

*Response to questions raised by EUAA  
at AER Public Forum held 20 April 2006*

*How Unique (Slide 5)*

<b>Q</b>	<b>But how unique is Powerlink?</b>
<b>A</b>	<p>Powerlink considers that many drivers which are resulting in higher costs for Powerlink will also result in higher costs for other electricity transmission businesses and indeed many other businesses involved in the provision of infrastructure generally. However, electricity transmission is a “transportation” activity – which is influenced by not only how much is transported, but also how far it has to be transported.</p> <p>There are several aspects which are unique to Qld when compared with other NEM transmission businesses. These include:</p> <ul style="list-style-type: none"><li>• High demand growth year on year</li><li>• Flat demand profile during critical summer period</li><li>• Low benchmarked operating costs</li><li>• Vast geography</li><li>• Hostile tropical environment in North Queensland</li><li>• Dispersed load centres over much of Queensland</li><li>• SEQ infrastructure plan and establishment of the “urban footprint”</li><li>• Increased obligations under the Vegetation Management Act</li><li>• Sharp increases in labour rates to close the wage parity gap with southern states</li></ul>

*Cost Pressures (Slide 6)*

<b>Q</b>	<b>Why should high labour and material costs affect Powerlink more than other companies?</b>
<b>A</b>	<p>Powerlink is experiencing the same cost pressures impacting other businesses which need to acquire construction and maintenance services and materials. In relation to the costs of materials, the mix of materials which Powerlink uses in the provision of services results in an overall impact on costs which is different to other businesses. In the revenue proposal Powerlink has sought to take the cost of materials into account on the basis of the use of these particular materials.</p> <p>Labour cost increases are currently higher than those being experienced by some other businesses. This is resulting from two things - the need to close the wage parity gap between Queensland and the southern states for workers in electricity transmission and distribution businesses and a general shortage of skilled workers, particularly in the construction industry. Both of these aspects will impact Powerlink to a greater extent than companies generally.</p>

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<b>Q</b>	<b>A relevant question for AER to ask: How do companies in a competitive industry behave in response to such cost pressures? Can they simply raise prices? Go to the regulator to seek pass through?</b>
<b>A</b>	<p>Businesses in competitive industries are experiencing the same cost pressures as Powerlink is. Two major mining companies recently reported major blowouts in operating costs to shareholders and cited the same underlying drivers as Powerlink. According to BRW (Feb 23, 2006), Rio Tinto announced a 135% increase in its annual operating costs. BHP Billiton's costs blew out by almost \$US 800 million in the half year. Powerlink's costs increases are much more modest.</p> <p>Competitive industries may elect to defer capital expenditure when construction costs are high. Due to the discretionary nature of their capital investments they are able to respond in this manner. Powerlink is not able to defer investments in this manner because mandatory obligations result in non-discretionary investment requirements.</p> <p>For operating expenditure, rising operating costs in competitive industries are generally outweighed by higher revenues. Many competitive companies are experiencing much larger increases in revenues (eg. Mining companies associated with the current resources boom) than the increases in their operating costs. Powerlink's revenue is regulated and hence Powerlink must make its regulator aware of these rising costs and recognition of them by the regulator is necessary to ensure Powerlink remains a viable business.</p> <p>As with all businesses, Powerlink continues to seek efficiencies to offset rising costs, whilst still meeting our obligations.</p>

**Regulatory Asset Base (Slide 9)**

<b>Q</b>	<b>Has Powerlink responded to increased demand and cost pressures not foreseen; or has it significantly ramped up capex in the second period to increase its RAB?</b>
<b>A</b>	The increase in capex during 2005 – 2007 is due to two main factors - increases in demand above those forecast at the time of the 2001 revenue cap decision, and significant increases in input costs. The facts regarding the actual demand to be supplied and the cost of construction (which Powerlink sources on a competitive basis) support this.

<b>Q</b>	<b>Assets under construction are depreciated even before they are completed?</b>
<b>A</b>	<p>Powerlink has <u>not</u> included depreciation of assets under construction in its revenue proposal.</p> <p>However, the AER has stated in its consultation on regulatory accounting methodologies that its preference is to depreciate assets under construction as part of the capex incentive framework. The AER may therefore require assets under construction to be depreciated.</p>

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**Capex Efficiency Savings (Slide 11)**

<b>Q</b>	<b>Reasons supplied, however, indicate that the savings may have been more fortuitous than any efficiency?</b>
<b>A</b>	<p>The savings to customers in the case of supply to the Gold Coast area have occurred directly as a result of Powerlink's management action of obtaining and, even more importantly, maintaining the right to construct on easements in locations.</p> <p>It is not simply fortuitous that Powerlink acquired this easement which would now be very costly to acquire. And it is not simply fortuitous that Powerlink maintained the right to construct an overhead transmission line on the acquired easement. This required a persistent and directed effort to ensure local government bodies, the community and individual property purchasers are aware of easements and take them into account. This is anything but a "do nothing" exercise.</p>

