Stakeholder submissions to our transitional Revenue Proposal

Appendix 2

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Transend Networks Pty Ltd

Stakeholder submissions to our Transitional Revenue Proposal

We submitted our transitional proposal to the AER on 31 January 2014. The transitional Revenue Proposal facilitated the finalisation of the AER guidelines by acting as a 'placeholder' to cover the one-year period commencing on 1 July 2014. As a placeholder, the scope of the transitional Revenue Proposal and the AER's review was much more limited than would ordinarily be the case. The AER published its decision for the transitional Revenue Proposal on 28 March 2014.

In reaching its decision on the transitional Revenue Proposal, the AER considered submissions from:

- Major Energy Users (MEU);
- National Generators Forum (NGF); and
- Tasmanian Small Business Council (TSBC).

A number of the issues raised in these submissions were specific to the transitional Revenue Proposal and have already been addressed by the AER in its decision. However, a number of matters raised by stakeholders remain relevant to the Revenue Proposal. The table below identifies these issues and explains how they have been addressed in our Revenue Proposal.

Table 1 – Stakeholder Issues and our response

Stakeholder feedback	How our Revenue Proposal addresses stakeholder feedback
Prices To achieve community expectations of lower prices, requires the networks to reduce their revenues to offset the impact of lower demand and consumption. (MEU, page 3) The import of the Transend proposal is that consumers should be pleased with what Transend is proposing. However, [...] Transend costs have risen massively over the past decade, despite peak demand and consumption not changing significantly. So when seen in this context, the Transend proposal returns to consumers a small proportion of the increases seen over the past, yet what consumers get for this increase in revenue is little in terms of service improvement. (MEU, page 9) Whilst the TSBC welcomes the price path and sees it as a significant departure from the large increases in Tasmanian transmission prices seen over the past decade, we do not accept that Transend has gone far enough with its proposals. (TSBC, page 9) Dramatic increases in network charges in the past five years were passed through directly to all end use customers. The period of sharply rising retail prices coincided with an unprecedented decline in overall energy consumption and the level and frequency of peak demand events. This decline in both energy consumption and peak demand has damaged the financial viability of all generation businesses operating in the competitive wholesale market. (NGF, page 1)	We recognise and share community expectations that transmission prices should reduce in real terms. We now propose that prices should be reduced further and more quickly than we anticipated in our transitional Revenue Proposal. Our proposal will deliver significant price reductions over the next two years, and below CPI increases thereafter. We have factored in immediate operating cost savings from merger efficiencies, and set ourselves the target of achieving real controllable cost reductions for each of the following four years. This is despite significant new obligations from the AER and AEMO that make these savings harder to achieve. As explained in Section 9.3 of the Revenue Proposal, we have also proactively adjusted our depreciation profile, to reduce transmission charges by $13 million per annum. Our proposal means it will take us longer to recover the investment made in our assets. We have accepted this risk in order to reduce customer charges.
Pricing Methodology The current pricing methodology provided by Transend has resulted in some considerable anomalies and a loss of equity. It must be assessed in keeping with the basic premise that each user pays its "fair share" and that prices will generally move with the AER approved yearly change in revenue. (MEU, page 4) The MEU is extremely concerned that Transend pricing does not reflect the costs for the service provided. The AER has an obligation to ensure there are no anomalies in network pricing through the pricing methodology approved but the outcomes do not support this requirement. (MEU, page 23)	We note that the MEU has identified a number of aspects of the pricing methodology that it regards as anomalous. Our pricing methodology proposal explains that we have complied with the Rules and AER Guidelines. The resulting prices should therefore be regarded as 'fair'. We acknowledge MEU's concerns and we would be pleased to engage in discussions regarding a future Rule change proposal. It is important to recognise, however, that transmission pricing is necessarily imperfect and any change will create 'winners' and 'losers'.

