Australian Energy Regulator

TasNetworks Transmission Revenue Reset, 2014/15 to 2018/19 – Draft Determination & Revised Proposal

Submission

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Executive Summary

This submission responds to the Australian Energy Regulator's (AER's) Draft Determination (DD) of TasNetworks' *Transmission Revenue Proposal, Regulatory Control Period 1 July 2014 – 30 June 2019* released in November 2014. TasNetworks' Proposal will have an important bearing on transmission charges for Tasmanian small business over the regulatory period.

Rapid increases in Tasmanian electricity prices are of significant concern to the TSBC and its members. Nominal electricity tariffs for small business increased by 101 per cent from 2000 to 2011 and regulated electricity prices increased by 36 per cent from 2009/10 to 2013/14, or 9 per cent per annum. Network charges increased by 50 per cent over the latter period.

Our interest in TasNetworks' Proposal is heightened by these increases and we welcome the opportunity to comment on the DD. Our objective is to have transmission prices falling over the next regulatory period.

Impacts of the Draft Determination on Small Business

The DD will have a welcome, albeit modest, impact on electricity prices for small business, with the average small business expected to see a $48 reduction in electricity bills over the regulatory period. This partly meets our objective of falling transmission prices over the period as prices fall but then rise again slightly. We feel that more could and should be done towards our objective. Our submission examines how this can be done.

We recognise that the DD has other benefits for small business, including the continuation of a reliable and secure transmission system, notwithstanding large reductions in expenditure, some improvements in the way that TasNetworks is regulated (also providing a likely better basis for the next determination) and improved consultation by TasNetworks.

Benchmarking

We welcome the seminal benchmarking undertaken by the AER and its application this DD. The results of this benchmarking helps both in terms of establishing a set of more efficient future expenditures by TasNetworks, and assisting the TSBC's understanding of the TasNetworks' performance against its Australian peers. The AER has flagged likely improvements in benchmarking in future and we offer some suggestions on this.

Opex

The AER has accepted TasNetworks' proposed opex of $218.3 million for 2014-19. TSBC welcomes that this involves a $29.4 million (or 11.8 per cent) reduction in opex over that incurred during the last regulatory period. However, we are not satisfied that this is as

efficient as it should be. Overall, the AER's opex forecast is somewhat higher than TasNetworks', which is a source of concern.

The AER uses a 'base-step-trend' approach to determine forecast opex.

We are not satisfied that its base year (2012/13) opex is efficient. This year was within a regulatory period where opex allowances were demonstrably inflated. Whilst TasNetworks made some welcome reductions in actual opex below its allowance, its actual opex was still above that of its previous regulatory period. Furthermore, the AER's limited application of benchmarking to base opex heightens our concerns. We note that benchmarking consistently shows TasNetworks as being a lower end or mid-range performer with its performance sometimes deteriorating. Taken together, the above suggests a need to adjust TasNetworks' base opex downwards.

We note that the AER has not included any step changes in its forecast opex.

The trend, or rate of change, element of the AER's forecast opex comprises price, output and productivity changes. We support the AER's approach to forecasting non-labour costs, which uses the CPI as the best proxy, but have some concerns about forecast labour costs. For changes in output, the AER's approach produces a higher forecast than TasNetworks.

Regarding productivity, the AER's approach uses an industry growth rate derived from its benchmarking work, which produces a lower growth than TasNetworks', which uses a forecast annual improvement in efficiency and savings from the merger of the Tasmanian transmission and distribution entities. We welcome the additional reduction is opex which TasNetworks' approach involves. The AER's application of an industry productivity trend may be impacted by the poor productivity track record of transmission businesses.

Capex

TasNetworks' proposal forecast capex of $275.9 million ($2013/14). The AER has reduced this by $29.5 million to $246.4 million ($2013/14) on the basis of advice from TasNetworks that two major projects originally proposed were no longer required. This is a 54 per cent reduction on TasNetworks' actual capex on the previous regulatory period. We welcome these reductions.

For Tasmanian small businesses, it is also significant that TasNetworks' capex over the current regulatory control period will be subject to additional disciplines in the form of the Capital Expenditure Sharing Scheme (CESS) and an *ex post* review of its actual capex over the period. Small business has the opportunity to share in the benefits of these (but may also bear most of the costs of any over-spends).

We support the AER's application of a combination of 'tops down' and 'bottoms up' assessments of TasNetworks' forecast capex and the AER's expectation that TasNetworks will reply on both in future (rather than merely a 'bottoms up' approach).

The submission next comments on some aspects of the AER's assessment.

- The AER's application of economic benchmarking is supported and shows TasNetworks as a high end performer relative to other TNSPs but with a deteriorating performance such that much of its advantage has been lost. This calls into question the efficiency of its capex proposal, even allowing for recent reductions. The AER has not applied PPI benchmarks to further assess TasNetworks' proposal but their application appears to support this view.
- Submissions from consumers, including the TSBC, have questioned TasNetworks' proposed capex but it is not clear how the AER has included their views in its proposed capex allowance.
- TasNetworks has not included any non-network alternatives in its Proposal that would reduce its capex but has said that it will keep these options open. The AER has accepted this, but its DD contains limited information as to how it has considered the efficiency of TasNetworks' non-network proposal. The AER should undertake a more rigorous assessment of non-network alternatives.
- The AER has reduced TasNetworks' augmentation capex by around $30 million to take account of two major proposed projects that TasNetworks advised are no longer necessary due to reduced demand. We welcome TasNetworks' proactive approach. The AER has also accepted TasNetworks' proposed additional $5.6 million in replacement capex as a consequence of this deferral. We accept that this may be justified but the AER should scrutinise this proposal and the amounts involved.
- In our earlier submission, we also raised questions about proposals involving an additional $20 million in capex. We also suggested that there could be scope for savings in capex through TasNetworks making increased use of some existing assets. The AER appears not to have considered the above matters in its DD.
- The DD accepts an amount of $213 million in forecast replacement capex (repex), which comprises 87 per cent of TasNetworks' capex. Asset renewal is the largest component at $151 million (71 per cent of repex). Whilst there are welcome reductions in asset renewal capex, these are mainly due to the end of TasNetworks' major asset renewal program and not necessarily indicative of an efficient level of expenditure, a point made in several consumer submissions. Moreover, the AER's application of trend analysis is unlikely to reveal whether proposed expenditure is efficient due to its cyclical nature. We also query the findings of AEMO analysis of one asset replacement project and question the need for another.

- Security and compliance repex of $14.4 million is accepted by the AER on the basis of trend analysis, but we believe additional vetting is justified. Spare assets valued at $15.1 million are proposed. We query the need for a mobile sub-station and suggest that the spare transformers also proposed could be substituted for this. Expenditure of $32.5 million for operational support systems is proposed, a 103 per cent increase on expenditure over 2009-14. The AER found this justified on grounds that it was prudently deferred in the 2009-14 regulatory period due to merger synergies and because of reductions in repex, maintenance expenditure and extended asset lives. However, the quantifiable impacts of the merger and the link between the other factors remain unclear. Expenditure of $12.5 million on non-network capex is proposed, a 75 per cent reduction. We have not raised issues with this.
- Growth in peak demand is a key driver of capex. This has reduced by 0.6 per cent per annum over the past 5 years but the AER DD accepts that it will grow by 1.18 per cent annually over the 2014-19 regulatory period. We believe that this forecast is too optimistic and should be revised downwards to zero or even slightly negative growth. This is based on a consideration of the optimistic bias in TasNetworks' and (to a lesser extent) AEMO's forecasts, the likely continuation of factors contributing to the recent declines in demand and the problematic impact of differences between TasNetworks' and AEMO's forecast assumptions about energy efficiency.
- We also comment on the cost escalators used to establish a capex forecast. We accept that zero real increase is a preferable approach to using forecasts of commodity prices for material costs, and also support the AER's desire to place incentives on TasNetworks to manage these costs efficiently. In relation to labour and construction costs, the AER proposes to use forecasts of these as they are directly observable and more transparent but we suggest that it also consider the subdued state of the Tasmanian economy and its likely continuance.

