Tasmanian Small Business Council
Uniting Small Business

# Australian Energy Regulator

# TasNetworks Distribution – Draft Regulatory and Tariff Structure Statement Determinations, 1 July 2017 to 30 June 2019

## Submission

November 2016

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## Executive Summary

This submission from the Tasmanian Small Business Council (TSBC) responds to the recent Australian Energy Regulator Draft Determinations on TasNetworks' Regulatory Proposal and its Tariff Structure Statement Proposal for the period 1 July 2017 to 30 June 2019. We welcome the opportunity to respond.

Both TasNetworks' regulatory proposal and the AER's draft decision contain welcome reductions in allowed revenue, with the latter providing deeper cuts. These are expected to provide useful network price reductions in the first year of the next regulatory period (2017/19) but followed by a small increase the following year. The reductions in revenue and prices are welcome and supported by the TSBC.

However, a significant share of the AER's revenue and price reductions are driven by the windfall effect of lower interest rates on TasNetworks' allowed rate of return and a difference in view between the AER and TasNetworks on the value of imputation credits (*gamma*) to be included in TasNetworks' revenue allowance. The future of interest rates is uncertain, with some analysis suggesting increases in future and gamma is the subject of an ongoing appeal. Furthermore, demand forecasts included in the draft decision could well be too optimistic and actual expenditure may vary from forecasts, which would put future prices under additional pressure. This introduces uncertainty into the price outcomes that consumers can expect from the regulatory determination, a risk which they will carry, and makes the draft decision less attractive to them than might appear at first.

This means that, in its final decision, the AER needs to carefully examine all the factors that feed into TasNetworks' revenue and prices so that consumers' access to network price reductions is more certain. We raise a number of relevant matters in our submission.

The regulated rate of return for 2017/18 contained in the AER's draft decision is 56 basis points less than that proposed by TasNetworks and 280 basis points less than that allowed in the AER's current regulatory determination. We welcome these reductions but note that this is largely due to lower interest rates (which could increase again) and a lower equity beta (compared to the current determination). The rate of return accounts for 40 per cent of TasNetworks' allowed revenue, attesting to its importance to its prices. We question the value of some rate of return parameters used by the AER, especially the equity beta and market risk premium, which we suggest are too high (as do other consumer advocates).

There is a difference of view between the AER and TasNetworks' on value of imputation credits (*gamma*), with the former proposing 0.4 and the latter 0.25. This has material bearing on revenue outcomes for TasNetworks and price outcomes for its customers, with a higher gamma lowering corporate tax allowances, revenue and prices. We support the AER's *gamma* value for reasons outlined in this submission.

*Gamma* is subject to a current appeal by the AER. We note that the outcome of this will have important implications for network prices, including for small business. If the appeal confirms an existing Australian Competition Tribunal Ruling, network prices will rise.

We support the AER's downward adjustment in TasNetworks' proposed opening Regulatory Asset Base (RAB) and its forecast closing RAB, but reserve our position on the inclusion of TasNetworks' full capex program in the latter.

We also support the AER's draft decision to apply an 8 per cent reduction to TasNetworks' regulatory depreciation allowance based on its preference for year-by-year tracking of depreciation for existing assets and the impacts on depreciation of other elements of the AER's draft decision, namely a lower opening RAB and lower forecast inflation. We continue to hold concerns about expenditure on TasNetworks' Ajilis system, its 10 year depreciated life and its value to customers (as do other customer advocates).

Notwithstanding a welcome fall in capex, TasNetworks still proposes substantial expenditure for the next regulatory control period of $213.4 million in total, including $18.7 million for augex, $38.1 million in connections capex and $98.4 million for repex, which the AER accepts. We have raised several concerns with capex which would have the effect of either further reducing capex or establishing its robustness.

The draft decision accepts TasNetworks' full opex forecast of $123.1 million over the 2017–19 regulatory period. In this submission, we raise several questions about the proposed opex allowance including concerns about the asymmetric application of OEP factors to benchmarking, the static nature of the AER's productivity growth estimate and the inputs into its output growth forecast. We support the AER's decision to remove four of the five step changes proposed by TasNetworks. We observe that actual opex is subject to uncertainty, including the risk that TasNetworks is able to over spend its allowance if circumstances demand, which is a further risk to anticipated network price reductions.

The draft decision includes a cost of corporate income tax of $18.7 million over the 2017–19 regulatory control period, a reduction of $12.1 million (or 39.3 per cent) on TasNetworks' proposal. This is due to the impact of a series of related AER decisions, which we support.

The draft decision adjusts the EBSS carryover downwards to $18.1 million, a difference of $23.0 million compared to TasNetworks' proposal. Having regard to the AER's reasoning, we support this adjustment.

We support the AER's draft decision not to accept TasNetworks' proposal that the revenue at risk under the Service Target Performance Incentive Scheme (STPIS) for its distribution network be reduced from ±5 per cent to ±2.5 per cent.

