014/15 as the base year for its opex forecasts (after deducting an abnormal component). This results in a base year opex of \$66.0 million for 2017/18. We accept this subject to the outcome of the AER's benchmarking confirming it as efficient.

TasNetworks proposes to add step change in costs amounts to this base of \$1.3 million and \$1.7 million in 2017/18 and 2018/19 respectively. We reserve our position on this pending assessment by the AER.

It further proposes that no zero-base expenditure be added and no real price escalators for labour and non-labour components, which we welcome.

TasNetworks proposes to deliver productivity gains in opex over the next two-year regulatory period amounting to \$20.3 million. This reflects savings from the merger and a commitment to keep total opex flat (in nominal terms) relative to the base year. The TSBC supports these merger based savings and TasNetworks commitment to hold opex flat in nominal terms, albeit a stronger commitment to reduce opex in nominal terms could have been adopted.

Regulatory Asset Base

TasNetworks Regulatory Asset Base has grown by 14.6 per cent over the current regulatory period (5 years) and by 69 per cent since 2008. Ratios presented at the AER's public forum show that the RAB has increased significantly in proportion to the number of customers and peak demand (a key driver for capex). This growth in the RAB is a concern, particularly as it reflects excessive levels of past capex, which continue to impact on distribution prices.

More welcome is the slowdown in the growth of the RAB to 7 per cent nominal and 2 per cent real over the next regulatory period, reflecting lower levels of capex. Nevertheless, the impacts of past asset growth is also still impacting distribution prices.

Regulatory Depreciation

TasNetworks applied the AER's method of determining depreciation and its standard and remaining asset lives are unchanged from its last Determination. The one exception is the 10 year life proposed for its Ajilis asset management and IT solution, which is much longer than normal for IT. We expect that the AER will make an independent assessment of this.

Weighted Average Cost of Capital

TasNetworks' annual revenue is very sensitive to the Weighted Average Cost of Capital (WACC), as are its prices. It has proposed a WACC of 6.04 per cent (nominal), a significant reduction on the 8.28 per cent allowed for its current regulatory period. The TSBC welcomes this reduction. Notwithstanding this, the main reasons for the fall in WACC results from falls in market interest rates.

We welcome TasNetworks' decision to adopt all but one of the AER's WACC parameters, although it reserved its right to change its position pending an appeal on three parameters, equity beta, cost of debt and gamma. This appeal has now been decided, with the AER's equity beta value confirmed but the other two not and subject to an AER court appeal. On this basis we would expect that TasNetworks will adopt the confirmed parameter.

We have expressed reservations about the values of two AER WACC parameters, the equity beta and the market risk premium, as we believe there are firm grounds for the AER to reduce these, with beneficial impacts on distribution prices.

We have also noted that the 60/40 (debt/equity) gearing ratio used by the AER does not reflect TasNetworks' actual debt gearing of more than 70 per cent.

Incentive Schemes

Our submission comments on TasNetworks' proposals for the opex, capex, service levels and demand management/embedded generation incentive schemes which apply to it.

The Efficiency Benefits Sharing Scheme (EBSS) provides incentives (ultimately shared with customers) for TasNetworks to improve its opex efficiency. It proposes to continue existing exclusions for these in the next regulatory period. We note that this removes the efficiency incentive on these items.

TasNetworks proposes to accept the AER's Service Target Performance Incentive Scheme (STPIS), which provides an incentive to maintain service levels when costs decrease, with one exception. Instead of the AER's revenue at risk in the range ± 5 per cent, it proposes limiting this to ± 2.5 per cent. We raise several issues about this and suggest that a preferred way forward, which is consistent with customer preferences that they did not want to pay

for service improvements but also did not want reductions, would be for a penalty of up to 5 per cent for below target service performance.

TasNetworks proposes expenditure of \$400,000 (June 2017 \$) per annum for the Demand Management and Embedded Generation Connection Incentive Scheme (DMEGCIS), a small increase on current levels. Small business may ultimately benefit through more reliable or lower cost electricity supply, or perhaps direct participation. However, TasNetworks' DMEGCIS projects must actually benefit customers and not duplicate other projects.

Total Revenue

We welcome the overall reduction in TasNetworks' Total Revenue, but points we have made in this submission about the individual building blocks that jointly determine revenue would further reducing revenue. We also note that the bulk of the reduction in total revenue is caused by the lower WACC, itself significantly driven by the exogenous impact of lower interest rates. Management induced reductions in revenue, whilst important, are of lesser magnitude and offset by other increases.

Prices

TasNetworks is forecasting real reductions in its distribution prices over the next regulatory period. For a typical small business customer this indicatively results in a reduction in their network bill from around \$1,800 per annum in 2016/17 to \$1,400 per annum in 2017/18. This represents a reduction of around 20 per cent in network charges for a typical small business, or 10 per cent of their total bill. Households also see reductions, but not as large. The TSBC welcomes these price reductions for small business.

Tariff Reform

TasNetworks has also submitted tariff reform proposals. These involve a move to cost reflectivity in existing tariffs, as well as more emphasis on standing charges; and the introduction of new tariffs using a combination of standing charges and demand based charges, initially on an opt-in basis.

For small business, a major attraction of the changes is the unwinding of inefficient cross-subsidies in small business tariffs, which recovers more than the efficient costs of serving these customers. The TSBC has been advocating for the removal of such cross-subsidies for some time and is pleased to see they are being removed.

However, the 15 year transition proposed by TasNetworks seems excessively long and we would prefer a shorter period, say until the end of the 5-year regulatory period following the next 2-year regulatory period.

We note the lack of detail in TasNetworks' tariff reform proposal, which makes it more difficult to assess and respond to. The AER should ensure that TasNetworks provides more of the detail needed for a robust assessment.

1 Introduction

This submission responds to TasNetworks Pty Ltd's (TasNetworks) *Distribution Regulatory Proposal, Regulatory Control Period 1 July 2017 – 30 June 2019* (the Proposal) lodged with the Australian Energy Regulator (AER). TasNetworks' proposal will have an important bearing on network charges paid by small business in Tasmania over the term of the next regulatory control period and feed directly into their retail tariffs. It also responds briefly to TasNetworks' *Tariff Structure Statement (TSS)* Proposal lodged with the AER. This is expected to significantly impact the cost reflectivity of the small business tariffs in Tasmania. The Tasmanian Small Business Council (TSBC) welcomes the opportunity to comment on the important matters raised in both Proposals.

In preparing this submission, we also considered various other related information, including the AER's *Framework and Approach Paper*, its *Issues Papers* for both the TasNetworks' Regulatory and TSS Proposals, other documents provided by TasNetworks as part of its proposals and released by the AER, and presentations to and other information gained from the AER's public forum held in Hobart on 17 March 2016.

1.1 Background to Tasmanian Small Business & the TSBC

Small business is the 'engine room' of the Tasmanian economy. There are more than 37,000 small businesses in Tasmania, 30,000 of which are employers, employing over 70,000 full and part-time people. Numerically, they make up in excess of 96 per cent of all businesses in Tasmania and the sector provides more than half of the State's private sector employment. Understanding the small business sector, its aspirations and needs is of vital importance to the enterprises themselves, as well as Government and regulators, as decision-maker. The resources to address the future needs of the state can only come from the generation of new wealth and healthy, vibrant small businesses are critical to this.

The Tasmanian Small Business Council (TSBC) is an "association of [small business] associations", each of which represents their market grouped industry sector. The TSBC seeks to provide the representative voice of small business in Tasmania. The TSBC's role in facilitating meetings of and forums for these trade associations, whose members are predominately small businesses, is paramount to providing informed insights and advice to governments and regulators.

An obvious difficulty for owners of small and micro businesses is the absolute necessity to spend their time working "in the business", while those with larger numbers of employees take a more managerial role and begin to spend some of their time working "on the

business". Small business is therefore even more reliant on groups such as the TSBC to develop and put forward informed policy positions to Government and regulators that truly represent their interests.