Stakeholder feedback	How our Revenue Proposal addresses stakeholder feedback
Consumer engagement The MEU is pleased that this engagement has occurred but is still concerned that such interaction still consists more of "this is what we have planned" and "the reliability and availability is this and this is that [sic] it costs" rather than "how can we provide the service you need which meets your ability to pay"; reports from MEU members indicate that Transend still has the attitude of telling consumers rather than consulting with them. (MEU, page 7) The TSBC wishes to place on record that Transend has not consulted with it, or (as far as we are aware) other representatives of small business in preparing its Transitional proposal. This is disappointing and unfortunate as Transend's Transitional Proposal was therefore not informed by small business views and issues prior to being submitted the AER. (TSBC, page 8)	We are continuing to improve our approach to consumer engagement. Chapter 3 of the Revenue Proposal explains our approach in developing the Revenue Proposal. We recognise the importance of small businesses to the Tasmanian economy and as part of our consumer base. In response to the concerns raised by TSBC, we met with the TSBC in March 2014. In addition, we regularly engage with the Office of the Tasmanian Economic Regulator's Customer Consultative Committee, to engage with members and seek feedback on our plans. This process provides a further opportunity for engagement with small businesses.
Reliability standards We also note that Transend has not included any impacts from the AEMC's recommendations from its recent review of national reliability standards, which have not yet been agreed to. (TSBC, page 12)	The transmission plans set out in the Revenue Proposal reflect the current reliability standards in Tasmania. If the reliability standards are amended, our plans will be adjusted accordingly.
Demand Both Transend and AEMO have revised further downwards the demand growth outlook for Tasmania for the coming regulatory period. Transend has reflected this – and remaining uncertainty about the forecasts – by proposing to adopt AEMO's low demand forecasts in its Transitional Proposal. Our concern with this approach is that it could prove to be too bullish. For one thing, AEMO's forecasts have in recent years all been subsequently revised downwards and it is possible that, based on current trends, this will happen again. (TSBC, page 10)	We agree that demand forecasting is inherently uncertain. Our demand forecasts are set out in section 5.7 of the Revenue Proposal. While it is possible that actual demand will be lower than forecast, the converse is also possible. In any event, our analysis confirms that future augmentation requirements will be very much lower than the recent past. We will monitor load growth and seek to deliver efficient and innovative solutions to manage demand with the help of our customers wherever possible.
Asset utilisation Furthermore, Transend has presumably undertaken a range of investments in the current regulatory period that reflect optimistic growth forecasts that did not eventuate and it will be important for the AER to ensure that such spare capacity is used before any new capacity is added. It is difficult to tell from the Transitional Proposal whether Transend has adequately taken this into account. (TSBC, page 10)	Our proposed augmentation capital expenditure is substantially lower than recent historic levels. In addition, our annual average capital expenditure forecast is 52 per cent lower compared to the current period. These comparisons should provide comfort to stakeholders that the forecast capital expenditure is appropriately scoped. In addition, we have a well-established history of releasing capacity through innovation and we are the Australian leader in the application of dynamic ratings and use of control schemes to optimise network capacity and utilisation.
Capital Expenditure Forecasts In most cases the allowance for each element of capex continues the general downward trend shown over time where the capex claim for each element is either equal to or lower than the recent past performance, although there are exceptions such as operational support systems where the step increase (year on year) to the transition year is 225% and IT systems where the increase is 383%. There are given no reasons for such large increases raising concern that these are ambit claims. (MEU, page 15) We do not doubt that Transend's augmentation and connection proposals for the coming regulatory period are more reasonable and better suited to the conditions it is likely to face. [...] However, these still need to be verified as being efficient and prudent investments which are in the long term interests of consumers of electricity [...]. (TSBC, page 14) It is concerning that Transend report that they will actually overspend their regulatory allowance for this [renewal] element of capex by $31 million in the current regulatory period. No explanation is provided as to why this will be the case. (TSBC, page 15)	As noted above, our total capital expenditure allowance is 52 per cent below our actual capital expenditure in the current period. We think this reduction should provide confidence to all stakeholders that the proposal is not an ambit claim. We accept that operational support capital expenditure is increasing significantly in percentage terms. It is important, however, to put these percentage increases into context. In particular, our forecast average operational support capital expenditure is $6.5 million per annum over the 5 year period, compared to $3.2 million per annum in the current period. The proposed increase partly reflects the impact of the deferral of asset management information system (AMIS) renewal in the current period. The deferral of AMIS was efficient, given the proposed merger of the transmission and distribution network companies. The renewal of AMIS is now planned for the forthcoming regulatory period. In addition, investment is also required to strengthen our condition information and to progress our smart transmission grid development program. IT capital expenditure is forecast to increase to $7 million over the forthcoming regulatory period compared to actual IT capital expenditure of $6.4 million in the current period. This is not a material increase. Section 4.3 of the Revenue Proposal explains our capital expenditure performance compared to the AER's allowance in the current period. While renewal capital expenditure exceeded the AER's allowance by approximately $24 million or 9 per cent, the total capital expenditure was approximately $115 million or 16 per cent below the AER's allowance. As noted in section 4.3.2, the increased scope of our optical fibre earth wire program contributed to higher than forecast renewal/enhancement costs.