Regarding the TSS, we strongly support the removal of cross-subsidies in TasNetworks' existing tariffs, which are imposing costs and inefficiencies on small business. We also support the thrust of the tariff reforms more broadly but have some concerns with their specifics. In particular, we remain to be persuaded about the benefits of rebalancing tariffs in favour of fixed charges and note that TasNetworks' estimates of the benefits of proposed new tariffs (whilst providing useful information that is welcome) are limited by a lack of complete data. We expect that steps TasNetworks says it will take in the next regulatory control period will help to inform these concerns.

We are also concerned that the 15 years transition period proposed (with 12 years remaining) is far too long. This will considerably delay the benefits of tariff reform, including removing cross-subsidy costs to small business. The very modest negative impacts shown by TasNetworks' customer impact estimates, whilst subject to potential data gaps, indicate that fears about the negative impacts of reform could be overblown. A preferable transition would be until 30 June 2024.

Our submission welcomes the positive steps that TasNetworks has taken to engage with its customers and consumer advocates about its regulatory and TSS proposals. We acknowledge that TasNetworks is continuing to improve this and has accepted some suggestions on how to do so. We would welcome additional steps by TasNetworks that clearly show it has been influenced by customer suggestions and preferences and that would integrate customer consultation holistically into its operations. Our involvement with TasNetworks' Tariff Reform Working Group has sometimes seen important suggestions not acted upon. We have an expectation that there will be further positive steps taken on customer consultation in TasNetworks' next regulatory and TSS determinations.

Just prior to the date for lodgement of this submission, the AER released its annual benchmarking report for distributors. This allowed us to take the results into account. Overall, we welcome the improvements shown in TasNetworks' benchmarked performance, especially its opex, but note that it still has significant room for further improvement in all areas. We expect the AER will consider the implications of these outcomes in its final decision.

# 1 Introduction

In this submission the Tasmanian Small Business Council (TSBC) responds to the Australian Energy Regulator's (AER) Draft Determinations on TasNetworks' Regulatory Proposal for Distribution Services and on TasNetworks Tariff Structure Statement (TSS) Proposal for the period 1 July 2017 to 30 June 2019. We welcome the opportunity to respond.

Our submission responding to TasNetworks' Regulatory and TSS Proposals was lodged in May.[1] It provides background on the TSBC and the reasons for its interest in the AER's review of TasNetworks' Distribution Services and the impacts on Tasmanian small business.

This submission is focused on:

- Our response to the draft decision and its small business electricity price impacts.
- Matters raised in the AER's Draft Regulatory Determination where there are material impacts on small business, namely, the regulated rate of return, the value of imputation credits (*gamma*), the regulatory asset base, regulatory depreciation, the Capex and Opex allowances, corporate income tax, the efficiency Benefits Sharing Scheme (EBSS), the Service Target Performance Incentive Scheme (STPIS) and customer consultations.
- The Draft Determination on TasNetworks' Tariff Structure Statement (TSS) Proposal.

Once TasNetworks' releases its Revised Proposal we will assess it to determine the need for a further response on it.

# 2 Allowed Revenue and Distribution Price Impacts

The draft decision approves average annual revenues for the 2017–19 regulatory control period that are $93.1 million ($2016–17)—or 30.2 per cent—lower than approved in the AER's decision for 2012–17 in real terms. This is 12.7 per cent ($2016–17) less revenue than TasNetworks sought to recover through its regulatory proposal.

The impact of the draft decision on small business electricity bills is expected to be a $331 (-10.2 per cent) reduction in 2017/18 compared to 2016/17, followed by a $31 (1.1 per cent) increase the next year. Compared to the Regulatory Proposal, the draft decision results in a small business prices that are $141 and $125 lower in 2017/18 and 2018/19 respectively.

The TSBC welcomes that the outcomes for 2017/18 are broadly consistent with the key objective outlined in our submission on TasNetworks' Regulatory Proposal, that is, that the

[1] See http://www.aer.gov.au/system/files/Tasmanian%20Small%20Business%20Council%20-%20Submission%20on%20TasNetworks%27%20regulatory%20proposal%20-%20May%202016.pdf.

TSBC would welcome significant reductions in future distribution charges and that they are achievable without any compromise to the reliability of electricity supplies. Unfortunately, the increase in charges that follows in 2018/19 is not consistent with our objective, although the AER's draft decision will deliver lower distribution bills for small business than the TasNetworks' Proposal in both years of the next regulatory period.

We also retain a concern that the revenue and price outcomes contained in the AER's draft decision are not as low as they could be and contain risks to higher actual network prices than those anticipated by the AER, namely, that:

- The opex allowance exactly matches TasNetworks' Proposal. Our submission on their proposal questioned in several ways that their proposed allowance was not optimally efficient, notwithstanding its welcome reductions in opex and inclusion of additional opex savings. Moreover, the AER's draft decision on opex is based on its alternative estimate of an efficient opex for TasNetworks being higher than TasNetworks' own proposal. We find this to be a curious outcome.
- A significant proportion of the reductions in revenue compared to both the current regulatory period and TasNetworks' proposal are due to the exogenous influence of lower interest rates on the rate of return. These are essentially windfall outcomes rather than ones reflective of a more efficient network. Others are due to a difference of view on the value of imputation credits, which remains under legal appeal. Actual price outcomes could be significantly impacted by factors such as rising interest rates or appeal decisions. Consumers are left to carry this risk.
- Price outcomes also assume that actual energy demand and expenditure will equal the draft decision forecasts. As the draft decision points out, "since TasNetworks operates under a revenue cap, changes in demand will also affect annual electricity bills across the 2017–19 regulatory control period."[2] Past experience shows that forecasts are often too high with actual price reductions less than expected. Actual expenditure can vary from its forecast.
- As the AER also points out, whilst Tasmanian distribution charges are significant, comprising 38 per cent, on average, of an electricity customer's bill, changes in the remaining 62 per cent of bills will also impact what small business consumers pay and could outweigh the impacts of the draft decision.