1.2 TSBC's Interest in TasNetworks' Proposal

Electricity is important to the health and vibrancy of the Tasmanian small business sector. Tasmanian small businesses have a need for competitively priced electricity that supports their competitive advantage *vis-à-vis* larger competitors in the local market, inter-state firms providing goods and services in Tasmania and international competitors (where they sell into export markets or compete against imports). Small businesses are also important input and labour suppliers to larger firms and provide support to them. Many of the competitors of Tasmanian small businesses have access to cheaper energy and to competitive energy offers. Tasmanian small businesses therefore suffer a disadvantage in these respects and the TSBC supports policy and regulatory steps to help redress this. Having access to a reliable supply of network services at prices that truly reflect efficient costs and therefore contribute to the provision of competitively priced electricity to Tasmanian businesses is important to the health of the Tasmanian economy.

Looking across the small business sector overall, electricity is a middle sized cost of production, typically making up between 3-5 per cent of total costs, although within some sectors, such as Tasmanian Independent Retailers, it can be substantially more. This, in itself, makes electricity important. However, its importance to small businesses in Tasmania is elevated by:

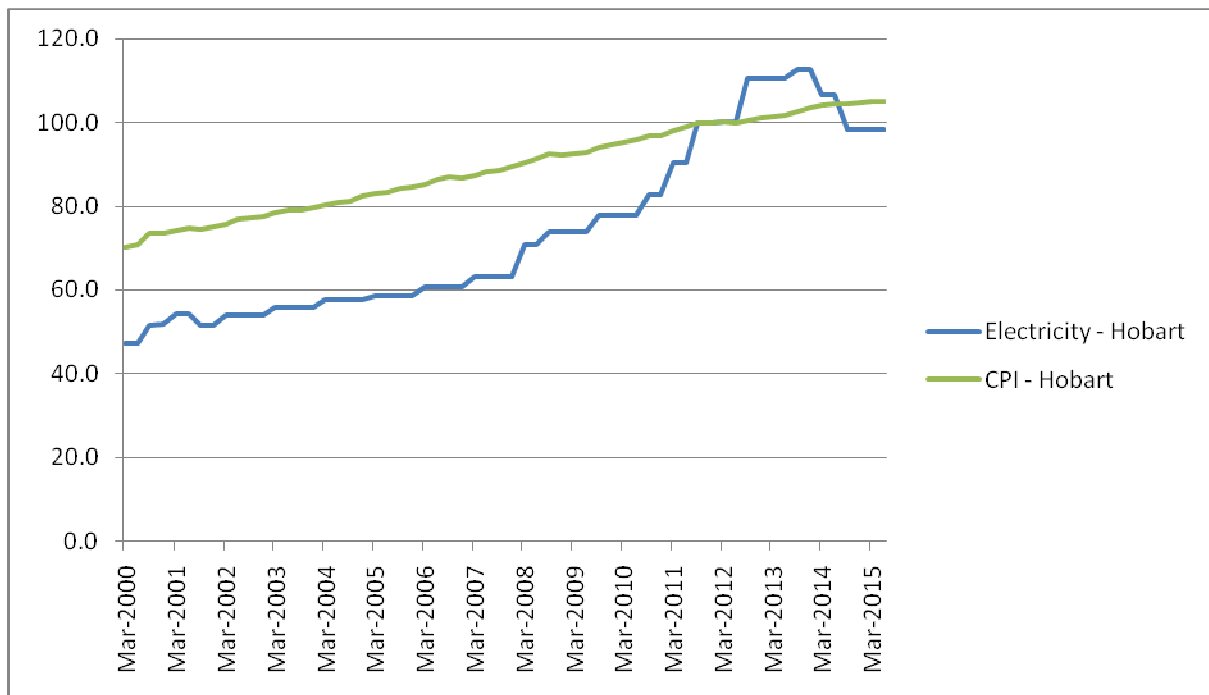
- The need to have access to a reliable source of supply, as many small businesses are heavily dependent on a continuous supply of electricity.
- The fact that some small businesses have energy costs well in excess of the average and, for them, access to competitively priced energy is particularly important.
- The large increases seen in Tasmanian electricity prices earlier this decade, which have affected small businesses (see Section 1.3). Many have been unable to pass on these cost increases due to the very competitive markets in which they operate and cannot access competing suppliers due to a lack of retail competition, making their competitive disadvantage worse.

We also note that small business, commercial and industrial customers, comprise approximately 15 per cent of the distribution system's customer base, but consume approximately 54 per cent of the electricity delivered by the distribution network. On this basis, TasNetworks should also have a strong interest in ensuring that its prices and operations support the electricity needs of its small business customers.

1.3 Electricity Price Trends in Tasmania

Tasmanian electricity prices increased rapidly from 2007 until 2012, after which there have been some welcome reductions but nowhere near enough to make up for the increases (see Figure 1 below). Moreover, the increases in electricity prices has been much faster than the rate of inflation, meaning that there have been large real increases in the price of electricity for Tasmanian consumers, including small business, albeit with falling real prices since early 2014.

Figure 1: Tasmanian Electricity Prices



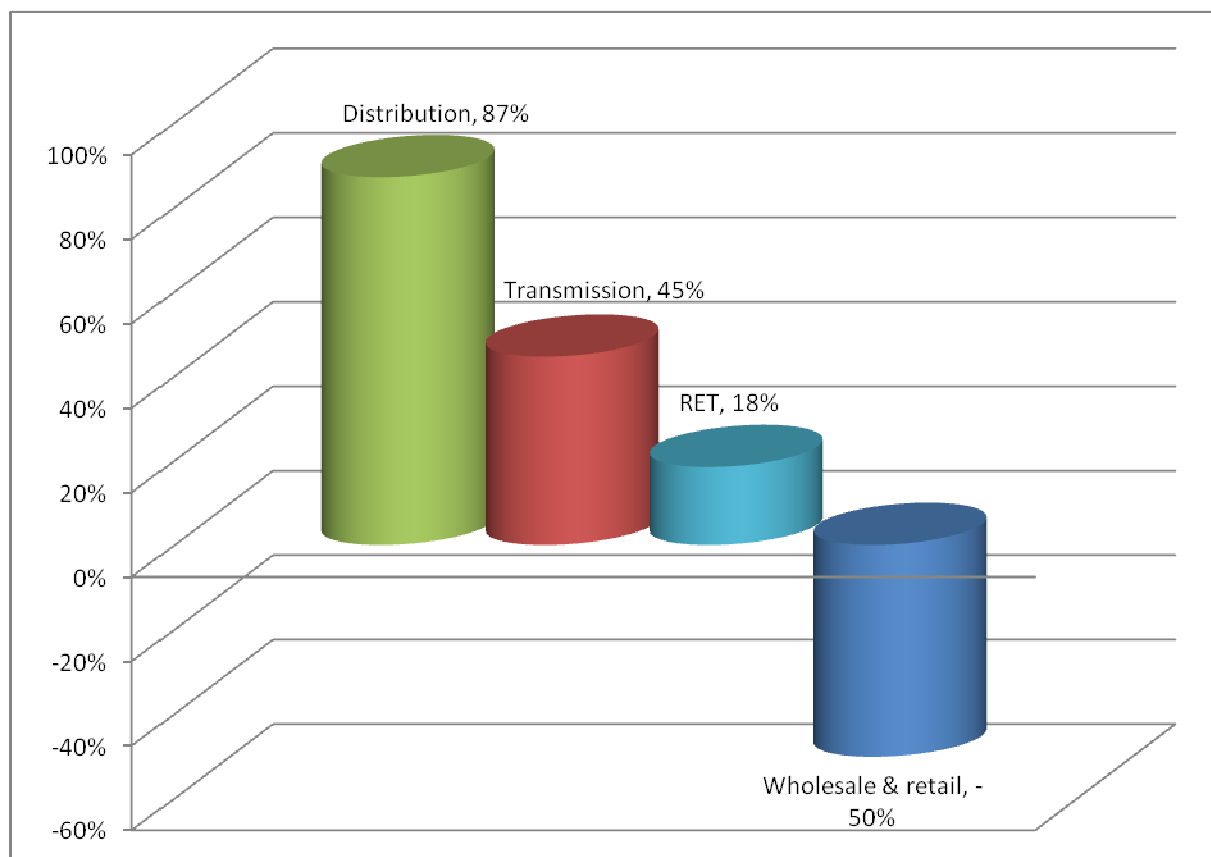
Source: Goanna Energy Consulting from ABS, 6401.0 Consumer Price Index, Australia, TABLE 11. CPI: Group, Sub-group and Expenditure Class, Index Numbers by Capital City

According to Goanna Energy Consulting, Tasmanian electricity prices increased by around 17 per cent from 2009/10 to 2014/15. Over the same period, the Hobart CPI increased by only 13 per cent.

