Tasmanian
Small
Business
Council

'Uniting Small Business'

Australian Energy Regulator

Transend Transitional Revenue Proposal, 2014/15

Submission

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Executive Summary

This submission responds to Transend's *Transitional Revenue Proposal, Regulatory Control Period 1 July 2014 – 30 June 2015* lodged with the Australian Energy Regulator (AER). Transend's proposal will have an important bearing on network charges paid by small business in Tasmania beginning on 1 July this year and feeds directly into their retail tariffs. The Tasmanian Small Business Council (TSBC) welcomes the opportunity to comment.

The rapid increases in Tasmanian electricity prices are of significant concern to the TSBC and its members. Nominal electricity tariffs for small business increased by 101 per cent from 2000 until 2011. Whilst forecasts suggest that prices will stabilise over the next three years, network charges are forecast to still increase by 6.4 per cent annually. Our interest in Transend's Transitional Proposal is heightened by these increases and we desire an outcome from the AER Determination which sees transmission prices falling.

Transend is required to conduct effective consultations with consumers in developing its regulatory proposals. However, there are important gaps in what it has done, including a lack of consultation with small business, and the AER needs to consider this in assessing Transend's Transitional Proposal.

Transend is proposing a small (1 per cent per annum on average) real reduction in transmission prices over most of the coming regulatory period, although nominal prices will continue to increase by 10 per cent over the same period. Whilst the TSBC welcomes these real price reductions and sees them as a significant departure from the large increases in Tasmanian transmission prices seen over the past decade, we do not accept that Transend has gone far enough with its proposals. We discuss why below.

Transend has provided forecasts of demand growth which have a significant bearing on its capex proposals. Although these forecasts recognise that electricity demand has and continues to fall in Tasmania, they may not be bearish enough. For example, AEMO has in recent days issued a further downward revision to its demand forecasts for the NEM.

The Transend-Aurora Energy merger is meant to deliver costs savings of $8 million per annum. Transend's share needs to be included in its proposal but is not made explicit.

Transend proposes a significant reduction in capex compared to the current regulatory period. This is welcome but not surprising given its lower demand growth forecasts, reforms to the way that capex proposals are assessed and the community and political heat created by rapid increases in electricity prices. The question remains, however, of whether Transend has gone far enough? TSBC has considered all areas of capex and found that many of Transend's proposals lack adequate explanation and justification, including for its larger projects. The AER needs to ensure that this serious gap is closed, otherwise consumers will have no way of knowing if they are only paying for capex which is needed and efficient.

Transend proposes $226.7 million ($2013/14) in opex over the next regulatory period. This compares to $246.6 actual opex for the existing period, a real reduction of $20 million, or 8 per cent. This is a useful reduction in opex towards more reasonable levels and is welcome. However, real reductions in Transend's opex effectively ended in 2012/13. It proposes to achieve further real reductions in total and controllable opex of only $0.7 million over the whole coming regulatory period. This suggests that the drive to lower costs, which Transend says it is committed to, is not going to be realised. It is important to electricity consumers, including small business, that Transend actions its commitment.

In assessing Transend's opex we have noted that its forecasting approach, whilst consistent with regulatory requirements and now subject to some additional checks and balances, is still prone to exaggerated expenditures. We have also queried that some of the assumptions used to determine opex are opaque or not backed up by detailed justification. This includes productivity growth, labour cost escalators and other cost escalators.

It will be important for the AER to test the veracity of Transend's Regulatory Asset Base (RAB) proposals in determining the roll forward of its RAB, including that Transend's capex over the current regulatory period has been efficient and prudent. This is notwithstanding that Transend has kept capex below its regulatory allowance, a welcome outcome.

Transend has proposed a rate of return, or post-tax Vanilla Weighted Average Cost of Capital (WACC), of 8.43 per cent. This provides it with $632 million in revenue out of a total of $1,122 million (or 56 per cent) over the next regulatory period. This is an important part of Transend's proposal to carefully scrutinise. To achieve this, Transend has departed from the AER's values for two important parameters used to calculate its rate of return, the return on equity and the value of imputation credits. The impact in both cases is to significantly increase Transend's rate of return. TSBC does not support Transend's departures based on the weight of available evidence for both parameters. Application of TSBC's preferred values would usefully reduce Transend's revenue and prices.

