Major Energy Users Inc.

Australian Energy Regulator

Tasmanian Electricity Transmission Revenue Reset

AER Draft Decision and TasNetworks revised proposal

A response

by

The Major Energy Users Inc

February 2015

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The views expressed in this document do not necessarily reflect the views of the Consumer Advocacy Panel or the Australian Energy Market Commission.

The content and conclusions reached are the work of the MEU and its consultants.

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Executive Summary

The Major Energy Users (MEU) welcomes the opportunity for presenting its views on the Australian Energy Regulator's (AER) Draft Decision on the regulatory proposal by TasNetwork's transmission (TN) for the period 2014-15 – 2018-19).[1]

In this submission, the MEU considers the AER's Draft Decision on TN's initial regulatory proposal and the TN revised proposal. The AER's Draft Decision did not vary a great deal from TN's initial proposal, other than updating a number of WACC proposal elements. In January 2015, TN formally accepted the AER's Draft Decision as its revised regulatory proposal[2] albeit with a number of caveats.

The MEU is concerned that the AER will regard the determination process as complete and will not revisit the concerns raised by large and small businesses with TN's initial regulatory proposal.

For this reason, the MEU's submission revisits some of the issues raised in the MEU's original detailed submission to the AER in response to TN's regulatory proposal. These issues are revisited in summary form in this submission. The MEU requests, however, that the AER take account of the detailed information provided in the MEU response to TN's initial regulatory proposal.

The MEU, however, would welcome further discussion with the AER or TN on any of the matters raised herein or in the original submission.

TasNetwork's Revised Regulatory Proposal for 2014-15 to 2018-19

The MEU notes that TN submitted a revised proposal which formally accepted the AER's Draft Decision but raised some caveats about the AER's Draft Determination.

Because of this, this MEU response concentrates on its concerns with the AER draft decision and how aspects of it have not recognised key issues raised by consumers. The MEU response also raises some aspects which the AER has failed to grasp when reaching its draft position on the TN proposal

AER draft decision on TasNetwork's Regulatory Proposal for 2014-15 to 2018-19

In making its Draft Decision (DD), the AER made the following constituent decisions:

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[1] AER, Draft Decision, *TasNetworks transmission determination 2015-16 to 2018-19*, November 2014. [AER*, Draft Decision*, 2014].

[2] TasNetworks, *Tasmanian Revised Transmission Revenue Proposal (Regulatory control period 1 July 2015 – 30 June 2019)*, 6 January, 2015. [TN, *Revised Proposal*, 2015]

- Reduced TN's proposed capital expenditure (capex) or the period by around 11%;

- Accepted TN's proposed operating expenditure (opex); and

- Accepted TN's proposed weighted average cost of capital (WACC), after adjusting for changes in the risk free rate and debt costs;[3]

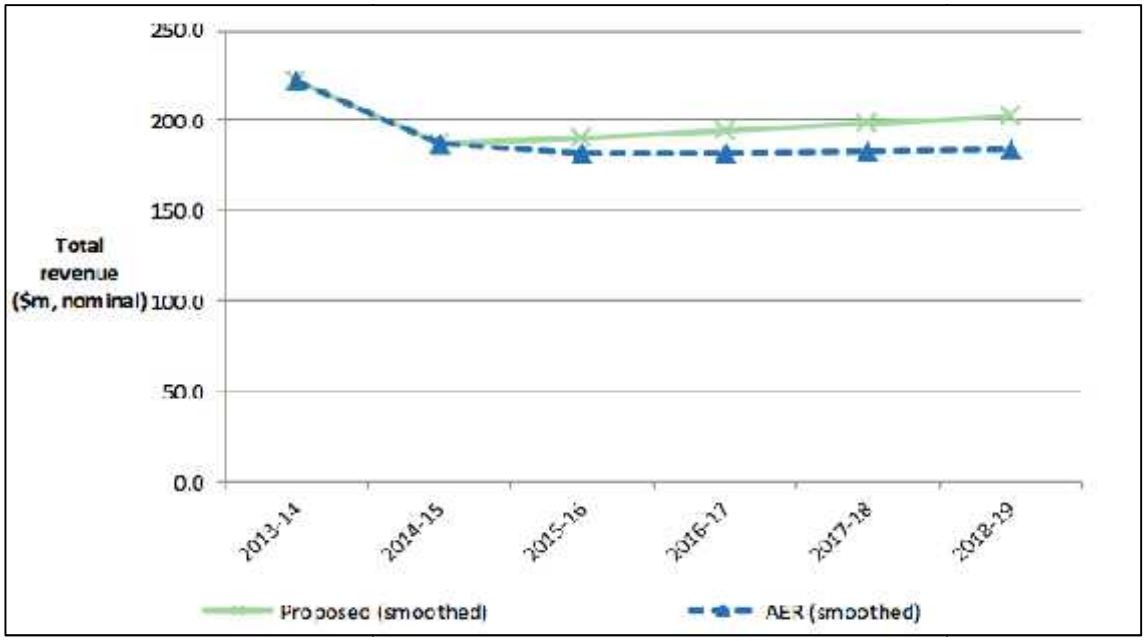
Overall, the AER has determined a total revenue allowance for the remaining four years of the regulatory period (2015-16 – 2018-19) should be some 6% lower than TN had requested in its Initial Proposal.

The MEU acknowledges that TN had already reduced its revenue below its regulated allowances in the last two years of AA2. For example, TN states that it has foregone $37 million of revenue in the two years, 2012-13 and 2013-14. Further, despite being allowed to have a higher allowance and the ability to recover these under-runs, TN has commented that it does not seek to recover these shortfalls in the future[4]. The reduction in revenue in 2013-14 was about 10% and this flowed through to TN prices. This reduction in revenue was facilitated by TN reducing its capex by 17% and opex by 14% compared to the AER's allowance for AA2. While it is pleasing that TN recognised the issues facing it reasonably early in AA2, the reductions should be seen against the backdrop of the very large increases allowed for AA2 compared to AA1 as discussed below.

[3] There was also a small difference in the cost of debt reflecting somewhat different sources of information

[4] This is a strikingly different view to that expressed by TransGrid which similarly reduced its revenue in the current period but will recover the foregone revenue

Figure 1: AER's draft decision on MAR compared with TN's proposed MAR



Source: AER, Draft Decision, 2014, Figure 7-3, p 28

The MEU also notes that TN undertook a significant reduction in its average selling prices by nearly 20% in the first (transitional) year of AA3 (2014-15). Figure 1 also demonstrates that the TN proposed a small increase in nominal terms from 2015-16. The AER's amendments to the allowed revenue means that there is now a slight fall in nominal revenue for the rest of the new period.

The MEU also acknowledges that TN has generally complied with the AER's Guidelines, in particular, the AER's Rate of Return Guideline[5] as it developed its initial proposal The AER's Guidelines were developed after extensive consultation by the AER with all stakeholders and the MEU appreciates that TN has respected this process.

The MEU also noted in its previous submission that TN's revised pricing methodology was not cost reflective and was not therefore consistent with the pricing objectives under the NER. The MEU argued that cost reflective pricing principles mean that prices should be based on the peak usage each user imposes on the network rather than TN's proposal, i.e., that of using the lower of demand and consumption for non-locational TUoS and common service charges.[6]

[5] AER, Rate of Return Guideline, December, 2013.
[6] The MEU has provided an extensive discussion of its concerns with TN's pricing approach in its previous submission. See: MEU, *Submission on TasNetworks revenue proposal*, August, 2014, pp 72-78.

The MEU's concerns with the AER's Draft Decision

As noted above, in its Draft Decision, the AER has accepted much of TN's initial revenue proposal, with only relatively small cuts to its proposed capital expenditure and minor adjustments to the WACC (reflecting in large part the reduction in interest rates since the TN's proposal was submitted in May 2014).

In accepting much of TN's proposal, the MEU believes that the AER has not properly considered the views of consumers in Tasmania as set out in their submissions to TN's original regulatory proposal. The MEU considers it is particularly important for the AER (and TN) to acknowledge the concerns of large users given the reliance of TN on the sustainability of the continued operation of these users.

The reliance on these large customers has in fact been recognised by TN who recently stated that: "*TasNetworks therefore remains vulnerable to the loss of one major customer"*.[7]

Indeed, the MEU would go further. There is an absolute need for both the AER and TN to recognise the importance of restoring electricity pricing to acceptable levels at all parts of the electricity value chain. We believe that the AER has incorrectly concluded that: [8]

> "…the overall revenue allowance for TasNetworks provides a return sufficient to promote efficient investment, while incentivising TasNetworks to operate its network more efficiently. We are also satisfied that the overall revenue allowance, will, to some extent, mitigate potential risks that consumers are unwilling or unable to efficiently use the network."

In response to this, the MEU notes in the first instance that, while the AER has accepted TN's proposed opex, the savings demonstrated by TN appear to be largely the $8 million annual savings in corporate overheads from the consolidation of Transend with Aurora Energy. We would expect both greater synergy savings over the five years and additional savings in improved operational efficiency in its operations. In this regard, the MEU notes that the users of the TN services have faced significant pressure to reduce their costs as a result of considerable market movements, yet there appears to be no expectation that TN should be required to reduce its costs to the same extent when faced by a falling demand for its services.

The MEU also sees a stark contrast between the AER's conclusion that its Draft Decision will "mitigate potential risks" of consumers using less than the efficient level of electricity and all the submissions from all the major users and the Small Business Council.

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[7] Caruana P, "*Power Boss Warns pricing 'unrealistic'*", The Examiner, October 30, 2014.
[8] AER, *Draft Decision*, 2014, p 24.

The MEU considers that both the levels of pricing and the structure of the tariffs still imposes considerable negative influence in attempting to get active consumer engagement in demand management

Some conclusions

Overall, whilst the revenue outcome approved by the AER in its Draft Decision takes TN in the right direction, and is an improvement on the AER's past decision on Transend's previously allowed revenues, there are a number of aspects that must still be addressed.

In particular, the MEU reiterates that, although TN has acted to improve its efficiency, TN's proposal is not delivering the outcomes for consumers that are expected, particularly when considering the extensive work that has been carried out over the past few years to address the ever-burgeoning costs for the provision of electricity transmission network services in Tasmania.

The MEU expected that the TN proposal, or the AER's Draft Decision, would have resulted in considerably greater reductions in both opex and capex than has been allowed in the draft decision. In particular, the MEU highlights that the AER approach incorporates considerable conservatism that effectively allows higher costs for TN than is warranted.

The MEU, therefore, does not accept that the AER's Draft Decision is in the long-term interests of Tasmanian consumers. The MEU is, looking to the AER to revise its Draft Decision in line with the recommendations of the MEU, its members, small business and, more generally, the Tasmanian public.

A summary of the key constituent decisions in TN's initial proposal, and by the AER, is set out in Table 1 below. It demonstrates that despite the strong views of users expressed through the process that costs must be cut back further, the AER has made only slight amendments to TN's proposal.

Table 1: Comparison of TasNetwork's regulatory proposal, the AER draft decision and TasNetwork's revised proposal

	Capex $ millions 13-14	Opex $ millions 13-14	WACC (1) (indicative) %	Maximum Average Revenue (2) $ millions nominal	Closing RAB $ millions nominal
TasNetworks Proposal May 2014	275.9	218.3	7.58	972.9	1603.9
AER Draft Decision Nov 2014	246.4	218.3	6.88	918.1	1553.8
% change	*10.7%*	*0%*	*N/A*	*5.6%*	*3.1%*
TasNetworks Revised Proposal Jan 2015	246.4	218.3	6.88	918.1	1553.8

(1) The difference in the WACC is largely a matter of timing. Both parties agree that the WACC will be updated to reflect the risk free rate and debt costs closer to the final determination. TN also used a somewhat different approach to calculating the cost of debt; TN only used the Reserve Bank 10-year BBB bond data, The AER applied an average of Reserve Bank and Bloomberg fair value curve.

(2) The MAR figures include revenue forecast for the transitional year 2014-15. The revenue in subsequent years was adjusted to account for the over-recovery of revenue in the in the transitional year 2014-15.

It should be noted, for instance, that the reduction in WACC from 10% in AA2 to around 6.9% in AA3, is very largely due to the fall in interest rates that has occurred since May 2014. Similarly, the reduction in capex is in part a recognition by both TN and the AER that some projects need not proceed given the decline in demand relative to forecasts. However, there is still considerable replacement capex proposed by TN that is probably not required to maintain the levels of network reliability and performance set out in the relevant regulations.
The resultant very considerable revenue requirement that the outturn AER assessment results in allows considerably more revenue than the MEU considers is necessary for the provision of the services and to achieve what consumers require will involve some more hard choices by TN and its owner about priorities and asset values.

The MEU has appreciated the recent, more consultative approach by TN and we would welcome the opportunity for further discussions with TN and the AER to explore these options. The time is short for real reform that will support a sustainable and productive industry sector in Tasmania.

As noted above, the MEU believes that despite the AER largely accepting TN's proposal, the MEU's concerns are still very relevant and these have been previously expanded on in our earlier submission. Rather than reiterate in detail our previously

expressed concerns in this submission we will only briefly repeat those arguments, and refer the AER to the MEU's earlier submission if further details are required.

The MEU is also happy to clarify any of these matters with the AER.

1. Introduction

The Major Energy Users Inc (MEU) welcomes the opportunity to provide comments on the application for a revenue reset for the Tasmanian electricity transmission system by TasNetworks (TN).

The members of the MEU are large energy intensive businesses that use a significant proportion of the electricity generated in Tasmania. As such, they are highly dependent on the transmission network to deliver an efficient, reliable and affordable supply of electricity. Transmission charges are a very large part of their business input costs.

The MEU also reiterates some of its comments in the submission on TN's original revenue proposal in that the AER must take account of the following matters:

- Transmission charges are a very large component of the companies electricity input costs;
- Reliable supply of electricity is critical to their energy intensive operations;
- The quality of that supply is increasingly important given the move to more sensitive equipment to maintain full production; and
- The businesses have invested considerable capital in establishing operations in Tasmania, and have done so on the basis of a sustainable supply of reasonably priced electricity (and gas); recent developments have challenged this assumption.

The recent capital investment program by TN has done much to shore up TN's supply reliability and quality, perhaps even excessively so. The MEU also notes that TN is now talking with its large customers about cost-effective trade-offs between further investment and reliability of supply and demand management options. This consultation started to take place in the later stages of the development of the TN initial proposal and has continued thereafter.

However, TN's investment program in the most recent period (AA2) was approved and implemented in an era of forecast continued growth in demand that never eventuated. The additional but not required investment, therefore has led to excess capacity in many parts of the TN transmission network. This reduces the stress on the system and provides TN with a unique opportunity to cut back its capex program (both augmentation capex - augex - and replacement capex - repex) further without impinging on the reliability and quality of supply.

1.2 The scope of this review

The MEU notes the 2012 revisions to the NER and the AER's subsequent 12 month Better Regulation program which provided the basis for the AER to develop a number of formal guidelines. The changes to the NER have provided a much greater opportunity for the AER to exercise its discretion and make its decisions with the long-term interests of consumers as its primary objective. The rule amendments also reinforced the AER's obligation to use benchmarking as a tool to assess the efficiency of the businesses.

It is noted by the MEU that TN has elected to generally comply with the approaches set out in these guidelines and that TN has accepted the revisions to its proposals as set out in the AER's Draft Decision.

This is welcomed by the MEU as the new guidelines were developed after wide consultation and with significant consumer input. In the MEU's view, it is important for the development of a more cooperative and constructive approach to network regulation that the AER's guidelines are followed and that any variation from the guidelines is only undertaken in consultation with consumers.

Although the MEU does not agree with all aspects of the guidelines, particularly the Rate of Return Guideline (which the MEU believes has provided a conservative assessment of WACC parameters), it must be acknowledged that TN has led the way for other electricity network companies in working cooperatively with the AER on this matter and genuinely engaging (and continuing to do so) with its customers.

Importantly, TN appears to now acknowledge the stress that the recent electricity price rises have caused its customers, the threat that this in turn poses to their own business' viability and, therefore, the need for urgent action to put electricity supply on a sustainable footing.

The MEU has observed that many other NSPs have not yet grasped the impact of the changing market dynamics and continue to try to protect their monopoly status and financial benefits. TN is at the forefront of recognising the need for change.

That does not, however, mean that the MEU accepts all aspects of TN's proposal or of the AER's Draft Decision. The MEU's submission to TN's May 2014 regulatory proposal demonstrated a number of areas of concern to the MEU. The MEU considers that the AER has not adequately addressed these concerns in its draft decision as highlighted in this submission.

