22 February 2008

Mr Mike Buckley
General Manager
Network Regulation North Branch
Australian Energy Regulator
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CANBERRA ACT 2601

Dear Mike

ELECTRANET REVISED REVENUE PROPOSAL

Powerlink appreciates the opportunity to provide comment on ElectraNet's Revised Revenue Proposal. These comments are limited to a number of specific matters below.

Inflation Forecast

The inflation rate forecast was an issue raised by Powerlink in its response to the AER's Draft Decision on Powerlink's revenue cap on 9 February 2007. In particular, that the methodology employed by the AER and other regulatory authorities to derive an inflation forecast may not provide an accurate estimate.

However, despite having provided the AER with additional information from NERA and undertaken public consultation on this matter, the AER concluded that it had insufficient time to complete its assessment. On this basis, the AER decided not to depart from the current methodology of forecasting inflation from observed Commonwealth Government Security (CGS) yields in Powerlink's Final Decision (June 2007).

Powerlink notes that in ElectraNet's Draft Decision, the AER agreed that there was evidence of distortion in the indexed CGS market and considered that an alternative means of deriving a best estimate of expected inflation was necessary. To this end, the AER was guided by the Reserve Bank of Australia's inflation target range of 2 to 3 per cent, and accepted that ElectraNet's proposed forecast was not materially different to its forecast of 3 per cent.

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Powerlink agrees with the arguments articulated in ElectraNet's Revised Revenue Proposal that the AER's inflation forecast is not a 10-year forecast consistent with the Rules. Further, if the AER decides to maintain its position to apply the RBA target range for inflation, Powerlink considers that the mid-point of the target range – 2.5 per cent per annum – is the maximum long term inflation forecast that can reasonably be adopted.

Cost Estimation Risk Factor

In ElectraNet's Draft Decision, Powerlink notes SKM's advice (SKM) that notwithstanding its concerns about some of the inputs in the Evans & Peck modelling conducted for ElectraNet, industry experience suggested that the originally proposed cost estimation risk factor of 5.2 per cent was not excessive. Contrary to this advice, the AER chose to apply a lower risk factor of 2.6 per cent consistent with information and analysis conducted for the purposes of Powerlink's revenue determination, as opposed to that provided by ElectraNet.

Part of the AER's reasons for deciding on a lower risk factor was that the risk profiles and costs were considered to be based upon arbitrary projections rather than actual past outcomes. In light of its own revenue determination process and the detailed information provided therein, Powerlink has serious difficulty with the AER's position in this regard. One of the reasons cited by the AER for rejecting Powerlink's proposed cost estimation risk factor of 2.6 per cent in its Draft Decision was that there was no actual evidence that the risk was material or of the magnitude proposed. In response to the AER's Draft Decision, Powerlink:

- provided significant additional actual cost data on the majority of projects completed over the regulatory period;
- re-engaged Evans & Peck to analyse this data; and
- demonstrated, on the basis of actual cost data evidence, that actual project costs have been 9.4 per cent higher than estimated costs over the last regulatory period.

Having provided compelling evidence that the cost estimation risk factor was materially higher than the value sought by Powerlink in its original Revenue Proposal, the AER decided that 2.6 per cent was appropriate after all[1].

Given Powerlink's experience that asymmetry of the order of 9.4 per cent exists in forward cost estimating, Powerlink strongly believes that a revised factor of 4.6 per cent is not unreasonable in ElectraNet's case.

[1] It should be noted that the only reason Powerlink did not propose that a 9.4 per cent cost estimation risk factor be applied to its forecast capital projects in the first place was because it had not collected sufficient historical data to allow statistical analysis of this nature to be undertaken at the time of lodging its original Revenue Proposal (April 2006).

Non-Labour Construction Cost Escalation

In relation to SKM's recommended non-labour cost escalators, Powerlink believes that in the current high construction cost environment, it is implausible for SKM to suggest and for the AER to accept that key electricity transmission construction components such as primary substation equipment, overhead lines and underground cables will increase by less than inflation over the next five years. This outcome alone indicates there is something awry with SKM's modelling. The front-ended profile of these escalations is also at odds with the current and immediate future cost environment.

Powerlink considers that the revised escalation methodology applied by ElectraNet appears to be logical and reasonable. A similar approach was adopted by Powerlink and accepted by the AER and its consultants in demonstrating the reasonableness and efficiency of forecast cost increases on active projects.

Replacement of Assets Providing Transitional Services

As identified by ElectraNet, there is some uncertainty as to the appropriate treatment of replacement assets which provided connection services at the transition from the old Chapter 6 Rules and new Chapter 6A Rules determined by the Australian Energy Market Commission in late 2006. In this regard, Powerlink supports ElectraNet's proposed approach to continue to treat the replacement of such assets as prescribed services under the Rules. Consequently, the AER should incorporate the associated costs of providing transitional services into its Final Decision on ElectraNet's revenue cap.

If you have any queries in relation to this submission, please contact Merryn York on (07) 3860-2143.

Yours sincerely

Merryn York.

Merryn York
Manager, Network Strategies and Performance