Transend has sought the ability to pass through any additional costs it incurs due to a Natural disaster event or Insurance cap event. We do not support either of these proposals, which expose consumers to a risk of higher transmission charges and as cost pass through provisions work to increase costs but rarely to reduce them. Small business can also be impacted by such events but does not have access to regulatory pass throughs.

We also comment on certain aspects of the Service Target Performance Incentive Scheme (STPIS), a regime applied by the AER to incentivise networks to improve their service to benefits consumers and the wholesale electricity market.

1 Introduction

This submission responds to Transend Networks Pty Ltd's (Transend) *Transitional Revenue Proposal, Regulatory Control Period 1 July 2014 – 30 June 2015* (Transitional or Placeholder Proposal) lodged with the Australian Energy Regulator (AER) on 23 January 2014. Transend's proposal will have an important bearing on network charges paid by small business in Tasmania beginning on 1 July this year and feed directly into their retail tariffs. The Tasmanian Small Business Council (TSBC) welcomes the opportunity to comment on the important matters raised by the Transitional Proposal.

In preparing this submission, we also considered various other related information, including the AER's *Framework and Approach Paper* (January 2014), Transend's *Forecasting Approach* paper and various other documents released by Transend and the AER.

1.1 Background to Tasmanian Small Business & the TSBC

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

The Tasmanian Small Business Council (TSBC) is an "association of [small business] associations", each of which represents their market grouped industry sector. The TSBC seeks to provide the representative voice of small business in Tasmania. The TSBC's role in facilitating meetings of these trade associations, whose members are predominately small businesses, is paramount to providing informed insights and advice to governments and regulators. An obvious difficulty for owners of small and micro businesses is the absolute necessity to spend their time working "in the business", while those with larger numbers of employees take a more managerial role and begin to spend some of their time working "on the business". Small business is therefore even more reliant on groups such as the TSBC to develop and put forward informed policy positions to Government and regulators that truly represent their interests.

1.2 TSBC's Interest in Transend's Transitional Proposal

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

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

- The need to have access to a reliable source of supply, as many small businesses are heavily dependent on a continuous supply of electricity.
- The fact that some small businesses have energy costs well in excess of the average and, for them, access to competitively priced energy is particularly important.
- The recent large increases seen in Tasmanian electricity prices, which have affected small businesses, many of whom have been unable to pass on these cost increases due to the very competitive markets in which they operate and who cannot access competing suppliers, due to an absence of Full Retail Competition (FRC), making their disadvantages referred to above worse.

As mentioned earlier, Transend's transmission charges for 2014/15 will have an important bearing on network charges which will be passed on by retailers in their charges. Moreover, Transend's transmission charges have been one of the largest components of higher electricity prices in Tasmania over the past decade (see Section 0) and the TSBC is keen to see this end with the AER's new determination.

1.3 Electricity Price Trends in Tasmania

The rapid rate of increase in Tasmanian electricity prices is of significant concern to the TSBC and its members. Our interest in Transend's Transitional Proposal has been heightened by this.

As the final report of the Tasmanian Electricity Industry Expert Panel (Expert Panel) shows:

- Electricity tariffs for small business increased by 101 per cent in nominal terms from 2000 until 2011, or by around 6 per cent per annum.
- The average annual increase was 3 per cent in real terms, or roughly double the rate of inflation.
- Increases were particularly pronounced in 2010/11 and 2011/12.
- Network charges accounted for half f the increase and wholesale charges for 40 per cent.

Analysis by Goanna Energy shows that transmission charges contributed around 30 per cent of the total increase in regulated Tasmanian electricity prices between 2009/10 and 2011/12, almost double its share of electricity bills.

The AEMC forecasts that Tasmanian retail electricity prices should remain relatively stable over the next three years. However, network charges are forecast by the AEMC to increase by 6.4 per cent per annum over this period. Without this increase consumers would be experiencing falling electricity prices.[1]

1.4 Consultation with Small Business

Transend is required to consult with consumers in preparing its Transitional Proposal and the AER can take its approach into account in setting Transend's expenditure forecasts. The consumer engagement process requires Transend to identify consumer cohorts and the views of those cohorts. Small businesses are clearly an important consumer cohort in the context of Transend's Proposal. This requirement follows the Australian Energy Markets Commission's (AEMC) 2012 Rule changes and the AER subsequent Guideline on consumer engagement by network service providers.