1.3 A summary view of the TN's Initial Proposal for 2015-2019 & the AER's draft decision

There are a number of significant events in the Tasmanian energy market that have had an influence on TN's proposal and the AER's response to this. These include:

- The forecast demand growth, which was a major contributor to the previous high investment in augmentation capex, has not occurred, leaving a significant overhang of capacity;

- The strong feedback from customers that the increases in transmission prices were not viable and put at risk industry development and even the viability of the TN business model;

- The cost of capital has significantly declined, and has remained at historically low levels for some years providing an opportunity for a reduction in the regulated WACC of over 200 basis points;

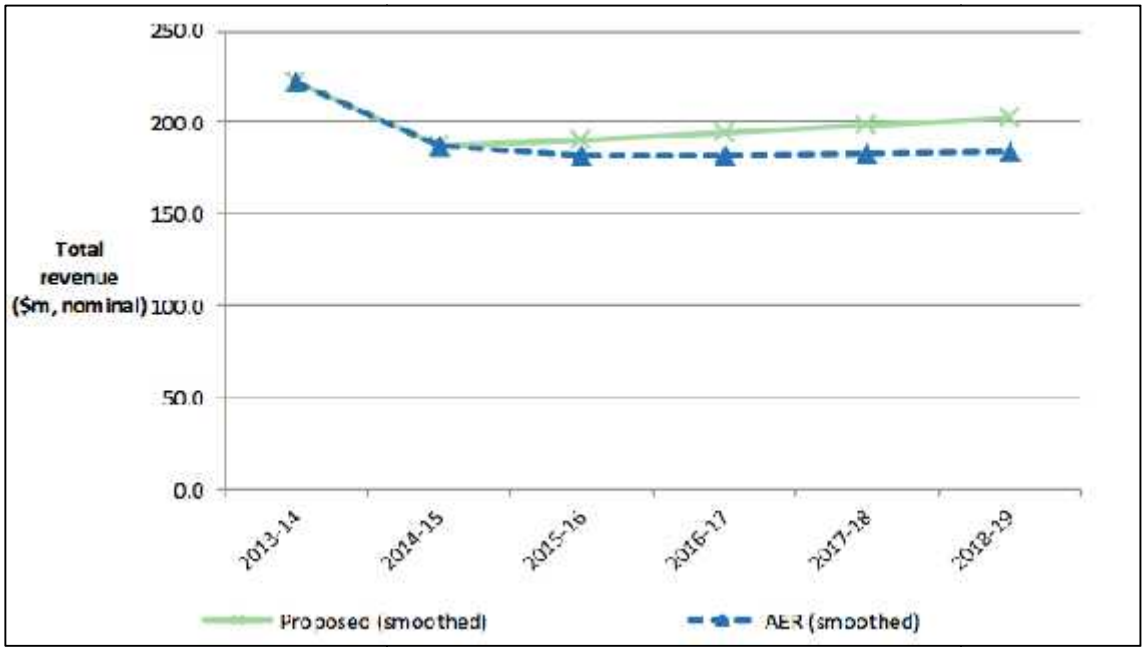
- The merger of Transend and Aurora into the one corporate entity, TasNetworks that should generate immediate cost savings in overheads and longer-term savings in synergy of work forces, equipment and property.

All these factors, plus the general reduction in labour costs and costs of materials, provides an opportunity for further significant reductions in revenue without threatening the viability of TN.

It is to TN's long-term advantage to adjust the price of its transmission services in order to maximise these opportunities and to stimulate an efficient level of growth in electricity demand. For example, the fall in the Australian dollar provides an opportunity for Tasmania to expand its processing, manufacturing, agriculture and tourism **- if domestic electricity price settings are right**. TasNetworks is integral to getting the domestic settings right as it accounts for some 15% of electricity costs, and even more for larger businesses.

TN's proposal includes significant reductions in expenditure and the maximum allowed revenue (MAR) in the first year of the new regulatory period (2014-15) followed by relatively small increases in nominal revenue for the remaining four years (decrease in real revenue). The AER's Draft Decision results in a small reduction in nominal prices across the regulatory period, as illustrated in Figure 2 below.

Figure 2: AER's draft decision on MAR compared with TN's proposed MAR
Source: AER, Draft Decision, 2014, Figure 7-3, p 28.



The reduction in TN's proposed revenue requirement reflects reductions in all the three of the key building block components compared to the previous regulatory period (AA2). The AER has accepted TN's proposal in large part, subject to two matters:

(i) an agreed and relatively small change in the capex allowance (due largely to the agreed postponement of a number of larger projects), and
(ii) the agreed updating of parameters in the WACC. TN has accepted these changes albeit with a number of caveats.[9]

Table 2 below sets out TN's initial proposal on the key building block components and the AER's Draft Decision on each of these. For completeness, the table includes a line for TN's revised proposal. However, as TN has accepted the AER's Draft Decision, the outcomes are the same.

[9] TN has accepted the AER's WACC assessment but points to a number of studies that suggest the cost of equity should be higher. The MEU does not agree with this alternative approach to the assessment of the cost of equity. TN has also queried the AER's treatment of provisions in assessing the opening RAB has it believes the AER has previously indicated it would accept the approach adopted by TN. See, TasNetworks, *Revised Proposal*, 2015.

Table 2: Comparison of TasNetwork's regulatory proposal for 2014-15 to 2018-19, the AER draft decision and TasNetwork's revised proposal

	Capex $ millions 13-14	Opex $ millions 13-14	WACC (1) (indicative) %	Maximum Average Revenue (2) $ millions nominal	Closing RAB $ millions nominal
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1. The difference in the WACC is largely a matter of timing. Both parties agree that the WACC will be updated to reflect the risk free rate and debt costs closer to the final determination. TN also used a somewhat different approach to calculating the cost of debt; TN used the Reserve Bank data 10-year bond data only, AER applied an average of Reserve Bank and Bloomberg fair value curve.
2. The MAR figures include revenue forecast for the transitional year 2014-15. The revenue in subsequent years is adjusted to account for the over-recovery in the transitional year.

However, the MEU considers that the AER's Draft Decision for AA3 should not be made without considering it in the context of the previous decision in AA2 which saw significant over forecasting of demand, massive increases in investment and doubling of prices to consumers. That is, the AER needs to assess TN's proposal on the basis that the cost rises in the last period (AA2) were demonstrably excessive and has left an overhang of capacity across most of TN's network.

In the MEU's view, the corollary of the over expenditure in AA2, and the forecasts of low or even declining growth in usage and demand, is that TN's capex and opex proposals for AA3 should be examined in greater detail than is evident from the AER's Draft Decision.

As noted above, however, these reductions in average revenue should be seen against a backdrop of the massive increases in TN's prices seen between 2010 and 2013 (effectively doubling over the period 2008/09 to 2011/12[10]) and some 300% in price rises over the decade 2000 to 2010.

[10] For instance, see the MEU response to the TN initial proposal page 3 which shows the change in average prices relative to peak demand in the TN network

The significance of these changes in transmission prices can be seen in the table 3 below extracted from the 2012 review of the electricity industry in Tasmania. The transmission charges are costs that are passed through to the regulated retail prices for customers supplied from Aurora's distribution system. However, they are also indicative of the proportional increases that would be faced by direct connection customers.

Table 3: Components of Aurora Energy's revenue allowance (c/kWh nominal)

	2000	2010-11	Nominal change since 2000	Change (%)	Contribution to total change (%)
Wholesale Energy Allowance	3.89	8.26	4.37	112	41
Transmission Charges	0.89	3.56	2.67	300	25
Distribution Charges	3.74	6.45	2.72	73	25
NEM Costs	0.09	0.10	0.02	18	-
RECs	0.00	0.41	0.41	n/a	4
Cost To Serve + Retail Margin	1.10	1.65	0.55	50.0	5
Total	**9.70**	**20.43**	**10.73**	**111**	**100**

Source: Data supplied by the Office of the Tasmanian Economic Regulator

Source: Electricity Supply Industry Expert Panel, Volume 1, Table 14.1, p 163.

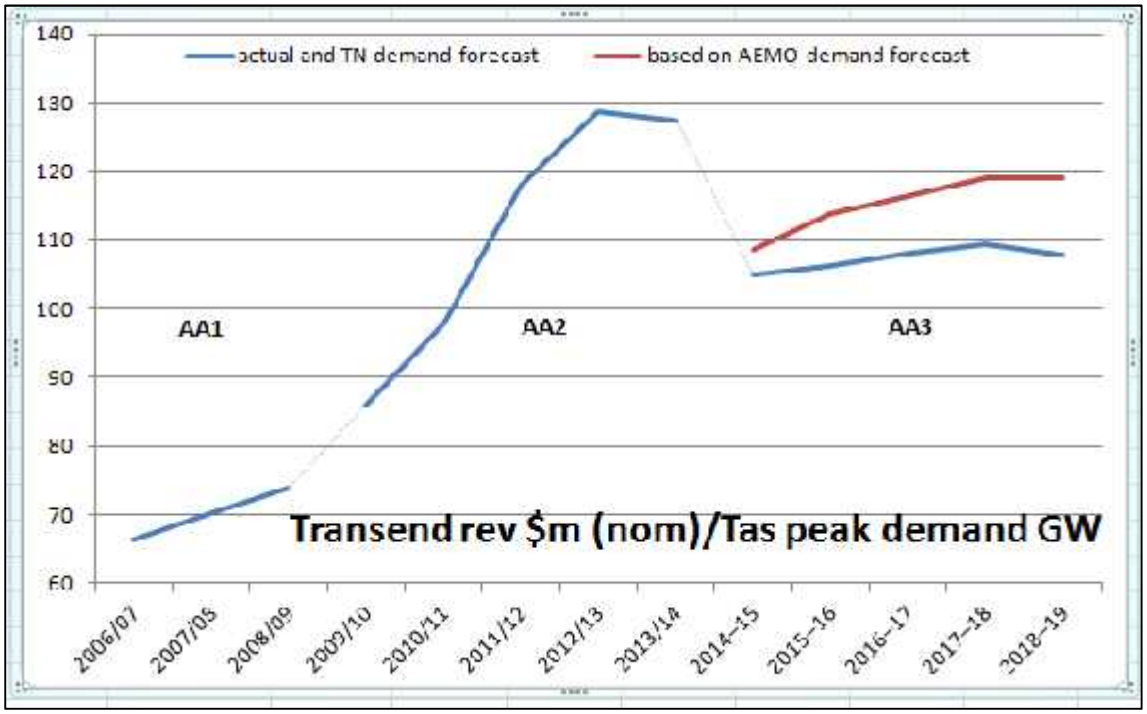
Given such substantial increases, the MEU considers that there was still scope of, and a necessity for, further reductions in expenditures, not withstanding the actions taken by TN to date and signalled in their current proposal.[11]

The MEU's submission identified potential savings in operating costs (opex), replacement and augmentation capex and in the application of the Network Capability Incentive Parameter Action Plan (NCIPAP). Submissions from larger users and the Small Business Council of Tasmania highlighted similar opportunities for further reductions in costs and prices to consumers.[12]

As illustration of the scope for further price reductions, the MEU's response to the TN initial proposal included the following chart (Figure 3 below) that looks at average revenue per GW of peak demand., The chart demonstrates that average revenue per GW nearly doubled over a very short period of time – so short that business had little opportunity to adapt their processes to accommodate the increase within tight budgets. In the MEU's previous submission, it was demonstrated that average revenue per MWh similarly doubled.

[11] MEU, *Tasmanian Electricity Transmission Revenue Reset, TasNetworks Application, A response by the Major Energy Users Inc*, August 2014. [MEU, *Response to TN's Proposal*, 2014]
[12] For example, Small Business Council of Tasmania*, Transend Revenue Proposal 2014/15 Submission*, 2014

Figure 3: TN initial proposal, average revenue per GW peak demand



Source: TN benchmarking RIN, AEMO June '14 NEFR, TN application. As the AER has made little change to TN's overall revenue, the MEU believes this chart is still relevant to understanding the history and forecast of revenue.

As TN effectively recognised through its decisions to reduce the revenue required in the last years of period AA2 and its reduced claim for period AA3, this outcome was absolutely unsustainable. TN reduced prices in 2013-14 then made a further reduction of nearly 20% in average prices between 2013-14 and 2014-15 (the first year of AA3). The price path indicated small increases in nominal prices (reductions in real prices) for 2015 to 2019.

While TN's recent reduction in average revenue per GW of demand is significant, it still meant that users were paying much higher prices than they were prior to the AA2 regulatory period (2009-10 to 2013-14) expansion. The "correction" to the forecast, using updated AEMO data also illustrated the risks to achieving real price reductions.

The opportunities for further savings will be discussed in somewhat more detail in subsequent sections of this submission. However, as noted above, the MEU also refers the AER to its more detailed comments in the MEU's August 2014 submission.

1.4 The impact of the TN asset valuation decision in 2003

While the MEU, large users and small business representatives all argue that TN must undertake further cuts in capex and opex, and lower the returns to government, the MEU considers that the problems for TN (and the AER as its regulator) go

deeper than this, and the recent actions by the Tasmanian Government have only exacerbated the more fundamental problem facing TN.

In the MEU's view, TN's options have been unnecessarily restricted by the excessive initial valuation of the transmission network when the assets were revalued by the Tasmanian Treasurer prior to the handover of economic regulation to the ACCC in 2003.

In its submission to the ACCC in response to the Transend proposal in 2003, the Major Employers Group commented:

> "The value placed on the Transend assets has been set by the relevant Minister in accordance with the Tasmanian Electricity Code (TEC) and the National Electricity Code (NEC). After undertaking analysis of the proposed RAB there is no doubt that the RAB set by the Minister clearly overstates the value placed on the assets. Attached to this submission is a paper which demonstrates that the RAB (July 2001) value is overstated by some $70m."

In its assessments of the regulated asset base (RAB), the ACCC was similarly concerned with the revaluation of Transend's RAB. The ACCC noted that after the revaluation, Transend's RAB was some 15.9% ($72 million) higher than the valuations previously set by the Tasmanian economic regulator (OTTER). This RAB increase alone would increase Transend's allowed revenue by some $7 million a year ($2000-01), increasing prices without benefit to consumers.[13]

As TN has indicated elsewhere, it considered its network assets were old and in poor condition – had they been valued on a historical cost or book value, the "starting point" would have been significantly lower than the Treasurer's 2003 valuation.[14]

In addition, because the assets were in relatively poor condition, TN sought and received first from the ACCC (in 2003) and then from the AER (in 2009) additional expenditure allowances to augment and replace the existing infrastructure. The issue was further complicated by overly optimistic forecasts of growth in demand.

Together, all these factors served to drive up the value of the RAB (from an initial value of some $433m assessed by OTTER in 2001) first from the ACCC decision in AA1 and even further by the AER decision during AA2 as illustrated in Figure 4. The regulatory allowances driving the RAB increases for TN have been excessive, consistently surging well ahead of inflation in AA1 and AA2.

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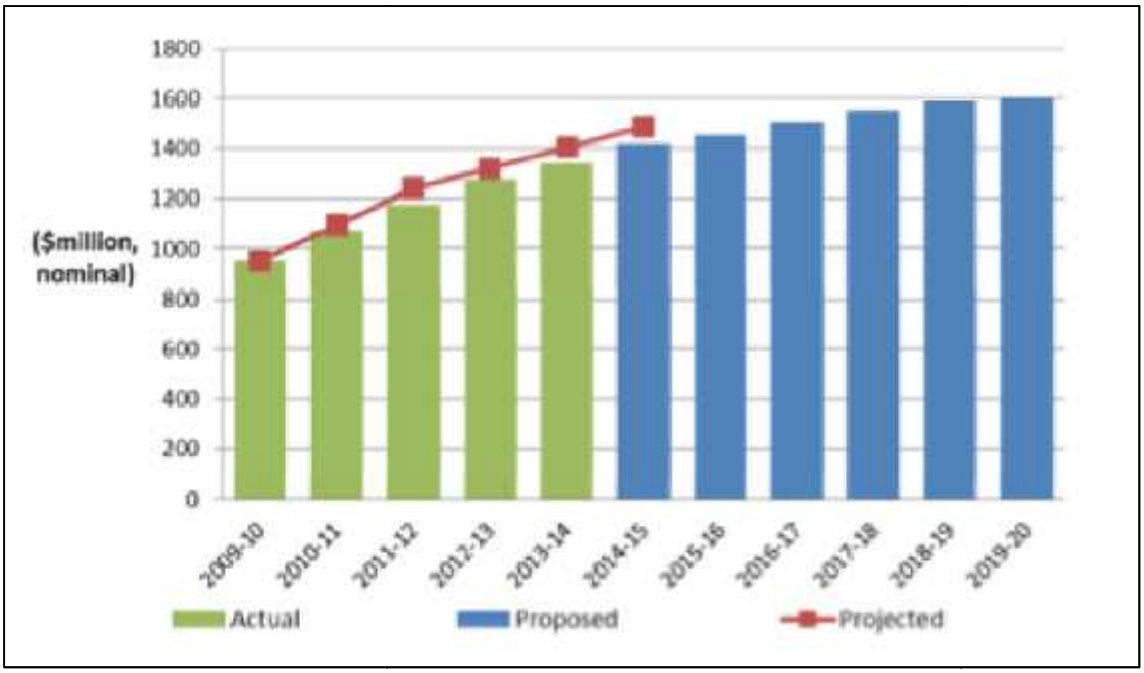
[13] For a discussion on this, see *Electricity Supply Industry Expert Panel, An independent Review of the Tasmanian Electricity Supply Industry, Final Report*, Volume 1, March 2012, pp171-172.

