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20 February 2012

Mr Warwick Anderson
General Manager
Network Regulation
Australian Energy Regulator
GPO Box 3131
Canberra ACT 2601

Dear Warwick

re: Powerlink Draft Transmission Determination 2012-13 to 2016-17

ElectraNet appreciates the opportunity to provide comment on Powerlink's Draft Transmission Determination released by the AER on 29 November 2011. This submission addresses the following key issues:

- Labour cost escalation;
- Capital expenditure efficiency adjustment;
- Debt Risk Premium;
- Contingent Project assessment;
- RIT-T as a contingent project trigger;
- Portfolio risk allowance; and
- Completion of the Regulatory Test.

Labour Cost Escalation

ElectraNet notes that the AER is not satisfied that forecast growth in Average Weekly Ordinary Time Earnings (AWOTE) reasonably reflects a realistic expectation of the change in labour costs. The AER considers that forecasts based on Labour Productivity Index (LPI) most reasonably reflect expected real labour costs.

LPI effectively measures the underlying change in the price of labour, or wage rates, for specific occupations or job classifications and therefore has tended to be less volatile in recent years than AWOTE which takes into account shifts in the overall labour cost.

However, ElectraNet considers that AWOTE is a more comprehensive measure of overall labour cost as it takes into account movements of employees to higher grades, changes in the composition of the workforce

and payments over and above base rates of pay such as incentive payments and penalty rates. These changes are not taken into account in the LPI, but can have a material impact on the efficient labour costs of a regulated business.

On this basis, ElectraNet believes that Powerlink's approach of using the AWOTE series as the basis for labour cost escalation is appropriate.

Further, the AER dismissed the use of the Australian Bureau of Statistics (ABS) electricity, gas and water (EGW) sector as an appropriate index for labour escalation in favour of the electricity, gas, water and waste services (EGWWS) index. Since late 2009 the ABS has reported AWOTE and LPI data under the ANZSIC 2006 (EGWWS) industry classification rather than the ANZSIC 1993 (EGW) classification. Under the new classification waste services has been included with the electricity gas and water industries (EGWWS).

This decision was taken on the basis that the difference between the two indices was not considered to be statistically significant, and it was therefore not necessary to remove the waste services component from the EGWWS data.

However, it is our view that the inclusion of waste services sub-sector will lead to lower wage growth outcomes for the combined EGWWS industry and therefore will not accurately reflect labour escalation actually occurring within the electricity sector.

Therefore, we consider using the AWOTE series for the EGW sector index is a more accurate and representative approach for forecasting labour escalation for the electricity sector.

We also note that the AER believes that the LPI adjusted for productivity provides a more realistic expectation of labour cost than AWOTE adjusted for productivity. The AER applied 'unadjusted' Utilities industry productivity forecasts prepared by Deloitte Access Economics to the LPI forecast to derive productivity adjusted real cost escalators for the utilities sector.

ElectraNet notes that while the ABS publishes 'unadjusted' labour productivity statistics for the EGWWS industry sector, a quality 'adjusted' labour productivity index is only available at the overall market sector. It was on the basis of this general index that the AER determined to apply a zero quality adjustment to the productivity forecasts for the utilities sector.

Based on our independent advice, we consider that labour productivity measures applied to LPI should be adjusted for workforce compositional and up-skilling effects. However, in the absence of an appropriate 'adjusted' industry labour productivity measure, AWOTE adjusted for productivity would be a more appropriate labour escalation measure for the AER to use. It is highly questionable to apply economy wide data in deriving a specific labour cost forecast that should reflect the position of a regulated network business.

ElectraNet is also concerned that the productivity forecast provided by Deloitte Access Economics (DAE) to the AER in November 2011 is potentially too optimistic. We are currently in the process of reviewing the analysis upon which this forecast is based however, our initial analysis suggests that productivity output in the utilities sector will remain weak due to a number of issues including:

- Higher utilities prices, particularly with the imposition of a carbon tax;
- Slower population growth; and
- Reduction in the number of energy intensive capital projects (i.e. aluminium smelters) due to the carbon tax.

The above issues are likely to contain the demand for energy. This combined with forecast moderate growth in employment in the utilities sector in Australia will likely moderate productivity growth as measured by DAE in the future.