Transend's Transitional Proposal says that:

> *In recent years we have made a concerted effort to strengthen our relationship with customers and to better take account of their business drivers in our decision making. (p. 17)*

We welcome this approach by Transend and look forward to participating in future.

Transend's Transitional Proposal goes on to outline the direct consultations it has had with larger users directly connected to its network. In relation to other consumers, connected via Aurora's distribution network, it says in its Transitional Proposal that:

[1] These forecasts were made before Transend submitted its Transitional Proposal to the AER.

> *We are building on our customer engagement experience to develop a similar program for end-use consumers not directly connected to the transmission network. In preparing this transitional proposal, we consulted not only with customers but with other consumers and their representatives. (p. 17)*

The TSBC wishes to place on record that Transend has not consulted with it, or (as far as we are aware) other representatives of small business in preparing its Transitional proposal. This is disappointing and unfortunate as Transend's Transitional Proposal was therefore not informed by small business views and issues prior to being submitted the AER.

The Office of the Tasmanian Economic Regulator's website confirms that Transend meet with its Consumer Consultative Committee in November last year to brief Committee members on its forecasting methodology (neither of the two small business members of the Committee were present at this meeting) and again on 26 February to brief them on its Transitional Proposal (the Committee's TSBC representative was present at this meeting). This means that:

- Transend appears not to have briefed any small business consumers on, or discussed with them – other than its directly connected large customers –its Transitional Proposal prior to submitting it.
- This includes the TSBC.

We therefore believe that there are significant gaps in Transend's consumer consultations and that they have not adequately fulfilled the requirements placed on them by the Rules and the AER's Guideline on Consumer Engagement by Network Service Providers. It appears to be too late for Transend to remedy this and the AER needs to take it into account when assessing its Transitional Proposal.

TSBC believes that its input on the Proposal would have benefitted from such consultations to, for example, allow it to better understand the Proposal and provide responses which Transend could have considered prior to submitting it.

1.5 Outline of This Submission

The remainder of this submission comments on Transend's *Transitional Revenue Proposal* especially in the context of the AER Framework and Approach Paper. It cover transmission prices (section 2), forecasts and the operating environment (section 3), capital expenditure (section 4), operating expenditure (section 5), the regulatory asset base (section 6), the cost of capital (section 7), cost pass throughs (section 8) and the service target performance incentive scheme (section 9).

2 Transmission Prices

For consumers, including small business, transmission price impacts are the single most important outcome of any AER transmission revenue reset. The prices paid for transmission services along with the reliability provided are at the core of consumer interests in the AER's processes.

We welcome Transend's inclusion of a transmission price path in its Proposal to the AER. This is helpful information for Tasmanian electricity consumers, for the TSBC and for consumer advocates participating in this review. It is also apparent from the Transitional Proposal that Transend is tuned in to the need for Tasmanian electricity consumers, including small business, to see an end to the price shocks of recent times. We encourage the AER to similarly report on the price impacts of its Transitional and Subsequent Determinations.

Analysis of Tasmanian transmission charges by Goanna Energy shows that these increased by 27 per cent in real terms from 2004/05 to 2013/14, or an annual rate of 3 per cent.

Transend's proposal involves a transmission price increase of almost 10 per cent, or an average of 1.9 per cent per annum, over the 2013/14 to 2018/19 period. This translates to a real price reduction of 5 per cent over the same period, or somewhat less than 1 per cent per annum.

Whilst the TSBC welcomes the price path and sees it as a significant departure from the large increases in Tasmanian transmission prices seen over the past decade, we do not accept that Transend has gone far enough with its proposals. In other parts of this submission we point to areas where we believe that Transend's proposal should be modified, paving the way for further reductions in transmission charges for Tasmanian consumers, without any diminution in its service levels.

3 Transend's Operating Environment and Its Forecasts

Transend's Transitional Proposal discusses a number of aspects of its operating environment and its forecasts. We comment on some of these below.