[14] The MEU considers this issue is not unique to Tasmania and TasNetworks. It is a particular issue in all cases where the electricity assets were old at the time of revaluation. The effect is that there may be a large requirement for additional capex to renew the network, however, the network being replaced has been valued, and earns returns, on the basis of a replacement cost valuation – thus creating a double jeopardy for consumers

The much reduced capex in the AER's current draft decision means that the RAB is growing around the rate of inflation in AA3. However, the massive growth of the RAB from the initial over-valuation in 2003 followed by excessive capex ever since has effectively "locked in" that high value for AA3 and beyond.

This means that, in the absence of a revaluation and/or write down of the assets to their economic value, the AER's scope to drive lower costs is now limited as over 68% of the AER's revenue determination is set by "fixed" capital costs (return of and return on capital). This is not to say, however, that TN's proposed capex and opex should not be challenged more than the AER has done in the Draft Decision. The issue of developing sustainable network prices for consumers is too vital an issue for Tasmanians and an equitable outcome must be sought for all parties.

Figure 4: Recent and proposed growth in TasNetwork's RAB



Source: CCP presentation to the AER Public Forum, 9 July 2014. The chart is based on TN's May 2014 Regulatory Proposal, however, the AER's draft determination only moderately changes the projected RAB.

However, the devaluation of the TN assets is an option that must be seriously considered by the owners of TN if it is to preserve the ongoing sustainability of electricity supply and business in Tasmania.

1.5 The impact of the debt transfer to TN

The MEU notes with considerable concern the recent decision by the Tasmanian Government to allocate an additional $325 million of debt to TN from Hydro

Tasmania and another $30 million to prop up Forestry Tasmania.[15] Together, these two debt transfers increased TN's debt levels to around $1.64 billion.

This process of loading additional debt onto TN, transfers debt and credit risk to electricity users. It greatly restricts TN's ability to respond to the issues raised by users, by reducing prices and/or revaluing the assets. It also increases TN's vulnerability to changes in external conditions or the loss of a major customer.

The MEU considers that the AER must seek absolute assurances from TN and the Tasmanian Government that the additional debt assigned to TN will not be a barrier to TN aggressively addressing the issues outlined above or a cost that electricity consumers will be required to carry.

In requesting this assurance, the MEU notes the statement made recently by the Chief Executive of TasNetworks, Mr Balcombe, who is quoted as saying that "*TasNetworks was a regulated business with no capacity to alter its prices*".[16]

The MEU considers that prices should not increase (all other things being equal) as a result of this additional debt loading on TasNetworks because the AER should make its decisions relative to a benchmark efficient operator rather than an individual NSP. However, the MEU is concerned that the debt loading will reduce TN's capacity to further reduce network prices to a level that reflects TN's optimal cost structure and revenue and responds to the very real concerns raised by the major electricity users in the state.

However, the addition of this debt will increase the gearing of TN (thereby requiring the AER to review whether its benchmark gearing is too low[17]) and this will impact the ability of the owner to vary the RAB to overcome the ravages of the massive capex programs the ACCC and AER have permitted in the past.

1.6 The impact of the AER's draft decision on average prices

Table 4 below summarises the expected impact on the retail prices for residential and small businesses, taking into account that transmission charges make up some 15% of the retail bill of residential and small business consumers.

The MEU expects that large user will see a more significant percentage reduction in their overall electricity price as the transmission costs represent a much greater proportion of a large users final electricity bill. Reform of tariffs would also lead to

[15] Sources: (i) TasNetworks Media Release, *Capital Structure Review*, 28 January 2015. Daniel McCulloch, *Debt won't affect power bills*, Examiner, 29 January 2015.
[16] Daniel McCulloch, *"Debt wont' affect power bills*", 29 January, 2015.
[17] The MEU notes that if the owner of an electricity network can increase the level of debt of a network to this extent without impacting its anility to secure future debt at benchmark rates, then the AER should reassess its financing structure of the benchmark entity

additional price reductions for segments of the market that have good load factors reflecting the fact that they minimise the costs on the network.

The MEU also recognises that since TN's proposal, the AER and TN have agreed on a lower forecast of demand growth. The AER states that this is in response to new information from TasNetworks and AEMO.[18] The MEU welcomes this change in forecast as it was one of the areas of concern that the MEU had with TN's forecast of prices. However, the MEU sees little evidence that supports an annual price growth rate of 1.18% per annum, given that historically, demand has decreased by around 0.63% per annum.[19]

Table 4: Average retail price impacts of TN's proposal and the AER's draft decision (percentage change, $ nominal)

	2013-14 $ bill/yr	2014-15 % change	2015-16 % change	2016-17 % change	2017-18 % change	2018-19 % change
TN proposal (May 2014)						
Residential	2,256	-2.0%	0.2%	0.3%	0.3%	0.4%
SME	3,782	-2.0%	0.2%	0.3%	0.3%	0.4%
AER DD (Nov 2014)						
Residential	2,256	-2.0%	-0.4%	0.1%	0.1%	0.1%
SME	3,872	-2.0%	-0.4%	0.1%	0.1%	0.1%

Source: AER, Draft Decision, November 2014, Table 7-2, p 28.
The average residential usage is 8800kWh and the average usage for small business is 11MWh. For details of the assumptions see Table 7-2 in the Draft Decision.

That is, under a revenue cap, average prices will move away from the forecast trend in direct relationship to the variation of real demand/usage from the forecast. TN had proposed a significant growth in demand which the MEU did not consider probable or consistent with the most recent forecasts of AEMO.

As stated above, the MEU now understands that the AER's Draft Decision is based on "flat or small demand growth"[20] in the order of 1.18% per annum. The MEU highlights that in its December update for Tasmania, AEMO made further revisions to this forecast of 0.2% growth per annum for winter maximum demand.

[18] AER, Draft Decision, 2014, p 9.
[19] Ibid, p 22.
[20] Ibid, p 9.

Nevertheless, as noted above, the reductions in TN's revenues (and prices), as approved by the AER in its Draft Decision, will not lead to energy prices reverting back to more sustainable levels that will underpin growth in the Tasmanian economy.

There is a way to go yet, and the MEU is concerned that following TN's acceptance of the AER's Draft Decision, the AER will not further examine opportunities for cost reductions through more efficient and prudent capex and opex.

In saying this, the MEU still agrees with the general principle that where NSPs apply the Guideline and accept a Draft Decision, there should be a more 'light handed' approach. TN has accepted these parameters, including reduced demand forecasts and postponed capex, and the MEU does not consider that a great deal of further technical investigation is warranted.

What the MEU does propose, however, is that the AER investigate further opportunities for savings in opex through greater efficiency and synergy effects that go beyond those initially achieved through the merger of Transend and Aurora.

In addition, the MEU considers there is further scope for reductions in capex. The MEU acknowledges, for instance, that TN has substantially reduced its initial augmentation capex of $36.8 by removing two major projects. This decision by TN was consistent with the review conducted by AEMO. However, the MEU considers there is still further scope for TN to reduce its capex while maintaining reliability and quality of supply. Continuous engagement with its customers, for instance, may provide opportunities to seek non-network solutions to any supply security issues.

The next sections of this submission will summarise a number of cost saving opportunities, the details of which can also be found in the MEU's original submission to TN's Regulatory Proposal.

1.7 The conservatism built into the AER draft decision

The MEU notes that the AER draft decision does deeply analyze the TN proposal and identifies a number of aspects where the TN proposal is deficient. That said, the AER finds that the TN proposal was acceptable in many aspects and this is reflected in the modest changes the AER makes in its draft decision.

What is concerning to the MEU is that the AER has a tendency to set a conservative allowances (which are moreover biased towards TN interests) when there might be some doubt at the actual allowance. Whilst the MEU does not disagree that the AER needs to be conservative, the MEU is concerned that consistently this conservatism is compounding within the decision. This means that the overall conservatism which has been applied in its draft decision is significant but unquantified.

This conservatism operates in two clear ways:

- When a series of unrelated conservative allowances are made, statistically not all elements will be result in the extreme condition that justifies the conservatism allowed but some will. To address this additive conservatism, the AER should make an assessment as to which elements are most likely to be at the extreme of any likely range. Then the AER should apply the conservatism only to that element and hold all other elements at their most likely operating point. This approach recognises that there will be a spread of likely outcomes rather than all outcomes being assumed to be at the extreme point of a likely range.

- When there are a series of elements that build on each other and a conservative approach is taken for each, the overall conservatism builds up geometrically. So if two elements are multiplied and both have a conservative aspect, then the overall conservatism is enhanced. An example of this is the equity risk premium where the equity beta and market risk premium are multiplied to create the equity risk premium. If there is conservatism applied to both then the outcome is more conservative than either of the two inputs. For example, if there is a 10% conservatism built into both the equity beta and the market risk premium, the equity risk premium will have built into it a 21% conservatism allowance which is twice the amount of conservatism allowed for either.

With this in mind, the MEU has identified a number of conservative allowances that have been built into the draft decision revenue allowance and these are detailed within the body of this submission. However, some of the more obvious elements where the AER has provided conservatism are:

- Setting of equity beta
- Setting of market risk premium
- Assuming all debt will be provided from corporate bonds
- Not recognising that networks have a lower cost of corporate bond than other seekers of debt with the same credit rating
- Setting gamma in a lower end of the likely bounds
- Assuming the revealed opex for the base year is efficient when it is still remote from the efficient frontier
- Allowing a productivity adjustment lower than indicated to allow for a lesser amount of step changes
- Allowing a bonus under the NCIPAP even though there is no certainty that each project will deliver a benefit to consumers, or if the payback on a project is efficient.
- Providing excess opex and capex in the regulatory allowance when its inclusion will result in out-performance in service (and hence deliver a bonus under the STPIS)

The EMRF considers that the AER should have used the midpoint of any range of point estimates where there might be doubt and then applied an overall level of conservatism to the final assessment of the revenue allowed.

1.8 Consumer engagement

The MEU considers that the AER assessment of the TN consumer engagement carried out so far is a reflective of what the MEU members have experienced.

The over-riding view of consumers is that TN prices are too high and, whilst accepting that TN is reducing its costs (and therefore prices), the degree of cost reductions achieved are insufficient. In this regard, it must be noted that TN prices are still significantly higher than those of other TNSPs. Consumers have commented that TN has the ability to reduce its costs much more than they have so far indicated because MEU members (and others) have market pressures that force them to reduce their costs by much more than TN has achieved to date or proposes in the future.

The AER notes that in aspects of capex and opex, it seems to consider that TN has responded to consumer views. The MEU accepts that this has happened to a degree, but not to the extent needed. The MEU highlights aspects in its discussions on opex and capex where further cost reductions have been expressed to TN that consumers consider should be implemented to achieve their expectations.

The concerns of the major users were captured recently (and after the AER's Draft Decision) in their presentations to the current Senate Inquiry on network pricing.[21] For example:[22]

Bell Bay Aluminium general manager commented:

> "The current regulations and the way in which TasNetworks chooses to operate within them, if unchanged will potentially lead to a death spiral...it is imperative that TasNetworks and its owners focus on finding the right balance between service delivery, reliability and cost in order to minimise the risk of losing one of the state's major users."

Big Picture Tasmania[23] commented*:*

[21] Senate Inquiry into the Performance and Management of Electricity Network Companies, established 2 October, 2015.
[22] The quotes were taken from the Daniel McCulloch: *Bell Bay Aluminium power fears*, The Examiner, February 2, 2014. Importantly, the quotes reflect the ongoing concern with the AER's Draft Decision.
[23] Big Picture Tasmania represents Tasmania's six largest energy-intensive employers, which together contribute about 40% of TN's revenues and over half the energy usage.

> "...[large profits and infrastructure projects] are "not needed, grossly overestimated or driven by flawed peak demand projections" and were undermining the state's economic and social security."

1.9 Shared assets

The MEU notes that TN does not provide advice about whether it provides services to others using the assets fully paid for by consumers.

The MEU therefore assumes that the "shared assets" guideline does not require TN to provide information on shared asset use.

2. Forecasts of demand, consumption and input cost changes

2.1 An overview of electricity demand and consumption forecasts.

2.1.1. Peak Demand forecasts

The peak demand forecasts are integral to the overall forecast growth in augmentation capex requirements. It is essential, therefore, that there is strong justification for the forecast, particularly if the forecast does not follow the historical trends. For instance, the Australian Energy Market Operator (AEMO) stated that TN's peak load declined at a rate of 0.68% per annum over the past period (AA2). However, TN's initial forecast was for a peak demand growth rate of some 1.8%.

The MEU expressed considerable concern with TN's peak demand forecast in its response to the TN initial Regulatory Proposal. It was highlighted in the MEU's submission that the historical demand peaked at 1,743 MW in 2008. It was also noted that AEMO's 2014 National Electricity Forecasting Report (NEFR) suggested that at 50% POE[24], this level of peak demand would not be exceeded in the next decade. On a 10% POE, AEMO forecast that the 2014-15 peak demand might just exceed the 2008 peak, but was likely to flatten or decline thereafter.

Since TN's Regulatory Proposal was presented in May 2014, there have been further declines in the projections of peak demand in Tasmania. In the MEU's submission in August 2014, the MEU provided data from the most recent 2014 NEFR report.

Since that time, AEMO has updated the 2014 NEFR report (December 2014),[25] and this update confirms the MEU's view that demand growth is minimal and should not be a justification for any additional augmentation capex proposals.

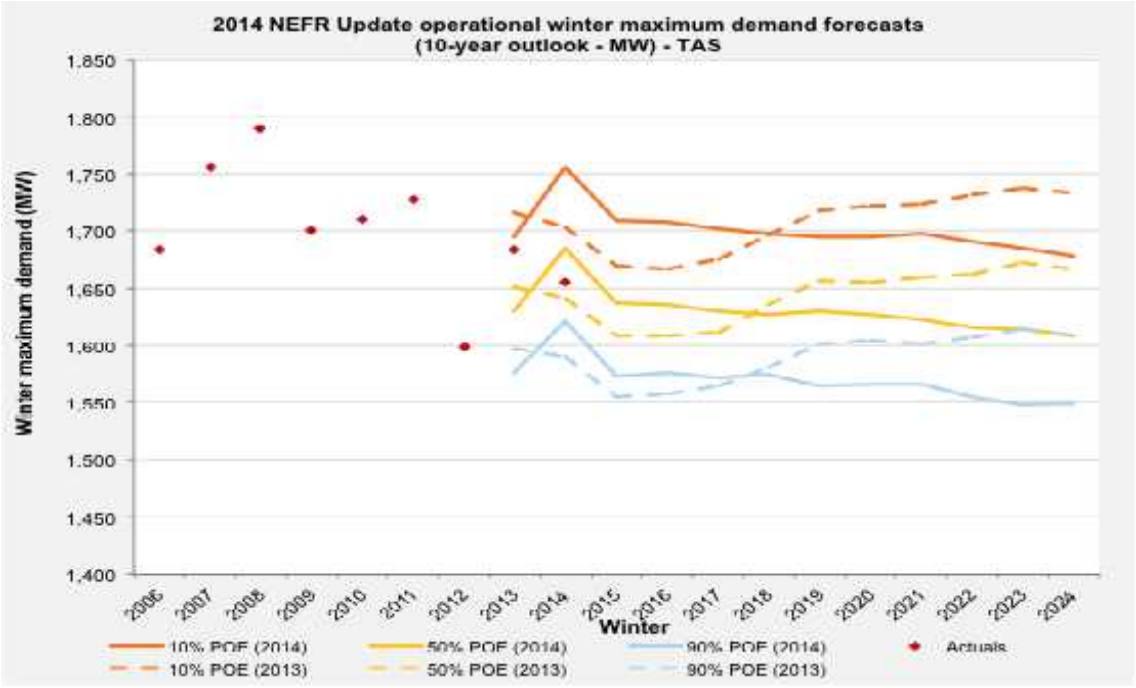
AEMO's updated NEFR states: "*The updated MD forecasts result in slower short term average annual growth rate of 0.2% for winter MD, down from 0.9% in the 2014 NEFR.*"[26] This is almost a full 1% point below the assumptions that the AER is using (1.18% annual growth) in its assessment of TN's capex forecast. This alone should be sufficient information for the AER to revisit the capex projections in the Draft Decision.