As mentioned earlier, TasNetworks' distribution charges have an important bearing on small business retail electricity tariffs. Distribution charges make up around half of the electricity bills paid by small business and, as such, are the single largest component of their electricity bills.

Goanna Energy Consulting has decomposed the increases in Tasmanian electricity prices over this period according to the different elements of an electricity bill (Figure 2 below). This shows that distribution charges accounted for 87 per cent of the increase and transmission charges 45 per cent, a total of 132 per cent, whilst wholesale and retail charges were responsible for a 50 per cent drop in electricity prices, acknowledging that there were more modest increases and even reductions towards the end of the period.

Figure 2: Tasmanian Electricity Price Changes, 2009/10 to 2014/15



Source: Goanna Energy estimates based on AEMC 2015, 2015 Residential Electricity Price Trends, Final report, 4 December 2015, Sydney

The rapid increase in distribution charges and their large contribution to electricity price increases is of concern to the TSBC notwithstanding the reductions or more modest increases that have characterised recent years. They have left small businesses more vulnerable and we desire to see further reductions in network charges in future to enable small businesses to recover lost ground.

The TSBC would welcome significant reductions in these charges in future and believes they are achievable without any compromise to the reliability of electricity supplies. We look towards the TasNetworks regulatory proposal and the AER Determination to achieve this.

1.4 TasNetworks' Approach to Its Proposal

In this regard, we welcome a number of aspects of the TasNetworks Proposal including:

- Their recognition of the challenges currently facing the Tasmanian economy and the importance of delivering the lowest sustainable electricity prices to support economic growth (p. 34). As we pointed out in Section 1.1, small business plays a vital role in the State's economy.
- Their acknowledgment that, with network costs presently making up over half of the average Tasmanian electricity bill, TasNetworks have a key role to play in keeping electricity prices low, while delivering safe and reliable services (p. 35).
- Their stated focus to reduce costs and increasing efficiency (p. 35).
- Their customer strategic goal, which is to "understand our customers and make them central to all we do", with the ultimate aim of improving price, service and reliability outcomes for customers (p. 36).

Small business should be a beneficiary of this approach and we support it. Bearing this in mind, we intend to focus this submission on assessing the TasNetworks Proposal from the perspective of how well it delivers on the points above and the small business need for distribution prices that contribute significantly to our objective of competitive electricity prices and a reliable supply.

1.5 Outline of This Submission

This submission is structured as follows:

- The next section covers TasNetworks' customer engagement activities.
- Section 3 covers planning and performance issues.
- Section 4 covers TasNetworks forecast of demand, electricity consumption and network connections.
- In section 5 we discuss TasNetworks capex forecasts.
- Section 6 deals with the opex proposals.
- Section 7 addresses the Regulatory Asset Base.

- Section 8 covers Regulatory Depreciation.
- In Section 9 we discuss the Weighted Average Cost of Capital.
- Section 10 focuses on Incentive Schemes that apply to TasNetworks.
- Section 11 comments on TasNetworks' Total Revenue, its X-factors and indicative distribution prices.
- Finally, section 12 comments on TasNetworks' TSS Proposal.

2 TasNetworks' Customer Engagement

We welcome TasNetworks' customer engagement strategy, processes and endeavours including:

- Its *Voice of the Customer Program*, including its focus on quality service outcomes, the creation of trust by its customers, engagement with them and recognition that the needs of customers will differ, but:
 - We note that the focus of this program, as outlined in the Proposal (p. 37), does not mention the need to keep distribution prices low or provide customers with value for money (which is critical to small business), and was the most important issue raised in TasNetworks' customer engagement. Its program would be improved from adding this as an area of focus.
- TasNetworks' Revenue Reset Engagement Plan and the specific consultation activities resulting from this although we continue to have some concerns as to how well TasNetworks has responded to the issues raised by customers, for example:
 - In relation to its Tariff Reform Working Group, we are aware through participation in this and the associated process, from discussions with other participants and from comments made at the recent AER public forum that some people feel that their comments were not listened to, or acted upon, effectively enough.

We have found TasNetworks willing to engage with us when requested to do so. This applies to its transmission reset, this Proposal and its TSS. In terms of this Proposal and the TSS, our consultants, Goanna Energy, meet with TasNetworks in Hobart on 17 March 2016 to discuss a number of relevant matters.

TasNetworks' customer engagement processes lead to a number of key messages (pp 40-1), the highest priority ones being:

- Cost is the greatest concern to customers and lower prices - without reducing service quality - would lead to the greatest uplift in satisfaction.
- Customers are not willing to pay higher prices for reliability improvements.

These messages were reflected in the areas for improvement that resulted from the TasNetworks' customer engagements. In addition, improving the quality of service was mentioned, which is an important issue for a number of small businesses.

We would expect these messages and nominated areas for improvement to be reflected in the TasNetworks Proposals and will consider this in our comments in this submission.

Suggestions were also made for how TasNetworks could improve its customer engagement (listed on p. 41), namely more regional consultations, allowing sufficient time to respond and recognising that customers often lack the technical knowledge to respond to complex issues in detail. We support these and welcome that the Proposal mentions ways in which TasNetworks intends to respond. In relation to the latter, we believe that TasNetworks could improve responses by keeping information to the general public simple (recognising that it is already making such attempts) and through engaging with consumer advocates on matter of detail.

Finally, we welcome that TasNetworks has acted on its commitment, made at the time of its transmission reset, to continue to improve its customer consultation processes. Several improvements are evident in its distribution Proposal and TSS, although there are also areas where TasNetworks could do better and hopefully it will continue to improve both its customer engagement and how it acts on this.

3 Planning and Performance

This section comments on TasNetworks' planning processes and its network performance.

3.1 Planning

This includes TasNetworks' risk management framework, adoption of a single planning process following the merger, the asset management framework, investment governance and works delivery organisational arrangements. What is set out appears reasonable but we find it difficult to make an informed assessment as this would need information about how the processes affect internal decision making and operations. We note that what can appear reasonable on paper may still result in inefficiencies and higher costs than necessary. We expect that the AER will be better placed to make an informed assessment of this although it also faces an asymmetry in information.

The Proposal says that TasNetworks' "planning processes have changed as a result of the merger of the transmission and distribution networks. While these changes are currently in the 'bedding down' phase, the benefit of transmission and distribution integration is reflected in our expenditure plans." The main reason given for the merger was that it would result in economies of scale and reduce costs. We therefore believe that it is very important that TasNetworks achieve lower costs through the merger and pass these on to consumers. Its Proposal needs to reflect this in a concrete and robust way and show clear evidence that the foreshadowed gains are being realised in a timely way. At the time, at least \$8 million in savings were foreshadowed. The AER needs to confirm that this has happened.