3.1 Market Conditions and Forecasts

TSBC concurs with many of the difficult conditions which Transend point out are impacting on the Tasmanian economy, which is largely stagnant, and the impact which these are having on electricity demand (and will likely continue to have over the coming regulatory period). In fact, for many small businesses the conditions they face are even worse than Transend has indicated. For example, final demand is stagnant, capital investment is weak and unemployment is higher than any other State. TSBC also point out that one of the reasons for the fragile State economy is the large increases in electricity prices experienced by Tasmanians in recent years, including Transend's own charges.

We note Transend's comment that it has made a conscious effort to improve its forecasting for this revenue reset (e.g. working with its customers and AEMO to improve the forecasts). It is clear that the forecasts included in Transend's current determination were at odds with what actually transpired over the subsequent years. One impact of this was that Tasmanian consumers paid transmission charges which reflected a bullish outlook for electricity demand (underlying and peak), whereas demand actually fell considerably below this, notwithstanding that some corrective action was subsequently taken by Transend.

Both Transend and AEMO have revised further downwards the demand growth outlook for Tasmania for the coming regulatory period. Transend has reflected this – and remaining uncertainty about the forecasts – by proposing to adopt AEMO's low demand forecasts in its Transitional Proposal. Our concern with this approach is that it could prove to be too bullish. For one thing, AEMO's forecasts have in recent years all been subsequently revised downwards and it is possible that, based on current trends, this will happen again.[2]

Furthermore, Transend has presumably undertaken a range of investments in the current regulatory period that reflect optimistic growth forecasts that did not eventuate and it will be important for the AER to ensure that such spare capacity is used before any new capacity is added. It is difficult to tell from the Transitional Proposal whether Transend has adequately taken this into account.

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[2] Indeed, AEMO has recently released a new forecast of NEM demand further revising downwards its forecasts from November 2013.

Finally, and bearing in mind that the natural tendency for networks to inflate their forecasts has not been entirely blunted by the recent reforms to network regulation, the AER should verify that the AEMO/Transend forecasts are robust and current by having them independently checked by experts.

In making the above points, we recognise that Transend's forecasts will be of more significance in the Subsequent Determination given the application of the Transitional Determination to only a single year and its 'placeholder' status.

3.2 Merger with Aurora Distribution

Transend and Aurora Distribution are to merge on 1 July 2014 to form a single Tasmanian government-owned network business. The Tasmanian Government has given as one of its main reasons from doing this that it will lower costs and that this will deliver lower electricity bills. It flagged savings of $8 million per annum.[3]

Whilst this is only a relatively small proportion of the combined opex of the two businesses (around 7 per cent), TSBC desires to see firm evidence that the merger will have this impact. In the case of Transend, its Transitional Proposal should clearly identify where these savings have been realised and by how much. However, aside from referring to the savings and saying that its "future revenue requirements recognise the scope for efficiency improvements as a result of the merger" (p. 29), the savings are not specifically identified. The AER needs to ensure that the savings are made explicit.

3.3 Costs of *Better Regulation*

Transend has said that there will be significant increases in its obligations under the AEMC Rule changes and AER *Better Regulation* Guidelines. It has also indicated that this will apply to information required in the Subsequent Revenue Proposal. Transend believes that its expenditure will increase as a result of this but has not identified in its Transitional proposal where and by how much. The AER needs to confirm the extent of these costs savings and ensure that they are efficient.

[3] See the Hon Bryan Green, Deputy Premier and Minister for Energy and Resources, *Energy for the Future*, Ministerial Statement to Parliament, 15 May 2012, p. 6.

3.4 Reliability Standards

We note that Transend has assumed in its Transitional Proposal that its reliability obligations will remain the same, although it will be possible under changes to Tasmanian regulations for customers to explicitly accept lower standards provided all those affected agree. Whilst we do not object to Transend's approach, if such agreements eventuate, it should be incumbent on Transend to adjust its costs and prices accordingly. We also note that Transend has not included any impacts from the AEMC's recommendations from its recent review of national reliability standards, which have not yet been agreed to.