Figure 5 sets out AEMO's latest long-term forecast for maximum demand. It demonstrates that AEMO expects a long slow decline in Tasmanian peak demand. The driver (at least in the first years) reflects AEMO's observation that there is a:

[24] POE: Probability of exceedance. Usually expressed as 10% probability, 50% and 90% probability; the former meaning that the event is unlikely to occur.
[25] AEMO, *2014 NEFR Update, Tasmania*, December 2014, (excel spreadsheet) @ http://www.aemo.com.au/Electricity/Planning/Forecasting/National-Electricity-Forecasting-Report
[26] Ibid. TAS Overview.

"*continuing decline in actual residential and commercial MD [Maximum Demand], despite increases in gross state product (GSP) for Tasmania".*[27]

Figure 5: AEMO's updated (December 2014) NEFR forecast of Winter MD & AEMO 2013 NEFR winter MD forecast (at 10%, 50% and 10% POE).



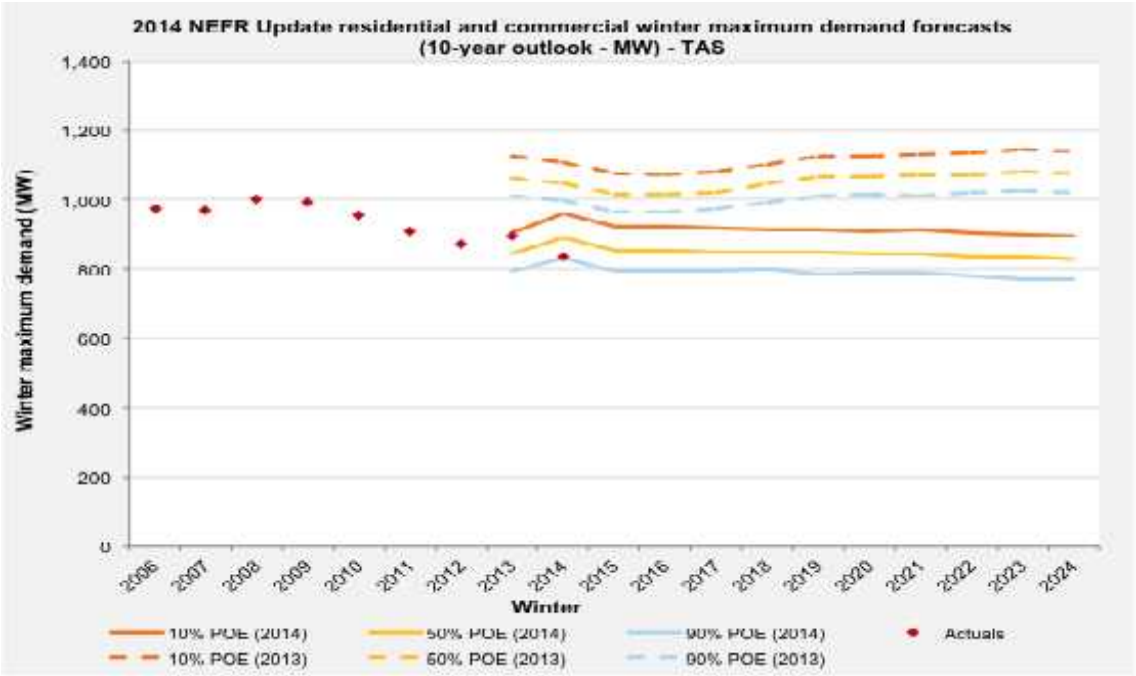
Source: AEMO, 2014 NEFR Update: Operational Maximum Demand.

The MEU considers this updated forecast, based on further refinements of AEMO's forecast modelling,[28] provides the best basis for assessing TN's augmentation capex proposal. The MEU further notes that for the 10%, 50% and 90% POE, the updated forecasts show a gradual decline over time, where the 2013 forecast showed a slow increase after 2014-16.

One of the issues that AEMO has identified is the difficulty of forecasting the demand of large industrial customers, particularly in Tasmania as they have a large effect on overall winter peak demand. For example, AEMO modelling finds a consistent decline in peak demand by residential and commercial customers. However, industrial demand shows significant swings. Figures 6 and 7 demonstrate this point.

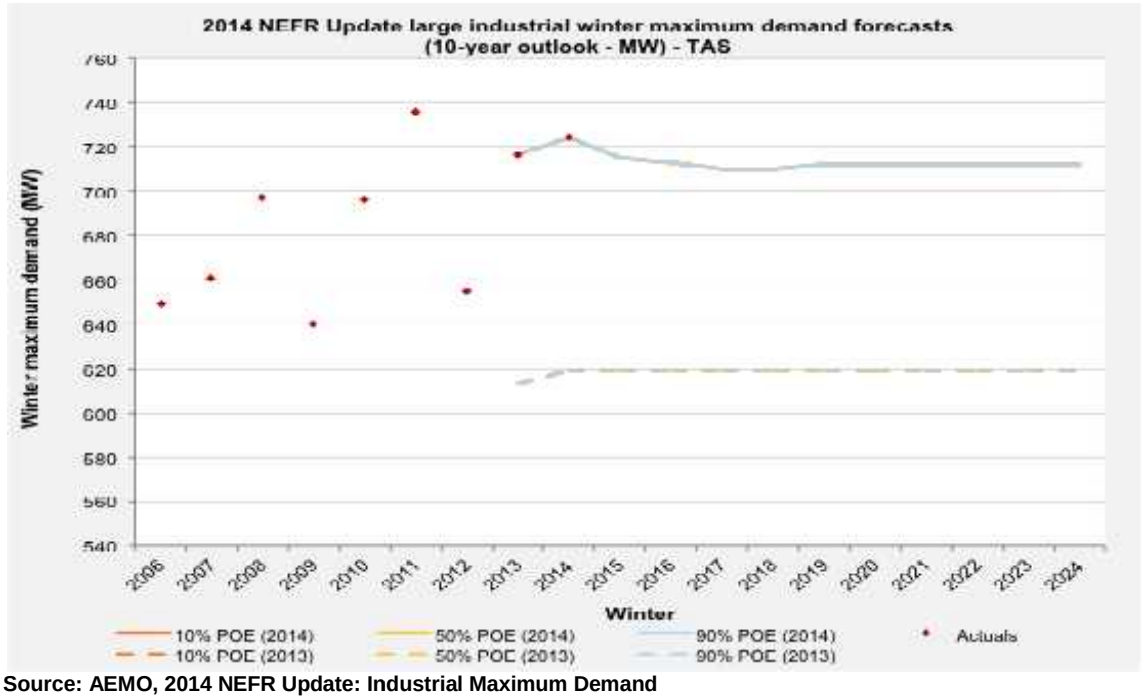
[27] Ibid.
[28] AEMO conducts periodic evaluations of its forecast performance and develops its models accordingly.

Figure 6: AEMO's updated NEFR for Residential & Commercial Winter MD



Source: AEMO, 2014 NEFR Update: Residential & Commercial Maximum Demand

Figure 7: AEMO's updated NEFR for Industrial Winter MD



Source: AEMO, 2014 NEFR Update: Industrial Maximum Demand

But what is very clear is that the expected industrial demand will not exceed the peak seen in 2011 (or even that of 2007), supporting the MEU's view that no augmentation capex is required in the new regulatory period

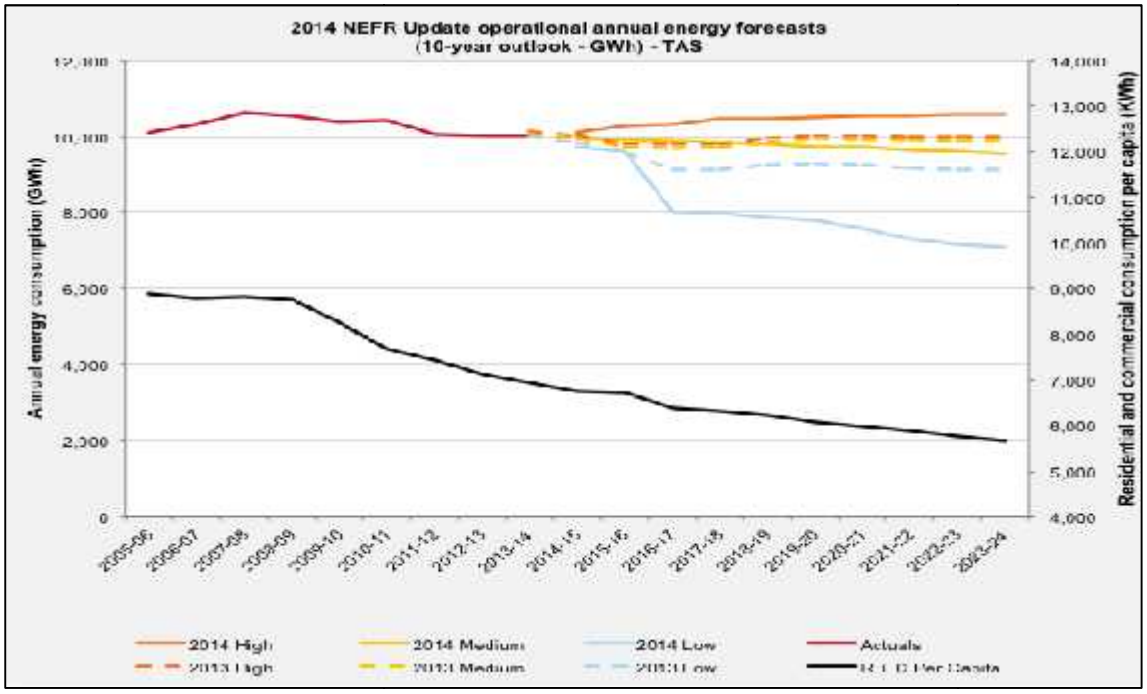
2.1.2 Energy forecasts

In terms of capex, the forecast of overall energy flows are not as important as the forecasts of peak demand. AEMO's updated NEFR (December, 2014) maintains its earlier forecast of an average annual decline of 0.5% for "operational consumption". AEMO reports the outcome in the short-term is for:[29]

- growth in roof-top PV at a faster rate;
- decline in residential and commercial consumption (2.1% average annual decline, compared to 1.8% in the 2014 NEFR); and
- faster average annual growth of 1.1% (up from 1.0%) in large industrial consumption, despite the Queenstown mine closure.

Figure 8 below sets out AEMO's forecast of 'operational energy' use for the next 10 years and demonstrates decline in the annual average use of 0.5%. The "low case" in the chart also demonstrates the risks in the forecast of annual usage arising from two factors. First, there is a longer-term uncertainty about whether the trend for rooftop PV and greater efficiency will continue over the long term. Second, there is uncertainty in the shorter term with the forecast of industrial usage as the closure of one large plant can affect the forecast accuracy.

Figure 8: AEMO's 10-year forecast of operational energy use.



Source: AEMO, 2014 NEFR Update: Operational Annual Energy

[29] AEMO, National Electricity Forecasting Report Update for the National Electricity Market, December, 2014, p 4.

Notwithstanding this uncertainty, the MEU encourages the AER to adopt this latest AEMO forecast when assessing the total revenues (and the outturn price paths). The AEMO modelling is more transparent and objective than the transmission companies and AEMO undertakes a process of regular reviews of its forecast accuracy and the models that underpin it.

2.2 Trends in Labour & Contracting Rates

The MEU agrees with the AER that its task is to select the efficient labour price for an efficient service provider on the opex frontier and that this requires a forecast of the "benchmark labour price".[30]

In its regulatory proposal, TN used the TasNetworks enterprise agreement for the first two years of the forecast period and independent Economics' labour forecasts for the remaining years. The MEU opposed this approach, noting that an Enterprise Agreement does not necessarily represent the most efficient expenditure. Moreover, if the AER accepted Enterprise Agreements then the management incentives for efficiency are reduced and the regulatory concept of the benchmark efficient entity made void.

The MEU notes that the AER has not accepted this approach and has, instead adopted an average of Deloitte Access Economics (DAE) and Independent Economics (IE) WPI for the EGWWS sector.

The MEU also recommended that the AER review the performance of different professional labour rate forecasters, as there was concern that different forecasters may exhibit a constant bias in one or other directions. The MEU is pleased that the AER has undertaken this research and we note the AER's conclusions that IE is generally higher and DAE is generally lower than the average, with BIS Shrapnel in between.

The MEU, therefore, sees the AER's averaging approach (of IE and DAE) as more reasonable than selecting a single forecaster. While not stated, this would suggest a real increase in labour costs of about 1.2%. The MEU does highlight, however:

- The ABS Australia wide EGWWS actual results for 2013-14 was 0.02% real;[31]
- There is ongoing downward pressure on general labour rates reflecting the generally higher levels of unemployment and very low inflation.

For these reasons, the MEU would expect the AER to review and update its Draft Decision in line with the direction observed in updated ABS data and the general economic conditions before its Final Decision.

[30] Ibid, p 7-38.
[31] Ibid, 7-39.

2.3 Producer price indices (PPI) and CPI

The MEU expressed concern about the forecasts of movement in various materials provided by CEG to TN. The MEU was concerned about the divergence between the CEG forecast (with increasing materials costs) and the Bloomberg forecasts of material cost (which decrease prices in some components).

The AER has chosen a different approach, and is simply applying the CPI on the basis that historical analysis indicated no material differences between the forecasts based on CPI and the five PPIs. In effect, the CPI represents a composite index and one that is reasonably robustly and consistently measured compared to the five PPI.

However, the MEU also notes that there have been significant falls in recent months for the cost of oil and other raw materials used in the development of indices that have been used by networks and the AER in the past to adjust for future movements The MEU is concerned that by changing to the use of the CPI as allowed in the AER draft decision, consumers will not benefit from the massive falls in materials prices seen in recent times (eg oil). This effectively allows the networks to have had the benefit of material price index rises which have since fallen but the use of the CPI provides an avenue to insulate the networks from the full impact of these price falls. The outcome of the change has resulted in a benefit to networks in the past and a loss of a benefit to consumers.

This effective "heads networks win, tails consumer lose" outcome form the change in approach reinforces the view of the MEU that the AER has not addressed the proposal submitted by the MEU in its submission to TN's regulatory proposal. We continue to be of the view that an industry specific escalation index, updated annually during the regulatory period, would reduce the inaccuracies inherent in the AER's "CPI" approach and give confidence to consumers that prices were adjusted in an equitable and realistic manner, both up and down..

The AER has previously responded to the MEU that such a measure would lead to more volatility and uncertainty on a year-on-year basis. However, that argument no longer applies. Given that the AER will be updating the cost of debt each year; updating an industry cost index would have only a small additional impact in comparison to the update of the cost of debt and other movements (such as adjustments under the revenue cap, and settlement residues). We also note:

- An industry index would provide an opportunity for consumers to benefit from a decline in prices and/or NSPs be protected from sudden rise in prices.

- It is common practice in industry to use specific cost indices reflecting the nature of their activities – not all businesses are exposed to movements in the price of bananas!

- As materials indices also include an element of labour (through processing, conversions, etc) the MEU highlights that materials indices themselves are set on the international market (rather than the Australian market) and include some labour which might not reflect labour cost movements in Australia. So the use of Australian CPI would not fully reflect the cost of manufactured products used by networks (eg drawn aluminium cable, steel for towers or transformers) which might or might not be captured by the Australian CPI except perhaps as a "lagging indicator".