[2] AER Draft Decision, Overview, fn 6, p. 14.

The above uncertainties could have a material impact on the actual electricity bills of Tasmanian small businesses over the next two years and make the draft decision less beneficial to them than first appears.

# 3 Regulated Rate of Return

The AER draft decision provides TasNetworks with an allowed rate of return (nominal vanilla) of 5.48 per cent in 2017/18. This compares to 6.04 per cent under TasNetworks' proposal, a difference of -56 basis points, and 8.28 per cent for the AER's previous regulatory decision (2012-17), a difference of -280 basis points. This provides for a substantial reduction in TasNetworks' allowed rate of return, which has a significant influence on reducing network prices compared to both TasNetworks' Proposal and the AER previous decision. This is a welcome development for small business.

The main reason for the reduction in the rate of return in the draft decision compared to the previous AER decision and TasNetworks' proposal is lower interest rates since the proposal was submitted and associated reductions in both the returns on equity and debt; and a lower equity beta compared to the AER's previous decision. We welcome that TasNetworks' Proposal accepted the AER's rate of return guideline and its parameter values with one exception (see Section 4).

As pointed out earlier, the reliance on falls in market interest rates to deliver a significant share of the expected lower prices in the draft decision leaves Tasmanian electricity consumers exposed to a risk that interest rates will rise before the AER's final decision.

Moreover, prevailing interest rates feed into both the return on equity and return on debt components of the allowed rate of return. Whilst the return on equity is fixed for the duration of the regulatory period, the return on debt is adjusted each year for any changes in interest rates. This means that the return on debt component of the allowed rate of return could increase further in 2018/19, if interest rates rise.

In making the above points we acknowledge that any further lowering of interest rates would have the opposite effects, but current market sentiment seems to suggest that a further lowering of (historically low) interest rates are the least likely outcome.

We believe that these risks to future network prices place considerable importance on the AER ensuring that other aspects of both its allowed rate of return – and the building blocks of its draft decision more broadly – are set so as to ensure both a rate of return that reflects TasNetworks' regulated and low risk status, and costs that are demonstrably efficient.

In our previous submission on TasNetworks' Proposal we questioned the appropriateness of the setting of some of the Weighted Average Cost of Capital (WACC) parameters in the AER's Rate of Return Guideline, especially the equity beta and market risk premium, which we believe should be lower, as well as the debt/equity ratio, which we believe is not reflective of TasNetworks' actual gearing. Alternative values for these parameters and our reasons for supporting these were set out in our previous submission.

# 4 Value of Imputation Credits (*Gamma*)

The AER's draft decision includes a value of imputation credits (*gamma*) of 0.4, which is deducted from TasNetworks' estimated cost of corporate tax.[3] This differs from TasNetworks' Proposal, which was for gamma to be set at 0.25. The impact of this difference is that the estimated corporate tax allowed TasNetworks is lower by $6.2 million under the draft decision. TasNetworks' allowed revenue is similarly lowered with lower network prices the end result for consumers.

The AER's draft decision says that a *gamma* value of 0.4 "will result in equity investors in the benchmark efficient entity receiving an *ex ante* total return (inclusive of the value of imputation credits) commensurate with the efficient equity financing costs of a benchmark efficient entity."[4] It goes on to provide the justification for its value.

The value of *gamma* and the methodology used to calculate it was subject to recent extensive consultation through the AER's *Better Regulation* Program, with a value of 0.5 set by the AER (subsequently revised to 0.4).

We note that the value of gamma has been subject to recent legal appeal with a decision by the Australian Competition Tribunal supporting a value of 0.25, as proposed by TasNetworks. This has, in turn, been appealed by the AER to the Federal Court with a decision yet to be made.

Whilst the value of *gamma* will ultimately be determined through this appeals process, in the meantime we support the use of the AER's estimate in the draft decision. This is on the basis of the reasons outlined by the AER in its draft decision, the extensive and wide ranging consultations undertaken to support it, and as we believe that the value determined through this process should stand unless it is overturned by the eventual outcome of the appeals process. We also remain concerned that, whilst the 0.25 value is consistently

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[3] The National Electricity Rules require that the estimated cost of corporate income tax be determined in accordance with a formula that reduces the estimated cost of corporate tax by the 'value of imputation credits' (represented by the Greek letter, γ, 'gamma'). This form of adjustment recognises that it is the payment of corporate tax which is the source of the imputation credit return to investors.