4 Capital Expenditure

Transend has forecast that it will underspend its capital expenditure (capex) allowance for the current regulatory period by $106 million (-15 per cent) and that it proposes to spend $304.2 million in coming regulatory period, a decline of $280 million on its actual spending for the current period. This is a significant reduction more attuned to the current conditions and times, and we welcome Transend's comment that:

> *"During the current regulatory period, we have responded to the lower than forecast demand by deferring or cancelling planned development projects. … A lower asset base directly contributes to our objective of containing transmission revenues and prices to our customers." (p. 35)*

However, Transend's significant reduction in capex is hardly a surprise given factors such as:

- The stagnant Tasmanian economy and Transend's low demand growth outlook;
- Transend having concluded a significant asset renewal phase;
- The fact that, at the time of the last reset, there were significant distortions in the regulatory regime (some now reformed), issues about the AER's application of it and problems with the merits review appeals mechanism (with major changes recommended but not yet agreed to by Ministers), which created large incentives on Transend (and the other networks) to propose excessive amounts of capex, which were largely approved; and
- The political backlash in Tasmania from high electricity prices, which Transend is not immune from.

The AER's assessment of Transend's capex proposals needs to go beyond the 'headline' numbers and assess whether Transend's reduced capex proposals go far enough, are efficient and are robust. It should also consider that Transend's capex in the current regulatory period involved excessive amounts of capex with some of this excessive allowance spent by Transend and what impact this has on Transend's efficient level of capex for the coming period, including the Transitional one.[4]

Below we comment on a number of specific aspects of the Transend Transitional Proposal on capex.

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[4] Transend says in its Transitional proposal that it deferred some augmentation and connection projects and delivered some at lower cost. Whilst this is to be welcomed, it is also possible that some of these may not have been needed in the first place or that the initial costs were excessive.

4.1 Key Variables and Assumptions

We have examined Transend's approach and the basic structure it outlines appears to be sound but there is very little detail provided to show how it has applied this to its capex proposals and with what impact. TSBC is left with the feeling that Transend is asking consumers to 'trust' that it has done this well. It needs to go beyond this, even in a Transitional Proposal (which should establish a sound footing for its Subsequent Proposal).

TSBC welcomes Transend's comment that it has included a forecast productivity improvement and cost savings in its Transitional Proposal but we can find no detail on how it has done this and with what impact. Transend needs to be clearer on this matter.

4.2 Interaction Between Capex and Opex

The Transitional Proposal discusses how Transend has proceeded to optimise the link between its capex and opex (operational expenditure) proposals so as to ensure the lowest cost outcome. This issue was considered in depth in the AER's *Better Regulation* program and devices such as equal incentive powers between the AER's Efficiency Benefits Sharing Scheme (EBSS) for opex and its new Capital Expenditure Efficiency Scheme (CESS) were introduced to help ensure such an outcome. However, as the CESS will not apply in the Transition period, we expect that the AER will ensure that this has not in any way distorted capex and opex decisions in Transend's Transitional Proposal.

4.3 Development Capex

We do not doubt that Transend's augmentation and connection proposals for the coming regulatory period are more reasonable and better suited to the conditions it is likely to face. We note that augmentation capex of $50.5 million is proposed (compared to $190.8 million actually spent in the current period) and that $37 million in connection capex is proposed ($68.6 million). However, these still need to be verified as being efficient and prudent investments which are in the long term interests of consumers of electricity, as required under the National Electricity Objective (NEO), and as reflecting the Rule changes and the AER's Expenditure Assessment Guidelines, which the AER is applying to the Transitional Determination.

This should be particularly the case with the larger projects such as the security augmentations proposed to the Newtown-Queenstown and Waddamana-Palmerston corridors, which drive significant spikes in augmentation capex in 2015/16 and 2016/17. Limited information is contained in the Transitional Proposal. Transend's proposed augmentation capex also includes a probability weighted allowance for dynamic reactive support in the north of the State, which drives significant augmentation capex in 2017/18. Again there is little in the way of detail to support this project or its inclusion at a 50 per cent probability of being needed. We note that these projects are costed in Table 3.1 of Transend's Transitional Proposal at $67 million.[5]

Turning to Transend's main connection projects, these comprise two projects at the Bridgewater and Roseberry substations, which make up $24 million of the $37 million proposed for connections. We note that both are at least partly the result of connection inquiries. This being the case, the AER should ensure that the parties seeking the connections are contributing a fair share to the cost of these projects commensurate with the benefits they receive. It should also confirm that there is a genuine need for the projects beyond the needs of the parties seeking connection.

