OFFICE OF THE CHIEF EXECUTIVE

16 February 2009

Mr Mike Buckley
General Manager
Network Regulation North
Australian Energy Regulator
GPO Box 3131
CANBERRA ACT 2601

Dear Mike

Draft Decision
TransGrid Transmission Determination 2009-10 to 2013-14

Powerlink provides this submission in response to the AER's Draft Decision on TransGrid's 2009-10 to 2013-14 revenue cap. In responding to the AER's consultation, Powerlink has focussed on a number of specific issues below.

Cost Estimation Risk Factor

Powerlink notes that TransGrid's cost estimation risk analysis applied ratios which resulted in increases to the estimated costs of between 2-7%. While the AER appears to have accepted the principle that actual project cost outcomes are asymmetric (ie. outturn costs for capital projects are higher than estimated costs more often than they are lower), it considered that a different risk adjustment should be applied to the P50 risk profile.

Without commenting directly on the AER's conclusions, Powerlink considers that cost estimation risk factors of the order proposed by TransGrid are reasonable. Based on its experience and evidence from outturn project costs in its last regulatory period, Powerlink determined that actual project costs were 9.4% higher than estimated costs. Therefore, having made a number of adjustments to the methodology for risk adjustment, it would be appropriate for the AER to consider whether its adjusted methodology delivers a reasonable adjustment for risk in outturn costs in overall terms.

Options Analysis

One of the criticisms levelled by the AER is that TransGrid relied on engineering judgement to select particular options rather than rely solely on economic considerations.

Powerlink submits that not only is the application of engineering judgement an important and necessary tool in options assessment, but the key issue is the valid role which engineering judgments play at various stages in the assessment process. Clearly, it would be impractical, time consuming and inefficient for TNSPs, during the preliminary stages of assessment, to undertake detailed estimates and full scale assessments of every conceivable option to address an identified network need.

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As some projects included in a revenue proposal may not be required for up to seven years in the future, the AER must recognise that the detail of options analysis will vary across different projects.

Defect Maintenance

Powerlink disagrees with PB's recommendation and the AER's decision not to allow defect rectification costs on new assets, with the exception of those identified and rectified during the warranty period.

From experience, Powerlink is well aware that equipment can and does fail during its life cycle, including during the early stages of equipment life. That newly installed assets will operate at a particular level of performance upon installation and throughout its operating life without failure is a common misperception which those operating in the electricity and other industries know not to be the case. This is particularly the case of many electrical and electronic assets.

To demonstrate the need and efficiency of its own regulatory proposal regarding condition based maintenance for new assets, Powerlink sought an independent check from Asset Partnership[1], the Australasian authority in reliability centred maintenance implementation. Among other things, Asset Partnership advised that condition based maintenance is required for assets of all ages, including new assets, which tend to suffer from 'teething' problems or 'infant mortality'.

The primary driver for defect maintenance costs on newly commissioned assets is the need to monitor and detect any loss in the condition of the asset prior to potential failure, which in some cases can be catastrophic, creating safety risks. This necessarily requires that asset condition is monitored from the time equipment is installed and, that action be taken when an abnormal condition is identified – regardless of when this occurs in the life cycle.

Equity and Debt Raising Costs

The AER has not provided any allowance for the costs of raising equity in its Draft Decision. In formulating its position, the AER noted that there is no need to take account of the indirect costs of raising equity under a benchmark regulatory framework.

Powerlink questions whether the AER has given due and appropriate consideration to the expert advice from CEG in support of TransGrid's proposal. This is because the AER accepts that underpricing can occur for both initial public offerings and seasoned equity offerings on the one hand (consistent with CEG), then leaps to the view that compensation for such costs would be inconsistent with the benchmark regulatory framework to determine the WACC and, that efficient benchmark service providers should be able to raise capital without incurring underpricing costs.

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[1] Asset Partnership, 18 January 2007. Report attached to Powerlink response to AER Draft Decision on Powerlink's 2007-08 to 2011-12 revenue cap.

Powerlink does not consider that the AER has demonstrated why either of these propositions is true, nor has it provided any empirical basis for them.

The principle of compensating service providers for the indirect as well as direct costs of capital raisings identified in relation to equity raising costs equally applies to debt raising costs. In the past, there has been an absence of acknowledgement and compensation by regulators for such indirect costs. Given that compelling evidence has been presented by CEG to show that these transactions costs do exist and are incurred, Powerlink submits that the AER should reconsider its position on this matter.

Self-Insurance

In its Draft Decision, the AER reduced TransGrid's total revised self-insurance proposal of $15.8 million to $6.8 million for the five-year regulatory period. The AER's primary reason for this reduction is that it is not satisfied that SAHA provided robust analysis to support the probability of certain events occurring or that the costs of those events are reasonable. On the other hand, PB concluded that TransGrid's proposed self-insurance provision was reasonable.

Powerlink notes that the AER has rejected a number of risk premiums associated with different types of risks put forward by TransGrid. Key examples of this relate to the risk of environmental contamination, bushfires (aside from very minor events) and damage claims for underground cable incidents. Powerlink does not consider that it is reasonable for the AER to reject the principle of claiming for such risks outright, even if it considered that the full extent of the proposed allowance is not justified. In other words, an assessment of the legitimacy of the risk alone should have resulted in some allowance being provided by the AER under the regulatory framework, as opposed to no allowance at all.

If you have queries, please contact me directly or Jennifer Harris on (07) 3860-2667.

Yours sincerely

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CHIEF EXECUTIVE