



20 April 2007

Mr Mike Buckley
General Manager
Network Regulation North
Australian Energy Regulator
PO Box 1199
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Email: powerlinkreset@aer.gov.au

Dear Mike

SUBMISSION – BIAS IN THE RISK FREE RATE

On 30 March 2007, Powerlink provided additional expert information to the AER on the inflation forecast incorporated in its Draft Decision. This information comprised a report prepared by Dr Tom Hird (NERA) and Prof. Bruce Grundy (Melbourne University) on the *Bias in Indexed CGS Yields as a Proxy for the CAPM Risk Free Rate*. The report concluded that:

- regulators should adopt a minimum 20 basis points adjustment to estimates of the real risk free rate to account for the downwards bias in indexed CGS yields; and
- an additional adjustment to indexed CGS of between 42-44 basis points to reflect the downwards bias in nominal yields may be appropriate.

Given the proposed timing of the release of the AER's Final Decision and that further empirical work is currently being undertaken by NERA in relation to the bias in nominal yields, Powerlink reiterates that it is only seeking to have the AER incorporate the proposed 20 basis points (minimum) adjustment to the real risk free rate. As a consequence of this adjustment, the AER's derived inflation forecast would be lowered from 3.15 per cent to 2.95 per cent, which is in line with a number of other economic forecasters.

Powerlink does not seek the additional adjustment of 42-44 basis points.

This issue was first raised on 9 February 2007, in response to the AER's Draft Decision. Powerlink believes that, in the interim, the AER has had adequate opportunity to review publicly available market evidence on this matter as well as the analysis provided by NERA. We believe that there is adequate time for the AER to consider this matter and to make the necessary adjustment (which can be simply done in the revenue model) without impacting on the timing of Powerlink's Final Revenue Decision.

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The already indicated timing for the Final decision is beyond the point at which Powerlink could practically change the transmission prices for the 2007/08 year, which have already been provided to DNSPs to enable them to have DUOS prices approved and published. The upshot is that, regardless of the AER's decision on this particular (estimating bias) matter, there will need to be adjustments to transmission prices in 2008/09.

Powerlink believes this information is material to its revenue position over the 2007-12 regulatory period and, therefore, must be considered by the AER in reaching its Final Decision. Failure of the AER to do so would not provide Powerlink with a return that is commensurate with prevailing conditions in the market for funds and the risks involved in providing its regulated transmission services.

If you have any queries in relation to this submission, please contact Merryn York on (07) 3860-2143.

Yours sincerely,

A handwritten signature in cursive script that reads "Gordon Jardine".

Gordon Jardine
CHIEF EXECUTIVE