[4] AER Draft Decision, Overview, p. 25.

supported by network businesses, this could be based on self-interest supported by detailed and complex argument. As the AER notes in the draft decision:

> *Estimating the value of imputation credits is a complex and imprecise task. There is no consensus among experts on the appropriate value or estimation techniques to use. Further, with each estimation technique there are often a number of ways these may be applied resulting in different outcomes. Conceptually, the value of imputation credits must be between 0 and 1, and the range of expert views on the value of imputation credits is almost this wide.*[5]

We note that TasNetworks has said it will accept the AER's estimate if this is confirmed by outcome of the appeal.

Finally, the uncertainty continuing to surround the eventual value of *gamma* to be used in the AER's final decision is a matter of concern to the TSBC. This adds to the uncertainly associated with the impacts of the decision on consumer prices spoken of earlier in this submission. If the outcome of the appeal is a gamma value of 0.25, revenue and prices will increase above the levels contained in the draft decision.

# 5 Regulatory Asset Base

The AER draft decision includes an opening Regulatory Asset Base (RAB) value of $1,629.4 million ($ nominal) as at 1 July 2017 for TasNetworks. This is $17.4 million (or 1.1 per cent) lower than TasNetworks' proposed opening RAB of $1,646.7 million ($ nominal). This reflects an updated 2015/16 inflation rate using the actual CPI for indexation in the RAB roll forward. We support this but refer the AER to the qualifications about TasNetworks' opening RAB included in our previous submission.

The draft decision also includes a forecast closing RAB value at 30 June 2019 of $1,753.9 million ($ nominal). This is $9.4 million (or 0.5 per cent) lower than the amount of $1,763.2 million ($ nominal) proposed by TasNetworks. This reflects the lower opening RAB, and the AER's slightly lower expected inflation rate, its lower forecast depreciation and full acceptance of TasNetworks' forecast capex. The TSBC supports the AER's lower inflation forecast, on the basis that this is more consistent with the contemporary inflation outlook and its forecast depreciation (refer to Section 6), but reserves its support for the AER's inclusion of TasNetworks' full capex program (refer to Section 7).

[5] AER Draft Decision, Overview, p. 25.

## 6 Regulatory Depreciation

The TSBC supports the AER's draft decision to include a regulatory depreciation allowance of $98.6 million ($ nominal). This represents a reduction of $8.6 million (or 8.0 per cent) on TasNetworks' proposed amount of $107.2 million ($ nominal). The main reasons for the difference and our response to each are:

- The AER's implementation of a year-by-year tracking method to calculate the depreciation for TasNetworks' existing assets instead of the average depreciation method proposed by TasNetworks. We support the AER's alternative, which will provide for more disaggregated tracking of assets and is likely to give a more accurate picture of remaining asset lives. We note that AER's comments that the application of forecast depreciation and year-by-year tracking may give rise to some distortion in the depreciation of disaggregated asset sub-classes, which can reduce the benefit of year-by-year tracking (particularly for short lived assets) and that it may also increase the prospect of negative asset sub-classes at the end of the regulatory control period. We support the AER's proposal to return negative amounts to customers over the next regulatory control period.
- Adjustments to other aspects of TasNetworks' Proposal, which impact on the regulatory depreciation allowance, namely, a downwards adjustment in its opening RAB and a lower expected inflation rate. As pointed out in Section 5, we support both these adjustments.

We note that the AER has accepted TasNetworks' proposed 10 year asset life for its proposed new Business Management System asset class, which includes its new asset management and IT solution, Ajilis. In our previous submission on TasNetworks' proposal, we expressed the need for the AER to make an independent assessment of TasNetworks' proposed asset life for the Ajilis system. We note that the AER has found that the proposed standard asset life of 10 years reflects the nature of the assets in this class and is comparable with the standard asset life used by other distributors for similar assets. The AER's assessment is limited and we remain concerned that the Ajilis system is costly and may well be of limited benefit to consumers.

## 7 Capex Allowance

TasNetworks proposed total forecast capex of $213.4 million ($2016–17) for the 2017–19 regulatory control period. The AER draft decision accepts TasNetworks' proposal.

The TSBC recognises that the AER has undertaken a detailed assessment of TasNetworks' capex proposal in line with its requirements under the NER. Notwithstanding this and the welcome falls in TasNetworks' total capex proposal, we have some remaining concerns about the Proposal and the AER's acceptance of it in full. These are discussed below.

## 7.1 Augex

TasNetworks proposes $18.7 million ($2016–17) in forecast augex (excluding overheads). The AER has accepted this. Our comments on augex follow.

- We are concerned that the AER has accepted TasNetworks' reliability augex proposal ($5.18 million, $2016/17) for its worst seven performing feeders, despite finding that outage drivers for these related to weather, vegetation and unknown factors, with planned outages also contributing. In our view the AER rightly concluded that "it is not clear whether there is a growing systemic problem of asset failure that contributed to the exceedance of the reliability standards on the seven worst feeders."[6] We believe that this finding should have lead to a closer examination of the need for some downward adjustment in the TasNetworks' Proposal. Instead, the AER has asked TasNetworks to more closely consider the willingness of customers to pay for such augmentations and consider the impacts of weather and other non-recurrent drivers. TasNetworks should do this as part of its Revised Proposal.
- TasNetworks proposed $3.26 million ($2016–17) (excluding overheads) to address quality of supply constraints, which the AER has accepted on the basis that TasNetworks has shown it to be the lowest cost option and as it was made based on historical expenditure trend. We have difficulty accepting historical trend as a basis for capex forecasts unless this can be shown to be efficient. The AER note that the amount forecast is incremental to historical trend on the basis of a predicted increase in the uptake in solar PV. In our view, this element of the forecast should be charged on a causer pays basis implemented through TasNetworks' reformed tariff structure.