4.4 Renewal and Enhancement Capex

It is concerning that Transend report that they will actually overspend their regulatory allowance for this element of capex by $31 million in the current regulatory period. No explanation is provided as to why this will be the case. We contrast this to other projects which Transend completed for less than they were allowed due to efficiencies and cost control.

Transend notes in its Transitional Proposal that:

> *"We have cleared a backlog of renewal projects and our renewal program is returning to a more typical level. Our forecast renewal/enhancement capital expenditure for the forthcoming regulatory period is lower than the current period." (p. 42)*

The TSBC welcomes this.

We offer the following comments on renewal/enhancement capex for consideration by the AER and Transend:

- Table 3.5 shows that Transend's larger renewal projects (>$5 million) total $96 million out of a total of $203 million for this category. Beyond a series of ticks under broad category headings in the table there is little detail to justify these projects.
- Transend's largest project ($13 million) is for replacement of insulators, which it says is to maintain service levels, keep people safe and mitigate bushfire risks. Beyond

[5] Transend's total augmentation capex for the regulatory period is shown at only $50.5 million in Table 3.1.

this there is no detail given to justify this expenditure to stakeholders, such as TSBC, or the AER.

- Transend is proposing to spend $6 million to replace outdated telecommunications technology. Transend say that this upgrade will be "partially funded" by its non-regulated telecommunications customers "in accordance with our cost allocation methodology." (p. 42) The AER needs to ensure that this allocation as between Transend's regulated and unregulated customers is fair and reasonable.
- Transend's proposal identifies expenditure of $15.1 million for spares and inventory, including three spare transformers (in case of in-service transformer failure) and a mobile sub-station ($7 million). There is no detailed justification for any of these items.
- Operational support capex to a value of $33.5 million is proposed over the coming regulatory period. More than half of this ($18 million) is for the Asset Management System and IT systems. Transend say that part of this is due to a deferral of projects in the current regulatory period to allow it to derive synergies from the upcoming merger. It also refers to spending to strengthen its condition information and progress its smart transmission grid. Transend should provide adequate justification for these before they are allowed.

4.5 Support the Business Capex

Transend proposes a total of $13.5 million in this category of capex (compared to $31.8 million spent in the current period). Again this reduction is more commensurate with current conditions and times. Nevertheless, Transend needs to provide adequate justification for its proposals. We also note that we would expect that the upcoming merger would allow some savings in business support costs but none appear to be identified?

5 Operating Expenditure

Transend's Transitional Proposal is for $226.7 million ($2013/14) in opex for the next regulatory period. This compares to $246.6 actual opex for the existing regulatory period, a real reduction of $20 million, or 8 per cent. This represents a useful reduction in opex towards more reasonable levels and is welcome. We support the specific steps taken by Transend to drive down costs which are listed on p. 52 of the Transitional Proposal and note its statement that:

> *"The forecast reflects continuous improvement of all business processes and practices to achieve better cost and performance outcomes. The hard work we have undertaken in recent years will continue to deliver benefits over the forthcoming regulatory period and beyond.*
>
> *We are also committed to find future efficiencies to offset upward pressure on our operating expenditure requirements. This commitment recognises the importance of minimising the costs of transmission services." (p. 49)*

However, it is noteworthy that the real reductions in Transend's opex effectively ended in 2012/13 (see Figure 4.2 and Table 4.2). It proposes to achieve a further real reduction in total and controllable opex of only $0.7 million over the whole coming regulatory period. This suggests that the drive to lower costs, which Transend says it is committed to continue, is not going to be realised. It is important to Tasmanian electricity consumers, including small business, that Transend achieves this commitment. This will help them to secure access to competitively priced electricity.

The remainder of this section comments on specific aspects of Transend's Proposal.

5.1 Forecasting Approach

Whilst we recognise that the AER has stipulated in its Opex Assessment Guideline its preference for use of a 'base-step-trend' approach to forecasting opex, which Transend says it has applied, we do not share the AER's enthusiasm for this method on several grounds:

- We are sceptical that this approach actually reflects efficient costs. We support the concerns raised by the Council of Small Business Australia (COSBOA) in its submissions on this matter through the AER's *Better Regulation* program. These concerns relate to each element of the approach and place electricity consumers at risk of being subject to a cost-plus outcome.