3. OPEX

The AER has indicated that its decision on the efficient opex allowance will be based on consideration of the total opex and not about particular categories or projects in that opex forecast.[32] The AER contends this is in line with the intentions of the AEMC when introducing the rule changes in 2012; i.e. the AEMC stated: *"it should be noted here that what the AER approves in this context is the expenditure allowances, not projects*".[33]

The MEU interprets this to mean that if the AER finds the total opex reasonable, then it is not necessarily too concerned if there are differences in the categories of opex. If, however, the AER does not find the proposed opex reasonable, then it must substitute its own forecast to achieve the operating expenditure objectives.[34]

The AER has decided that the TN opex forecast reasonably reflects the opex criteria in the NER.[35] The AER has therefore approved TN's forecast opex of $218.3 million ($2013-14) across the five-years of AA3. The forecast is 11.8% lower than the total actual opex for AA2.

TasNetworks states that this saving of $29.4 million comes mostly from forecast efficiency improvements attributable to reduced staffing levels, rationalisation of systems and improved methods of delivering services to customers.[36]

The MEU is concerned that the AER accepts TN's proposed opex. Our view is that TN has set out some initial efficiency savings but has not adequately pursued a process of continuous improvement in efficiency and extraction of further synergies from the sharing of operational staff.

These issues are discussed below by briefly examining each of the steps in the AER's approach to assessing efficient opex, namely:

- Selecting the base year and assessing whether the opex in that year reasonably reflects the opex criteria, adjusting the base year costs as necessary if deemed not efficient;

- Trend the adjusted base year expenditure forward to take account of other changes in prices, outputs and productivity – *the rate of change*

- Adjust the base year for any other specific costs that have an impact over the next regulatory period, such as regulatory changes – *step changes.*

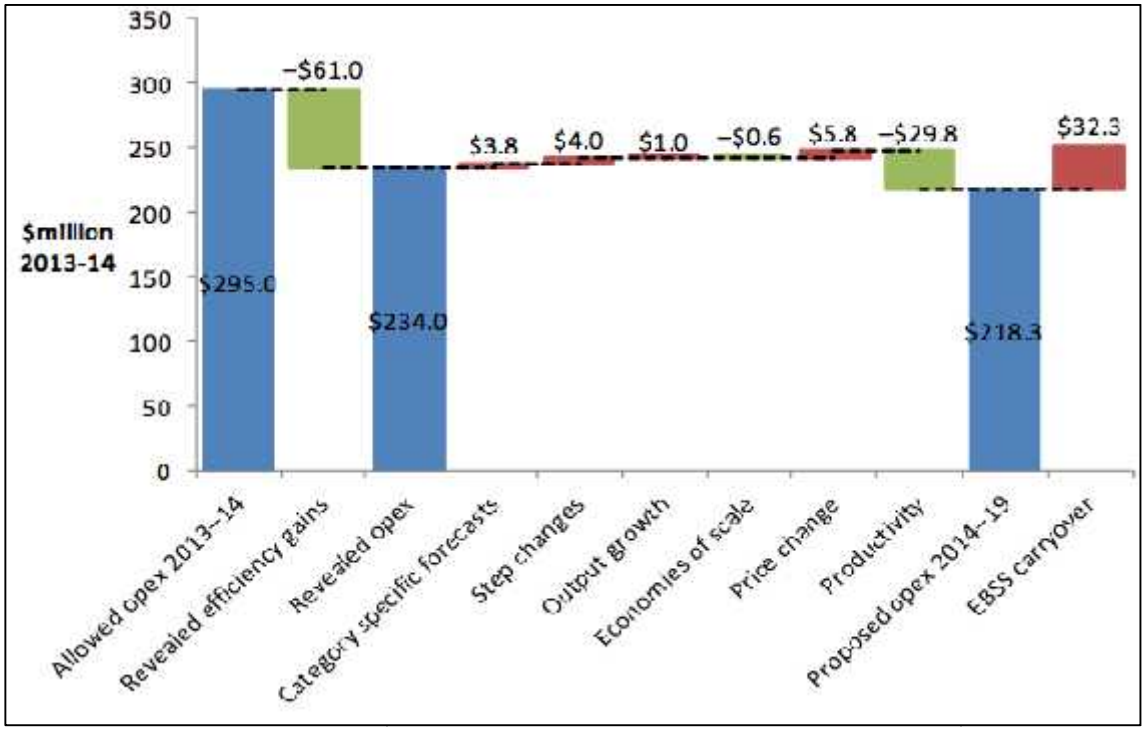
[32] AER Draft Decision, *TasNetworks determination – Attachment 7 – Operating Expenditure*, November, 2014, p 7-8.
[33] See ibid.
[34] Ibid, 7-9. The opex objectives for the transmission businesses are set out in NER, clause 6A.6.6(a).
[35] Ibid, 7-9. The opex criteria for the transmission businesses are set out in the NER, clause 6A.6.6(c).
[36] Ibid, 7-8.

- Add in any additional opex components relevant to the efficient provision of the regulated services, such as debt raising costs.

The AER states that having applied its approach, there was no material difference between the TN's forecast of opex and the AER's estimated of the efficient cost a prudent operator would require to achieve the distribution opex objectives.[37] The AER found that TN proposed lower output growth and higher forecast productivity throughout the forecast period than the AER's models indicate and higher prices for the users of the network's services. .In the outer forecast years there is forecast to be more certainty and stability in price expectations with the outer years somewhat offset by a lower price change in 2014-15.

TN's approach to assessing the forecast opex is broadly similar, as illustrated in Figure 9. The largest sources of reductions are the efficiency gains (arising from the amalgamation) and productivity improvements across the five years.

Figure 9: TasNetworks' approach to assessing efficient opex ($million, 2013-14)



Source: AER analysis, AER Draft Decision, Attachment 7, Figure 7.1, p 7-17.

The starting point for the analysis of the chart above is TN's allowed total revenue for 2013-14. From that, the efficiency improvement of $61 million was deducted (representing a saving of around $12 million per year, so that the 'revealed' opex

[37] Ibid, 7– 15.Table 7.2, p 7-16 indicates that the AER's alternative estimate of an efficient opex was in fact higher than the TN's proposal

was $234 million (represented as a five year total). The various costs were added back into this to get to the final proposed expenditure allowance for the AA3 period of $218.3 million

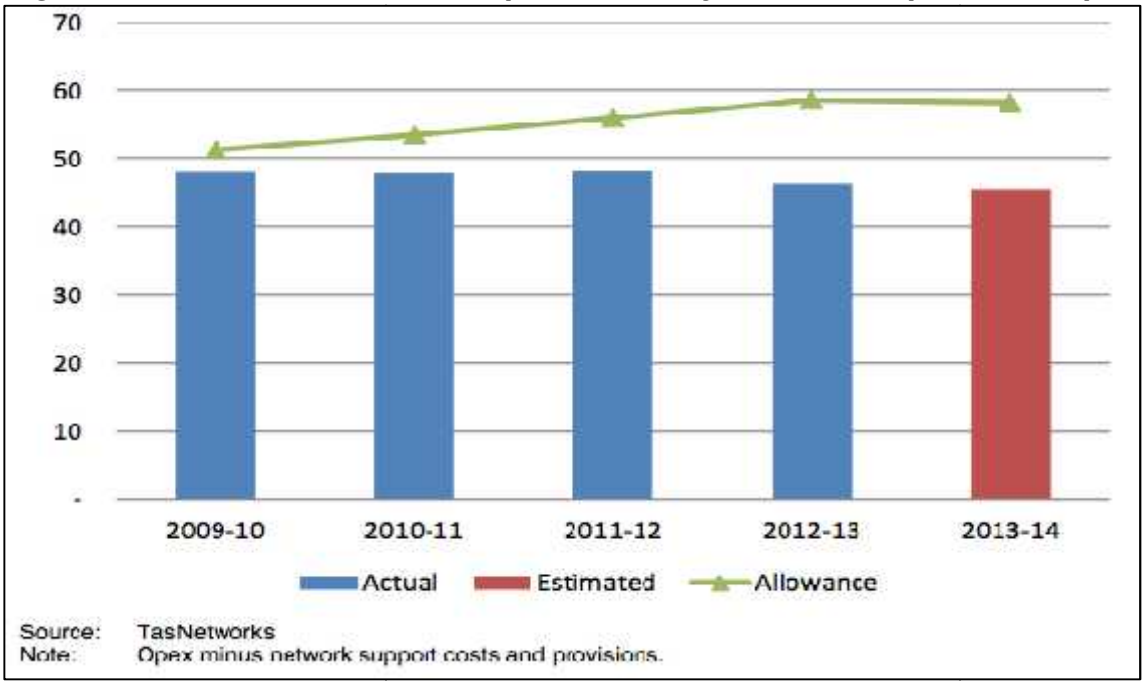
3.1 Assessment of the Base Year & Step Changes

3.1.1 The Base Year

Both TN and the AER have selected 2012-13 as the base year. The MEU agrees with this, noting that it is lower than the allowed efficient cost and lower than the previous three years in AA2. The MEU considers that the 2012-13 amount comes closest to meeting the conceptual test, namely: "The chosen year should reflect an efficient re-current level of opex as the starting point for the forecast".[38] Figure 10 below illustrates this outcome.

Figure 10 also supports the view that 2012-13 is not only lower but also more efficient relative to the previous years. TN's consultant, Huegin Consulting, (Huegin) advised that 2012-13 was the most recently audited financial year and reflected the latest year of a period of deliberate opex reduction, it was an appropriate year for the purposes of forecasting future opex.[39]

Figure 10: TasNetworks' actual opex for base year 2012-13 ($M 2013-14)



Source: AER Draft decision, Attachment 7, Figure 7.2, p 7-22.

[38] Ibid, 7 – 20.
[39] For a more extensive discussion on this, see MEU, *Submission on TasNetworks' Revenue Proposa*l, August 2014, p 43 – 48.

However, this trend data does not establish whether TN's 2012-13 opex is efficient relative to an external benchmark. The MEU remains concerned that 2012-13 opex does not represent an efficient base year for a benchmark efficient transmission entity.

For example, the MEU highlighted in its previous submission that Huegin's analysis indicated that TN was not operating at the efficient frontier in 2012-13 and that on several benchmark assessments, it was one of the least efficient.[40] The MEU also highlighted the lack of international comparisons – comparing efficiencies with transmission networks dominated by government owned monopolies in Australia, is hardly a way to discover the efficient frontier of transmission performance.

For instance, the MEU notes that TN's workforce had grown from 127 in 2003 to around 270 by 2011-12[41] with little change in output (see for instance, Figure 8 above showing that consumption has varied little over the past decade). Other interested parties are clearly of the view that TN had not operated in a prudent and efficient way in 2012-13. Certainly, given the very generous regulatory allowances for 2009-14, there was a lack of any strong management incentives to drive efficiency across the business (even with an EBSS in place[42]).

The AER has, therefore, attempted to assess the question of where TIN sits on the scale of relative efficiency using its new benchmarking tools. However, the AER stated it found it difficult to draw any conclusions regarding the efficiency of TasNetworks even relative to the Australian only sample of transmission companies. The AER concluded:[43]

> "On the whole our benchmarking analysis for TasNetworks is inconclusive. Therefore we have no evidence to suggest that TasNetworks revealed base year expenditure is materially inefficient."

The AER also agrees with the MEU that the use of some partial indicators, such as the opex as a percentage of RAB, is fraught because of unrelated movements in the RAB from year to year. The MEU is pleased to see that the AER has now chosen not to use this type of measure for benchmarking, although it has considered other partial indicators.

Even though the AER finds it difficult to draw conclusions on TN's opex efficiency, the MEU considers the AER has sufficient evidence available to it, that it could draw some conclusions about the level (and direction) of its efficiency). For example, in

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[40] Ibid, p 43.
[41] Electricity Supply Industry Expert Panel, *An Independent Review of Tasmanian Electricity Supply Industry, Final Report*, Volume 1, March 2012, p 172 – 173.
[42] The MEU would argue that if the AER's allowance is an 'easy' target, then there is less incentive to perform at the most efficient level, the company can receive EBSS payments at a lower level of efficiency. In addition, it is not clear if internal management incentives are sufficiently aligned with the achieving of EBSS rewards some years down the track.
[43] AER, *Draft Decision*, 2014, Attachment 7 – Operating Review, p 7-22.

the AER's Annual Benchmarking report for TNSPs released in November 2014, the AER provided a number of partial productivity charts for TNSP opex.

In these, TN does not compare well overall in the benchmarking report. For example, just looking at the base year opex comparisons:

- In opex/entry/exit point (Figure 11 in the TNSP Benchmarking report), TN is only middle of the road in performance and has perhaps a 30% cost premium over the most efficient. It is also important to note that in this measure, TN has more entry points than most TNSPs due to the large number of relatively small generators in the Tasmanian system which therefore implies a ranking closer to the efficient frontier than might be the case if the number of generators was reduced to levels seen in other networks

- In opex/km of circuit line, (Figure 12), TN is the highest cost TNSP (with a premium of perhaps 25% above the most efficient TNSP) as it is in the measure for opex/MW of maximum demand (figure 13) where its performance is double the most efficient

- In opex per MVA of downstream capacity (Figure 14) it is the second highest cost performer and more than double the most efficient firm.

On this basis, it would appear that TN's base year opex, is at least 50% away from the efficient frontier.

A further review of the benchmarking data in the report shows that TN performance over time on most measures, has not reached the level of efficiency shown in 2006 and 2007. This indicates that TN has a way to go before it reaches its own previous most efficient performance level.

The MEU does recognise that benchmarking report is showing TN is improving but its 2012/13 performance cannot be accepted as being efficient, and this was the view of TN's own consultant (Huegin) that it was not efficient.

Therefore, the MEU cannot accept the implications of the AER's statement above that the benchmarking tools are not adequate, as the benchmarking demonstrates quite the reverse.

Of immense concern to the MEU is the AER's view that it considers the benchmarking tools it has developed and implemented are not adequate to give a more conclusive outcome. The clear outcome of the benchmarking done shows that TN opex is not at the efficient frontier and not anywhere close to it. It is simply insufficient to the AER to aver that its benchmarking is inconclusive when it patently does show the TN opex is inefficient.

If the AER is correct that the benchmarking is inconclusive when it appears to be conclusive, this highlights that the AER is doubting its own benchmarking process

that it developed as part of the Better Regulation program. The MEU cannot accept this as the AER has used similar benchmarking to adjust opex claims from other networks.

If the AER considers that its benchmarking is inconclusive, then it has to explain in detail where the benchmarking is in error and why it will not use it to adjust TN's opex claim.

Despite the MEU being able to use the benchmarking report to identify that the TN base year opex is relatively inefficient (by being some 50% or more than an efficient opex), if the AER persists in not being able to use its own benchmarking to assess efficiency, then it must find another way to make its assessments of the efficiency of the base year. The MEU repeats – consumers in Tasmania have experienced 300% increases in the transmission prices – transmission now accounts for some 15% of their retail bill (up from around 4%-6% 10 years ago).

Consumers, therefore, expect the AER to review TN's opex (and capex) most carefully in this regulatory period, using category level benchmarking and engineering sampling assessments.

The MEU also expects the AER to expand its benchmarking tools for transmission businesses, including the assessment of international transmission businesses[44]. The MEU must emphasise here that our members are effectively benchmarked against international operations and markets every day. We see no reason why the monopoly businesses should be protected by the regulator from the same pressures.

3.1.2 Step Changes

The AER had chosen not assess TN's proposed step changes. TN proposed a number of small items (totally $4 million over five years)[45] which the AER considers should be included as part of its productivity forecast.

This is a little concerning as it is recognised that the other TNSPs considered that there had been considerable step changes over the years that impacted their productivity.

If TN considers there are few step changes for the next period, then the AER should apply a productivity increase reflective of the fact TN is not faced by significant step changes and should therefore experience considerable increases in productivity.

[44] The MEU's affiliate, the Energy Markets Reform Forum (EMRF), accepted that in the assessment of the TransGrid opex, the benchmark data was inconclusive but the MEU does not agree with the AER that benchmarking shows a similar outcome for TN.
[45] Ibid, Table 7.3, p 7-25

3.2 Rate of Change in Opex

The AER's approach to forecasting opex, as set out in the Expenditure Forecast Assessment Guideline, is to assess an efficient base year, determine if there are any step changes (positive or negative) and to apply an aggregate year on year change in the efficient opex and risk parameters. The three opex drivers of the rate of change index are outputs, productivity changes (relating to the quantity of inputs required) and prices (capturing the forecast change in the prices of those inputs).[46]

The AER states that it has assessed TN's proposed labour price changes, network growth and productivity as an overall rate of change figure. The main difference between the AER's forecast of rate of change and TN's rate of change is "*TasNetworks' higher productivity change forecast*".[47]

Notwithstanding the AER's approach of assessing the overall rate of change inclusive of labour, material and productivity growth, the MEU comments are in section 2 above regarding the assessment of labour and non labour costs.