## 7.2 Connections Capex

The AER has accepted TasNetworks' proposed $38.1 million ($2016–17) (excluding overheads) in connections capex, which includes $22.2 million ($2016–17) of customer contributions. Tasmanian Treasury forecasts of growth in Gross State Product (GSP) and population are used to justify these proposals. We believe that the AER should check the robustness of the State Treasury forecasts, including undertaking a 'back casting' exercise and cross-checks with other independent forecasts.

We pointed out in our submission on TasNetwork's Proposal that the forecast increases in the volume of both residential and commercial connections needed to be clearly explained. We accept that the State Government's New Home Owner Grant scheme is likely to increase residential connections, though how robustly this has impacted the forecasts remains unclear. Moreover, the justification for the increase in commercial connections should be made clearer. The back-casting of NIER's modelling and historical GSP to help establish them as useful proxies for residential connections is welcome. However, whilst we acknowledge that the use of HIA forecasts of dwelling constructions provides a cross-check for residential connection forecasts, we do not accept that

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[6] AER Draft Decision, Attachment 6 – Capital Expenditure, p. 6-32.

these forecasts are "independent" and believe further checks are justified (preferably against the truly independent source, if possible).

The TSBC welcomes that TasNetworks has taken steps to reduce its forecast expenditure across all categories of connections costs, with unit rates (after applying a top-down adjustment) much lower than the average unit rates across 2012–15. The draft decision says that this "suggests TasNetworks unit rates are likely at or close to an efficient level."[7] We do not accept this comment as it merely suggests that unit rate have fallen compared to 2012-15.

TasNetworks proposed a rate of growth of maximum demand of 1.4 per cent over the next regulatory period. In our submission on its Proposal, we noted that this is well above the level forecast by AEMO. The AER concluded that: "we consider that TasNetworks' demand forecast may not reflect a realistic expectation of demand." We concur with the AER. As they point out, whilst maximum demand has little impact on capex for the next regulatory period (due to proposed augex not being demand driven), nevertheless, the way in which maximum demand is set is likely to be important in subsequent regulatory periods and, in our view, it is important that the AER ensure the robustness of TasNetworks' forecast.

### 7.3 Repex

The AER have accepted TasNetworks' proposed repex of $98.4 million ($2016–17). Our comments on repex follow.

- The draft decisions says that implementation of TasNetworks' Asset Management Systems (AMS) has largely driven the higher trend in repex over the final two years of the last regulatory control period, and also higher repex in the first year of the 2017–19 regulatory control period. We do not agree fully with this as Figure B-9 of Attachment 6 shows a trend of rising non-AMS repex for the period 2016/17 to 2018/19, before the forecasts tail off.
- We note that the repex model under the benchmark input scenario estimates $68 million of repex. The draft decision says that this "demonstrates that TasNetworks' forecast of $77 million for the modelled asset categories is more in line with the benchmarked average asset replacement lives of service providers in the NEM than what would be expected based on their recent past replacement practices."[8] The AER appears to conclude from this – and the fall in repex over the remainder of the forecast period – that TasNetworks' repex proposal reasonably reflects the capex criteria. We find this difficult to reconcile with the gap between TasNetworks' proposal and the benchmark estimate for repex.
- We recognise that the inability of the AER to apply the repex model and tools such as benchmarking limits its assessments of AMS repex to a tops down approach, which we do not find convincing as a means of assessing capex forecasts, especially given its contribution

[7] AER Draft Decision, Attachment 6 – Capital Expenditure, p. 6-38.
[8] AER Draft Decision, Attachment 6 – Capital Expenditure, p. 6-47.

to past inflated levels of capex. Nevertheless, we welcome the detailed assessment that the AER has undertaken of TasNetworks' AMS capex, especially considering the significant increases in this component since 2015/16. Whilst we do not question the need for TasNetworks to update its AMS systems and welcome the AER's finding that TasNetworks forecast expenditures have been justified by a sound business case, consideration of alternative options and a competitive tender process, including for the Ajilis project, we remain concerned that the benefits to consumers of the expenditure have not been sufficiently demonstrated.

- We note the AER's Network Health Indicator assessment of TasNetworks' past replacement practices. We express some concern about the apparent recent deterioration in asset performance shown in Figure B-11 of Attachment 6 and expect that TasNetworks will clarify the reasons for this in its Revised Proposal.

# 8 Opex Allowance

The draft decision accepts in full TasNetworks' opex forecast of $123.1 million ($2016–17) over the 2017–19 regulatory period (including debt raising costs of $2.2 million). TasNetworks' proposal is 14.5 per cent lower (in real terms) than its annual opex spend over 2012–17. The AER's alternative forecast opex is $138.9 million (excluding debt raising costs), or $18.0 million higher than TasNetworks' proposal.