- For the last Determination, Transend proposed and was more-or-less allowed significant increases in opex using this approach.[6] It subsequently transpired that the regulatory regime was allowing regulated networks, including Transend, to propose exaggerated expenditures, a fact acknowledged by the Chairman of the AER. Whilst the AEMC and AER have now ensured that additional checks are in play to help ensure that opex proposals are more reflective of efficient costs, it is possible that exaggerated opex could still form part of the Transend proposal, notwithstanding its proposed reductions in opex for the coming regulatory period.
- The Rule changes and Guidelines issued by the AER make clear that techniques such as benchmarking will be used in assessing expenditure proposals put forward by networks in future determinations. We fully support this and will be looking towards the AER to ensure that this is done for Transend as part of its Transitional and Subsequent Determinations. The AER's *Framework and Approach* Paper says that it will be. However, Transend has not included any such techniques in its Transitional Proposal.

5.2 Assumptions

Transend says that it has applied annual productivity factors to its opex, anticipating future cost savings and efficiencies, including those arising from its forthcoming merger. We welcome this but Transend's proposal contains no detail on this, how it was done or what level of productivity has been applied. This makes it difficult for us to assess what Transend has done.

Brief comments on Transend's other assumptions follow below:

- The cost impacts of the AER's *Better Regulation* program and other regulatory changes are not made explicit making them difficult to check.
- The asset growth factor applied to opex is not set out in the Proposal.
- The labour and non-labour input escalation rates are not specified.
- The AER needs to assess the veracity of Transend's asset management plans and strategies and the way these have been used to inform field operations and maintenance expenditures.

[6] Transend was allowed an increase of nearly 60 per cent in opex over its previous allowance which was around 90 per cent of its proposal.

5.3 Efficiency Benefits Sharing Scheme

Transend has lowered its EBSS payments to reflect that demand growth is outside the range of scenarios modelled in the approved forecast capital expenditures. We support this noting the requirement to so under Transend's EBSS for the current regulatory period.

6 Regulatory Asset Base

We note that Transend is proposing to roll forward a regulatory asset base (RAB) that is slightly lower, in real terms, than its closing RAB for the current regulatory period. It is also forecasting that its RAB at the end of the coming regulatory period will be slightly lower again. We generally welcome this, noting both its important link to past and future capex and that it will assist with keeping transmission prices under control in the coming regulatory period. Nevertheless, it will be important for the AER to test the veracity of Transend's RAB proposals in determining the roll forward of Transend's assets, including that Transend's capex over the current regulatory period has been efficient and prudent, notwithstanding that Transend has kept capex below its regulatory allowance.

7 Cost of Capital

Transend has proposed a post-tax Vanilla Weighted Average Cost of Capital (WACC) of 8.43 per cent, with a range of 8.20 to 9.32 per cent. It has for the most WACC parameters followed the AER's Rate of Return Guideline. However, Transend has differed in respect of its proposed equity beta and gamma values. The WACC is quite sensitive to these two parameters and there can be a significant impact on Transend's revenue and transmission prices. We note that the impact of Transend's divergence from the Guideline to increase its revenues and transmission prices compared to adopting the AER's values.

It is also worth noting that TSBC supports much of the AER's treatment of WACC in its Guideline and recognises that these, along with AEMC Rule changes, have resulted in movement towards an improved approach to the WACC. However, consistent with COSBOA's submissions during the AER's consultations on the Guideline, we do not support some of the AER's approach or the AEMC's Rule changes, including that:

- Setting the equity beta at 0.7 is too high based on available evidence and it should be further reduced to reflect this.
- The cost of debt provided to government owned networks, including Transend, is excessive and does not reflect the fact that they can access debt at a lower cost based on their public ownership.

We also note that uncertainty remains around the final cost of capital applied to Transend due to possible changes in financial market conditions and the AER's setting of the cost of debt on an annual basis.

Below we comment further on the two WACC parameters where Transend has departed from the AER's Guideline.

7.1 Equity Beta

Transend has proposed an equity beta of 0.91, which is substantially higher than the 0.7 favoured by the AER. We note that the AER considered a wide range of evidence in arriving at its preferred value. We support that the AER's evidence establishes a sound case for an equity beta no higher than 0.7.