3.2.1 Productivity Improvements/Rate of Change

As noted above, the AER is adopting an overall rate of change that includes (a) price changes (of inputs, including labour and non-labour costs – see above), (b) output changes, and (c) a productivity growth factor. TN has adopted a similar overall approach in their proposal.

Other changes during the regulatory period that are not compensated for either in the base year or the rate of change are classified as step changes – TN did not seek significant specific step changes (see above) so it does not follow that the productivity index used for TN forecast trends should inherently include the adjustments for previous step changes.

TN proposed an aggregate productivity change of for each year that was higher than the AER's draft decision. This is illustrated in Table 5 below.

Table 5: AER and TasNetwork's forecast productivity change (per cent)

	2014-15	2015-16	2016-17	2017-18	2018-19
AER forecast	0.86	0.86	0.86	0.86	0.86
TN forecast	4.90	1.48	2.60	2.44	2.75

[46] Ibid, p 7-25.
[47] Ibid.

TN's productivity forecast includes a recurrent $2.4 million per year from 2014-15 (to capture ongoing efficiencies from the merger of Aurora Energy and Transend) and a productivity improvement target of 1.75% in 2013-14 and 0.5% each of the remaining years.

The AER has, however, adopted the approach of using historical opex partial productivity growth rates inclusive of historic step changes to provide "*a reasonable approximation of the opex cost function*" in the absence of a more robust opex cost function based on MTFP benchmarking.[48]

The MEU finds it most strange that the AER would assign a productivity function (that combines price and output factors) that is lower than the business is seeking itself. The cumulative difference between the AER's proposal and TN's forecast is quite significant, i.e. 4.3% saving versus a 13.3% saving using TN's approach over the five year period. However, at this stage, this is more of a question of principle than an issue that will have a substantive impact on the overall outcome.

3.3 Concluding comments on the opex allowance

In its submission to TN's regulatory proposal, the MEU concluded as follows: [49]

> "The MEU considers that TN has approached the issue of opex with the aim of reducing their costs, and this is to the credit of TN. Equally, the MEU considers that TN is not at the efficient frontier and therefore more cost savings are available but which have not been proposed."

The MEU continues to hold this position. We have set out our concerns with the use of the 2012-13 year as the base year without adjustment towards an efficient frontier. The MEU does not agree that the AER should largely accept that year as efficient because the AER considers that its MTFP benchmarking is not robust.

Other data, including views expressed by TN itself, indicate that there are more efficiencies to capture. If the AER is so convinced that its TNSP benchmarking is not robust (which the MEU does not agree with) then the AER must immediately take action so that other measures can be explored, applied and added to the current suite of benchmarks.

In the meantime, we reiterate our view that even if the AER is unsure about the robustness of its MTFP approach for transmission companies, it should still look to drive greater efficiency in the relevant transmission businesses – an outcome that is surely no different than the pressures the TNSPs' customers are under every day. We give credit to TN for setting more ambitious productivity targets for itself than the AER has done.

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[48] Ibid, 7 – 42.
[49] MEU, *Submission on TasNetworks' Revenue Proposal*, August 2014, p 50.

The AER has stated a view that in order for the new incentive programs to deliver better outcomes for consumers, the allowances must be set at (or at least near) the efficient frontier to avoid the incentive programs being used as vehicles for giving the networks unearned benefits. This means that the AER's decision on opex (and capex) must reflect that TN efficiency has declined and that allowances must be at the efficient frontier in order to be part of the solution to deliver a turn around in these trends.

The MEU has concerns that with the qualifications the AER has made about its benchmarking, the AER will provide a less than efficient allowance, With this in mind, as noted in section 7 below, if the AER provides an opex allowance that is not efficient, then it will be effectively granting TN and unearned benefit. It is therefore essential that the opex allowance must be demonstrably efficient.

4. Capex

4.1 Overview

In its Draft Decision, the AER has rejected TasNetwork's total forecast capex. The AER's total capex allowance is $275.9 million ($2013-14).[50] This is 52% lower than the actual capex that TN spent in the 2009-14 regulatory period, and is considerably lower than the AER's AA2 capex allowance.

The AER's Draft Decision rejected some components of TN's proposal. TN's proposal was reduced by $29.5 million (10.7%)[51] and TN has accepted this in its revised proposal to the AER.

The AER has stated that, in making its decision, it has:

- rejected TN's augmentation (growth) capex;
- accepted TN's proposal for replacement capex; and
- accepted TN's proposal for non-network capex

Before commenting on the individual components of capex listed above, the MEU reiterates a number of points raised in its submission on TN's original proposal. We do so while acknowledging that the AER's Draft Decision reduces TN's proposed capex and TN has accepted this decision in its revised proposal.

However, we regard these points as still being relevant to the AER's assessments. They are summarised below:

4.1.1 Historical trends in TasNetwork's capex

Figure 11 below, illustrates the actual historical and forecast capex (before the forecast adjustment by the AER). A number of important conclusions can be drawn from this:

- Beginning in the last few years of AA1, and lasting to the 2011-12 year, there has been a very large surge in actual capital expenditure; The MEU's investigations suggested that this was due to increases in both augmentation (augex) and replacement (repex) expenditures. As noted above, this has resulted in a massive increase in TN's RAB

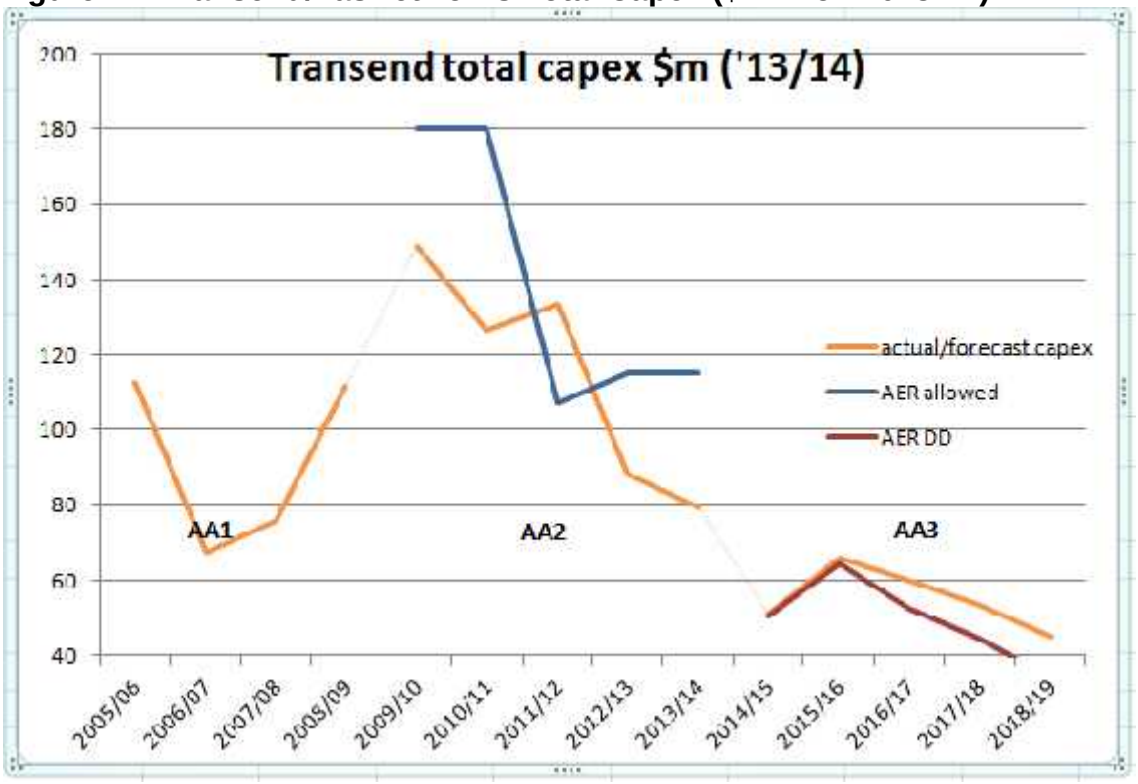
[50] AER, Draft Decision, TasNetworks Transmission Determination, Attachment 6 – Capital Expenditure, November, 2014, p 6-11. [AER, *Draft Decision, Att 6*.]
[51] Ibid,

- In AA1, TN expended 25% more on capex than was allowed, even though the 2003 review approved a massive increase in capex. This, additional capex was rolled into the RAB without assessment of its efficiency or prudency.

- The AER's capex allowance in AA2 was around double that of AA1, and appeared to be in response to the high actual spend in AA1, together with a forecast growth in demand of around 15% over the AA2 period. TN has not explained this error satisfactorily, and the MEU expects the AER to review TN's forecast methodology more carefully in the future.

- TN underspent this increased allowance by $120 million or almost 20%, and by doing so, the MEU considers TN has accrued a cash benefit exceeding $25 million.[52] The MEU believes that TN has not adequately explained this outcome. We acknowledge that, in part, it is a reasonable response to demand growth lower than forecast, but we question whether there was also a capability gap to manage this level of expenditure. It would be concerning for consumers if they were paying for this latter error.

Figure 11: Transend/TasNetworks Total Capex ($ million 2013-14)



Source: TN proposal and TN proposal appendix 22, MEU *Submission on Proposal*, p 51 with AER DD data added.

[52] The cash benefit has been assessed on the aggregate capital under-run each year of the period and the regulated WACC. See MEU, *Submission on TasNetworks' Revenue Proposal*, August, 2014, p 51 – 52.

Figure 11 highlights that the AER Draft Decision does little to reduce the TN capex claim and the comments the MEU makes regarding the need for forecast replacement capex below should result in even a lower capex allowance than is allowed in the Draft Decision.

4.1.2 Other issues raised by the MEU

In its submission on the initial regulatory proposal the MEU also raised the following issues on capex which we believe are still relevant:

- The new CESS provides an incentive for NSPs to overstate their capex requirements in order to receive a 'bonus" at the end of the regulatory period and reduce the risk of any ex-post review of the efficiency and prudency of actual capex spend.[53]

- To the extent that the allowed WACC exceeds TN's actual cost of capital, there is an additional incentive to overstate capital requirements as this enables a profit on investment above the cost of capital. In the past, this has provided a strong incentive.

  As discussed in Section 5, this incentive might be somewhat reduced for TN under the WACC in the Draft Decision. The AER has reduced the allowed WACC from the 10% in AA2 to 6.88% in AA3.[54] However, it is likely to continue to provide some incentives to TN and, more particularly, its owners, the Tasmanian Government who can borrow (to raise funds for TN) at costs reflective of its current "Stable AA+" credit rating.[55]

In addition, the MEU is not convinced that TN's costs of delivering capital projects and programmes are at the efficient frontier. One of the reasons for integrating Transend and Aurora is the potential to share resources, including resources related to capital and project planning, management and implementation.

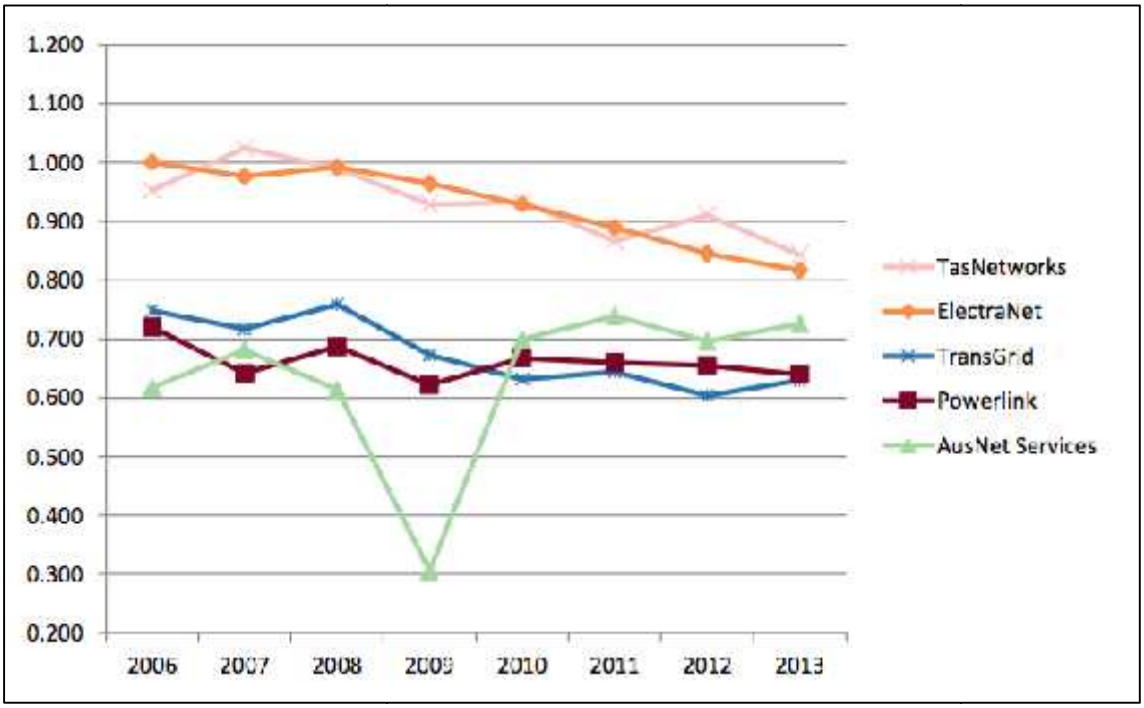
The MEU would expect savings across all capex expenditure categories as a result of this. While some savings in opex are captured in TN's proposal (see above), there does not appear to be similar savings captured in the capex proposal – the focus in the capex proposal is on reduced quantum of work, but not the efficiency of that work.

The outcomes of the AER's benchmarking study of transmission companies supports the general view expressed by the MEU that the excess expenditures in

[53] The CESS involves both ex ante and ex post review of capex. The AER has conducted the ex ante review as part of the Draft Decision, and removed some proposed capex, related to the deferral of two major projects. The ex post review will only "kick in" if the DNSP overspends its regulatory allowance. Hence, having a higher capex approved means less chance of this review.
[54] This will be updated prior to the Final Decision to reflect changes in the interest markets.
[55] As assessed by Standard and Poor's in November 2014.

AA2 (particularly, but not only) should have led to a relatively steep decline in the overall productivity of TN. This is demonstrated in Figure 12 below, extracted from the AER's benchmarking study. Figure 12 shows the progressive decline in multilateral total factor productivity (MTFP). [Note: MTFP also includes changes in opex)

Figure 12: Relative MTFP performance of transmission networks



Source; AER, Draft Decision, Att 6, Figure 6-2, p 6-19.

What figure 12 shows is that although TN exhibits a higher performance level than most of the TNSPs in the NEM, its performance has declined significantly by some 20% over the past eight years supporting the view that TN has been stretched in its ability to deliver efficient services.

The MEU can understand the AER's concern about placing too much reliance on the benchmarking study for assessing comparative efficiencies,[56] or for setting specific expenditure allowances. However, the benchmarking does provide a very useful guide for trends in the performance of individual companies.

The AER has stated a view that in order for the new incentive programs to deliver better outcomes for consumers, the allowances must be set at (or at least near) the efficient frontier to avoid the incentive programs being used as vehicles for giving the networks unearned benefits. This means that the AER's decision on capex (and

[56] However, we believe it has more value to the AER's assessment than the AER is acknowledging – see discussion in Section 3.1.1.

