Revenue Reset
Telephone: 9284 3507
22nd February 2008

Mr Mike Buckley
General Manager Network Regulation North
Australia Energy Regulator
GPO Box 3131
Canberra ACT 2601

Dear Mike,

Submission on the AER's Draft Decision for ElectraNet's Revenue Proposal

TransGrid welcomes the opportunity to comment on the AER's draft decision for ElectraNet and ElectraNet's revised Revenue Proposal. TransGrid would like to address the following matters:

1. Non-Labour construction cost escalation
2. Cost Estimation Risk Factor
3. Replacement of Assets Providing Transitional Services
4. Forecasting Inflation

1. Non-Labour construction cost escalation

TransGrid supports the methodology for escalating capital costs used in the ElectraNet revised Revenue Proposal.

The methodology used in the AER draft decision, produced by SKM, as well as the methodology produced by Competition Economists Group (CEG) set out in the ElectraNet revised Revenue Proposal generally provide a sound approach to this matter. Both methodologies break down the capex program into different categories and take a weighted average of cost increases for each category. TransGrid believes that this is an appropriate approach to forecasting the increases in costs for an organisation's capital program.

However, the justification for individual cost category forecasts using the SKM methodology is not clear to TransGrid. By way of comparison the CEG methodology provides a robust justification of the forecasts for individual categories by clearly indentifying and using reasonable projections of the relevant input costs. For this reason the CEG methodology should be given more weight in the AER's assessment process.

Based on TransGrid's experience in recent years input cost increases, which are largely outside of TransGrid's control, have a material bearing on the ability to benefit from efficiency improvements under the ex-ante capex incentive scheme. For this reason the development of appropriate cost escalation methods is a critical part of a TNSP revenue determination, and the choice on methodology is vital to achieving regulatory outcomes supportive of the National Electricity Objective. With this in mind, TransGrid encourages the AER to give positive consideration to the revised proposals from Electranet, based on the CEG methodology.

2. Cost Estimation Risk Factor

TransGrid is supportive of the AER's conclusion that it "is reasonable to provide a cost estimation risk factor to take account of risks that are outside of ElectraNet's control when estimating projects". Clearly, transmission companies face significant risks in relation to the development of long lead projects. The risk approach provides a structured methodology allowing a reasonable allocation of risk between the TNSP, and its customers.

Our primary concern in relation to the AER's draft determination is that a 2.6% "one size fits all" approach has been applied based on the Powerlink Determination. Whilst acknowledging the significant work completed by Powerlink in relation to their application and the development of the methodology, it is generally acknowledged that the 2.6% value proposed was conservatively established prior to the completion of the full analysis of the historical relationship between budgets and outturn costs. As such, it lies below the range of risk faced by a prudent TNSP applying reasonable estimating and risk management techniques.

ElectraNet's analysis, which has been supported by the AER's review consultant, SKM, indicates that a higher value is appropriate in ElectraNet's case. Based on its own analysis, TransGrid is of the view that the 5.2% submitted by ElectraNet in its initial proposal, and subsequently revised downward to 4.6% in the revised proposal (primarily due to the removal of a contingent project) is more representative of the risk range faced by TNSP's.

3. Replacement of Assets Providing Transitional Services

Section 4.4 of ElectraNet's Revised Revenue proposal proposes that expenditure on replacement assets providing transitional services be included in the capital expenditure forecast used to establish ElectraNet's prescribed services revenue cap for the upcoming regulatory control period. TransGrid supports this proposal.

Based on TransGrid's recent experience, the need to replace assets that provide transitional services arises relatively frequently. For example, transformers servicing existing individual generators or customers face an increasing risk of failure over time due to aging. This risk is usually identified via condition monitoring and is scheduled to be addressed, relatively routinely, before material risk to service, safety, or the environment arises. To require such replacements to be treated under the negotiated services framework, when most of the remaining assets at the same connection point are not covered by this framework results in additional administrative costs that effectively produce no demonstrable benefit.

Furthermore, asset replacement on a 'like for like' basis simply ensures that existing service levels are maintained. That is, no new service arrangement is created. For this reason TransGrid does not consider that these assets were intended to be treated as new connection services to be negotiated bilaterally under the negotiated services framework.

Finally, it is worth noting that customers of transitional (connection) services, in accordance with the principles in the Rules for pricing prescribed services generally pay for these services in proportion to the (new) replacement cost of the assets providing these services. As such the relevant directly connected generator or customer generally bears the average cost of these replacement assets over time.

In summary, there is a net benefit to electricity consumers generally in adopting ElectraNet's proposed approach to the regulatory treatment of replacement assets providing transitional services. Furthermore, under the application of current transmission pricing principles the cost of these replacements, over time, is generally borne by the relevant directly connected generator or customer. Finally, this approach appears to be consistent with the treatment set out in the Rules for existing (transitional) and future connection services.

4. Forecasting Inflation

TransGrid notes that in the AER's final decision for SPAusNet, inflation is based on a 10 year forecast. TransGrid also notes that this decision was taken on the basis of thorough analyses provided by recognised experts in this field, and that the inflation forecast period is now in alignment with the duration of the bonds used in calculating regulated cost of capital. As a result, TransGrid believes the preservation of this approach in the final ElectraNet decision would be consistent with the evidence and current good regulatory practice.

Yours sincerely

Anthony Meehan

Manager/Revenue Reset