The AER's considerations included an SFG Consulting study commissioned by the Energy Networks Association (ENA). The AER concluded that the most relevant evidence in the SFG study related to the nine listed Australian firms included, which all had significant regulated energy network revenue, and that this supported an equity beta of 0.7. The Transend Transitional Proposal refers to this study and its recommendation of an equity beta of 0.82

(still below Transend's proposal) but does not mention that the AER excluded the SFG results for US data due to a range of factors and also those based on the Fama-French model. We find the AER's decisions to do this compelling.

Transend refer to studies for the ENA by NERA to support their upper bound of 1.0 for the equity beta. The AER also considered this study on developing the Rate of Return Guideline but was not persuaded that it supported such a high upper bound.

We therefore do not support Transend's equity beta proposals and prefer the AER's point estimate of 0.7[7] and its range of 0.4 to 0.7.

7.2 Value of Imputation Credits (Gamma)

Transend agrees with the AER's reasonable estimate of 0.7 for the payout ratio in calculating the value of imputation credits (gamma) but believes that the utilisation rate of 0.7 favoured by the AER should be reduced to 0.35. This is on the basis that the Australian Competition Tribunal has accepted this value for the utilisation rate based on a study it commissioned by SFG. As the AER has pointed out, this is based on the results of a single study (in which the Tribunal had confidence). We note that the AER has considered a wider range of theoretical and empirical evidence in establishing a robust value for the utilisation rate, which both pre and post-date the SFG study. Given this, we find the AER's reasoning for applying a utilisation rate of 0.7, leading to a gamma of 0.5, more persuasive than Transend's proposed sole reliance on the SFG study for the Tribunal.

[7] As mentioned above, we believe that a point estimate of 0.7 is still too high based on both theoretical and empirical considerations (see for example, the COSBOA submission on the AER's draft Rate of Return Guideline).

8 Cost Pass Throughs

TSBC has significant concerns with the continued application of cost pass through provisions to network service providers. We note that:

- Such provisions are inimical to the concept of ensuring that monopoly energy networks mimic the workings of a competitive market, given that firms operating in competitive markets have no access to such provisions.
- Cost pass throughs have a track record of being upwardly asymmetrical. That is, they often provide monopoly energy networks with additional revenue based on their own proposals to compensate them for increased costs but rarely (if ever) work the other way.
- Consumers have limited ability to seek negative pass throughs and limited resources with which to do so.

Transend has sought pass through provisions in its Transitional Proposal based on a Natural disaster event and Insurance cap event. We do not support either of these proposals given the points made above and also believe that Transend ought to be strongly encouraged to manage the impact of such events as part of its normal course of business rather than falling back on the cushion of a pass through event. Small business can also be impacted by such events but does not have access to regulatory pass throughs.

9 Service Target Performance Incentive Scheme

We note that while the Rules require that the AER apply the current service target performance incentive scheme (STPIS) applied to Transend during the Transitional Period, it has the ability to make modifications to this scheme. The AER has decided that it will only modify the existing STPIS applied to Transend to include the Market Impact Component (MIC) and Network Capability Component (NCC) included in later versions of the STPIS, but to not include recent changes to the STPIS service component. The AER say in their *Framework and Approach* Paper that application of the latter would be a significant task and would not be practicable in the Transitional period. Whilst we accept the AER's reasoning, we believe that Tasmanian electricity consumers should not have been denied the benefits of improvements to the service component during the Transitional period. We believe that the AER needs to use resets to challenge the TNSPs to 'go the extra mile' wherever possible and has missed an opportunity to do this. We do, however, support the AER's early application of the MIC and NCC, even though the one-way incentive provided by these provisions seems at odds with sound incentive regulation.

Transend has submitted a Network Capability Incentive Parameter Action Plan (NCIPAP) to support its NCC proposals. This plan lists numerous projects in support of NCC payments. The project list includes annualised market benefits for each project, expenditures and the types of benefits claimed. The AER needs to carefully assess this list and ensure that it is robust and capable of delivering the benefits claimed at the costs identified. We note, for example, that Transend has provided no details about benefits and costs, or how they have been calculated.