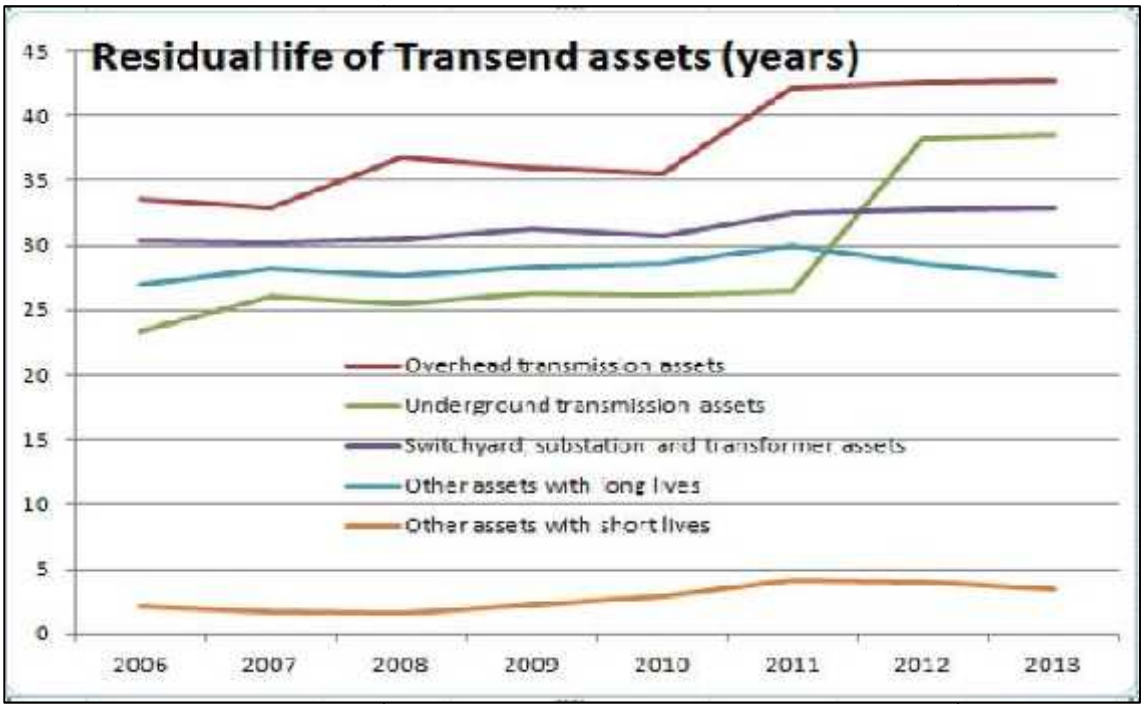
opex) must reflect that efficiency is declining and that allowances must be at the efficient frontier in order to be part of the solution to deliver a turn around in these trends.

4.1.3 Residual life of TasNetworks' assets (years or remaining life)

The MEU believes that TN's capex proposal must be considered not only in the context of the very significant increases in expenditure in AA2, but also the impact this has had on the residual life of TN's assets.

Figure 13 illustrates the quite dramatic change in the residual life of the assets in the last regulatory period, particularly the overhead and underground transmission assets. As set out in the MEU's initial submission on TN's expenditure proposal, the residual life of TN's assets significantly exceeds 50% of the expected lives. For example, overhead transmission lines have an expected life of about 60 years; by 2013 the residual life of this asset was 42 years or about 30% of its expected life – or put another way, the average age of the asset was 18 years (60 – 42 years).

Figure 13: Average residual life of TasNetwork's system assets (years).



Source: MEU, Submission on TasNetworks proposal, August 2014, p 55.

The assessment of both augex and repex must take into account these changes in residual life of TN's principal assets. For example, the MEU would expect to see a very significant reduction in repex expenditure to reflect the large average residual life remaining for TN assets.

4.2 Forecast Drivers of Capex

Section 4.2 briefly considers the individual capex drivers; augmentation capex (augex), customer connections capex, asset replacement capex (repex) and non-network capex.

In looking at the four individual drivers of capex (as defined by the AER), the MEU notes the AER's preference to consider the capex amount holistically. In particular, the AER is suggesting that they (and the NSPs) take a top down approach as well as a bottom up approach. Thus, the AER puts a cap on overall expenditure, but does not approve/review specific projects[57] as actual use of the allowance should rightfully be for TN management to prioritise.

As a general rule, the MEU would agree with that approach; it is essential that management be held accountable in terms of how they choose to spend their allowed capex, as is the case in most large multi-activity firms. However, given the transition to the new rule settings, and the lack of incentives for efficient capex in the past (see above), the MEU considers that a bottom up approach which includes sampling of individual projects for efficiency, is still required.

The AER has highlighted, however, that TN has provided only a bottom up approach to forecasting (in contrast to the approach outlined in the AER's Expenditure Forecast Guideline[58]). The MEU agrees with the AER that a bottom up technical approach is likely to lead to overestimation of the total.[59] TN should be required in future to adopt a top down approach as well as a bottom up approach to assessing their expenditure requirements.

Nevertheless, the MEU believes that the AER must scrutinise TN's capex proposal further, perhaps by more extensive sampling of projects and plans, before the AER makes its final decision.

Users believe that there are sufficient weaknesses in just relying largely on the top down approach and expenditure trends, particularly as the AER has a view that its benchmarking for TNSPs is not robust. There is also adequate evidence of previous overspending of allowances and a wide-spread view that what tasks the TN did in the past were not done in the most cost efficient manner. This further suggests that relying on trends will not lead to the most efficient outcome and that deeper bottom

[57] More precisely, the AER will use some bottom up investigation, particularly if the total seems excessive, however, the AER's starting point is the overall result, not the detail. The AER has expressed some frustration with the number of NSPs who still focus on project-by-project submissions without considering whether the total spend is reasonable. The bottom up forecasting approach will almost invariably lead to excess spending proposals, as there is no pressure to rationalize or prioritise.

[58] AER, *Expenditure Forecast Electricity Transmission Guideline*, November, 2013.

[59] For example, individual planners may have a tendency to overstate their particular regional requirements and opportunities for synergies in costs and timing may be missed.

up sampling review or projects is required to give assurance to users that TN's capex represents prudent and efficient investment.

The MEU also notes the AER's advice that if special circumstances arise for a requirement of additional prudent and efficient expenditure above the allowance, TN can recover this in AA4 (assuming it is prudent and efficient). Alternatively, TN can seek a pass through or nominate the project as a 'contingency project'. In this regard, there is no need for TN to include, and/or the AER approve additional risk "padding" in the allowed capex in the Final Decision.

4.2.1 Augmentation Expenditure

The reasons for the AER rejecting the augmentation capex related largely to two individual projects: the Waddamana-Palmerston 22 kV security augmentation project and the Newton-Queenstown security augmentation project. The AER notes that subsequent to TN's regulatory proposal, TN and AEMO agreed that both these projects could be prudently deferred until after 2014-19 period. TN also amended other aspects of its augex and repex proposal in light of this postponement.

These adjustments resulted in a $35.2 million reduction in TN's proposed augex and an upward revision of $5.6 million to TN's proposed repex for necessary replacement of assets that would have been replaced part of the overall augmentation project.[60]

In its submission on TN's original proposal, the MEU expressed its view regarding TN's inclusion of these two large projects in its proposal even though they had not yet passed the RIT-T process. The MEU is, therefore, pleased that TN has worked with AEMO and found these prudent savings in its proposed capex forecast prior to the AER's draft decision.

TN's augmentation capex is now reduced to $1.6 million ($2013-14). The MEU agrees with the AER that this amount reasonably reflects TN's requirement for growth capex over the regulatory period.

4.2.2 Connections Capex

TN proposed some $19.3 million ($2013-14) for forecast connection capex for 2015-19, representing a substantial reduction of 72% from 2009-14. The AER has accepted this proposal, agreeing that it was necessary to meet joint planning requirements with the surrounding distribution networks.[61]

The MEU notes that AEMO has concluded that the additional connection expenditure associated with Rosebery substation augmentation, which represents

[60] See AER, *Draft Decision, Att 6*, p 6-23 – 6-24.
[61] Ibid, 6-24.

about 30% of TN's proposed expenditure, is required during this 2015-2019 regulatory period.

On the basis of this advice, the MEU accepts the AER's decision on TN's proposed connections expenditure. It is pleasing to see TN is working with the independent expert, AEMO, on these types of expenditures as well as with AEMO on the large project augmentation expenditures.

4.2.3 Replacement related expenditures

TN proposed a total of $207.4 million ($2013-14) for renewal/enhancement capex for 2014-19. Subsequently it sought an additional $5.6 million replacement in lieu of the deferral of two key augmentation projects (see above).

The AER has accepted TN's replacement capex proposal, having reviewed expenditure components of asset renewal, security compliance, spare assets and operational support systems.

The MEU notes that the AER has relied heavily on trend analysis to assess TN's proposals both for the overall repex and for each of the categories. Where there were deviations from trend (up or down) found, the AER has sought further explanations from TN.

The MEU has some concerns with this trend analysis approach. The AER does not appear to have sufficiently sampled individual costings of different activities, or at least, not made any assessment available for public review. The AER states its intent as follows:[62]

> "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."

It is not enough for the AER to say the trend is down overall (although some categories have increased substantially, such as operational support systems). As the MEU highlighted in its submission, consumers in Tasmania have every right to expect that capex would be down given the substantial investment in augex and repex in the previous period.

In addition, the trend analysis provides no assurance that the remaining expenditure is efficient. We do not believe that the AER has met the requirement of ensuring expenditures are prudent and efficient unless it can demonstrate both lower overall allowances (related to a cut back in activities) and the efficient performance of these activities. This aspect is particularly important as the age analysis of the TN assets

[62] Ibid, 6-27

indicates that the residual lives of the assets has increased significantly in recent years because of the massive capex programs in the last two periods.

The MEU therefore advises the AER to not rely solely on the trend analysis at this time and considers that the AER has been overly generous in assuming that the trend analysis is sufficient to demonstrate the repex allowance is efficient. The MEU expects that a more robust analysis on repex will be undertaken.

4.2.4 Non-network capex

The AER states that TN's proposal for a capex of $12.7 million for non-network capex (including IT, communications, buildings and property and motor vehicles) is 75% lower than actual capex in the period 2009-14. The AER also notes that the expenditure is relatively stable in each category across AA3.

The MEU believes it is reasonable to expect some synergy savings following the merger of Transend and Aurora, but it also acknowledges that there are likely to be additional expenditures to align IT and communication systems, albeit with long-term savings and enhanced service delivery.

The MEU also note that some of this amount represents postponement of capital from AA2 to avoid rework of systems. We consider this a prudent deferral. Overall, the MEU believes that that the non-network capex proposal is reasonable and agrees with the AER's acceptance of the proposal in its Draft Decision.

4.3 Conclusions on the AER's Capex Decision

The MEU has highlighted above its expectations for substantial reductions in augex and repex as a result of both the very large increase in expenditures in later part of AA1 and the first years of AA2 in both categories.

The MEU is pleased that the AER has reduced the allowed capex, although note this reduction reflects TN's updated proposal in September 2014 and the agreement to defer two substantial projects on the advice of AEMO.

The MEU is also pleased that both TN and AER are working with AEMO in terms of forecasting overall and regional demand, and are able to adopt a more objective view of the cost benefit of different capex investments. AEMO has developed considerable skills in the assessment of prudent transmission projects taking into account not only projected demand, but also actual and forecast sources of generation including roof-top PV. It is a welcome development that TN, and the AER, are both taking advice from the AEMO.

The following are aspects the MEU considers must receive further consideration by the AER in preparing its Final Decision on TN:

- Given the history of TN's forecast errors and overspending, the MEU believes that the AER needs to go further than trend analysis. The MEU considers that the AER should undertake reviews of more individual replacement projects, to ensure that what is delivered, is delivered at an efficient cost;

- Further attention should be paid to the fact that the age of TN's assets is much reduced, particularly for overhead and underground lines. Performance in the past reflects activity when assets were significantly older than they are now, and the AER's trend analyses should take that into account.

- The MEU expects there to be greater synergy savings in capex following the amalgamation of Aurora and TN. While these are clearly identified in the opex proposal, it is not as transparent in the capex proposal. The MEU requests the AER consider this further.

5. WACC and Imputation Credits (gamma)

5.1 Overview

In May 2014, TN proposed a WACC of 7.58% largely applying the methodology set out by the AER in its Rate of Return Guideline (RoR Guideline), and a gamma value of 0.5.[63] The MEU notes that TN had some reservations about the AER's approach to the cost of equity, however, it has chosen to accept the approach set out in the RoR Guideline to both WACC and imputation credits.

The MEU considers TN has taken a very practical approach to this issue and has recognised the need to return to more sustainable pricing for its customers and to support the growth of the Tasmanian economy and the competitiveness of their "product" (electricity transport) in the market. It is also recognition of the fact that the RoR Guideline was developed over an extended time period with considerable input from all stakeholders and experts in financing and risk management.

In November, 2014, the AER's Draft Decision set a WACC of 6.88% noting that this WACC will be revised before the AER's Final Decision. The difference between TN's proposal and the AER's WACC was largely a function of the change in risk free and 10-year commercial bond interest rates.

TN has accepted the revised WACC and the processes involved in its development.

Table 6 below sets out the changes in the overall WACC and the WACC parameters.

Table 6: AER's draft decision on TasNetwork's rate of return (nominal)

	2009–14 AER decision	2015–19 TasNetworks proposal[a]	2015–19 AER draft decision
Nominal risk free rate (cost of equity)	5.80%	4.11%[b]	3.55%[c]
Equity risk premium	6.0%	4.55%[a],[b]	4.55%
MRP	6.0%	6.6%	6.6%
Equity beta	1.0	0.7	0.7
Gearing ratio	60.0%	60.0%	60.0%
Inflation forecast	2.47%	2.52%	2.50%
Nominal post tax return on equity	11.8%	8.7%	8.1%
Nominal pre-tax return on debt	8.81%	6.84%	6.07%[c]
Nominal vanilla WACC	**10.00%**	**7.58%**	**6.88%**

Source: AER Draft Decision, TasNetworks, Overview, November 2014, Table 8-3, p 34. The details of the AER's assumptions are included with Table 8-3 in the AER's Overview document.

[63] AER, *Rate of Return Guideline*, December 2013, AER, *Explanatory Statement, Rate of Return Guideline,* December, 2013.

5.2 The MEU's concerns with the AER's RoR Guideline

As noted above, TN has accepted (albeit with caveats) the AER's RoR Guideline approach and the resulting WACC.

The MEU also accepts the AER's Draft Decision based on the RoR Guidelines, but for different reasons.

We consider that the Guideline approach results in a WACC that is still excessive when considering the risks faced by monopoly networks and the protections that the regulatory framework provides such as a revenue cap, pass through arrangements, contingent projects and potential to recover excess capital expenditure if it is established to be prudent and efficient.

The MEU also notes that the AER has adopted the approach of accepting NSP's proposals if they are, in aggregate, reasonably likely to represent efficient and prudent expenditure – this is a generous approach that also provides more light handed regulatory management; firms are free to choose their own priorities according to their management assessments.

Importantly – and an area where the MEU has increasing doubts – the value of the assets is protected by annual inflation adjustments and protection from devaluing of assets even when there economic value is not substantiated. We note this is on top of generally high initial valuations of the assets prior to the state governments handing regulatory control to the ACCC and then the AER.[64]

The MEU, representing similarly large capital intensive businesses, considers that the advantages in terms of risk exposure that these monopoly businesses have compared to the risks faced by their businesses in the open market are significant and not fully recognised in the process of setting the WACC under the AER Guidelines. For example, for MEU members, their business revenue is not protected and nor is the value of the assets – assets that no longer deliver economic returns are written down or written off.

For these reasons, the MEU sets out its reasons why it believes the regulated WACC is generous for the monopoly networks and why, therefore, networks have no basis to claim the AER's approach is inconsistent with

- The revenue and pricing principles (RPP) in the National Electricity Law (NEL),
- The rate of return objective in the NER; and/or

[64] The ACCC became the economic regulator of transmission companies from 2003. This responsibility was transferred to the AER in 2005/2006. The economic regulation of distribution was transferred directly to the AER from 2006/2007.

Nor is it appropriate to claim as some NSPs have done (not TN), that the rate of return calculated within the RoR Guideline framework will leave them unable to invest in the network – and all that follows from that. .

The MEU's response was set out in detail in its original submission to the AER on TN's proposal.[65] For convenience, it is summarised below along with some additional issues that have emerged more recently.

- *Return on equity modelling*: As per the RoR Guideline, the AER has used the S-L CAPM model as the foundation model to set reasonable parameter ranges, and used other data sources as a guide to setting point estimates (such as the market risk premium (MRP)). The AER has selected these other data sources on the basis of a set of objective criteria Identified in the Guidelines

  The MEU generally supports the AER's approach while noting the conservative bias of the AER in selecting the point estimates within the S-L CAPM ranges. A number of these conservative biases are discussed further below (equity beta, credit rating, bond maturity).

