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Chris Pattas  
General Manager  
Network Regulation South  
Australian Energy Regulator  
GPO Box 520  
Melbourne VIC 3000

By email: [aer inquiry@aer.gov.au](mailto:aer inquiry@aer.gov.au)

Dear Chris,

### **SP AusNet Transmission Network Revenue Cap Draft Decision**

Thank you for the opportunity to comment on the AER's draft decision on the SP AusNet transmission determination 2008-09 to 2013-14 and the revised Revenue Proposal submitted by SP AusNet's in response to this draft decision.

This submission focuses on two issues that are of particular concern to ElectraNet.

#### ***Forecast Inflation***

To date the AER's approach to forecasting inflation, and the approach specified in the PTRM, has been to measure the difference between nominal CGS and inflation-indexed CGS using the Fisher equation.

In its draft decision the AER notes that the RBA has expressed concerns over the present usefulness of this approach to measuring forecast inflation due to current supply factors in the indexed CGS market and also notes similar views expressed by other experts.

The AER concludes that a general approach to forecasting inflation, selecting between the options of 2%, 2.5% and 3% within the RBA's target range for inflation, and considering a range of inflation indicators in making that selection, is the methodology that is likely to result in the best estimates of expected inflation at this time.

The AER further concludes that, at present, and after considering a range of inflation indicators, applying this general approach to forecasting inflation favours an inflation rate forecast of 3%, as opposed to 2% or 2.5%.



ElectraNet supports the need to change the existing methodology for forecasting inflation and accepts that there is merit in the following aspects of the AER's proposed general approach:

- determining an inflation forecast within the RBA target range between 2% and 3%; and
- considering a range of inflation indicators to determine a forecast within that range.

However, ElectraNet cannot see any basis for limiting the choice of inflation rate forecast to the options of 2%, 2.5% or 3% within the target range.

It is important that the inflation rate forecast be based on the best evidence and expertise available.

We note that SP AusNet has in its revised Revenue Proposal provided inflation forecasts from a wide range of independent forecasters and that the average of these forecasts over the regulatory period is close to the midpoint of the RBA target range.

Consideration of these inflation indicators in applying the AER's proposed general approach would lead to a forecast inflation rate that is at or close to 2.5%. ElectraNet is of the opinion that this is the best estimate of expected inflation over the forthcoming regulatory period supported by the available evidence.

### ***Risk Based Modelling of Capex Forecast – Contingency Allowance***

The AER in its draft decision removed the contingency allowance included in SP AusNet's cost estimates for its station rebuild/ refurbishment projects.

ElectraNet accepts that the traditional and commonly applied commercial approach to applying a set contingency amount to capital projects will likely give rise to an excessive contingency amount at an aggregated project portfolio level.

However, it is important to recognise 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. 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 the fact that the average project cost is greater than that estimated.

This means that the AER's decision must allow a reasonable risk adjustment to base cost estimates in order to satisfy the Rules requirement to allow efficient and prudent costs required to meet the Rules capital expenditure objectives.

ElectraNet supports the use of risk-based modelling, such as that undertaken for SP AusNet by Evans and Peck, to capture the uncertainty in project cost estimating and to determine an appropriate risk factor adjustment.

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 purpose of risk-based modelling is to determine a risk factor adjustment that when applied to the estimated cost of a portfolio of projects ensures that the overall capital expenditure forecast is unbiased (i.e. to ensure that the probability of actual cost outcomes exceeding the forecast is no higher than the probability of a cost underrun).

In summary, 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.

We note that the magnitude of the risk factor adjustment will be dependent on the nature of the risk assessment undertaken and the details of the capital project portfolio.

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

Yours sincerely,



**RAINER KORTE**  
**NEM DEVELOPMENT AND REGULATION MANAGER**