Whist welcoming the useful reductions in TasNetworks' opex proposal, we raised a number of issues in our earlier submission. We have also examined the AER draft decision, including its response to the issues we raised. In light of this we provide the following observations:

- We pointed out in our earlier submission that we would expect TasNetwork's actual opex expenditure over the next regulatory period to reasonably accurately reflect its forecasts given the short two-year regulatory period. This is notwithstanding TasNetworks' comment that, if they prove incorrect, there could be a material impact on actual opex. We note that the AER has not commented on this and also that the network tariff reductions expected to occur are already subject to risk from other elements of the AER's draft decision (e.g., interest rate changes, the outcome of the AER's appeal on gamma).
- We remain concerned about aspects of the AER's benchmarking of TasNetworks' base year opex, which indicates that TasNetworks is operating relatively efficiently when compared to other service providers in the NEM. As pointed out in our previous submission, the AER's broad ranging and somewhat asymmetric use of the OEP approach could be limiting the ability of benchmarking to help determine efficient costs.
- We support the AER's exclusion of four out the five step changes proposed by TasNetworks, which reduces the step changes from $6.7 million to $0.8 million ($ 2016/17). However, we note that this does not impact that total forecast opex accepted by the AER.
- A concern that the AER's productivity growth forecasts are static. The AER support these forecasts by saying that they have increased from past negative productivity and that declining demand reduces TasNetworks' ability to achieve productivity growth.

Nevertheless, the high levels of capital investment undertaken by all NEM distributors in previous regulatory periods should by now be providing a substantial productivity dividend. We are concerned that the AER's static productivity forecast may reflect inefficiencies. While TasNetworks has forecast productivity gains beyond the AER's forecasts so that the AER's alternative opex forecast is not in play, the AER's forecast alternative opex may be higher than it should be and any limitations in it could impact future opex allowances.

- In our previous submission we reserved our position on TasNetworks' proposed output growth forecast in its opex proposal. We note that the AER's forecast matches TasNetworks'. Nevertheless, we retain our concerns about the robustness of this forecast given our related concerns that the forecast growth in parameters feeding into the forecast.

We note the AER's comment that the draft decision to accept TasNetworks' proposal appropriately accounts for safety and reliability obligations and that:

> *If TasNetworks cannot achieve the proposed opex productivity gains, it may incur costs above what we consider are efficient levels.*[9]

However, given the shorter than normal two-year duration of this regulatory determination we would expect the forecasts to be reasonably accurate. Nevertheless, TasNetworks' ability to incur additional costs is another risk to the expected price reductions.

# 9 Corporate Income Tax

The draft decision includes an estimated cost of corporate income tax of $18.7 million ($ nominal) over the 2017–19 regulatory control period. This is a reduction of $12.1 million (or 39.3 per cent) on TasNetworks' proposed corporate income tax allowance of $30.9 million.

The difference reflects AER amendments to some of TasNetworks' proposed inputs for forecasting the cost of corporate income tax, including the opening tax asset base, standard tax asset lives and remaining tax asset lives. It also reflects the AER's higher value of *gamma*. Other draft decision adjustments to the EBSS carryover amounts, the return on capital and the regulatory depreciation have consequential impacts the tax calculation.

We support the AER's adjustments and hence its adjusted corporate income tax cost.

# 10 Efficiency Benefits Sharing Scheme

TasNetworks proposed a carryover amount of $41.1 million for the application of the Efficiency Benefits Sharing Scheme (EBSS) in the 2012-17 regulatory period. The draft

[9] AER Draft Decision, Attachment 7 – Operating Expenditure, p. 7-20.

decision applies a downwards adjustment to the EBSS carryover which becomes $18.1 million, a difference of $23.0 million. We support this adjustment which involves:

- The use of a different year (2015/16) by TasNetworks to forecast actual opex in the EBSS to that used (2014/15) as the base year to forecast opex, which reduces the EBSS carryover by $20.4 million ($ 2016/17).
- Use of an equation by TasNetworks to calculate the incremental efficiency gains in the first year of the regulatory control period which is meant to apply if the EBSS has previously applied to TasNetworks, which it has not. Using the correct equation reduces the carryover by $0.6 million ($ 2016/17).
- Using the same CPI used to calculate the efficiency gains as the CPI used to establish the base year used to forecast opex, which is not the case with TasNetworks' Proposal and may create windfall gains or losses, which increases the carryover by $0.9 million ($ 2016/17).
- Application of an NPV to the carry-over amounts in the two years of the next regulatory period that reflects the lower rate of return used in the AER draft decision. We note that this calculation will be updated in the AER's final decision.

# 11 Service Target Performance Incentive Scheme

In our previous submission, we commented on TasNetworks' proposal that the revenue at risk under the Service Target Performance Incentive Scheme (STPIS) for its distribution network be reduced from ±5 per cent to ±2.5 per cent. We raised some concerns with the proposal and suggested that the STPIS be modified to a penalty only scheme.