In relation to planning we raise the following points:

- We welcome that the merger has allowed TasNetworks to develop integrated capital and investment plans to minimise expenditure and maximise availability through coordinated renewals and maintenance, minimised maintenance and bundled contracts. How these benefits have impacted the capex and opex proposals could be more clearly spelt out and should be confirmed by the AER.
- The Proposal (p. 44) says that the goal of TasNetworks' asset management framework is to deliver the required level of service in the most cost effective manner, through the prudent and efficient management of assets, with assets replaced on the basis of asset condition and risk, rather than age. Efficiencies are achieved by adopting a holistic approach to asset renewals, augmentations and decommissioning, across both transmission and distribution networks. TasNetworks

need to outline (preferably quantified) how these factors have affected its expenditures and the AER should confirm this.

- It further says (pp 47-8) that its investment governance arrangements are centred on robust investment evaluation processes, and a gated investment approval framework, which includes taking account of feedback from consumers, cost effectively meeting legal and regulatory obligations and ensuring that capex is prudent and efficient. TasNetworks needs to show (preferably quantified or through examples) how these factors have affected its expenditures and the AER should confirm this.
- The Proposal describes (pp. 48-9) how TasNetworks has arranged its works delivery team following the merger. It says that this provides the 'leanest' and lowest cost, is focused on the needs of customers, provides flexibility between internal and external workforces, tightens the links between the delivery of work and their 'enablers', ensures a lean and stable team and facilitates efficient data capture. It would be helpful for TasNetworks to illustrate in a concrete way how this has impacted its Proposal and for the AER to confirm this.

3.2 Performance

The Proposal recognises that TasNetworks has not met its reliability targets (or the AER's targets), particularly for customers served by its low density rural network. This is a concern to the TSBC and affected small businesses, but we note that TasNetworks is proposing reliability reinforcement programs to restore the performance of the poorest performing reliability communities and feeders.

In relation to benchmarking of TasNetworks' performance, we comment on this in the sections on capex (5.4) and opex (0) below.

4 Exogenous Forecasts

This section covers TasNetworks' forecasts for maximum demand, electricity consumption and connections. These are important for determining forecasts for capex and also opex.

4.1 Maximum Demand

Using National Institute of Economic and Industry Research (NIEIR) forecasts prepared for its Proposal, TasNetworks forecast base level growth of 1.6 per cent annually (0.6 per cent under its low scenario). However, we note that the most recent (December 2015) maximum electricity demand forecasts prepared by the Australian Energy Market Operator (AEMO) are for zero growth in maximum demand in Tasmania (10 per cent probability of exceedance) over the regulatory period of this Proposal. AEMO has revised its forecasts down compared to those it published in mid-2015. Given the important role of this forecast, particularly in setting capex, the AER needs to ensure that it sets a robust and realistic forecast. In any case, AEMO will have more recent forecasts available in mid-2016.

4.2 Electricity Consumption

NEIR has also prepared TasNetworks' electricity consumption forecasts of 1.2 per cent annually for its base scenario (0.3 per cent for its low scenario). These forecasts appear high relative to those provided by AEMO in the middle of 2015 which were for 0.5 per cent for its medium scenario and 0.1 per cent for its low scenario. As AEMO has more recently revised its maximum demand forecasts downward, it is likely that it would now have a more bearish outlook for electricity consumption. It will update these in mid-2015, prior to the AER's Draft Determination.

4.3 New Customer Connections

The Proposal provides forecasts for new connections, which are a key input to TasNetworks' new connections capex for the forthcoming regulatory period. Forecasts are provided for residential and commercial connections (both basic and complex), irrigation (both basic and complex), as well as for embedded generation (mainly roof top solar installations). In regard to new residential and commercial connections, each forecast involves a significant upturn in the initial year of the next regulatory period, followed by a slight decline.

Based on the recent flat performance of the Tasmanian economy and declines in its housing/construction sector (both key determinants of new connections), we have significant doubts about the level of new connections being forecast by TasNetworks, especially in the first year of the regulatory determination. Moreover, we note from TasNetworks' *Customer Connection Forecasts 2015* that these forecasts are based on a one

year lag of the four year rolling average of growth in Gross State Product (GSP) produced by NEIR for use in TasNetworks' electricity demand and consumption forecasts, which we have pointed out, appear to be too optimistic. As GSP growth is a key input into these forecasts, we believe that AER needs to establish that TasNetworks' forecasts for new connections are robust and realistic.

In relation to embedded generation, TasNetworks' has adopted a historical average of connection volumes (after taking account of some abnormal historical impacts) in the absence of an appropriate forecasting indicator and uncertainty about future growth. We recognise the difficulties that TasNetworks has in forecasting these connections, but are not convinced that its approach is sufficiently robust. For example, it could have sought external advice on this and the outlook for electric vehicles, which would also be consistent with its emphasis on technological innovation as a business driver. AECOM's June 2012 final advice to the AEMC, "*IMPACT OF ELECTRIC VEHICLES AND NATURAL GAS VEHICLES ON THE ENERGY MARKETS*", provides a basis for projecting such connections, and work being undertaken by the University of Tasmania provides further detail.

5 Capital Expenditure Forecast

TasNetworks expects to spend \$595.3 million in total on capex in the current regulatory period, a reduction of 5 per cent on the AER's regulatory allowance. We welcome this reduction and note that it will make a contribution towards the goal of lower distribution prices which TasNetworks is seeking to deliver and which the TSBC supports. It forecasts capex of \$556.2 million over the next five years, a further reduction of 6.6 per cent. Again this is welcome.

TasNetworks further says that this represents the minimum efficient investment it requires in order to meet its compliance obligations, and to maintain an efficient balance between cost and reliability. It also maintains that this contains no 'ambit claims'.

Nevertheless, the TSBC would like to be assured that this capex proposal is the minimum level needed and looks forward to a rigorous assessment of it by the AER. Meanwhile, we have undertaken our own assessment and provide commentary below based on this.

At the outset, we are concerned that, notwithstanding the reductions mentioned above, TasNetworks capex may still be impacted by a period of overspending on capex by network service providers. This was a well known problem with the previous round of AER regulatory determinations and resulted in a number of rule changes designed to curb capex excesses. It is difficult for us to assess how much this continues to influence TasNetworks' capex but the mere fact that TasNetworks has reduced its capex and plans to continue to reduce it further is not to say that its capex is efficient. Therefore, we do not necessarily accept TasNetworks' comment that:

The reduction in our forecast capital expenditure should provide stakeholders with confidence that our proposed expenditure is efficient (p. 74)

Rather, how it sets its capex and what it proposes to spend in the next regulatory period needs to be rigorously scrutinised and tested.

We also note that capex forecasts are based on certain assumptions regarding forecasts for demand, new customer connections and capital contributions, together with projections for distributed generation and soundly based investment evaluations. TasNetworks notes that if these prove incorrect, there may be material impacts on capex. In this case, customers could be asked to pay more. Whilst we appreciate that forecasts cannot be guaranteed, we are not convinced that TasNetworks has sufficient incentives to minimise this risk, and with a short (two year) regulatory period forecasting accuracy should improve.

5.1 Development Capex

TasNetworks' proposes a 14.9 per cent reduction in development capex from the current regulatory period (\$179.6 million) to the next five years (\$152.9 million). This is responsible for nearly 70 per cent of the reduction in total capex planned for the next five years. We welcome this reduction. However, as this item is heavily influenced by maximum demand and new connections we refer back to our earlier queries on TasNetworks' assumptions about these. This could result in some over-estimation of the need for development capex over the next five years, including the next two year regulatory period. We recognise that the shorter two year regulatory period somewhat reduces uncertainty about the forecasts.