Stakeholder feedback	How our Revenue Proposal addresses stakeholder feedback
NCIPAP projects The MEU is most concerned with the NCIPAP claim and considers that some of the projects should be carried out under the normal opex and capex programs and others should not be accepted as the benefit to cost ratio is too small or non-existent. (MEU, page 4) The most common approach used by firms in the competitive sector is to assess small discretionary projects such as these on a simple pay back method – that the benefits of a project had to be recovered by savings made in 2 years (or perhaps 3 years at the most). The NCIPAP operation does not guarantee to deliver this sort of benefit (in fact there is no definition of the benefit that must be achieved). Further, in a competitive environment, if the project does not proceed there is no cost incurred. Under the NCIPAP, if the project does not proceed, there is a payment although this might be offset against the penalty, but again there is no certainty that the value of the penalty will exceed the value of not carrying out the project providing the network with a reward for doing nothing. (MEU, page 19) The AER needs to carefully assess this list [of NCIPAP projects] and ensure that it is robust and capable of delivering the benefits claimed at the costs identified. We note, for example, that Transend has provided no details about benefits and costs, or how they have been calculated. (TSBC, page 24)	We have consulted with AEMO in developing the action plan, which is set out in Appendix 21. The proposed projects comply with the requirements of the NCIPAP scheme and are designed to improve network capability. This information should address the concerns raised by TSBC. The NCIPAP scheme requires the network company to identify the benefits or improvement targets for each project. If we do not achieve the improvement targets, the NCIPAP scheme provides for penalties to apply. The NCIPAP scheme sets out the matters that the AER will consider in determining any penalties. Given the design of the scheme, we do not share the concerns expressed by MEU. In particular, there are sufficient safeguards to ensure that the proposed projects will deliver material benefits to customers. We note that the AER made similar observations in its decision on our transitional Revenue Proposal, page 33.
Operating Expenditure However, it is noteworthy that the real reductions in Transend's opex effectively ended in 2012/13 (see Figure 4.2 and Table 4.2). It proposes to achieve a further real reduction in total and controllable opex of only $0.7 million over the whole coming regulatory period. This suggests that the drive to lower costs, which Transend says it is committed to continue, is not going to be realised. It is important to Tasmanian electricity consumers, including small business, that Transend achieves this commitment. This will help them to secure access to competitively priced electricity. (TSBC, page 17) The Rule changes and Guidelines issued by the AER make clear that techniques such as benchmarking will be used in assessing expenditure proposals put forward by networks in future determinations. We fully support this and will be looking towards the AER to ensure that this is done for Transend as part of its Transitional and Subsequent Determinations. The AER's Framework and Approach Paper says that it will be. However, Transend has not included any such techniques in its Transitional Proposal. (TSBC, page 18)	It is important to note that the transitional Revenue Proposal was concerned with establishing a reasonable 'placeholder revenue' based on indicative expenditure forecasts and efficiency improvements. We have now firmed up on our planned reductions in operating expenditure and reflected these lower forecasts in our Revenue Proposal. Our forecast Controllable operating expenditure for the forthcoming regulatory period is approximately 11 per cent lower than the current period. Our forecasts include savings of $3.5 million in 2014-15 or approximately 8 per cent compared to 2012-13. Additional operating cost reductions, in real terms, are also proposed in the remainder of the regulatory period, despite projected increases in input costs. We also note that our total forecast operating expenditure (including debt raising costs) is 12 per cent lower than actual expenditure in the current period. This reduction reflects our focus on delivering further operating expenditure efficiencies in the forthcoming period. The real reductions will therefore continue. Details of our proposed efficiency improvements and benchmarking analysis are provided in sections 4.6, 6.5 and 6.10 of the Revenue Proposal. The analysis should provide stakeholders with comfort that we remain committed to delivering efficiency improvements and lower prices to our customers.
Efficiency Transend is claiming the full benefit of the Efficiency Benefit Sharing Scheme (EBSS) in the forecast revenue for its actual opex being lower than the allowed opex, further offsetting the value of the benefit of the lower revenue. (MEU, page 7) For Transend to have achieved such a significant reduction in opex implies that the original allowance was grossly overstated. The fact that this point was made by consumer stakeholders at the last two revenue resets yet the excessive allowance was provided. (MEU, page 14) The Transend-Aurora Energy merger is meant to deliver costs savings of $8 million per annum. Transend's share needs to be included in its proposal but is not made explicit. (TSBC, page 3)	We have applied the EBSS in accordance with the Rules. The purpose of the EBSS is to reward companies for delivering efficiency improvements. In addition, we have also factored in immediate operating cost savings from merger efficiencies, and set ourselves the target of achieving real controllable cost reductions for each of the following four years. This approach provides a good outcome for customers. The opex allowance established for the current regulatory period was determined following a lengthy review process. For the forthcoming regulatory period, we are setting ourselves challenging operating expenditure targets and will continue to seek innovative solutions to achieve further efficiencies in our operating and capital expenditure.