**Capex/RAB(Slide 12)**

<b>Q</b>	<b>Powerlink's forecast Capex/RAB ratio has significantly increased from the current regulatory period and is also significantly higher than comparable TNSPs.</b>
<b>A</b>	<p>Capex/RAB ratio is not a valid metric as it contains mixed units of measure - capex reflects replacement cost in the current construction environment which is significantly higher than historic costs while RAB is a depreciated historical cost.</p> <p>Comparisons with other TNSPs are not valid for the same reason. To achieve a valid comparison, one would need to express the RAB in terms of modern day replacement value (undepreciated).</p>

**Weighted Average Cost of Capital (Slides 13-15)**

<b>Q</b>	<b>Why a 'high' 6%?</b>
<b>A</b>	<p>After an extensive period of public consultation on all revenue matters including WACC parameters, the ACCC decided on a MRP of 6%.</p> <p>However, Powerlink notes that a MRP of 6% is also consistent with the recent regulatory decisions for TransGrid (2005), EnergyAustralia (2005), Queensland electricity distributors (2005), Victorian electricity distributors and Directlink (2006).</p>

<b>Q</b>	<b>SRP persists (illogically) in setting equity beta at 1.0.</b>
<b>A</b>	<p>A review of recent regulatory decisions (electricity and gas) indicates that an equity beta of 1 is within what regulators consider to be a reasonable range. For example, the WA regulator believed that certain businesses may be subject to higher systematic risk than the market and hence considered that the upper bound of the reasonable range for Be was 1.2. The QCA also adopted a Be of 1.1 in relation to the two Queensland gas distributors.</p>

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<b>Q</b>	<b>Debt Margin</b>
<i>A</i>	<p>In its application, Powerlink cited the SRP, which requires that a benchmark debt margin be calculated with reference to a 10-year term, and nominates a benchmark 'A' credit rating for a TNSP.</p> <p>Powerlink's debt margin was derived from two primary and common sources of credit spread information databases, namely CBA Spectrum and Bloomberg, averaged over 20-trading days consistent with the risk-free rate setting period. Adjustments were also included to reflect the underestimation inherent in the CBA Spectrum estimates (which other regulators have recognised) and as compensation for refinancing its debt consistent with the regulatory period (supported by analysis from a market practitioner).</p> <p>In relation to the credit rating, we would note the unsolicited observation from the representative of Fitch who attended the public forum, to the effect that the standalone ratings would be between BBB+ and A-.</p>

*Capex (Slides 16,17)*

<b>Q</b>	<b>Unclear which load forecast has been used in the calculation of capex?</b>
<i>A</i>	<p>The 2005 APR load forecast has been used to prepare the capex forecast for the revenue proposal. Powerlink also flagged that the 2006 load forecast would become available shortly, and if there are sufficient differences, this may necessitate a supplementary submission.</p>

<b>Q</b>	<b>Apparent discrepancies between supporting info and submission.</b>
<i>A</i>	<p>The apparent discrepancies arise due to probabilistic capex forecasting.</p> <p>The information templates containing the supporting information for future capex have been prepared in three sheets – one containing network projects which are common to all 40 scenarios with common timing, a second containing all other network projects and a third containing all non-network projects. It is the second sheet which gives rise to the discrepancy identified. This sheet contains information regarding the costs of each project which occurs in <u>any</u> of the 40 scenarios. The costs have been provided for the <u>median</u> timing at which that project is forecast to occur.</p> <p>The costs will therefore not correspond to the probability weighted average of the total capex. The probability weighted average capex for each of the listed projects is not considered meaningful because it does not reflect the actual cost which would be required in each of the years to construct the relevant project.</p>