5.1.1 Customer initiated capex

The main component of Development Capex is Customer Initiated Connections, which accounts for about 80 per cent of the total forecast for the next regulatory period. A total Customer Initiated Connection capex of \$50.6 million is forecast. The annual average forecast is around \$3 million less than the expected outcome for the current regulatory period. Nevertheless, we have several issues with this forecast that we believe the AER should examine more closely:

- A key driver for the forecast is GSP growth, using a one year lag of the 4 year moving average, as derived by TasNetworks from the data provided by NEIR. NEIR forecasts for GSP show a medium scenario growth rate of 1.9 per cent in 2014/15, which influences the capex forecasts for the next regulatory period. We note that the ABS reports a GSP growth rate of a more subdued 1.6 per cent for 2014/15. Given that actual data for 2015/16 will be available for the Draft Determination, the actual numbers should be used to update TasNetwork's forecast.
- TasNetworks will face a contestable environment for new connections for the first time during the next regulatory period. This is expected to place downward pressure on TasNetworks' new connections capex due to both less demand for TasNetworks' services and as competition should lower its unit connection costs. TasNetworks has recognised this in its new connections capex forecasts by placing a cap on capex for the next regulatory period. Whilst contestability for this service adds uncertainty to connection capex forecasting, TasNetworks has not clearly explained why it chose the cap approach or how it has done this. The AER needs to delve more deeply into this to establish its robustness.

5.1.2 Reinforcement capex

We note that the reinforcement capex forecast is dependent on, *inter alia*, the demand growth forecast and the forecast of new connections. Hence, our comments above on each of these could have implications for the reinforcement capex proposal. If so, the AER should review this item and its specific elements outlined in the Proposal (pp 76-7).

5.1.3 Application of the AER's Augex Model

TasNetworks engaged Nuttall Consulting to provide an assessment of its augmentation capex (augex) proposal using the AER's Augex model. It says in its Proposal (p. 77) that Nuttall "provided strong support for our forecasts." In fact, Nuttall used the more qualified term "largely support". We acknowledge that TasNetworks' augex forecast generally benchmarked well when compared to business-as-usual and its peers but believe that its position overstates Nuttall's level of support for the following reasons:

- Nuttall concluded that over the two-year assessment period covering TasNetworks' next regulatory period, the results are less supportive than for the full five years forecast, due to TasNetworks' higher per annum forecast over this period.
- It also said that the two-year period is most likely too short for a reliable assessment using the augex model. It suggested that the AER also use other assessment approaches.
- We also note that Nuttall was able to assess only 60 per cent of TasNetworks' augex forecast, so 40 per cent was not assessed through the model.
- Nuttall pointed out that its analysis is sensitive to TasNetworks' peak demand forecast, with the model forecasting a similar level of change in augex for the change in this assumption. We have raised some issues with TasNetworks' peak (maximum) demand forecasts earlier in this submission suggesting they may be too high.

5.2 Renewal and enhancement capex

TasNetworks' total renewal and enhancement capex in the current period is \$263.3 million. For the subsequent five-year period they forecast an increase of \$12.9 million (4.9 per cent) in expenditure to \$276.2 million. TasNetworks (p. 79) justify the need for increased expenditure by "the need to address increased safety and reliability risks associated with age-related asset deterioration."

We recognise that these are important factors in forecasting replacement capex and that consequently this category of capex will be less variable. Nevertheless, TasNetworks has undertaken a substantial asset replacement program over recent years and we are somewhat surprised by its need to forecast a further increase in replacement capex over the next five years.

We are also aware that TasNetworks has detailed plans and methods in place to determine forecasts for each component of its replacement capex program. It is problematic for an external party such as the TSBC to comment on and effectively second guess TasNetworks' detailed bottoms-up assessments. However, we expect that the AER will undertake assessments using techniques such as application of its repex model, category assessment

benchmarking and reviewing TasNetworks' detailed replacement capex plans. This is especially important given the forecast increase in replacement capex.

5.2.1 Application of the AER's Repex Model

TasNetworks engaged Nuttall Consulting to provide an assessment of its replacement capex (repex) proposal using the AER's Repex model. It says in its Proposal (p. 80) that Nuttall's "analysis provides strong support for our forecasts." We have examined Nuttall's report which confirms TasNetworks' comment. The report found that TasNetworks' forecast repex benchmarked well, being significantly below the AER repex model forecasts for both its 5 year and 2 year forecasts. Asset lives and unit costs were also below the AER's inter-company benchmarks. Nevertheless, Nuttall raised the following points:

- Concerns about the appropriateness of the AER's model, given that it always produced forecasts well above TasNetworks' own forecasts, particularly the overhead conductor and transformer groups. TasNetworks has pointed out that this could be due to a material share of assets being replaced through its network augmentation and customer connections activity, so that these do not enter the repex model. This caused Nuttall to comment (p. 22 of their Repex report):

"Consequently, the volumes used for the historical calibration was understating the true volumes, and therefore, the calibrated life would be too long."

- Though the results of Nuttall's alternative scenario to test for this issue still confirmed that TasNetworks' forecasts were below those of the AER, it is worth mentioning that time constraints prevented Nuttall from developing accurate replacement estimates for their alternative repex scenario and they relied on assumptions instead. Many of these seem rather arbitrary.
- Nuttall also found that TasNetworks' forecast was 5 per cent above the repex model study over the two-year regulatory period. However, they noted that this period is too short for a reliable assessment through the model. They suggested that the AER apply other techniques to determine the appropriateness of the repex forecasts.

Given the above and the increase in repex forecast by TasNetworks for the next regulatory period, we believe that the AER needs to apply its repex model cautiously, should apply Nuttall's alternative scenario but with accurate data to determine its real impact and should apply other techniques to repex for the two year regulatory period.

5.3 IT and Communications Capex

This is forecast to reduce from an expected \$82 million in the current regulatory period to \$74.7 million over the following five years, a decline of 9 per cent. Such a reduction is

welcome, however TSBC believes it is appropriate to challenge the need for the scale of such investment (both the \$82 million and the \$74.7 million) in what is a very small network business, with a capex program which totals \$481.5 million excluding IT.

TSBC does not claim expertise in this field but has a strong expectation of “fit for purpose”, and with it “fit for scale”. Given the recent experience with Aurora Energy’s implementation of its Retail IT systems, with final costs being a factor of some five times initial estimates, we suggest the AER should scrutinise the proposed IT investments with considerable vigour, in order to assess prudence and efficiency. That scrutiny should also apply to the \$82 million in the current regulatory period.

TSBC notes the flow on of IT capex into opex, typically at 10% per annum, and accordingly is strongly of the view that total IT costs passed through to small business customers should reflect the concepts of “fit for purpose” and “fit for scale” as noted above, and nothing more.

Expenditure on implementing FRC and the AEMC’s Metering Rule Change is proposed under this category. Whilst these expenditures relate to external policy decisions, the TSBC wishes to register its concern with these expenditures given that small customers have no choice of retailer in Tasmania, and that the metering rule change relies on retail competition being effective to justify its costs, which could be substantial. This makes any expenditure dubious with no demonstrable benefit delivered to customers.

We note that TasNetworks intend to revisit their forecasts under this item after the AER’s Draft Determination.

5.4 Benchmarking Capex

The TSBC strongly supports the use of benchmarking techniques to help establish an efficient level of capex and opex for TasNetworks’ regulatory determination. Without benchmarking there is reliance on a bottom-up assessments of TasNetworks’ proposals and consumers face an enormous information asymmetry. As was its intended purpose, the introduction of benchmarking allows consumers (and the AER) to better assess and establish the efficiency of the expenditure proposals of network businesses such as TasNetworks.

As benchmarking is relatively new in the context of the regulation of Australian electricity networks, it is still being developed (and hopefully improved over time). It needs to be allowed to do this, as has happened overseas, and we fully expect that there will be some changes in approach and methodology as this development proceeds. In our view, the effort will be worth it – for customers and networks – as a far more robust means of assessing network expenditure forecasts will emerge.

TasNetworks has expressed some concerns about the AER’s benchmarking of its capex, with the AER’s current approach showing TasNetworks’ capex as far less efficient than the AER’s

benchmark. One issue it has raised is that the AER's raw scores do not take account of unique aspects of its network, for example, the impact that the quantum, location and density of demand in its rural areas have on key inputs to the AER's calculations, especially overhead lines and transformers. We note that the AER has acknowledged the uniqueness of its circumstances and has urged caution when interpreting its benchmarking score.