The draft decision sets out why the AER has not accepted TasNetworks proposal. We have considered the arguments set out in the draft decision and accept the reasoning behind them. We also note the AER's comment that it is not able to depart from the design of the STPIS and its Framework and Approach for this determination without a full review.

# 12 Tariff Structure Statement

The TSBC supports the concept of network tariff reform to implement more cost reflective prices. We recognise that many of the proposals put forward in TasNetworks' Tariff Structure Statement (TSS) have the potential to ultimately benefit customers, including small businesses, the electricity industry and the Tasmanian economy more broadly.

We offer strong support for the proposal to remove cross-subsidies from existing network tariffs and note that, as the general business tariff (TAS22) – which applies to 95 per cent of business customers, including the vast majority of small businesses – is the source of a cross-subsidy, small business will benefit from its move to more accurately reflect costs.

However, we remain less persuaded about the desirability of moving to a regimen of more reliance on fixed charges in tariffs. We recognise that this may better reflect the costs of network investment for peak demand, but are concerned that customers' ability to respond to the resultant price signals may be more limited than thought, that some may be driven to disconnect from the grid and other potential unintended consequences.

We note the estimate in TasNetworks' submission on the AER's TSS Issues Paper that customers on TAS22 will pay $1,450 (or 25.2 per cent) less in 2018/19 than in 2015/16 as a result of its TSS proposals. We also note that the vast majority of small business customers on TAS22 are expected to benefit over this period, with the magnitude of the benefit increasing with energy consumption (Figure 11 of the submission).[10]

Whist we support the thrust of TasNetworks' proposals to introduce a range of new time-of-use tariffs, including for small business, on an opt-in/opt-out basis (at least for the two-year duration of the next regulatory period), at this stage we are unable to offer unqualified support for these. Whilst they will likely result in more cost reflective network pricing, more detailed and accurate information than is currently available about their benefits, including for small business customers, needs to be provided to allay consumer concerns. Moreover, it is possible that these tariffs could become mandatory in the subsequent regulatory period, making knowledge of their impacts even more critical.

In adopting this position we have taken into account TasNetworks' submission on the AER's TSS Issues Paper, which provides some estimates of the customer impacts of these proposed new tariffs. We particularly note TasNetworks' estimate that a typical small business customer could expect a reduction of 20 per cent ($150) per annum compared to its 2015/16 network bill. We further note that limitations in the data currently available to TasNetworks, including only the availability of average system load profiles, limits its ability to provide more accurate estimates of customer impacts. We welcome that it expects to undertake a range of activities, including trials, access to customers taking up the new tariffs and ongoing dialogue with customers and stakeholders, over the next regulatory period. This will allow it to provide more accurate calculations of customer impacts for the next AER determination.[11] We expect to then re-examine our position on these new tariffs.

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[10] Out of a total of 32,231 TAS22 customers, 28,286 (87.8 per cent) are shown to benefit. Nevertheless, 14,672 (45.5 per cent) either pay more or receive only modest savings and 18,115 (56 per cent) either pay more or get a saving of less than $200. Only 4,663 (14.5 per cent) save between $250 and $500.

[11] TasNetworks has stated that: "The information currently available is potentially unreliable for the purpose of estimating behaviour, price impacts and revenue. This increases the difficulty of calculating network tariffs and forecasting revenue, which will increase price and revenue volatility for customers and retailers." See TasNetworks, *Response to AER's Issues Paper: Tariff Structure Statement Proposals – TasNetworks, Submission*, April 2016, p 36.

We recognise that the opt-in/out-out basis for the introduction of time-of-use tariffs allows customers to trial impacts themselves but their willingness to do so will likely be impacted by a natural aversion to the unknown, transaction costs, information gaps and a need to pay for new meters.  If TasNetworks were able to assist customers in better understanding the new tariffs and their impacts it could help mitigate such factors.

It would be useful for TasNetworks' to update the estimates of the customer impacts of its TSS proposal in its revised proposal, and to include a comparison with 2016/17 and (expected) 2017/18 tariffs (based on the AER draft revenue determination).

The TSBC is also concerned with the length of the 15 year transition (with 12 years remaining) for tariff reform proposed by TasNetworks and accepted by the AER.  This is an exceptionally long transition that will mute the benefits of tariff reform, including for small business and the economy, for a very long time.[12]  TasNetworks and the AER should consider shortening this to, say, the end of the 2019-24 regulatory control period.

Moreover, based on TasNetworks' estimates, the vast majority of residential and small business customers will obtain benefit from reform, the delivery of which will be substantially delayed by the long transition.  We note that TasNetworks' submission estimates that the most negatively impacted customer on the TAS31/41 residential tariff combination will experience a very modest increase in network charges of about $6 between 2015/16 and 2018/19.  This suggests that concerns about tariff shock may be overblown, though uncertainties about actual customer impacts remain.

In support of this section of our submission, we apend a copy of a report by Goanna Energy Consulting entitled, *Cross-subsidies in Tasmanian Electricity Tariffs – their Impacts on Small Business*, which we recently commissioned reflecting our long-standing concern that small business has been the source of a significant cross-subsidy in Tasmanian electricity tariffs.