  Nevertheless, the AER's approach (and accepted by TN although with caveats,) is much more acceptable to the MEU and almost all other consumer groups, than the modelling approach applied by most of the networks to date, and cited by TN as preferable to the AER approach.

  The multi-model approach proposed by the NSPs is untested; it includes multiple assumptions, and provides very unstable and uncertain outcomes for consumers and investors alike.[66] In the MEU's view, the NSPs approach will generally over compensate the networks and fail to satisfy the NEO.

  The MEU also considers that the AER has met the requirements under the rules for considering a variety of data and models as part of its RoR Guideline development process – having considered these, it is at liberty to exercise its discretion to use the models that it considers as "fit-for-purpose including deciding not to use some models at all (such as the Fama French 3 Factor model).

[65] MEU, *Submission on the TasNetworks revenue proposal*, August 2014, p 33 -36.
[66] For example, the multi-model approach makes assumptions about the various inputs such as the future growth rate of dividends and GDP, for example, it includes models such as the dividend growth model (DGM) which may be specified in many different ways, and produces highly volatile results depending on assumptions, as identified by the Australian Competition Tribunal. In addition, the NSPs have decided on particular weightings of the four models which appear to be entirely arbitrary, and liable to change. The MEU does not believe it is in the best interests of consumers (or the NSPs) that each determination round will be a battleground of growth forecasts and model weightings.

- *Equity beta:* The AER's RoR Guideline specifies an equity beta at 0.7, although the most recent research conducted by the AER's consultants suggests the most reasonable range for Australian utilities is between 0.4 and 0.7. Various consumer groups, including the MEU, have advocated for an equity beta closer to the middle of this range (around 0.5 to 0.6), not only on the basis of the empirical studies but from the conceptual view that an efficient and prudent monopoly network operating under the protection of the NEL and NER represents the lowest risk businesses in the market.

  Notably, this low risk, and promise of steady cash flows (because of the 5-year guarantee on revenues and cost pass throughs) indicates that although the benchmark credit rating is BBB+ (see below), because of its gearing, lenders see it as a much safer investment (assuming it is well run).

- *Credit Rating*: Under the benchmark efficient entity approach, the AER assigns a credit rating of BBB+ to the regulated network. TN acquires debt from its owner, via TasCorp who raises funds on the basis of Tasmania's AA+ credit rating.

  In addition, the AER assesses the cost of debt using the Reserve Bank (RBA) and Bloomberg fair value curve (BFC) data. This data includes BBB+, BBB and BBB- companies, and is therefore more reflective of a BBB rated company than a BBB+ company.

- *The transfer of risk:* The MEU is of the view that the amendments to the form of control to a revenue control mechanism transfers additional risk to the consumer for variations in demand. While the transmission businesses such as TN have always been subject to a revenue control mechanism, this is relatively new for most distribution businesses.

  Either way, it should be recognised that consumers, rather than businesses, incur forecast demand risk and this should be taken into account by:

  - ensuring that the equity beta and credit rating (above) reflect this significant protection not available to businesses in the competitive market ; and
  - ensuring that the NSP forecasts its expenditures on the best available forecast of demand.

  In similar vein, the NSPs enjoy the protection of the value of the RAB and annual indexation of the RAB, along with a conservative depreciation schedule.[67] In effect, the risk of asset redundancy is transferred to the consumer who must pay for it, whether or not it is useful in providing the services. In a competitive market, the asset owner wears this risk.

[67] The MEU has argued that in many instances the effective life of the assets may be longer than the depreciation schedules.

- *Corporate bond rate*: TN proposed to assess its cost of debt on the basis of the RBA's 10-year corporate bond series for BBB rated firms (including BBB+ and BBB-). The AER has proposed an average of RBA and Bloomberg Fair Value, noting that both have weaknesses and an averaging approach offers the best estimate than using one or other of the series.[68]

  The MEU does not disagree with the AER's averaging approach, noting the spread between the series and the strengths and weaknesses of each of them and that neither fully replicates the AER's view of the "benchmark efficient financed network entity". In addition, given the RBA series is new, averaging with the existing Bloomberg series reduces the regulatory '"shock" of changing the approach.

  What the MEU also highlights, however, is that by using a 10-year bond series, the AER is selecting the higher cost series. There was considerable divergence of views over whether the AER should adopt a five-year debt series (or seven years) which come at around 100 basis points lower costs. Our observation is that networks borrow capital for a range of maturities (to cover risk) and that a five or seven year bond series is more reflective of actual costs.

- *Transition to the 10 year trailing average:* The AER's RoR Guideline sets out the AER's intention to use a transition approach to the new 10 year trailing average, which in principle will reduce the risk of regulatory changes to NSP's who have built their portfolio of debt around the previous "on the day" approach. The AER has applied this approach to TN and the MEU supports this outcome.

- *Value of imputation credits (gamma):* TN has accepted the AER's assessment of the value of imputation credits. The AER has revised its own Guidelines to assess this value as 0.4 rather than the RoR Guideline of 0.4.

  The MEU is not in a position to debate this arcane issue, although we expect the AER to hold to this figure going forward until the next WACC review.

- *The use of actual data in the assessment of the WACC parameters:* The NER provides for the AER to collect and use actual financial and operational data. However, the AER has chosen to minimise the role of actual outturn returns, arguing in part (it seems) that this will contradict its central conceptual theme of assessing the efficient financing of the benchmark efficient business.

  The MEU understands this concern. However, we would also argue that real world data, such as data on actual borrowing costs, borrowing structures,

[68] The MEU notes that the Australian Competition Tribunal has endorsed an averaging approach when there is no reason to prefer one series above another, as appears to be the case here.

profits, dividends and taxes (in Australia and overseas), should be collected by the AER and used to assist them in exercising their discretion. The AER can gain access to even confidential data in establishing a data base of real world outcomes.

Most particularly, the collection of such data will provide a means of assessing the validity of the CAPM parameters and assumptions around the cost of debt and equity. Research by the Consumer Challenge Panel and other experts, has already identified that actual profits and return on assets and equity, are often considerably greater than the regulatory "targets".

It will also assist the AER assessing the validity of claims made be some NSPs that they will not be able to finance their operations or provide the network services unless they receive higher regulatory allowances.

The AER has developed its approach to assessing efficient financing and has developed models to achieve this. However some NSPs (not TN although it has expressed concerns about the AER approach) strongly oppose this on the basis that it will harm their capacity to borrow and invest in the reliability and safety of network services. As the NSPs have made objections based on "real world claims", it behoves the AER to address these objections equally based on "real world actual data", and of course, including an assessment of the efficiency of this data and to tie this additional information back into the benchmark concept.

The MEU therefore strongly recommends that the AER commences this piece of research as soon as possible using audited company account data as a starting point.

5.3 Conclusions on WACC

The MEU notes that TN has accepted (with caveats) the AER's Draft Decision on the WACC of 6.88% and imputation credit value of 0.4. This decision by TN to accept the AER's decision recognises the reality and urgency of returning transmission prices to more sustainable levels that will support growth in the Tasmanian economy and the competitiveness of TN's "product" – grid supplied electricity.

The MEU acknowledges this, and also accepts that the AER's decision is in line with its RoR Guideline approach, although we note that the AER has reduced the value of gamma from 0.5 to 0.4 to the benefit of the NSPs. The MEU very much hopes that this settles the gamma issue over which there has been so much arcane and expensive dispute.

More generally, while the MEU accepts the AER's Draft Decision (subject to it being recalculated closer to the Final Decision as set out in the Draft), we wish to highlight again that the RoR Guideline is based on some very conservative assumptions that,

amongst other things, fail to fully recognise the degree to which these businesses are protected against many of the risks faced by their customers.

The MEU is of the strong view that the current approach to the WACC will, on balance, over-compensate NSPs relative to the risks they bear and reduces the effect of the regulatory incentives while sitting outside the discipline of the competitive market that leads to efficient capital management, investment and expenditure.

The MEU therefore believes it is important that the AER test its assumptions and benchmarks its own approach by developing a database of "real world" business outcomes. Consumers do not in principle object to an NSP earning greater profits by being more efficient, but not by taking advantage of the conservatism of the regulator.

5.4 Pass through events

The use of "pass throughs" is a mechanism for the regulated entity to reduce its risk by passing these onto consumers. Consumers have little ability to manage such risks faced by networks whereas a network has the ability to prevent, mitigate or pass the risk to another party (eg insurance). The MEU points out that the rules are designed to pass a risk to the party best able to manage the risk. In principle, this means that there should be limited ability for a network to pass a risk onto the consumers.

Regarding previously accepted pass throughs, TN proposed new definitions to previously accepted pass through events.

The AER has not accepted the TN proposed changed re-definitions. The EMRF considers that the AER is correct in its draft decision for the reasons given.

The MEU notes that TN has an ability to better manage its pass through events through better management. With this in mind, the MEU notes that TN should have an incentive to better manage the risks inherent in **all** of the allowed pass through events. In this regard, the MEU considers that TN should be exposed to some share of the costs that might result from these pass through events. If TN was so exposed to even a relatively small proportion of the risk, then this could result in better management of the risk. The concept of sharing is already embedded in the regulatory bargain through the benefits of revenue from shared assets and the EBSS, the CESS and STPIS and a sharing of the costs from allowed pass through events would be no different.

6. Depreciation

TN has proposed the introduction of a new asset class based on communication assets and has revised the pre 2009 asset valuations for transmission and substation assets.

The MEU notes that the AER has accepted the proposed changes to the depreciation schedule as considers this appropriate

7. Efficiency gain

The MEU is totally supportive of an opex incentive scheme to encourage regulated businesses to reduce their costs. The benefit of this is that TN can reduce the costs of providing the service, and by sharing the savings with TN, consumers will be better off in the long term.

The MEU notes that the AER has marginally reduced the carry forward benefit of the Efficiency Benefit Sharing Scheme (EBSS).

As noted in the response to the TN proposal, the MEU is concerned that the opex allowances granted by the AER for the period AA2 were excessive providing TN with an unearned benefit.

The MEU is concerned that the allowance provided in the AER draft decision for period AA3 is also not at the efficient frontier and the MEU concerns are more fully detailed in section 3 above. If the opex allowance is not at the efficient frontier then the application of the EBSS for period AA3 will provide TN a high likelihood that further unearned EBSS benefits will be effectively given to TN by the AER.

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8. Service standards

TN considers that its service standards performance has been good and will use the new (version 4) STPIS as the basis for its future performance incentive arrangements.

The AER has not accepted the caps and collars proposed by TN although the targets are much the same although TN rounded the targets whereas the AER has applied the actual targets to two percentage points.

The main difference appears to be that the AER has applied a 2 SD range for the caps and collars rather than what appeared to the MEU to be 1.5 SD used by TN. The AER points out that the 2 SD is preferred because a tighter cap/collar range would provide a disincentive once the cap/collar was exceeded. The MEU acknowledges this but comments that the same disincentive applies using 2 SD - the only difference being that the likelihood of exceedance using the tighter cap/collar relationship will be greater with 1.5 SD than using the 2 SD.

The MEU also commented that during the current period, TN increased its replacement capex (although still remaining under the overall capex allowance) and this would have contributed to TN gaining a bonus under the performance element of the STPIS - that is consumers effectively contributed to TN gaining the bonus.

In its draft decision, the AER has commented that by using the recent average performance and assessing the claimed amount of repex, it has balanced the capex incentive with the performance incentive and therefore using historical averages is internally consistent.

Where the MEU has a major disagreement with the AER is in the AER decision to approve the NCIPAP (albeit somewhat modified) and not to adjust the performance targets to reflect that a number of the NCIPAP projects are designed to improve network performance. Yet the AER draft decision (whilst acknowledging the impact of repex on performance) totally overlooks the impact of the NCIPAP.

When the impact of past and future repex is added to the benefits to performance resulting from the NCIPAP projects, the MEU considers that the AER has failed to ensure that there is a clear balance between the various incentive programs affecting performance, repex and NCIPAP.

The second leg of the STPIS is the market impact component of TN performance. Again the EMRF notes that a number of the NCIPAP projects will result in improving the impact of the network on the market. Yet there is no proposal by either TN or the AER to adjust the market impact component for the impacts generated by the NCIPAP. This is a significant oversight in the draft decision.

9. NCIPAP

The MEU made its views on the NCIPAP program very clear in its response to the TN proposal. Whilst the MEU supports the concept of the program it considers that its implementation leaves a lot to be desired.

In particular, the MEU is very concerned that the wording of the NCIPAP indicates (and this is confirmed by the AER in attachment 11 pages 25 and 26) that if the amount of funding for the NCIPAP projects is less than 1% of MAR, the TNSP is still entitled to be paid 1.5% of MAR if it completes the projects listed. This indicates that the AER has carried out some very sloppy wording in its NCIPAP guideline. The MEU expects that the AER will carry out an immediate assessment of the NCIPAP wording to rectify the wording as a matter of urgency to prevent what is clearly an inappropriate use of consumer funds being included in the TN reset.

The AER draft decision has accepted the NCIPAP program submitted by TN and endorsed by AEMO subject to a few adjustments. The MEU is appalled by this element of the draft decision. That in its revised proposal TN has accepted the AER draft decision for this element is fully understandable as the MEU considers that the projects proposed and the rewards from the NCIPAP is a "licence to print money" for TN.

Of concern is that the development of the benefits is not fully explained or if the benefits will only provide a benefit under certain circumstances. Despite this, the AER has with some adjustment accepted the majority of the NCIPAP projects proposed by TN.

The AER asserts that the NCIPAP is to address small projects that are not those that would be carried out under normal operations and are intended to increase the export capacity of generation. Analysis of the NCIPAP projects does not support this contention. For example, priority project #5 is to upgrade the dynamic rating of a substation dedicated to a specific end user. There is no doubt that this is not related to generation export and is a project that should have been carried out under normal operations. There are other projects of a similar nature that are more related to consumer interests than increasing generator export capability such as the whole of network dynamic line rating, installation of fault line indicators and communications to these, dynamic rating of 220/110 network transformers, weather station telemetry, etc.

With these examples it is clear that the AER assertion that the NCIPAP only includes that would/could not otherwise be carried out under normal opex and capex allowances is not sustained.

While the MEU supports encouraging networks to identify and complete projects that add value to consumers, the major flaw in the NCIPAP is that there is no certainty that real benefits will be delivered although there can be certainty that projects

(whatever the benefit they deliver) can be delivered. This means that consumers will be paying for projects that have no certainty of delivering any benefit, let alone a commercial benefit.

Overall, the MEU is very concerned that the NCIPAP program is being used to generate a much better outcome for TN than was the original intent of the program.

10. Pricing methodology

The MEU is vitally interested, not only in the overall quantum of the revenue proposal, but also in the approach adopted by TN to network pricing. The NER sets out principles of cost recovery for TNSPs with much less attention to ensuring the pricing is cost reflective so that consumers can make efficient decisions on how they use the transmission networks. The pricing rules provide considerable flexibility to the transmission networks in the way they set prices. It would appear that generally TN wants to continue the current approach which the MEU has highlighted is not cost reflective. Nor do TN's current prices provide the appropriate and necessary signals for consumers to change their electricity usage practices to minimise future increases in network investment.

The MEU urges the AER to require TN to consult further with its customers on these pricing issues and for the AER to consult with TN to ensure best practice outcomes from the consumer engagement.

It is important to be equitable to all consumers, but it is also important to map out a path to more efficient and cost reflective pricing. The TNSP pricing rules have cost reflectivity as a driving aspect so that consumers will take actions to minimise their impacts on the transmission networks.

The approach used in Victoria, and the recent pricing review for transmission services in NSW, all indicate a need for other TNSPs, including TN, to amend their current approaches. In particular, these pricing amendments must ensure that transmission prices progressively reflect the long run marginal costs of peak demand. Along with lower overall revenues, these changes will assist in reducing TN's costs to supply to the benefit of all consumers as efficient pricing will result in consumers seeking to use the TNSP services more efficiently.

In summary, the MEU has noted on several occasions, its long-standing concerns with TN's pricing arrangements. This revenue reset process provided TN with the opportunity to implement change but it has not done so. The MEU expects these to be progressively addressed in the new regulatory period.

While the MEU notes that the AER does not address the question of tariffs and pricing structures in its Draft Decision (focusing more on whether the proposed methodology complies with the rules) the MEU believes it is important to highlight this issue as the introduction of more cost-reflective transmission tariffs provides an opportunity to address issues with expenditure and RAB growth over the longer term.