In our view, care is equally required in placing too much weight on the so-called unique aspects of networks in applying benchmarks. Taken to the extreme, such an approach could quickly erode any worthwhile contribution that benchmarking could make to AER Determinations. The AER therefore needs to find an appropriate balance, which recognises legitimate differences between networks that can bias benchmarking outcomes (e.g., factors beyond a networks' control) but at the same time not allow erroneous differences to overwhelm or undermine the legitimate use of benchmarking.

Indeed, we note that the AER has already included a range of such environmental factors, called Operating Environment Factors (OEFs), in its benchmarking results for 2015. It has also made *ex post* adjustments to take account of them in individual determinations.

We are concerned that the unique aspects raised by TasNetworks in relation to benchmarking of its expenditures are asymmetric, i.e., they all potentially improve its relative standing if applied. However, it is possible that there are also OEPs that influence the AER's adjusted benchmarking scores in opposite direction and would lower TasNetworks' relative position. Of course, it is very unlikely that network businesses would draw attention to these.

We note the long and extensive list of OEFs which the AER has developed for opex benchmarking and the significant impact they have had on the adjusted benchmark results adopted for the New South Wales and Queensland distributors, where OEF adjustments upwards of between 11 and 26 per cent have been applied. In our view this could begin to undermine the purpose of benchmarking in providing incentives for inefficient networks to become more efficient.

Benchmarking should encourage greater efficiency. Potentially, the overuse of OEFs could interfere with this important objective by muting the key efficiency drivers. In the commercial world, including in the Tasmanian small business sector, the safety of applying OEFs to adjust raw benchmarking results does not apply. Rather the cut and thrust of competing firms automatically benchmarks one firm against another with commercial survival ultimately at stake. Inefficient firms must become more efficient regardless of what unique conditions they face or exit the market. We note that one key goal of incentive regulation as applied by the AER is to mimic a competitive market for network services, if one could be created. The application of benchmarking is a key to this goal.

TasNetworks and its consultants Huegin have raised some questions about the current AER approach to benchmarking, including its OEF approach. We do not necessarily agree with these points but we assume they are a genuine attempt to raise issues intended to improve the application of benchmarking to AER Determinations so that more robust forecasts of capex and opex can be included in AER decisions. Naturally, we would not support changes merely intended to show individual distributors in a better light.

We are concerned that the AER's benchmarking consistently shows TasNetworks' capex is much less efficient than other benchmarked businesses. Subject to the results of the AER's benchmarking of TasNetworks' capex forecasts, if this is confirmed, we believe it provides additional grounds to reduce TasNetworks' capex forecasts for the next regulatory period.

6 Operating Expenditure Forecast

TasNetworks proposes an average annual total opex of \$61.6 million (real) per annum over the next regulatory period. This is a reduction of 13.1 per cent compared to the annual average over the current period. This is a significant reduction and the TSBC welcomes it.

Efficiencies stemming from the merger are the main reason for the reductions in the forthcoming regulatory period. TSBC has an expectation that the merger will deliver significant opex savings and that these will be immediately passed on to small business. We are pleased to see that TasNetworks proposes this.

TasNetworks have also pointed out that, while its opex forecast assumptions are reasonable, if they prove incorrect, there could be a material impact on actual opex. Given the shorter two-year regulatory period for this Determination, we expect that TasNetworks opex forecasts (and the AER's allowance) will be very close to actual outcomes. The quality of the forecasts would be highly questionable if this were not the case.

6.1 Base-Step-Trend Opex

TasNetworks' operating expenditure forecasting methodology essentially follows the base-step-trend approach adopted by the AER. We comment on this below.

6.1.1 Base Year Costs

TasNetworks proposes to use 2014/15 as the base year for its opex forecasts over the next regulatory period. After deduction an unusually high Guaranteed Service Level (GSL) payment of \$2 million, this results in a base year opex of \$66.0 million. TSBC agrees with this selection as reasonable on the grounds that it is the most recent full year of actual opex available and incorporates efficiency gains in opex achieved in that year.

Beyond this, it is also necessary for TasNetworks to verify that the base year expenditure is efficient. It points to cost savings delivered during the current regulatory period as evidence of this. We accept that this reflects more efficient opex than previously but not necessarily that this shows its opex is relatively efficient. This requires the application of opex benchmarking by the AER. The impact of this will not be known until the Draft Determination and we may well comment further in our submission on that. However, as pointed out earlier, we have some concerns with the current OEF approach of the AER and its impact on the incentives for networks to become more efficient. We would urge the AER to ensure that this is not the case for the TasNetworks Distribution Determination.

6.1.2 Step Changes in Costs

TasNetworks proposes to add step changes totalling \$1.8 million and \$2.3 million in 2017/18 and 2018/19 respectively. These relate to a range of factors summarised in the proposal and TasNetworks says (p. 100) they “have taken care to ensure that the forecast expenditure reflects the efficient costs of providing the required outcomes.” We reserve our position on these pending a detailed assessment of TasNetworks’ proposals by the AER.

6.1.3 Output Growth

TasNetworks proposes to add output growth changes totalling \$1.3 million and \$1.7 million in 2017/18 and 2018/19 respectively. Earlier in this submission we raised some issues with TasNetworks’ forecasts for new connections which would impact on output growth. We therefore reserve our position in relation to TasNetworks output growth proposals, pending the AER’s consideration of these forecasts.

6.1.4 Zero-base Expenditure

TasNetworks does not propose any expenditure under this item. We accept this.

6.1.5 Real Price Escalation

TasNetworks does not propose any real price escalations in its labour and non-labour costs for the next regulatory period, notwithstanding evidence to the contrary. They say in their Proposal (p. 102) that this reflects their “commitment to addressing customers’ concerns about electricity prices and the need for us to strive to deliver services for the lowest sustainable cost.” We support this position.

6.1.6 Productivity Growth

TasNetworks is proposing productivity gains amounting to a \$20.3 million saving in opex over the next regulatory period. They point out that:

This reflects our response to the feedback of customers and other stakeholders, who reasonably expect the merger of the transmission and distribution networks to deliver further cost savings, and that we should be working hard to deliver such savings. ... [And] our commitment to managing our total operating expenditure so that it remains flat in nominal terms relative to the 2014-15 base year (p. 103)

We strongly support the need for TasNetworks to maximise the savings in opex that result from the merger. However, we also support their total opex commitment, albeit that we believe a stronger commitment to reduce opex in nominal terms could have been pursued.

We note that TasNetworks has adopted a different approach to productivity growth than that adopted by the AER in recent Determinations. It is therefore uncertain if the AER will accept this. Nevertheless, we wish to put on record that, whatever approach is adopted, we expect the outcome of this Determination to deliver the cost savings inherent in the merger and to at least keep opex flat in nominal terms.

6.2 Other Opex

TasNetworks proposes that two additional opex items be included, namely:

- Self insurance costs of \$0.9 million per annum.
- A benchmark debt raising cost allowance of \$1.1 million per year.

If these items are included in TasNetworks opex for the next regulatory period, we expect the AER to establish that they are prudent and efficient.

7 Regulatory Asset Base

TasNetworks proposes an opening distribution Regulatory Asset Base (RAB) of \$1,656.7 million (nominal) at the beginning of 2017/18. At the beginning of the current regulatory control period (2012/13) the opening RAB was \$1,445.2 million. This is an increase of \$211.5 million, or 14.6 per cent in 5 years. Moreover, compared to the beginning of the previous regulatory determination (2008) when TasNetworks distribution's opening RAB was \$981 million, the increase is \$675 million, or 69 per cent (in a little under a decade). This growth in TasNetwork's RAB is a concern to the TSBC, particularly as it reflects excessive levels of past capex, which continue to impact on the distribution prices of Tasmanian small businesses. We also point out that it sits oddly with TasNetworks' stated desire to address customers' concerns about electricity prices and strive to deliver services for the lowest sustainable cost.