Finally, we draw to the AER's attention that the TSBC provided comments on the TSS proposal as part of its original submission on TasNetworks' proposals, but this appears not to have been recognised in the TSS draft decision.  TSS coverage was clearly labelled on the cover page of our submission.  We are concerned that this may have limited the AER's consideration of small business impacts in its TSS draft decision.

[12] We welcome that TasNetworks has said in its submission on the AER's Issues Paper that it will transition more quickly if future revenue reductions permit this.

## 13 Customer Consultation

The TSBC has previously welcomed TasNetwork's useful efforts at consulting with its customers on regulatory determinations and acknowledged the efforts it has made in this determination to date. We have also recognised the improvements that TasNetworks has made over time. Furthermore, we note that TasNetworks has committed to additional improvements in future, including on some specific suggestions emerging from this review. We note that the AER has said that it expects TasNetworks to take into account the issues raised by stakeholders in further developing its future customer engagement activities.

Our earlier submission highlighted that TasNetworks could more clearly and frequently set out how customer feedback has affected its expenditure forecasts. Our desire is to ensure that TasNetworks demonstrates that customers have influenced its revenue and TSS proposals in meaningful ways. As a member of TasNetworks' Tariff Reform Working Group, we are concerned that member argument against the greater use of fixed charges and the TSBC's support for a faster transition were not given sufficient weight by TasNetworks.

The TSBC supports other suggestions, such as the desirability of more opportunities for involvement from regional consumers, including small business. We also support that TasNetworks closely integrate customer preferences into its *Voice of the Customer* program, especially that cost is its customers' greatest concern and that they are not willing to pay higher prices for improved reliability. Finally, we would welcome additional steps from TasNetworks to build continuous consultation with its customers holistically into its operations. We have an expectation that there will be further positive steps taken on customer consultation in TasNetworks' next regulatory and TSS determinations.

## 14 AER's Latest Economic Benchmarking Report

Just prior to the deadline for lodgement of this submission, the AER released its latest Economic Benchmarking Report for Distribution Businesses, which shows results for 2014/15. This allowed us to examine the results and we include some comments on them below given their relevance to the AER's Determination for TasNetworks.

We are pleased to see a significant improvement in TasNetworks' Multilateral Total Factor Productivity (MTFP) and its Multilateral Partial Factor Productivity (MPFP) for opex. However, MTFP has not yet recovered to the levels shown for the early years of the measurement period. Moreover, MTFP, despite the improvement in 2015, remains anchored in ninth position.

Opex MPFP has improved so TasNetworks ranks second among NEM distributors and it has achieved its best score over the measurement period (commenced in 2006). It had previously ranked nearer the bottom on MPFP opex. This mainly reflects savings from the merger of its transmission and distribution arms, reflecting one of its main drivers. It gives us increased confidence that TasNetworks' opex is becoming more efficient, although gains are reflective of reduced overheads, with maintenance costs relatively steady.

Capex MPFP also improved in 2014/15 but less so and, on this measure, TasNetworks continues to rank at the bottom of NEM distributors. It has a considerable way to go to recover from its higher score and ranking early in the measurement period. This supports our reservations about TasNetworks' capex proposal.

The AER's report also shows a number of other partial productivity indicators (average for 2010/11 to 2014/15), namely, total cost per km of circuit line length against customer density, total costs per MW of maximum demand and total costs against total minutes off supply (per customer). These show TasNetworks' performance sits around that of its closet peers, though towards the high side of this group.

We also note the AER's comment that too much emphasis should not be placed on single year results with trends and longer term measurements providing better indicators of productivity. These show TasNetworks in a less favourable light and tend to support our reservations about its current expenditure proposals. Overall, we welcome the improvements shown in TasNetworks' benchmarked performance, but note that it still has significant room for further improvement in all areas.

We welcome the AER's benchmarking work which assists customer advocates and expect the AER will consider the implications of these latest outcomes in its final decision.

# 15 Conclusion

The TSBC welcomes the revenue and network price reductions that form part of TasNetworks' Regulatory Proposal. We also welcome that the AER's draft decision includes measures that will deliver savings to customers in addition to these. In this submission we have commented on numerous aspects of the draft decision that both support and raise issues about it. The issues suggest to us that further steps are possible to deliver and help lock in additional benefits to customers in the final decision.

Nevertheless, we remain especially concerned that several aspects of the draft decision leave consumers at risk of not attaining its revenue and price benefits in the AER's final decision through possible interest rate increases, an adverse Federal Court decision on *gamma*, demand forecasting errors and additions to allowed opex. In addition, TasNetworks' Revised Proposal could impact the revenue and price reductions. This downside risk to customers, including small business, suggests to us that the AER needs to take all reasonable steps to lock the expected benefits to customers into its final decision.

In relation to the AER's draft decision on TasNetworks' TSS proposal, we welcome the reductions in cross-subsidies, including those that penalise small business, retain concerns about the greater reliance on fixed charges, provide qualified support for the introduction of new time-of-use tariffs, including for small business, subject to provision of more accurate customer impacts and believe there is a justifiable case for a shorter transition to be completed by 30 June 2024, not 30 June 2029 as proposed.