Return on Capital

The DD includes a rate of return (return on capital) of 6.88 per cent (nominal vanilla), which is lower than the 10.00 per cent rate for the 2009-14 regulatory period. We welcome this reduction which will have a material impact in reducing transmission prices for small business over the 2014-19 regulatory period. The rate of return is an important determinant of TasNetworks' revenue and hence transmission price outcomes for consumers. It accounts for $512 million (56 per cent) of the $920 million (unsmoothed) revenue allowance proposed in the DD.

We generally support the DD approach to determining the allowed rate of return but have important concerns that it remains too high. We outline these in our submission.

In summary:

- The DD includes an equity beta of 0.7, which is slightly lower than the 0.8 applied by the AER in its recent network determinations. The TSBC's concern is that this is materially higher than it should be. Other consumer submissions have expressed similar doubts. Having assessed the AER's DD and the information it had regard to, we hold the view that the AER should further lower TasNetworks' equity beta to better reflect the empirical work the AER has placed most weight on, including estimates which post-date its 0.7 decision. This supports an equity beta of no more than around 0.5-0.6, and recognises that predictability and certainty are not compromised by a lower value based on better and more recent information.
- The AER has adopted a point estimate of 6.5 per cent for the Market Risk Premium (MRP) from within a range of 5.1 to 7.8 per cent. We have some difficulty reconciling its stated approach with the estimates it has adopted. After considering the AER's approach and its application in the DD we come to different conclusions. These suggest that the MRP should have a range of 5.1 to 6.7 per cent with a point estimate of 6.0 per cent.
- We also have a significant concern with the AER's approach to establishing the cost of debt. This turns on the use of a single benchmark efficient entity that applies to all NSPs. Its application to government owned entities, such as TasNetworks, is not consistent with the rate of return objective or the NEO (that is, in the long term interests of consumers of electricity). In particular, it exposes consumers, including small business, to substantially inflated rates of return that exaggerate the cost of debt to government owned businesses. As a consequence, consumers pay higher network prices than they need to. We considered the AER's reason for this and its response to earlier consumer concerns as part of this submission. After having done so, we remain convinced that the AER's approach is wrong as it ignores actual differences in the cost of debt, accepts an AEMC position on this which has flaws and appears to involve an inappropriate interpretation of competitive neutrality. Data and informational issues raised by the AER appear to be surmountable.

1 Introduction

This submission responds to the Australian Energy Regulator's (AER) Draft Determination on TasNetworks Pty Ltd's (TasNetworks) *Transmission Revenue Reset, Regulatory Control Period 1 July 2014 – 30 June 2019* released in November 2014. TasNetworks' revenue reset will have an important bearing on transmission charges for small business in Tasmania over the term of the next regulatory control period and will feed directly into their retail tariffs. The Tasmanian Small Business Council (TSBC) welcomes the opportunity to comment on the AER's Draft Determination.

In preparing this submission, we also considered various other related information, including TasNetworks' *Revised Proposal*, the results of the AER's published benchmarking report on Transmission Network Service Providers (TNSPs), Economic Insight's report to the AER on economic benchmarking of TNSPs and learned advice provided to the AER on the cost of capital by Associate Prof John Handley, Professor Michael McKenzie and Associate Prof Graham Partington, Dr Martin Lally and Professor Olan Henry, as well as presentations to and other information gained from the AER's Pre Determination Conference (PDC) held in Hobart on 11 December 2014.

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 small enterprises themselves, as well as Government and regulators as decision-makers. 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 provides a representative voice for 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 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' Revenue Reset

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 Tasmanian small businesses 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 to Tasmanian small businesses have access to cheaper energy and to competitive energy offers. Tasmania's small businesses therefore suffer a disadvantage in these respects and the TSBC supports policy and regulatory steps to help redress this.[1]

Having access to network 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 small business and the Tasmanian economy.

Looking across the small business sector, 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 is substantially more. This, in itself, makes electricity important. However, its importance to small businesses 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 recent large increases seen in Tasmanian electricity prices, which have affected small businesses. Many have been unable to pass on these cost increases due to the competitive markets in which they operate and cannot access competing suppliers due to a lack of retail competition, making their competitive disadvantage worse.

As mentioned earlier, TasNetworks' transmission charges have an important bearing on network charges which are passed on to small businesses by retailers in their charges.

[1] The Tasmanian Government has implemented Full Retail Contestability as of 1 July 2014. However, the lack of retail competitors continues to impact on Tasmanian small businesses' ability to gain access to competitive retail offers of the kind available in other parts of the NEM.

Transmission charges make up 15 per cent of small business electricity costs and are therefore important (by contrast, the retail component and green charges together comprise around half of this proportion). Moreover, TasNetworks' transmission charges have been one of the largest components of higher electricity prices in Tasmania over the past decade (see Section 1.3) and the TSBC is keen to see this end with TasNetworks' transmission determination.

1.3 Electricity Price Trends in Tasmania

The rapid escalation in Tasmanian electricity prices over recent years is of significant concern to the TSBC and its members, notwithstanding a fall off in prices since 2012/13. Our interest in TasNetworks' Proposal is heightened by this.

The final report of the Tasmanian Electricity Industry Expert Panel (Expert Panel) found that:

- Electricity tariffs for small business increased by 101 per cent in nominal terms from 2000 until 2011, or by around 6 per cent per annum.
- The average annual real increase was 3 per cent.

Goanna Energy Consulting analysis of regulated electricity price trends for Tasmania released by the AEMC shows that:

- Prices increased by 36 per cent from 2009/10 to 2013/14, or 9 per cent per annum.
- Over the same period network charges increased by 50 per cent with transmission charges increasing by even more than this.

More recently, network price increases, including for transmission, have moderated and the steps that TasNetworks has taken towards this are welcome. Nevertheless, we desire to see this continue over the next regulatory control period and that network prices reflect the outcomes of an efficient and productive transmission system.

1.4 Outline of This Submission

The remainder of this submission comments on specific aspects of the AER's DD and TasNetworks' Revised Proposal. It covers the impacts of the DD on small business (section 2), the application of benchmarking to the DD (section 3), opex (section 4), capex (section 5) and the return on capital (section 6). We consider the matters raised in sections 4-6 are the most important parts of the DD for small business and have therefore focused our comments in these areas. Our position on other parts of the determination was outlined in our submission on TasNetworks' Proposal.

