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RESPONSE TO AER / PB COMMENTS ON REGULATORY RESET CAPEX RISK ALLOWANCE

The Australian Energy Regulator (AER) has released its "*Draft decision – TransGrid transmission determination 2009-10 to 2013-14 31 October 2008*". Pages 72, 73 and 74 of that document discuss the "Cost estimation risk factor" that Evans & Peck assisted TransGrid quantify. Based on PB's analysis (PB Report Section 5.3.4 pages 110 to114), the AER has reduced the allowance by $11.7 million.

We have noted the AER's general concern in relation to the use of risk workshops. We have stated many times that it is preferable to use detailed analytical analysis of past projects as the basis of risk quantification. Were such data available, as it should be in support of future submissions, we would clearly recommend its use. In this instance such data is not available, but that does not exclude risk quantification. The workshop approach adopted is the next best alternative, particularly in the context of the intrinsically conservative approach taken to ensure that we do not overstate risk.

In order to move forward, we have confined the balance of our comments to the specific adjustment mechanism applied by PB / AER. We have no objection to the use of the P50 value as a fair allocation of risk between TransGrid and its customers. However, we have a number of concerns with the adjustment relating to escalation proposed by PB and accepted by the AER. It has flaws both in principle and application. In essence, the adjustment:

1. (Incorrectly) de –escalates the risk allowance.
2. Removes a component relating to escalation which PB believes has been inherently and inappropriately included as a risk during the workshop process.
3. Re-escalates the adjusted allowance to recognise future price increases.

In terms of principle, our concerns relate to Step 2. Escalation can be categorised in two ways - predicted (and built into the model in the form of escalators) and unpredicted. Escalation in line with predictions should not be included as a risk. Variation from predictions is a business risk. The workshop process focussed entirely on variations in physical quantities, and should therefore be immune from price escalation issues. It is naive to think that the experienced workshop participants would confuse "normal" escalation with cost overrun. At worst, escalation outside the bounds of expectations could influence the process. Comments relating to price variation highlighted by PB in the five dot points on page 113 reflect the extent of the increases, rather than escalation *perse'.* In our view, they do not provide evidence to support the assertion that escalation impacts were incorporated in the risk parameters and should therefore be removed.

In terms of application, we believe the data on which PB based their calculations is as shown below under the heading "Mean". Escalation is 10.3%, not 13% as used by PB (this includes the risk adjustment as well as escalation).

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Regulatory Period Summary (2009/10 - 2013/14) - $2007/08						
	P50		P80		Mean	
Cost Component	($million)	(% of base estimate)	($million)	(% of base estimate)	($million)	(% of base estimate)
Base Estimates	$ 2,314.0	100.0%	$ 2,314.0	100.0%	$2,314.0	100.0%
Risk Adjustment	$ 76.8	3.3%	$ 76.8	3.3%	$76.8	3.3%
Escalation (net of CPI)	$ 239.3	10.3%	$ 239.3	10.3%	$239.3	10.3%
Total	**$ 2,630.1**	**113.7%**	**$ 2,630.1**	**113.7%**	**$2,630.1**	**113.7%**

The risk value of $76.8 million does not include escalation. In our view, the “correct” calculation reflecting the intent of the PB methodology is:

1. Un-escalated mean Risk Factor = $76.8m
2. Remove escalation component =$76.8 –(239.3*76.8)/(76.8+2314.0)) = $69.11m
3. New escalation = $239.3*(2314.0+69.11)/(2314.0+76.8) = $238.53m
4. New mean escalated / risked total = $2314.0 +$69.11+ $238.53 = $2621.64m, a reduction of $8.46 million from the original **mean** total of $2630.1. A further 0.6 million needs to be deducted in moving to the P50 value in lieu of the mean.

TransGrid has advised that the actual data used in the Draft Decision is as follows:

Regulatory Period Summary (2009/10 - 2013/14) - $2007/08						
228.4	P50		P80		Mean	
Cost Component	($million)	(% of base estimate)	($million)	(% of base estimate)	($million)	(% of base estimate)
Base Estimates	$ 2,137.6	100.0%	$ 2,137.6	100.0%	$2,137.6	100.0%
Risk Adjustment	$ 70.5	3.3%	$ 81.3	3.3%	$70.6	3.3%
Escalation (net of CPI)	$ 168.3	7.9%	$ 169.4	7.9%	$168.3	7.9%
Total	**$ 2,376.4**	**111.2%**	**$ 2,388.3**	**111.7%**	**$2,376.5**	**111.2%**

Based on this data, and using P50 values, the correct calculation (to reflect the intent of the PB methodology) is:

1. Un-escalated Risk Factor = $70.5m
2. Remove escalation component =$70.5 –(168.3*70.5)/(70.5+2137.6)) = $65.1m
3. New escalation = $168.3*(2137.4+65.1)/(2137.4+70.5) = $167.9m
4. New P50 escalated / risked total = $2137.6 +$65.1+ $167.9 = $2370.6m, a reduction of $5.8 million.

Notwithstanding these calculations which are provided on a “without prejudice” basis, we remain of the view that there is no justification for removing the alleged “escalation” component of the risk allowance.

I trust that this meets your requirements. Should you require any additional information or clarification, please contact Bill Glyde on (07) 3377 7008.

Yours faithfully

EVANS & PECK PTY LTD

William D Glyde

PRINCIPAL