On an issue of process, it is noted that Powerlink considers the AER's labour productivity forecasts have not been reasonably substantiated. As we understand from its revised revenue proposal, Powerlink sought clarification from the AER and requested the data, source methodology and model(s) used by DAE to establish the labour productivity estimates. The AER subsequently sought this information from DAE however was informed that the information was confidential and cannot be provided.

ElectraNet considers that an effective regulatory process relies on transparency in decision making, and an opportunity for the regulated business and affected stakeholders to review and comment on the evidence on which a revenue determination rests, consistent with the requirements of the National Electricity Law and Rules. It is inappropriate for the AER to substitute a position put forward by a regulated business on the basis of evidence or information that is withheld or unavailable.

Capital Expenditure Efficiency Adjustment

We note that the AER applied an efficiency adjustment to Powerlink's forecast capital expenditure in the form of a 1% reduction in year two of its regulatory period and 2% reduction each year thereafter.

We understand that this adjustment has been made on the basis of improvements in efficiency which the AER believe Powerlink has the potential to make through the institution of a performance improvement program.

We note the apparent lack of evidence provided by the AER to justify its assertion that further capital efficiencies can be achieved.

Application of such efficiency adjustments without sound basis may potentially act to weaken the incentive properties of the capital expenditure framework. This framework already provides incentives for regulated network businesses to deliver capital projects more efficiently, and realise these additional savings within its benchmark allowances. The framework is also designed to incentivise regulated network businesses to reveal their true costs through the regulatory process. Imposing arbitrary efficiency adjustments undermines both of these properties of the regulatory framework as it removes the incentive to find efficiencies and weakens the incentive for TNSPs to put forward efficient costs.

Furthermore, ElectraNet is also concerned that by applying an efficiency adjustment to capital expenditure there is the potential for achievable productivity gains to be overstated as the AER has already applied a labour productivity adjustment to labour costs, resulting in a double-counting effect.

Debt Risk Premium

The AER did not accept Powerlink's proposed debt risk premium on the basis that it did not consider it appropriate to rely on or utilise Bloomberg's extrapolated five and seven year BBB rated fair value curves to estimate the debt risk premium.

ElectraNet notes that this approach is inconsistent with the outcomes of subsequent Australian Competition Tribunal decisions regarding the application of the debt risk premium.

With reference to Envestra's access arrangement proposal for the period 1 July 2011 to 30 June 2016, we note that the Tribunal upheld Envestra's view that the debt risk premium should be determined solely by extrapolating the Bloomberg fair value curve from seven years to ten.

ElectraNet is of the opinion that the Bloomberg fair market curve should be retained as an acceptable method for calculating debt risk premium, although ElectraNet agrees that direct interpretation of the market evidence should also be taken into account when calculating a DRP, as the AER has proposed.

Therefore, in preparing a reasonable estimate of the DRP, the AER should have regard to both the evidence of Bloomberg's fair value curve and relevant market data, noting that in relation to relevant market data there is an expectation that there is an objective and thorough examination of the evidence.

Contingent Project Assessment

Contingent projects are an essential risk management mechanism designed to protect both customers and regulated businesses from the impacts of large and uncertain capital expenditures. This feature of the regulatory framework recognises the large and often 'lumpy' nature of transmission network investment, and the reality that at the time of a revenue decision, particular projects may be uncertain in either scope (and therefore cost), timing (and therefore spend profile) or in terms of investment driver (such as market benefit driven investments).

Such projects by their nature are contingent on other events, for example unforseen increases in demand or step load increases, or the outcome of RIT-T assessments which will determine the optimal solution to address a particular need taking into account both reliability requirements and broader market benefits.

Contingent projects are, therefore, recognised as an important feature of the present regulatory framework (possibly being extended to distribution) in both managing risk and providing flexibility for future customer benefit to be delivered. Importantly, these projects have no impact on revenues or pricing until later triggered and approved by the AER through a transparent and public consultation process.

It is essential to preserve this important aspect of the regulatory framework and ensure that all reasonably foreseeable investments for which a need may be triggered in the forthcoming regulatory period are assessed on their merits against the criteria in the Rules for acceptance as contingent projects, having regard to the specific circumstances of the relevant network. Trigger events also need to be considered in this light, and must be both clearly defined and flexible enough to accommodate changing circumstances given the inherent uncertainty in such projects.