2 Impacts of the AER's Draft Determination on Small Business

Implementation of the AER's DD would undoubtedly have some benefits for small business in Tasmania, albeit not large. These include:

- A reduction in transmission charges of $46 in 2014/15 and $10 in 2015/16 for an average small business, although thereafter there will be an $8 increase over the remainder of the regulatory control period until 2018/19.
- The likelihood that the reliability and security of supply of the transmission system will not suffer, despite the significant reductions proposed in capex an opex compared to the last period (reflecting factors such as lower demand growth, the completion of a substantial replacement program and improved productivity).
- The application of new and improved incentive schemes for TasNetworks' capex and opex respectively which should improve the efficiency with which TasNetworks operates and establish a better basis for the following regulatory period.
- Improvements to TasNetworks' Service Target Performance Incentive Scheme from which consumers, including small business, should benefit through improved transmission services and better integration with the spot and wholesale markets.
- More generally, outcomes from improvements in the regulatory framework within which AER determinations are made reflecting changes to the National Electricity Rules (NER or Rules), the AER's application of these and improved consultations between TasNetworks and small business, including the TSBC.
- Outcomes from the TSBC's participation in this review which, to date, has included consultations with TasNetworks, participation at the AER's public forum and pre determination conference in Hobart, our submission responding to TasNetworks' Regulatory Proposal and this submission responding to the AER's DD.
- The co-operative manner in which consultations with TasNetworks have taken place are also seen as a benefit and foundation for further improvements in the future, in part due to the approach set out in the AER's guideline on network consultations with consumers but also reflecting the positive approach of TasNetworks towards these (albeit still leaving room for future improvements).

Notwithstanding these benefits, we feel that more could and should have been achieved. In particular, there are areas of the DD where we feel that the AER could have taken further steps to improve a number of the outcomes referred to above. There are also areas where small business would have benefitted from further reforms to both the Rules and they way the AER are currently implementing them. Our submission covers a number of the key areas. Addressing these in the Final Determination would result in a material improvement for small business in Tasmania.

3 Benchmarking

The AER has undertaken a substantial benchmarking exercise as part of current round of regulatory determinations, including for TasNetworks. We welcome this and its application by the AER to this DD. The availability of the results of this benchmarking work not only helps in terms of establishing a set of more efficient future expenditures by TasNetworks, but also helps the TSBC to understand better and more transparently the performance of TasNetworks seen against its Australian peers. From this small business can gain a better appreciation of how TasNetworks is performing, how efficient its costs are and whether they are changing over time.

Whilst recognising that this is the first time that such information has been collected by the AER and applied to its determinations, and also recognising that, at least as far as transmission goes, there is very little work of such an extensive nature that precedes it, we believe that it is important that benchmarking work be improved and extended.

In this context we raise the following points:

- The broader application of Multilateral Total Factor Productivity (MTFP) benchmarks should be treated as a priority.
- The application of Partial Productivity Indexes (PPIs), especially where these can assist in determining an efficient level of expenditure.
- The AER should investigate means by which it can bring international comparisons more into its benchmarking work and assessments.

We have raised specific points about benchmarking in the course of the two following sections.

4 Opex Allowance

TasNetworks proposed total opex over the next regulatory control period of $218.3 million. The AER has undertaken an assessment of this as part of its DD and has accepted TasNetworks' proposal.

The TSBC welcomes that TasNetworks' proposal involves a $29.4 million (or 11.8 per cent) reduction in opex over that incurred during the last regulatory period. This will result in transmission charges that are lower than they otherwise would be, which will flow though into lower electricity prices for Tasmanian consumers, including small business. Our support for this part of the TasNetworks opex proposal was also stated in our submission on its Revenue Proposal.

We also said in our earlier submission that the AER will need to establish robustly that the opex proposals provided by TasNetworks are as efficient as they can be, including through the use of benchmarking techniques. For a number of reasons, we are not yet convinced that this has been done satisfactorily. We discuss these reasons below.

4.1 Efficiency of Base Year Opex

In our earlier submission we stated that we did not believe that TasNetworks' choice of a base year, 2012/13, for setting opex was efficient and outlined our reasons for this. Other consumer submissions also questioned this.

We remain unconvinced that the base chosen for setting TasNetworks opex in the next regulatory period is efficient, notwithstanding the assessment undertaken by the AER in the DD. Our reasons are set out below.

- It is well established that the opex allowances for network service providers in the last round of AER regulatory determinations were at the top of, or above, reasonable levels. The AEMC rule changes for network regulation also recognised this and were partly intended to address the causes of these outcomes in subsequent regulatory periods. This provides strong *a priori* grounds for not accepting opex in the selected base year as efficient without further checking and possible adjustment.
- The mere fact that TasNetworks' actual opex over the last regulatory period was below its allowance does not mean that the opex in its selected base year can be regarded as efficient.
- In fact, the actual opex for 2012/13 was, in real terms, some 76 per cent higher than for 2004/05 and 33 per cent higher than the average for the previous regulatory period. Even allowing for factors such as demand related growth in TasNetworks' network over the previous regulatory period, which in any case did largely not materialise, these are large increases in opex.

- The AER now undertakes benchmarking to help it determine efficient levels of expenditure and is able to make use of this in helping it determine an efficient base for setting opex. As part of this determination it has had the benefit of the results of this benchmarking and made use of it to some extent. However, we are concerned about certain aspects of this work and the way the AER has chosen to make use of it. The AER has used benchmarking to only a limited extent in establishing the efficiency of TasNetworks' base year opex. For example, based on the results of its PPI benchmarking, the AER formed a view that:

  > *On the whole, and as explained below, our benchmarking analysis for TasNetworks is inconclusive. Therefore, we have no evidence to suggest that TasNetworks revealed base year expenditure is materially inefficient.*[2]

  We disagree with this conclusion. Based on the four opex PPI measures presented in Appendix A of the AER's *Annual Transmission Benchmarking Report, 2014*, TasNetworks is consistently shown as not among the best performers, with its performance typically being mid to upper range and sometimes deteriorating. The MTFP growth rates for TNSPs, which Economic Insights and the AER say are sufficiently reliable and robust for application, suggest that TasNetworks' productivity has been declining. Neither of these results suggests that an efficient level of opex can be established from the selected base year, or any other year during the last regulatory period, without the need for further downward adjustment. Yet the AER has concluded that opex in 2012/13 provides an efficient base for setting opex in the current regulatory period.
- In relation to PPIs, the AER comments that: "In assessing the efficiency of TasNetworks' opex, we do not consider that any significant conclusions can be drawn from its performance under the PPIs."[3] It goes on to outline some of the issues that arise such as differences in the nature of transmission networks, the existence of trade offs in how resources are allocated and, in the case of TasNetworks, the small size of its network and high proportion of overheads. It then goes on to say that:

  > *In assessing the efficiency of TasNetworks' opex, we do not consider that any significant conclusions can be drawn from its performance under the PPIs.*[4]

[2] Draft decision: TasNetworks transmission determination 2015–19, Attachment 7, p 7-22.
[3] Draft decision: TasNetworks transmission determination 2015–19, Attachment 7, p 7-23.
[4] Ibid.

> We do not deny that such issues exist and that they point to the need for some caution in how and when PPI indicators can be successfully employed in setting a base for opex. However, we believe that the PPIs point to the existence of inefficiencies in TasNetworks' opex, which the AER has not taken into account in setting the base amount for opex over the regulatory control period.

We note that the AER is not bound to accept TasNetworks' proposed base year and can adjust the opex in that year if it forms a view that this is justified. It states that:

> *If we find material inefficiencies or material one-off costs in a proposed base year, we do not rely on expenditure in that year as the basis for forecasting. If so, we first look for an alternative base year that does reflect an efficient recurrent level of opex.*
>
> *If no alternative base year can be identified we apply an efficiency adjustment to the estimated final year expenditure.*[5]

We believe that the AER needs to re-consider this matter in its Final Determination.