We note that the representative of the AER's Consumer Challenge Panel (CCP) also expressed the Panel's concerns about the RAB and presented information showing that, since 2006 TasNetworks' real RAB per customer had increased by 27 per cent and its real RAB per MW of peak demand by 60 per cent.

As TasNetwork's capex for the current regulatory period is below its allowance and no other grounds appear to be triggered, there appears to be no reason for the AER to conduct an efficiency review of TasNetworks' capex over the current regulatory period. This entrenches the high RAB.

TasNetworks has forecast a closing RAB of \$1,763.2 million (nominal) and \$1,678.3 million (real) at the end of the next regulatory control period. This represents increases of 7 per cent (nominal) and 2 per cent (real). This is a pleasing reduction on the recent growth in RAB, reflecting lower levels of capex in recent years and proposed for the next regulatory control period.

8 Regulatory Depreciation

TasNetworks has applied the AER's method of determining depreciation and (with one exception) the standard and remaining asset lives are unchanged from its last AER Determination. The exception relates to its asset management and IT solution, Ajilis, for which it is proposing a new asset category for the next regulatory period with a 10 year life as Ajilis will continue in use for a longer period than normal for such systems. We expect the AER to make an independent assessment of TasNetworks' proposed asset life for the Ajilis system.

9 Weighted Average Cost of Capital

TasNetworks has proposed a Weighted Average Cost of Capital (WACC) of 6.04 per cent (nominal). This is a significant reduction compared to the WACC allowed for its current regulatory period (8.28 per cent). TasNetworks' annual revenue is very sensitive to the value set for WACC, as are its prices. We therefore welcome the reductions in both that would follow from TasNetworks' WACC proposal, which would make a significant contribution towards TasNetworks' desire to address customers' concerns about electricity prices and strive to deliver services for the lowest sustainable cost.

However, we note that the key reasons for the reduction in WACC relate to falls in market interest rates which impact on the risk free rate. Without these the WACC proposed by TasNetworks would be significantly higher, as would its distribution prices in the next regulatory period.

TasNetworks proposes to adopt all but one of the WACC parameters currently used by the AER. We welcome this decision but note that TasNetworks has reserved the right to revisit this proposal. If it did so, it is likely that its preferred WACC would increase as would its distribution charges in the next regulatory period.

The main reason for qualifying its proposal is that the Australian Competition Tribunal (the Tribunal) was still considering an appeal by New South Wales and ACT distributors on key WACC parameters, namely, the return on equity, the return on debt and the corporate tax allowance at the time TasNetworks submitted its Proposal. The Tribunal has since made decisions which uphold the AER's decision on the equity beta, a key determinant of TasNetworks return on equity. We expect that TasNetworks will now confirm its adoption of the AER's value for this parameter (0.7).

The Tribunal did, however, find against the AER in relation to it adopting a 10 year transitional period for a distributor to move to its new 'trailing average' method of determining the return on debt. The Tribunal also determined that the AER's preferred estimate for the value of imputation credits, gamma, a key determinant of the corporate tax allowance, was too high. The AER had set gamma at 0.4 and the Tribunal has set it at 0.25. As a result, the AER is required to remake its decision. The impact of these two decisions will increase Distributors' revenues and their distribution prices.

The AER has recently appealed to the Federal Court for a judicial review of the Tribunal's decisions. The timing of this appeal is unclear as are its impacts for the return on debt and gamma.

The TSBC has strong reservations about the AER's decisions to depart from its own guideline in moving gamma down to 0.4 from the 0.5 it originally set.

We express again our concern, raised in our submissions on TasNetworks' Transmission determination, that the 0.7 equity beta set by the AER is too high. It is set at the top of the range estimated by the AER and we remain of the view that there are strong empirical reasons to bring it down to 0.5, notwithstanding that the Tribunal confirmed the AER value in the recent appeal. The Tribunal's decision essentially supported the AER's use of discretion in setting a point estimate for the equity beta, which could equally apply to an alternative value within the AER's current range for this parameter, provided its discretion is exercised appropriately.

We also continue to hold the view, for reasons outlined in our submission on the AER's Draft Determination on TasNetworks' last transmission reset that the value of the Market Risk Premium set by the AER (6.5 per cent) is too high and a more appropriate value would be around 6 per cent.

In addition, we note that the AER applies a gearing ratio (debt to equity) of 60/40. However, it was pointed out by the representative of the CCP in his presentation to the AER's public forum, that TasNetworks' actual debt gearing is in excess of 70 per cent. Hence, the AER's preferred gearing ratio is not reflective of the conditions TasNetworks faces. The impact of this is to increase the WACC, which then increases TasNetworks' revenues and its prices.

10 Incentive Schemes

TasNetworks' Proposal includes the impacts of various incentive schemes. We comment on a number of these in this section.

10.1 Efficiency Benefits Sharing Scheme

TasNetworks propose that application of the Efficiency Benefits Sharing Scheme (EBSS) for the forthcoming regulatory period continues to exclude the same cost categories as currently apply, with the addition of self insurance costs. We have a concern that their exclusion does not impose the EBSS discipline on TasNetworks for these items, though the inclusion of some may raise practical issues.

10.2 Service Target Performance Incentive Scheme

TasNetworks proposes to accept the AER's Service Target Performance Incentive Scheme (STPIS) with one exception. Instead of the AER's revenue at risk in the range ± 5 per cent, it proposes limiting this to ± 2.5 per cent. We provide the following comments on its reasons:

- The feedback it has received from its customers is that they do not want to pay for higher reliability at this point in time which TasNetworks say makes a potential 5 per cent addition to its revenue through the STPIS seems at odds with customer preferences. However, even the 2.5 per cent addition proposed by TasNetworks would be at odds with customer preferences. An alternative approach, which we would prefer other things being equal, would be to apply only a revenue penalty to TasNetworks during the next regulatory period as customer feedback also did not want to see reductions in current reliability levels. Other things being equal, we would favour this being at the 5 per cent level to maintain consistency with the lower bound of the STPIS.
- TasNetworks also argue that customers do not support price volatility and the application of the AER's revenue at risk of ± 5 per cent would increase the risk of this. They acknowledge that this could be managed through the scheme's banking mechanism but also point out that their move from manual to automated systems could cause a bonus or penalty not reflective of actual performance, though they expect this to be modest. We expect that customer aversion to price volatility is more likely to be in relation to the price increasing impacts of the scheme, which further supports our suggestion for a scheme of penalties only.
- Finally, TasNetworks have also argued that the AER's revenue at risk of ± 5 per cent is much larger than that applied to its transmission network and this could skew the

application of the scheme between the two networks. We recognise that this could be the case but further investigation of this is needed to determine its materiality.

In making the above points, we recognise that there are linkages between the operation of the STPIS, the EBSS and the Capital Expenditure Efficiency Scheme (CESS), which the AER needs to consider in regard to any changes to the way the STPIS works. In the meantime, we would support the application of the STPIS to TasNetworks as a penalty only scheme with up to 5 per cent revenue at risk.

10.3 Demand Management and Embedded Generation Connection Incentive Scheme

TasNetworks proposes expenditure of \$400,000 (June 2017 \$) per annum for the Demand Management and Embedded Generation Connection Incentive Scheme' (DMEGCIS). This compares to \$380,000 (\$2009/10) per annum at present. It is a modest increase and the scheme has now also been extended to embedded generation projects. TasNetworks has provided a list of demand management and embedded generation projects which it says are consistent with its Demand Management Plan and further states in its Proposal (p. 127) that its Network Innovation Strategy “provides a framework to focus our efforts to be truly innovative in how we apply and make use of emerging technologies, including demand management.”