Stakeholder feedback	How our Revenue Proposal addresses stakeholder feedback
Pass through events Transend has sought pass through provisions in its Transitional Proposal based on a Natural disaster event and Insurance cap event. We do not support either of these proposals given the points made above and also believe that Transend ought to be strongly encouraged to manage the impact of such events as part of its normal course of business rather than falling back on the cushion of a pass through event. Small business can also be impacted by such events but does not have access to regulatory pass throughs. (TSBC, page 23) In the current Rules there are defined elements where the "pass through" of actual costs is permitted. However, it is important to recognise that in a competitive environment, the ability to pass through costs to consumers is not possible, and firms have to absorb the costs (either through insurance or directly) of any exogenous impact. Because there is the ability to pass through such costs to consumers by regulated NSPs, the AER must recognise that with this transfer of risk there needs to be a compensating reduction in the equity beta to reflect the reduced risk faced by NSPs. (MEU, page 11)	The ability to pass through cost increases that are beyond our control appropriately balances risk between the company and its customers. In the absence of a pass through allowance, we would require a higher operating expenditure allowance. We agree that small businesses do not have the capacity to pass through natural disasters or insurance. By the same token, however, small businesses are not subject to revenue or price regulation. Pass through arrangements should be viewed in the context of revenue regulation, in which the AER determines the company's cost allowance and would prefer not to make an allowance for a low probability, high impact event such as a natural disaster. The costs relating to pass through arrangements, such as insurance, natural disasters and terrorism, are not correlated with market returns, and therefore are not relevant in estimating the equity beta.
Rate of return The MEU is most concerned that Transend has elected to approach the setting of the WACC for the transition year based on a variety of inputs reflecting both the old and the new approaches and has done so in a way that results in a higher WACC than might be expected when viewing the current relatively low risk free rate. Transend has also utilised those elements of the old approach which increases the WACC (such as equity beta and gamma) and then overlaid elements of the new approach which also increase the WACC (such as a higher market risk premium). (MEU, page 10) Transend refer to studies for the ENA by NERA to support their upper bound of 1.0 for the equity beta. The AER also considered this study on developing the Rate of Return Guideline but was not persuaded that it supported such a high upper bound. We therefore do not support Transend's equity beta proposals and prefer the AER's point estimate of 0.7 and its range of 0.4 to 0.7. (TSBC, page 22) We note that the AER has considered a wider range of theoretical and empirical evidence in establishing a robust value for the utilisation rate, which both pre and post-date the SFG study. Given this, we find the AER's reasoning for applying a utilisation rate of 0.7, leading to a gamma of 0.5, more persuasive than Transend's proposed sole reliance on the SFG study for the Tribunal. (TSBC, page 22)	In our Revenue Proposal we are adopting the AER's WACC parameters as set out in its Rate of Return Guideline and the accompanying Explanatory Statement. Our WACC proposal is lower than the estimates set out in the transitional Revenue Proposal and the estimates proposed by independent experts.
Regulated asset value We note that Transend is proposing to roll forward a regulatory asset base (RAB) that is slightly lower, in real terms, than its closing RAB for the current regulatory period. It is also forecasting that its RAB at the end of the coming regulatory period will be slightly lower again. We generally welcome this, noting both its important link to past and future capex and that it will assist with keeping transmission prices under control in the coming regulatory period. Nevertheless, it will be important for the AER to test the veracity of Transend's RAB proposals in determining the roll forward of Transend's assets, including that Transend's capex over the current regulatory period has been efficient and prudent, notwithstanding that Transend has kept capex below its regulatory allowance. (TSBC, page 20)	Chapter 8 of the Revenue Proposal sets out details of our regulated asset base. As a result of the lower capital expenditure in the current regulatory period, customers will benefit from a lower opening asset base and in turn, relatively lower revenues and prices in the forthcoming period. In addition, lower future investment in the transmission system means that the asset base is forecast to remain relatively stable throughout the next regulatory period, in real terms. This provides further downward pressure on revenues and pricing.