4.2 Step Changes

TasNetworks' Proposal included two step changes related to its operating agreement with AEMO and the costs of the AER *Better* Regulation program but it did not add these to its opex as it indicated that they would be absorbed by the business. We welcomed this in our earlier submission but noted that the efficiency and robustness of these costs should be established.

We note that the AER has not assessed these changes as part of its DD and has not included them in its alternative estimate of opex, but it has considered them (and our earlier comments) in its assessment of TasNetworks' future productivity performance.

4.3 Rate of Change

We comment below on various aspects of the DD discussion of the rate of change in setting TasNetworks' future opex. Our comments cover the three elements used to determine the rate of change, namely, price change, output change and productivity.

We note the AER's comments that the use of CPI rather than Producer Price Index series to forecast non-labour price changes is to be preferred on grounds of availability, practicality and robustness. We also note Economic Insights' comment that the PPI follows a similar trend to the CPI. We consider the AER's approach acceptable.

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[5] Draft decision: TasNetworks transmission determination 2015–19, Attachment 7, p 7-20.

The DD states that the AER's "choice of the labour price measure seeks to select the efficient labour price for an efficient service provider on the opex frontier."[6] Though not perfect, we recognise that practical difficulties in obtaining labour costs forecasts for an efficient TNSP lead the AER to adopt forecasts of the EGWWS industry, produced by expert forecasters, as a proxy for TasNetworks' labour price.

However, we have some reservations about the AER's approach:

- TasNetworks has adopted its actual enterprise agreement rates for the first two years of the current regulatory period, whereas that AER has adopted the EGWWS forecasts. We agree that it would be inappropriate to use enterprise agreement rates where they do not accord with an efficient labour price on the opex frontier. However, this may not always be the case. Comparing the AER's price change forecast to TasNetworks for 2014/15 and 2015/16, TasNetworks' forecast is lower in the 2014/15 but the AER's is lower in 2015/16. We believe that lower forecasts of labour costs should be preferred over higher ones.
- The AER has used an average of the forecasts produced by Deloitte Access Economics (DAE) and BIS Shrapnel (BIS) on the basis that DAE tend to under forecast actual outcomes whereas BIS tend to over forecast them. We agree that it is appropriate to take systematic bias into account when forecasting TasNetworks' labour costs and also believe that the extent of over and under forecasting should be taken into account when setting a point of difference between the two forecasters. It is not clear if this is the approach which the AER has used?
- We also maintain our view, expressed in the earlier TSBC submission, that any labour cost escalations need to consider the current subdued state of and outlook for the Tasmanian economy.[7] The wage forecasts applied in the DD do not discuss this.
- We agree with the AER's decision, consistent with the advice of Economic Insights, that it is preferable to apply an overall productivity adjustment to TasNetworks' forecast opex rather than apply a productivity adjustment to its labour costs, especially given that the AER has access to MTFP benchmarks to do this and as TasNetworks has also taken this approach to adjusting its opex for productivity improvements.

We note that there are differences in the approaches used to forecast output changes and consequential differences in outcomes, with TasNetworks' approach resulting in lower

[6] Draft decision: TasNetworks transmission determination 2015–19, Attachment 7, p 7-38.
[7] Whilst there are some indicators of improvement, these are weak, partial and have an uncertain outlook.

overall changes in output. This explains some of the difference in the rate of change between TasNetworks and the AER.

In relation to the productivity component of the rate of change, we note that the approach adopted by TasNetworks results in significantly higher productivity outcomes than that adopted by the AER. The AER alternative is based on an estimated industry average productivity outcome using data on PPI's derived from Economic Insights. We do not believe that this is a sufficiently challenging productivity growth rate. Moreover, being based on the historical performance of the transmission industry, it reflects what are known to be poor productivity outcomes achieved by the sector. As the DD points out, over the time period measured in the AER's benchmarking work, industry output has not increased to anywhere near the extent that inputs have increased.

We also note that AER's comments that:

> *Our alternative estimate uses a forecast of productivity that assumes a business as usual situation that does not account for the merger efficiencies, which are considered a structural change. Our productivity forecast also does not reflect service provider's pursuing additional efficiency gains such as TasNetworks' target of a 0.5 per cent annual reduction in controllable opex.*
>
> *This indicates TasNetworks' is pursuing a higher productivity level compared to the electricity transmission industry average between 2006 and 2013.*[8]

We welcome this more challenging approach by TasNetworks and support that the AER's Final Determination reflects this higher productivity growth. Nevertheless, we remain concerned that the industry productivity growth rate used by the AER reflects a track record of poor productivity growth in the transmission sector and is therefore not challenging enough, perhaps even allowing for TasNetworks' higher productivity forecast.

4.4 Treatment of Provisions

TasNetworks' proposal included an allowance for provisions related to environmental provisions, superannuation and other employment entitlements such as annual leave and long service leave. The AER has removed these from base year opex and the Regulated Asset Base (RAB) as they are not actual costs incurred and therefore should not be included when setting prices. It notes that the inclusion of anticipated costs in opex – which may or may not actually eventuate – could reward (or penalise) TasNetworks for changes in

[8] Draft decision: TasNetworks transmission determination 2015–19, Attachment 7, p 7-43.

assumptions not efficiency, as is intended by the National Electricity Rules (NER) and the Efficiency Benefit Sharing Scheme (EBSS). We agree with this approach.

The amounts involved are small with $0.2 million subtracted from the base year opex.

In its Revised Proposal, TasNetworks questions the AER's approach and maintained that, by removing provisions, the AER has adopted a definition of efficiency for the EBSS which differs from its 2009 Determination. It appears to acknowledge that the previous approach was imperfect but argues for application of the principal of 'no retrospectivity'. We do not support the TasNetworks' position on this matter. The AER's approach does not retrospectively penalise TasNetworks for past decisions and application of 'no retrospectivity' in such circumstances would preclude the application of a correct interpretation of how provisions should be treated.

TasNetworks also suggests that:

> *Adopting a regulatory approach that differs from the accounting standards imposes additional complexity and costs on our business, which are ultimately borne by customers.*[9]

Given the small sum involved, it is difficult to see how these costs could be material. Nevertheless, if TasNetworks has specific costs in mind, it should identify and quantify these and make them available so that they can be properly considered and taken into account.

[9] TasNetworks, Tasmanian Revised Transmission Revenue Proposal (Regulatory control period 1 July 2015 - 30 June 2019), p 6.

5 Capex

TasNetworks proposed total forecast capex of $275.9 million ($2013/14) in their revenue proposal. The AER has reduced this by $29.5 million to $246.4 million ($2013/14) on the basis of advice from TasNetworks that two major projects contained in its original proposal would no longer be required before 2019/20, the end of the current regulatory control period, given more up-to-date projections of likely demand. This represents a 54 per cent reduction on TasNetworks' actual capex in the previous regulatory control period.

The AER has therefore accepted TasNetworks' capex proposal, as amended by TasNetworks.

We welcomed TasNetworks' proposed reduction in capex in our submission responding to its proposal. We also welcome the further reduction in capex contained in the AER's DD and that TasNetworks has continued to adjust its forecast capex program downwards in light of more up-to-date information about changes in conditions during its regulatory control period. We further welcome that TasNetworks' Revised Proposal has accepted the AER's DD on capex.