We note that the AER reviews funding claims against the scheme’s criteria as projects are completed and merely caps the total funding under the DMEGCIS in its Determination. We recognise that funding innovative demand management and embedded generation projects can be worthwhile and may have eventual flow on effects in boosting the use of non-network solutions. Small business may also benefit though more reliable or lower cost electricity supply. However, it is important that TasNetworks’ DMEGCIS projects do actually benefit customers and do not duplicate other projects.

11 Total Revenue Requirement, X-factors and Prices

11.1 Total Revenue

We welcome the overall reduction in TasNetworks Total Revenue Requirement but note that points we have made about the individual building blocks throughout this submission would have a material bearing in further reducing it.

We also note that the reductions are almost completely due to falls in TasNetworks' WACC, which is significantly driven by the exogenous influence of declines in market interest rates. This also exposes customers to the risk that revenues (and prices) could see upward pressures again if market rates begin to rise as TasNetworks' cost of debt will be adjusted annually. The effect of management initiatives in reducing total revenue, whilst still material, is only about half that of the WACC and is more than offset by factors that act to put upward pressure on total revenue.

11.2 Application of X-factors

We also welcome that TasNetworks' proposed application of X-factors of 12.89 and 2.00 per cent in subsequent years of the next regulatory period results in no real increase in total revenue over the next regulatory period.

11.3 Prices

TasNetworks is forecasting real reductions in its distribution prices over the next regulatory period.

According to the TasNetworks' Proposal (Fig 4.4, p. 132) for a typical small business customer this indicatively results in a reduction in their network bill from around \$1,800 per annum in 2016/17 to \$1,400 per annum in 2017/18 (precise numbers are not provided in the Proposal), followed by a further modest decline in 2018/19. This represents a reduction of around 20 per cent in the network charges paid by typical small businesses, or around 10 per cent of their total bill. As the representative body for small business in Tasmania, the TSBC very much welcomes these reductions and we are confident that they will also be welcomed by small businesses throughout Tasmania.

These reductions in small business network tariffs appear to be the result of its TasNetworks' revenue proposal, plus the tariffs reforms that TasNetworks is proposing to begin at the start of the next regulatory period (see Section 12). However, from the information provided, it is not possible to discern the relative importance of each factor. It would be helpful to us and the small business sector if this additional detail were provided.

12 Tariff Reform and Tariff Structure Statement Proposal

TasNetworks' has submitted a Tariff Structure Statement Proposal to the AER, which involves a gradual rebalancing in its network tariffs over 15 years (from 2014/15) to:

- Unwind some of the long-standing cross subsidies that exist. Importantly, for small business, this results in a significant reduction in their tariffs. Naturally, the TSBC is very supportive of this change and favours its introduction as quickly as possible.
- Increase the emphasis on service charges and reduce that variable consumption charges, ie, to make its tariffs more reflective of the costs that customers impose on the network.
- Introduce a range of new demand based tariffs for residential and small business customers involving maximum demand based charges based on peak and off peak times of use.

It has also submitted an Indicative Pricing Schedule which includes indicative tariffs resulting from these reforms (and its revenue proposal) for the next regulatory period. We have also examined the AER's Issues Paper on the TSS.

We provide some brief comments below on the TSS submitted by TasNetworks.

First and foremost, the TSBC is very supportive of the unwinding of the cross-subsidies in current tariffs and favours the removal of any cross-subsidy which is serving to increase small business tariffs as quickly as possible. The TSBC has advocated for the removal of such inefficient cross-subsidies for some time and we welcome this proposal by TasNetworks. It should also be noted that we have also commissioned Goanna Energy Consulting to undertake an analysis of and provide us with a report on the cross-subsidies contained in small business tariffs. This should be available in the not too distant future.

The TSBC was a member of the TasNetworks Tariff Reform Working Group and we are supportive of the need to transition network tariffs in Tasmania more towards cost reflectivity and efficient pricing. Provided these changes are implemented sensibly, with long term customer benefits in mind and over an appropriate transition period to allow people to adjust we would support such changes. We recognise that existing tariffs are not efficient and do not send signals which align well with customers making efficient use of the network or with the need to make efficient network investment decisions. We also are aware that the problems with existing tariffs will be compounded by new technological developments placing different types of demands on the network, such as embedded

generation (solar/PV), battery storage and electric vehicles. TasNetworks tariffs will need to respond to these changes in the way its network is being used now and in the future.

Bearing this in mind we provide these brief comments on the TSS:

- We support the changes to existing tariffs proposed by TasNetworks noting that they will help to improve the cost reflectivity and efficiency of more tariffs. However, we would like TasNetworks to provide evidence of the impact of moving tariffs to a structure that places more emphasis on standing charges over variable charges.
- We support, in principal, the introduction of new tariffs based on demand. Beyond that, we require more evidence of the impacts of these tariffs. We expect that the trials that TasNetworks will be conducting will assist with this.
- We support the need to transition the tariff changes given that they will involve adjustments by affected customers (especially adversely affected ones) and will disadvantage customers that have installed appliances and equipment in good faith based on the tariffs. We are also mindful that some vulnerable customers could be adversely affected, but may have limited capacity to respond quickly. It would help understanding of these impacts and how long a transition should be if TasNetworks provided more information on these types of impacts. In the meantime, we have some concerns with the 15 years TasNetworks proposes to take to introduce its tariff changes. This seems like a very long time unless the magnitude of the adjustments customers need to make are very significant, which we have some doubts about and also bearing in mind that over time the transition issues are likely to be diminished by a range of factors (eg, properties are bought and sold, appliances and equipment are replaced), people will modify their use patterns as tariffs are phased in an overly lengthy transition will delay the benefits TasNetworks is claiming. In our view a shorter full transition should be considered (say until the end of the next regulatory control period).
- We support the need for network tariffs to be made fully transparent in customers' bills. This should assist understanding of the new tariffs, assist in encouraging changes in electricity use patterns and also with the transition path.
- As retailers ultimately are responsible for providing electricity to customers their willingness to pass on the changes in network tariffs will be important to the success of the reform proposal. We note that a representative of Aurora Energy provided some comments at the recent AER public forum on the TSS and provided a level of support for the TasNetworks proposal but was not able to provide details of how Aurora's retail tariffs would be impacted. However, we would expect that the common State Government ownership of both TasNetworks (distribution) and

Aurora, as well as the fact that they were both a common entity until recently, should make a positive retail response easier to achieve. It would be helpful if Aurora participated further in the AER's TSS process.

- OTTER regulates retail prices for small customers in Tasmania. Its approach to the TSS Proposal is therefore also important. OTTER is currently considering a retail tariff proposal from Aurora and its decisions will have a bearing on tariff reform. One important challenge for OTTER will be the extent to which it is willing not able to alter existing retail tariffs to align with the TasNetworks' TSS. It would be helpful if the AER and OTTER were able to cooperate with each other and align their processes.
- There is a lack of retail competition in Tasmania with Aurora the only retailer serving small customers. This poses additional challenges for tariff reform as there is little incentive to provide competitive offers and innovative ways of pricing. This could limit the benefits of tariff reform as well as its pace which is of concern to us.
- The great majority of Tasmanian customers do not have meters capable of measuring demand and time-of-use. This makes the task of implementing the TSS reforms more difficult. It also impacts on the transition possibilities. One option would be to remove the opt-in possibility from customers with interval meters sooner (say at the end of the next regulatory period). Beyond that, we note that Tasmania is also considering a recent meeting Rule change that provides for a new approach to meeting in the NEM, including contestability in meeting services and an acceleration in the roll out of smart meters. This is potentially useful to the introduction of tariff reform, but Tasmania faces the additional challenge of a lack of retail competition possibly making the case for smart meters weaker. The Tasmanian Government is considering this Rule change and it should liaise with the AER and OTTER.

We believe that the AER needs to obtain more information and detail from TasNetworks to enable a proper and robust assessment of TasNetworks' TSS to be made, including detailed disclosure of the impact of any changes, in isolation from the impact of other changes which are occurring simultaneously (such as reduced overall network revenues), at customer class level.