It is also important to recognise that the long lead times involved in large projects will mean that, once triggered, expenditures may well extend into future regulatory periods, as provided for under the Rules, and will not all necessarily occur in the upcoming period. Contingent projects are therefore an important mechanism to facilitate the timely delivery of projects with delivery dates in the upcoming or subsequent regulatory period, once the relevant trigger events have occurred.

RIT-T as a Contingent Project Trigger

The AER has indicated that, while necessary, the RIT-T cannot by itself be a sufficient trigger event for a contingent project. In the case of customer demand driven investments, this is accepted. However, for a project that is purely driven by market benefits, without any specific reliability driver, it is unclear that any trigger other than successful application of the RIT-T could apply.

Use of other triggers (e.g. identification of the project by AEMO and publication in the NTNDP) may be appropriate in some circumstances, for example major inter-regional transmission investments that would be expected to fall within the scope of the national transmission planning process.

However, for smaller scale investments designed to address intra-regional constraints on the network, the RIT-T alone should be sufficient as the critical trigger event to be satisfied for an augmentation purely driven by market benefits. Successful application of the RIT-T would demonstrate that net benefits are present, that an optimal investment solution and timing has been determined, that service providers have had the opportunity to identify non-network solutions, and that all aspects of the evaluation have been subject to appropriate public consultation.

Portfolio Risk Allowance

It is noted that the AER has rejected a portfolio risk allowance in the circumstances of Powerlink on the basis that the practice of continually updating the cost information applied in the project cost estimating process should mitigate this risk.

However, while this continuous improvement process can act to improve the accuracy of the cost estimation process and reduce the mean error, it can never remove the asymmetric risk inherent in major capital project delivery. Furthermore, updating unit costs will not capture unforseen variations in project scope.

We therefore strongly agree with the position put forward in Powerlink's recent revised revenue proposal that it is unreasonable to expect that a project's costs will not be exceeded due to unforseen issues impacting on the scope of a delivered project or due to the impact of low probability events that it would be unreasonable to include in the cost estimate in advance (i.e. extreme weather events).

The cost impact due to unforseen events on individual projects can be significant. However, the impact of cost overruns at the individual project level will impact to a far lesser extent if diversified across the project portfolio. It is therefore far more efficient from a customer perspective to diversify this risk across the portfolio in the form of a portfolio risk allowance that captures the average impact than it would be to price all conceivable risks into each individual project, and in effect assume a worst case outcome in every instance.

Rejection of the concept of a portfolio risk allowance by the AER represents a departure from established practice and the widely accepted methodology in project management that asymmetric risk exists in project cost estimation. We note that the AER agreed to the application of a cost estimation risk factor in previous TNSP decisions including Powerlink's 2007-08 to 2011-12 revenue cap and ElectraNet's 2008-09 to 2012-13 revenue cap.

Failure to accept a portfolio risk allowance in this instance would be unreasonable given that contingency was not included in each project estimate, consistent with the established methodology outlined above.

Completion of the Regulatory Test

In its draft decision the AER has determined not to accept a project option (namely a 500kV transmission line development) which has already passed the Regulatory Test (in 2009) on the basis of the options analysis undertaken at that time. In doing so, this effectively overturns the outcome of a published Regulatory Test for a committed project and places at risk significant capital expenditure which has likely already commenced.

Leaving aside the question of efficient cost, it is generally understood that the successful application of a Regulatory Test entitles prescribed assets to enter the RAB. The AEMC has confirmed on numerous occasions the direct link between satisfying the Regulatory Test and the classification of the service as a prescribed transmission service:

> Investments associated with an approved application under the Regulatory Test contribute to shared transmission services and therefore should be included in the RAB and the Revenue Cap.[1]

Given the specific auditing program the AER has established with respect to the application of the Regulatory Test and RIT-T, it is considered that the correct application of the RIT-T is a compliance matter separate from the revenue determination process, and that the revenue decision should focus on the appropriateness of the capital project forecast.

ElectraNet appreciates this opportunity to put forward its views on key issues arising in the AER's Draft Transmission Determination. If you have any queries or require additional information please do not hesitate to contact Simon Appleby on (08) 8404 7324 to discuss any aspect of this submission.

Yours sincerely

Rainer Korte

Rainer Korte
Executive Manager Network Strategy and Regulatory Affairs

[1] *Draft National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006, Draft Rule Determination*, AEMC, 26 July 2006, p29