For Tasmanian small businesses, it is also significant that TasNetworks' capex over the current regulatory control period will be subject to additional disciplines in the form of the Capital Expenditure Sharing Scheme (CESS) and an *ex post* review of its actual capex over the period, both intended to ensure that TasNetworks only undertakes efficient capex. These measures should provide small business with additional certainty that the prices they pay for transmission services reflect efficient investments by TasNetworks and the opportunity to ultimately share in the benefits of this.[10]

In the remainder of this section, we comment on aspects of the DD in relation to capex.

5.1 Forecasting Methodology

We note the AER's approach to developing its alternative capex forecasts uses a combination of 'tops down' and 'bottoms up' forecasts, with the latter relying on the application of economic benchmarking and trend analysis. We support this approach, which we believe provides more robust estimates of forecast capex.

[10] However, as expressed in the Council of Small Business Australia's submissions on the CESS, we remain concerned that consumers could also pay for 70 per cent of any over-expenditure by TasNetworks.

We also note that TasNetworks' Proposal relied only on 'bottoms up' forecasts, which the AER has pointed out can overestimate capex as it may not adequately reflect inter-relationships and synergies between projects.

Nevertheless, the AER's application of these techniques leads it to conclude that TasNetworks' forecast capex is efficient and reasonably reflects the capex criteria. We have some reservations about this, which we explore later in this section.

We support the AER's comment that:

> *… we expect TasNetworks to develop its capex proposals for future regulatory periods through a combination of top down and bottom up modelling.*[11]

5.2 The AER's Assessment

In this section, we comment on certain aspects of the AER's assessment of TasNetworks' capex proposal and the AER's alternative estimate.

5.2.1 Application of Benchmarking

As mentioned above, we support that application of economic benchmarking to help determine the efficient level of capex for TasNetworks. The AER has applied the results of its MTFP benchmarking for TNSPs to assist in its task of assessing TasNetworks' proposal and establishing its alternative.

The MTFP benchmarking results show that TasNetworks is the most efficient TNSP, although its performance has been declining to the point where, in 2013, it had lost most of its advantage over other TNSPs. This is of concern regarding the efficiency of its capex proposal, even allowing for the large reductions in capex compared to the last regulatory period.

We acknowledge the reservations that the AER has expressed about other benchmarks published in its report. However, we believe that this should not preclude their use by the AER to provide further guidance on establishing an efficient level of capex for TasNetworks. For example, the asset cost PPIs consistently show that TasNetworks is at best a mid performing TNSP and confirm that its performance has been deteriorating over time. This calls into question its past efficiency in spending capex, even allowing for reductions in its capex program.

[11] Draft decision: TasNetworks transmission determination 2015–19, Attachment 6, p 6-16.

Whilst its proposed future capex is much lower than its recent expenditures, this alone does not mean it is efficient.

5.2.2 Addressing the Concerns of Consumers

The capex factors require that the capex forecast includes expenditure to address concerns of electricity consumers as identified by TasNetworks in the course of its engagement with electricity consumers. We are concerned that this has not been adequately done in the DD.

Many of the submissions from consumers received by the AER in response to TasNetworks' Proposal, including our own, made the point that they were concerned that forecast capex was not yet efficient and would benefit from further reductions. Whilst the AER has referred to a number of these in its DD, it is not obvious how these have been included in the capex forecasts? We refer to some specific examples from our earlier submission later in this section.

5.2.3 Non-Network Alternatives

The capex factors also require that the AER consider the extent to which TasNetworks has considered and made provision for efficient and prudent non-network alternatives. TasNetworks has not proposed any such expenditure of this regulatory control period but said in its proposal that it will continue to pursue these where credible solutions exist. It is difficult to see from the DD how the AER has considered this matter in its assessment.[12]

In our submission on TasNetworks' Proposal we commented that:

> *The AER will need to ensure that TasNetworks gives serious consideration to non-network solutions in the next regulatory period. We also note that with the merger of Tasmania's transmission and distribution networks, TasNetworks should be able to provide both an holistic approach to non-network solutions covering all voltages and a seamless approach covering both transmission and distribution options. Efficiencies from the merger should extend to non-network solutions.*[13]

[12] The DD says in Table 6-5 of Appendix 6, p. 6-22 that the AER has had regard to the extent to which TasNetworks has made provision for efficient and prudent non-network alternatives and refers to Appendix A to Appendix 6 as providing details. However, Appendix A only includes a discussion of non-network capex, which covers information and communications technology (ICT), buildings and property, and motor vehicles, not non-network alternatives, which refers options such as embedded generation or demand management.

[13] TSBC, Submission on TasNetworks Transmission Revenue Proposal, 2014/15 to 2018/19, August 2014, p. 33.

5.2.4 Adjustments to Proposed Capex

As mentioned earlier, the AER has made a downwards adjustment to the capex originally proposed by TasNetworks after receiving further information from TasNetworks proposing this. The adjustments consisted of:

- Deferral of the proposed Waddamana-Palmerston security augmentation project until after the 2014-19 period based on lower demand forecasts. This reduced proposed expenditure of $21 million for this project to $1.4 million.
- Partial deferral of the Newton-Queenstown security augmentation due to a reduction in customer demand. This reduced proposed expenditure of $14.1 million for this project to $4.2 million.

TSBC supports the reduction in forecast capex for TasNetworks due to the deferral of both these projects. Indeed, in our submission on the TasNetworks' Proposal we queried the need for both projects as proposed. We welcome TasNetworks' initiative in bringing this change in demand conditions and its consequent reductions in capex to the attention of the AER.

TasNetworks also advised that it will require an additional $5.6 million ($2013-14) in asset replacement expenditure (repex) to replace ageing assets that would have been replaced as part of these two augmentation projects. The AER has accepted this amount and added it to its forecast of repex.

We acknowledge that deferral of these projects could involve the need for additional replacement expenditure on some older assets. However, we are concerned about the lack of justification for this and the amounts involved.

In our submission on the TasNetworks Proposal, we also questioned the need for several other parts of its capex program (with a total value of $20 million) and set out our substantive issues (see Table 2, p 33 of our submission). The AER does not appear to have considered the matters we raised and we again draw them to their attention.

We also again draw attention to our concern that the efficiency of TasNetworks' capex might be improved by means of increased use of existing assets. As pointed out in our previous submission, besides planning for potential 110 kV asset rationalization in the Southern region and consequently increased use of the new 220 kV assets, there are no projects seeking an increased reliance on 11, 22 and 33 kV distribution feeders to defer capex in the transmission network. As the transmission and distribution networks are now merged, it should also broaden the opportunities for these sorts of options.

5.2.5 Repex

The DD accepts an amount of $213 million in forecast replacement capex (repex). This comprises 87 per cent of TasNetworks' capex for the period 2014-19. The AER formed its view on the basis of analysis of trends in TasNetworks' repex, an assessment of each category of repex, namely, asset renewals, security and compliance, spare assets and operational support systems, and assessments of two asset replacement projects and one spare asset investment by AEMO.

Asset renewal

Asset renewal is the largest component of repex at $151 million in total. This represents 71 per cent of all repex and should be closely scrutinised.

