ElectraNet
electricity transmission

ElectraNet Pty Limited
ABN 41 094 482 416
ACN 094 482 416

PO Box 7096
Hutt Street Post Office
Adelaide 5000 South Australia

T (08) 8404 7966
F (08) 8404 7104

W www.electranet.com.au

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Mike Buckley
General Manager
Network Regulation North
Australian Energy Regulator
PO Box 1199
Dickson ACT 2602

By email: powerlinkreset@aer.gov.au

Dear Mike,

Powerlink Transmission Network Revenue Cap Draft Decision

Thank you for the opportunity to comment on the AER's draft decision on the maximum allowed revenues that Powerlink is entitled to recover for the period 1 July 2007 to 30 June 2012.

The Powerlink draft decision is of particular interest to ElectraNet as it prepares its own Revenue Proposal for the period 1 July 2008 to 30 June 2013. This submission focuses on a small number of issues that are of general concern to ElectraNet's and other TNSP revenue reset processes.

Arbitrary Reductions in Capex Forecast

Powerlink appears to have presented a comprehensive bottom-up forecast of its replacement capex requirements over the coming regulatory period, based on a robust condition-based analysis to identify optimal replacement timing and scope.

However, PB Associates recommended and the AER has accepted in its draft decision what amounts to an arbitrary reduction in the replacement capex forecast based on a crude top-down assessment. While a top-down assessment may (under some circumstances) provide a useful sensibility check it should not be relied upon for determining the efficient or prudent level of capex required.

We note that the top-down approach used by PB Associates assumes that assets will be replaced according to their age, which is not an approach that would be followed by a prudent operator. In practice age would only be used as an indicator to initiate a more detailed condition based assessment of the assets and to determine whether asset replacement or life extension is necessary.

ElectraNet is very concerned about the AER's acceptance of the crude top-down assessment recommended by PB Associates and makes the observation that this approach would not satisfy the standard of decision making required under the new Chapter 6A rules for assessing capex forecasts.

Risk Based Modelling of Capex Forecast

The AER in its draft decision removed the risk adjustment factor sought by Powerlink which recognises that project outturn costs are asymmetric compared to the revenue reset forecasts estimated prior to submitting a Revenue Proposal; i.e. there is a greater likelihood that project cost estimates will underestimate rather than overestimate outturn costs.

ElectraNet supports the use of risk-based modelling to capture project uncertainty. Risk-based capital forecasts founded on engineering assessments and historical performance provide a robust methodology which reflects the likely real cost of completing a portfolio of projects.

All projects involve risk – while modern risk identification and mitigation measures may reduce risk, it cannot be eliminated altogether. Large transmission projects are of a complex nature, making it difficult to estimate a final project cost with certainty. The traditional and commonly applied commercial approach to capture this uncertainty is to assign a contingency amount. This contingency may be expressed as a percentage of the project cost.

The approach taken by Powerlink, to consider the uncertainty inherent in each project and to assign a range of potential cost outcomes, is prudent. Uncertainty exists in both:

- the projects that need to be built; and
- the final cost of each of the projects.

Both Powerlink and ElectraNet have addressed the first uncertainty by identifying different scenarios, which recognise the influence of economic factors on electricity demand. These scenarios take into account uncertainty introduced by items such as economic growth, fuel availability scenarios, and the uptake of new technologies. The AER has recognised this treatment of the uncertainty (risk) of forecasting when a project may need to be constructed.

Powerlink has proposed a risk-based assessment of costs to address the second aspect of uncertainty – estimating the final project cost. Powerlink's proposed approach reflects the uncertainty in accurately forecasting the final cost of the project, which indicates that on average the final project cost is higher than the estimated project cost. This is intuitively correct, recognising that more projects come in over budget, rather than under budget. ElectraNet's own experience in estimating project costs supports Powerlink's assertion that the average project cost is greater than that estimated.

ElectraNet agrees with the AER that using the most up to date cost components from previous projects will improve the likelihood of accurately forecasting a project's final cost. However we note that this technique does not remove the uncertainty of future cost forecasting.

ElectraNet supports the use of risk-based cost estimating, as a more accurate and reliable method of cost estimating than traditional approaches such as the implicit or explicit inclusion of contingency, and one that provides a reasonable balance between the risks that should be borne by the customer and the risks that should be borne by the TNSP.

Reliability Standards and Demand Management

The MEU stated that Powerlink's capex proposal appears to be purely a network augmentation strategy and that there was no evidence that demand management strategies are being sought by Powerlink.

ElectraNet notes that the large majority of capex projects are driven by the need to continue to meet mandated reliability standards in the face of increasing customer demand. TNSPs are required to consider non-network options such as generation network support or demand side options in determining the most cost effective solution for meeting the reliability standard. However, given that there is a mandated obligation to meet the reliability standard within specified timeframes the non-network options considered must be known options that are practical and viable.

The large majority of customer demand that drives the development of the transmission network is distribution demand. DNSPs who connect the bulk of end use customers are in the best position to pursue demand side management initiatives and factor the impact of these initiatives into their transmission connection point forecasts; i.e. requested increases in agreed maximum demand at DNSP connection points that drive the majority of transmission investment are already reduced to take account of DNSP demand side management initiatives.

Regulated versus Competitive Environment

The draft decision makes several references to EUAA and MEU submissions regarding "firms in a competitive environment making efficiency gains and absorbing labour cost increases etc." ElectraNet observes that this is not a logical comparison, as TNSPs are not operating in an environment where the services they provide and investment decisions they make are under their total control (as is the case with firms in a competitive environment). The majority of TNSP investments are required to meet mandated reliability of supply standards. In this environment there is only so much a business can do to control costs through efficiencies. TNSPs simply do not have the discretion to close down or not service uneconomic parts of the business in the same way as businesses operating in a more competitive environment do.

Cost Escalation

ElectraNet notes that in the current construction environment special consideration needs to be given to the impact of lead times for equipment, availability of contractors, materials, sourcing strategies etc. on bringing forward or increasing the efficient costs of implementing projects.

ElectraNet also notes the AER's acceptance of wage growth forecasts provided by Access Economics. We find it difficult to believe that the low growth forecasts of 3.5 – 4% in the later years of the regulatory period are appropriate or will be sufficient to maintain an appropriate workforce. We are currently in the process of reviewing the analysis upon which these forecasts are based.

Please don't hesitate to contact me on (08) 8404 7983 to discuss any aspect of this submission.

Yours sincerely,

Rainer Korte

RAINER KORTE
NEM DEVELOPMENT AND REGULATION MANAGER