We welcome that the DD (and TasNetworks' Proposal) involve substantial reductions in repex compared to the last regulatory period. However, expenditure on asset renewals has varied substantially over time in line with factors including the need to replace older assets (this trend is shown in Appendix6, Figure A-1, p. 6-26 of the DD) and a mere reduction should not be equated with an efficient outcome. TasNetworks itself says the reduction is "because it is coming to the end of a period of relatively high asset renewal and enhancement capex."[14]

We note that numerous submissions from consumers/users expressed concerns about the size of TasNetworks' repex proposal.[15] We share these concerns especially in the context of a just completed major replacement program that involved historically high levels of asset renewal. The DD comments that:

> *In the context of repex, given the significant decrease in the proposal compared to the previous period, we intend to rely primarily on trend analysis rather than individual project review.*

Unfortunately, a reliance on trend analysis is unlikely to reveal whether concerns are justified or not.

We would urge the AER to delve deeper into the issue of whether the TasNetworks' asset renewal proposals are efficient. Whilst the AER has had regard to assessments by AEMO of

[14] Draft decision: TasNetworks transmission determination 2015–19, Attachment 6, p 6-26.
[15] These are mentioned in Draft decision: TasNetworks transmission determination 2015–19, Attachment 6, pp 6-26-7.

two such projects, we are not convinced that this is sufficient or that it goes far enough? For example, in our previous submission we raised specific issues to do with two asset replacement projects, the Lindisfarne Substation transformer replacement ($7 million) and Renewal of K-poles on the Triabunna Spur 110 kV transmission line ($6 million), the former of which was assessed by AEMO and found to be justified. Notwithstanding AEMO's finding we continue to have concerns about the need for both projects.

As mentioned earlier, we also believe that the AER needs to establish more conclusively that the $5.6 million in additional asset replacement expenditure proposed by TasNetworks due to the deferral of two augmentation projects is justified.

Security and Compliance

The DD contains an amount of $14.4 million over the period 2014-19 for security and compliance repex. The AER's assessment of this appears to be mainly based on the application of trend analysis which found that this amount was the same as over the period 2009-14 and was significantly below that spent over 2004-09. We again submit that, whilst the reductions in expenditure are welcome, the application of trends is insufficient to establish the efficiency of the forecast expenditure. The AER should delve deeper into the justifications for the expenditure proposed by TasNetworks.

Spare Assets

The DD contains an amount of $15.1 million over 2014-19 period for spare assets. This includes $7 million for a strategic mobile 110/33-22-11 kV substation. The DD also reports that AEMO has assessed the need for this mobile substation and found it justified. However, our earlier submission queried whether TasNetworks' spare transformers (the other major spare assets to be purchased) offer an alternative to purchasing a mobile substation? It is not clear to what extent the AER or AEMO have taken this into account?

Operational Support Systems

The DD accepts TasNetworks' proposal for expenditure of $32.5 million for this category. It also notes that this is a 103 per cent increase on actual expenditure over 2009-14. The DD explains that the AER has found the expenditure to be justified on the grounds that it was prudent to defer some expenditure from the last regulatory period given synergies from the merger of Transend and Aurora Networks and also because of reductions in repex, maintenance expenditure and an extension of asset lives. However, the quantifiable impacts of the merger synergies and the link between the other factors remain unclear.

Non-network capex

TasNetworks proposed – and the AER DD accepts – a total amount of $12.7 million over 2014-19 for non-network capex. The DD points out that this is 75 per cent below the level

for 2009-14 and also historically low. The AER has considered trends in expenditure (at both the total and category level), TasNetworks' reasons for the expenditures and the substitution possibilities with relevant elements of opex in forming its view that expenditure reasonably reflects efficient costs. Having regard to the large reductions and the ASER's assessment we have not raised any issues with this item.

5.3 Demand Forecasts

The DD points out that system peak demand in Tasmania decreased on average by around 0.63 per cent per annum over the past five years but accepts that growth in peak demand is expected to be on average 1.18 per cent per annum in the 2014–19 period. This assumption has an important bearing on capex (and opex).

Given current conditions, we find it rather incongruous that peak demand in Tasmania will grow at this level over the regulatory control period. There are a number of points that can be made to support our view:

- The basis for the AER's position is taken from the forecasts provided by TasNetworks and AEMO. However, the DD also provides evidence that TasNetworks' demand forecasts are consistently more optimistic than AEMO's and that this continues to be the case. Moreover, it is also apparent from recent experience that AEMO's demand forecasts have continually overestimated the actual growth in demand and have subsequently been revised downwards as the sticky nature of stagnant demand growth has become more apparent. This suggests that neither TasNetworks nor AEMOs demand forecasts can be accepted without qualification.
- Moreover, the factors that are generally agreed to be behind stagnant demand, including in Tasmania, namely, a decline in manufacturing output, high costs, high electricity prices, uptake of solar and greater energy efficiency show few signs of abating over the course of 2014-19.
- We note the AER's comment that both AEMO and TasNetworks are refining their approaches to forecasting. This may improve the accuracy of their forecasts in future but this remains uncertain.
- Differences in forecasts produced by TasNetworks and AEMO are, in part, due to different views about issues such as the impact of energy efficiency in Tasmania compared to other parts of the NEM. These differences are unresolved and make forecasting demand for the 2014-19 regulatory control period more problematic.

All things considered, we believe that there are strong grounds for amending the demand forecasts so that the likelihood of continued stagnant growth in demand is built into the Final Determination. We remain of the view that zero, or even slightly negative, growth in demand would be a justifiable assumption. We are also keen to avoid the risk, often

apparent in past determinations, that demand forecast proves too optimistic with the result that expenditure (and prices) are higher than they need to be.

We also note that, in its Final Determination, the AER intends to take into account updated demand forecasts being developed by the TNSPs.[16]

5.4 Cost Escalation

In this section we comment on cost escalators accepted by the AER in its DD.

5.4.1 Material costs

The DD sets out a range of arguments for why it is preferable to use a zero real increase approach to forecasting material costs based on the CPI and why TasNetworks' approach of forecasting material cost increases based on commodity price is inferior and less consistent with the capex objective. We support the AER's preference for a CPI approach, whilst also recognising that this is itself less than perfect.

Nevertheless, we retain concerns that a CPI approach, whilst superior to cost forecasts, will still provide TasNetworks with across-the-board stable real material costs when this may not be justified.

We therefore also support the AER's comments about the desirability of providing TNSPs with an incentive to manage material costs efficiently. We raised this need in our previous submission on TasNetworks' Proposal.

5.4.2 Labour and construction costs

In the DD the AER expresses confidence in the ability to use forecasts to establish escalators for labour and construction costs as these forecasts can be directly obtained and as the drivers for construction costs are more transparent and predictable. We acknowledge that the AER's reasons have some validity but reiterate our earlier comment that cost escalators should also reflect the subdued state of and outlook for the Tasmanian economy.[17]

[16] See Draft decision: TasNetworks transmission determination 2015–19, Attachment 6, p 6-35.
[17] As mentioned earlier, whilst there are some indicators of improvement, these are weak, partial and have an uncertain outlook.

6 Return on Capital

The AER DD includes a rate of return (return on capital) of 6.88 per cent (nominal vanilla). This is lower than the rate that was applied to the 2009-14 regulatory period of 10.00 per cent, due mainly to lower interest rates and downward adjustments in some of the rate of return parameters, most notably the equity beta. It is also lower than the 7.58 per cent proposed by TasNetworks, due mainly to favourable interest rate movements since TasNetworks submitted its Proposal.

We welcome this lowering in the rate of return, which will impact favourably on the transmission charges paid by Tasmanian small businesses over the course of this regulatory period. We also welcome that TasNetworks has applied the AER's regulatory rate of return guideline in its Proposal, including accepting the parameters therein. We note that other Network Service Providers (NSPs) currently under review by the AER have not done so. TasNetworks has indicated in its Proposal that it has accepted the AER's guideline as this serves the interests of its customers who will benefit from lower transmission charges.

The rate of return is an important determinant of TasNetworks' revenue allowance and hence transmission price outcomes for consumers. It accounts for $512 million (56 per cent) of the $920 million (unsmoothed) revenue allowed TasNetworks under the DD. Therefore, decisions impacting the rate of return will have important consequences, including a major impact on revenue (and prices).

We are generally supportive of the AER's approach to determining that rate of return and how its application to the DD. However, there are a few important areas where we retain concerns that the rate of return in the DD is not optimal in terms of the rate of return objective or the National Electricity Objective. As a result the rate of return contained in the DD is higher than it should be and this will flow though into higher prices. The rate of return should be further reduced in the Final Determination. We discuss our reasons below.

6.1 Equity Beta

The DD includes an equity beta of 0.7. This is slightly lower than the 0.8 applied by the AER in most recent network determinations. It reflects a review of the AER's approach to determining the rate of return as part of its *Better Regulation* program.

The TSBC's concern is that this is materially higher than information available to the AER suggests it should be and that the AER has not used its regulatory discretion in a balanced enough way in determining a point estimate for the equity beta. We note that numerous other consumer and other submissions have also expressed concern about this matter. As a

result, we raise the following points for the AER's further consideration on the equity beta. In so doing, we note that the AER has made clear that:

- It intends to apply the rate of return guideline to its determinations.
- The legislative framework allows it to depart from this but it will not do so lightly.
- It would depart from the guideline if doing so would result in an outcome that better meets the allowed rate of return objective.
- The AEMC expressed the view that it expected the AER to follow the guideline unless there was some genuine change in evidence.

Our substantive concerns with the equity beta set by the AER are as follows:

- The range for the equity beta set by the AER is 0.4 to 0.7 based on empirical research, including especially recent work by Prof Olan Henry. The AER has chosen a point estimate at the very top of this range. The AER explains that this recognises the uncertainty inherent in estimating an unobservable parameter such as the equity beta. However, it is less clear why uncertainty would cause the AER to select the very top of its range?
- Moreover, the point estimate chosen by the AER is clearly at the very high end of the range of estimates it has had the most regard to in its DD, as shown in Figure 3-3 of that decision.[18]
- The AER appears to have placed significant weight on recent estimates of the equity beta produced by Prof Loan Henry for the AER, which put its range between 0.3 and 0.8, with an average of 0.52. However, this work post dates the AER guideline and was not available when it set its range and point estimates. Further, we note that the spread of empirical observations taken from Henry is heavily concentrated around the range 0.4 to 0.6[19] and that the median value[20] is 0.33. This provides further evidence supporting a point estimate from within the mid to lower end of its range.
- The AER refers to additional information it has considered in forming its position on the equity beta point estimate. It refers to the most recent international empirical estimates, which it places in the range 0.45 to 1.14. However, it heavily qualifies these by saying that:

[18] Draft decision: TasNetworks transmission determination 2015–19, Attachment 3, p 3-31. We have ignored the higher estimates presented in Figure 3-3, which are taken from consultants engaged by NSPs mindful that NSPs have tended to produce estimates which favour their interests.
[19] See Draft decision: TasNetworks transmission determination 2015–19, Attachment 3, Figure 3-19, p 3-256.
[20] The median is that value separating the higher half of a series of observations from the lower half.

> *The pattern of international results is not consistent and there are inherent uncertainties when relating foreign estimates to Australian conditions.*[21]

It goes on to say that these provide only "some limited support" for its top of the range point estimate.

- The AER has also considered information from the alternative Black CAPM but comes to the conclusion that:

> *… we do not consider the theory underlying the Black CAPM warrants a specific uplift or adjustment to the equity beta point estimate.*[22]

It also says that the theory behind this model is qualitative in nature, yet it still points to this as being "reasonably consistent" with its upper end point estimate. We are unclear as to how the AER has reached this view but, in any case, find use of this model to justify a high end point estimate unconvincing. Elsewhere in the DD, the AER observes that:

> *There is little evidence that the Black CAPM is used by other regulators, academics or market practitioners to estimate the return on equity. Regulators, in particular, rarely have recourse to the Black CAPM.*[23]

- The AER also refers to the importance that all stakeholders placed on certainty and predictability in developing the guideline and suggests that departure from it at this time would be unlikely to better achieve the rate of return objective. However, it is not clear how certainty and predictability will be achieved by sticking to a point estimate that is higher than it should be. Predictability at least is more likely to be achieved by setting the most robust point estimate possible and being clear on how and why this was done.[24] For small business, certainty is important but not as important as setting a robust value. We note that in numerous other cases, past and present, the AER has opted for a mid-point of its range for parameters. This includes the Market Risk Premium, which is also not directly observable.
- It is also not clear to us that placing certainty and predictability as a higher priority in setting the rate of return than setting a point estimate that better reflects empirical estimates is more consistent with the rate of return objective?

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[21] Draft decision: TasNetworks transmission determination 2015–19, Attachment 3, pp 3-79-80.
[22] Draft decision: TasNetworks transmission determination 2015–19, Attachment 3, p 3-80.
[23] Draft decision: TasNetworks transmission determination 2015–19, Attachment 3, p 3-178.
[24] We note that in its 2008 WACC review, the AER referred to a desire to 'avoid shocks' as a reason for why it chose the upper bound (0.8) of its then (higher) range for the equity beta as a point estimate.

- Nor is it clear to us why the AER would place achieving certainty and predictability above its stated willingness to depart from the objective if the latter resulted in better meeting the rate of return objective and given the AEMC's view that a departure from the guideline would be justified by a genuine change in evidence, as seems to have been provided by Henry's most recent work post-dating the AER's guideline.

Overall, we find the AER's reasoning for its high end point estimate for the equity beta unconvincing. We believe that it should place greater weight on its foundation analysis and the results of recent empirical work by Henry, then exercise its discretion in a more balanced way. This points strongly to the need for a further downward adjustment in the equity beta to at least 0.5-0.6.

6.2 Market Risk Premium

The AER has adopted a point estimate of 6.5 per cent for the Market Risk Premium (MRP) from within a range of 5.1 to 7.8 per cent in the TasNetworks DD. It describes its approach as follows:

> *We place most reliance on historical excess returns. However, DGM estimates, survey evidence and conditioning variables also inform this estimate. We also have regard to recent decisions by Australian regulators.*[25]

We have some difficulty reconciling this approach with the AER's DD.

First, turning to the AER's choice of a value of 5.1 per cent for the lower bound of its range. The AER appears to have based this on a value that lies between the geometric mean of historical excess returns (4.0 to 4.9 per cent) and the arithmetic mean (5.9 to 6.5 per cent) on the advice of McKenzie and Partington that the unbiased estimator of the MRP lies between these two averages.

However, its choice of the upper bound appears to be based on the value determined from DGM estimates as this "currently provides the highest estimate of the MRP at about 7.8 per cent"[26] with a range of 6.6 to 7.8 per cent. Why the AER has chosen the high end of the DGM range when it says that it has placed most reliance on historical excess returns and it has attached a secondary reliance on the DGM to inform its estimate of the MRP is not clear.

[25] Draft decision: TasNetworks transmission determination 2015–19, Attachment 3, p 3-76.
[26] Draft decision: TasNetworks transmission determination 2015–19, Attachment 3, p 3-77.

We also note the concerns of McKenzie and Partington around the outputs from the DGM[27] and the significant risks that it would overestimate the MRP, as well as the AER's concerns that DGMs are highly sensitive to potential errors in inputs.[28]

The AER's approach, if applied consistently to the upper bound, would have produced an estimate that had more regard to historical excess returns with some reference to the DGM range. For example, taking the midpoint of the arithmetic mean range and the DGM range would produce an upper bound of 6.7 per cent, or taking the midpoint of the DGM range would produce 7.2 per cent.

The AER goes on to describe how it determined its point estimate from within its range:

- Using the ranges determined from the geometric and arithmetic averages of historical excess returns suggests a point estimate of 6.0 per cent.
- Survey evidence also supports 6.0 per cent.
- DGM estimates produce higher estimates with a range of 6.6 to 7.8 per cent (midpoint of 7.2 per cent).
- Conditioning variables suggest that market conditions are stable, levelling off and an MRP currently below its historical average. The AER said it did not believe that this suggested any need to upwardly adjust the point estimate.
- Evidence from other regulators cluster around 6.0 per cent but some are higher.

Based on the above, it selected a point estimate of 6.5 per cent, which is around the midpoint of its range.

Based on the above we have formed the following views about the MRP, which differ from the AER's

- The AER's lower bound is likely to be a reasonable estimate but its upper bound is too high. The most likely range is 5.1 to 6.7 per cent.
- The AER's point estimate is therefore also too high. Based on our alternative range, the point estimate should be 6.0 per cent.
- This point estimate is consistent with most of the evidence considered in the AER's approach (e.g., historical trends, survey evidence conditioning variables, the decisions of other regulators).

We consider these MRP estimates are consistent with the rate of return objective and that they would better meet it and the NEO.

[27] Draft decision: TasNetworks transmission determination 2015–19, Attachment 3, p 3-185.
[28] Draft decision: TasNetworks transmission determination 2015–19, Attachment 3, p 3-225.

6.3 Cost of Debt

We also have a significant concern with the AER's approach to establishing the cost of debt for TasNetworks. This particularly turns on the use of a single benchmark efficient entity that applies to all NSPs. Whilst this is for the most part acceptable to the TSBC, its application to government owned entities, such as TasNetworks, is not consistent with the rate of return objective or the NEO (that is, in the long term interests of consumers of electricity). In particular, it exposes consumers including small business, to inflated rates of return that exaggerate the cost of debt to government owned businesses. As a consequence, consumers pay higher network prices than they need to.

We discuss our reasons below.

The rate of return objective is:

> *…that the rate of return for a [regulated network] is to be commensurate with the efficient financing costs of a benchmark efficient entity* ***with a similar degree of risk*** *as that which applies to the [service provider] in respect of the provision of [regulated services].*[29]

Government owned TNSPs, such as TasNetworks, do not face the same degree of risk as privately owned networks, the basis for the AER's single benchmark. This is borne out by common knowledge that TasNetworks obtains its debt through the Tasmanian Government, which sources it at a AA+ credit rating and by empirical work (which the AER is already aware of). As the AER benchmark is BBB+, the cost of debt for Government owned NSP is considerably lower than for privately owned ones. The consequence of this is that TasNetworks will receive a windfall gain due to the application of a single benchmark that awards it a cost of debt well in excess of its actual costs. Such an outcome is inconsistent with incentive regulation, which is supposed to ensure that network entities do not benefit from windfall gains but rather benefit from the pursuit of greater efficiencies. For small business and other consumers, the result of this windfall is higher transmission prices.

In its submission on TasNetworks' proposal, the CCP also raised this matter and suggested that the AER apply a separate benchmark cost of debt to government owned networks. In its DD the AER responded to this raising a series of implementation issues.[30] Our comments on these are set out below.

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[29] Draft decision: TasNetworks transmission determination 2015–19, Attachment 3, p 3-15 (our emphasis).
[30] Draft decision: TasNetworks transmission determination 2015–19, Attachment 3, p 3-132.

- The AER says that if we were to base the allowed return on debt on actual costs, it would need to consider how this might affect service providers' incentives to minimise their debt costs. We acknowledge that applying actual costs might blunt this incentive, but note that the development of an appropriate benchmark would negate this and, even if this is not possible, there is a trade off involved between the desirability of avoiding a windfall gain to publicly owned NSPs (and their owners) which results in higher electricity prices.
- The AER refers to the AEMC's support for an efficient private sector provider as the appropriate benchmark and the AEMC's comment that:

> *If state-owned businesses issued their own bonds, without a government guarantee, they would face materially similar borrowing costs to privately-owned service providers. In the absence of competitive neutrality provisions, electricity consumers are unlikely to be better off from defining a separate benchmark for state-owned service.*[31]

  This is a counter factual argument that has no relationship to current reality. In our view, it should therefore be discounted. Its only practical relevance can be if an action by the AER to change its current approach caused government owners to withdraw their guarantee but they would appear unlikely to do so as there would be no benefit to them from such a course of action (e.g., they would not recover the windfall revenue by doing so). Moreover, even without a government guarantee it is not axiomatic that state-owned businesses would face a materially similar borrowing cost to private providers. Borrowers would still recognise that the entity is state owned and that State governments would be very unlikely to allow it to fail.
- In relation to competitive neutrality, it is important for the AER's approach to recognise that this principal applies where government owned businesses are in competition with privately owned ones and should not use ownership to their advantage. This is seldom the case with and between NSPs, who are spatial monopolies.[32]
- The AER comments that it would need detailed and timely data for its resets and annual reviews, which it does not currently have, to apply a different benchmark.

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[31] Quoted at Draft decision: TasNetworks transmission determination 2015–19, Attachment 3, p 3-132.

[32] The NSW Treasury puts it this way: "Typically, the application of competitive neutrality principles may require adjustments to the price of a good or service that make allowance for the following: • taxes that may not be paid by a government business but would be paid by a private sector competitor; • the cost of capital; • any other material costs not borne by a government business purely as a result of its public ownership status." See NSW Treasury, Policy Statement on the Application of Competitive Neutrality (TPP 02-1), January 2002.

We suggest that the AER could use its RIN process to obtain relevant and timely information from NSPs and also data from other government sources as needed.

- The AER has said that, at this stage, it is unsure how to account for changes in the financial environment. We suggest that a way forward on this matter would be for the AER to seek expert advice to assist it.
- The AER also comments that they would need to include debt guarantee fees, which reflect a business's indicative, stand-alone credit rating or commercial status. If included, such fees would need to reflect an efficient set of underlying costs. We also note that the inclusion of such fees, does not take away from the principal that there is currently a windfall being provided through the AER's approach, which is inconsistent with incentive regulation.

On a broader level, this problem (and other similar manifestations of it) arises because the AER regulates both private and publicly owned energy networks as though they were the same, when they are clearly not. And a regulatory framework is applied that was originally developed to regulate private networks in the aftermath of electricity privatisations in Great Britain and Victoria. The fitness-for-purpose of such regulation, unless appropriately modified, being applied to publicly owned electricity networks must be questionable given the pricing, consumption, investment, resource allocation and other distortions that it entails.

We believe that the response to this should be for the AER to adopt a separate benchmark to apply to government owned NSP, including TasNetworks, which recognises the difference in the cost of debt, and the greater consistency this would provide with the rate of return objective and the NEO.