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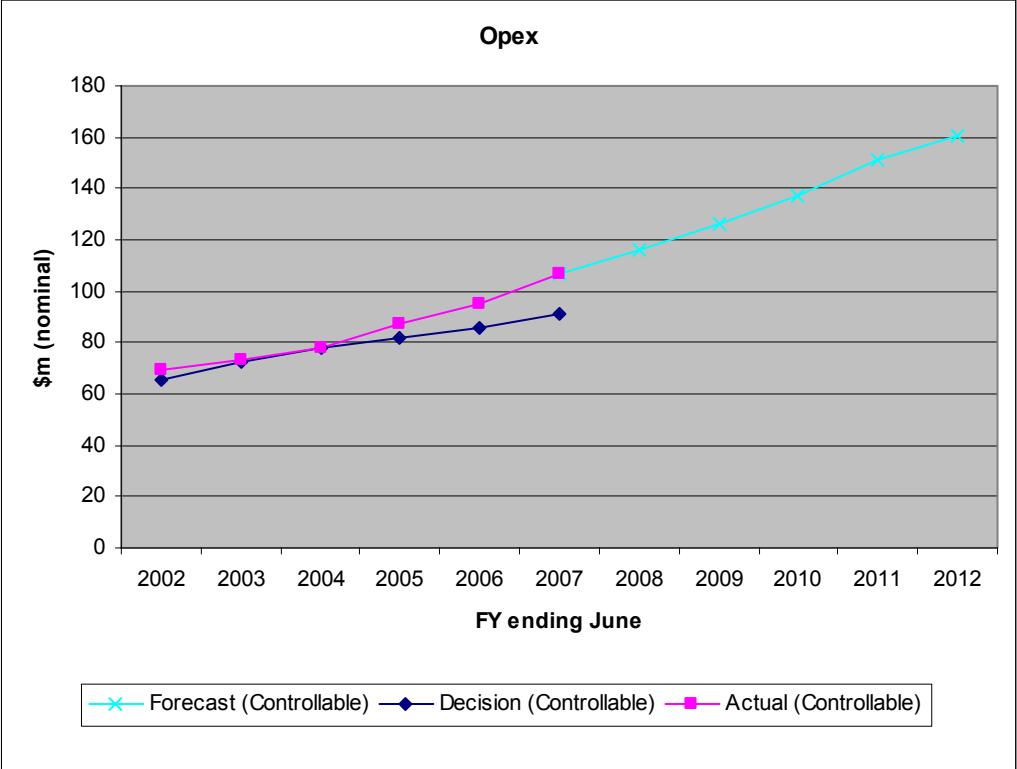
<b>Q</b>	<b>Augmentations seem high compared to connections. Where will increased load come from if not generator/customer connections? How are capital contributions from generators, etc. included?</b>
<b>A</b>	Connections to new generators are contestable and are categorised as unregulated assets. As such they do not form part of the regulated revenue proposal. Capital contributions from generators (should they occur) are therefore not relevant.

<b>Q</b>	<b>Augmentations are subject to Regulatory Test but have not indicated whether these projects are likely to pass Regulatory Test.</b>
<b>A</b>	<p>It is not possible for regulatory test analysis to be carried out for all augmentations in the revenue proposal. It is also not appropriate for this to be done as the projects would be commissioned at times as far out as 2016 and the input assumptions for these projects would be speculative.</p> <p>Powerlink has carried out initial planning analysis for all projects in each of the scenarios considered in the revenue proposal. This initial analysis includes a high level comparison of options including grid support options where there is known plant which could provide such services. This high level comparison of options is akin to the regulatory test analysis and provides an indication as whether the project is likely to satisfy the regulatory test under that particular scenario with its associated input assumptions.</p>

<b>Q</b>	<b>Are unit costs in line with industry practice? Do Powerlink's specification and construction standards compare to good industry practice?</b>
<b>A</b>	<p>Powerlink procures equipment and construction on a competitive basis. As such the unit costs reflect the cost of constructing assets in Queensland at the current time. Due to the high demand growth in Queensland, Powerlink constructs more transmission assets than any other NEM transmission business. Our cost estimates reflect this recent experience of competitive sourcing at the current time.</p> <p>Powerlink designs and constructs its assets in accordance with good electricity industry practice</p>

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**Opex (Slides 18 – 20)**

<b>Q</b>	<b>Forecast exceeds trend projection by an average of over \$30m (~30%) pa., and is 40% above the average approved in 2001.</b>																																																
<b>A</b>	<p>There is a major discontinuity in consistency between the historical data used by EUAA, and the forecast opex in the EUAA graphs. It is important that any comparisons (either over time or between entities) use “controllable” opex , as the ACCC does in its comparisons.</p> <p>“Controllable” opex specifically excludes grid support costs and other allowances (eg. capex efficiency). Grid support costs are excluded because they are a capex substitute, and are highly volatile, due to factors outside the TNSP’s control. The following graph shows Powerlink’s projected “controllable” opex and the historical trend. It can be seen that the future trend is consistent with historical actuals. The actuals show the high input costs which have arisen in the last part of the current regulatory period.</p> <div style="text-align: center;">  <table border="1" style="margin: 10px auto;"> <caption>Opex Data (Estimated from Graph)</caption> <thead> <tr> <th>FY ending June</th> <th>Forecast (Controllable) \$m</th> <th>Decision (Controllable) \$m</th> <th>Actual (Controllable) \$m</th> </tr> </thead> <tbody> <tr><td>2002</td><td>65</td><td>65</td><td>65</td></tr> <tr><td>2003</td><td>70</td><td>70</td><td>70</td></tr> <tr><td>2004</td><td>75</td><td>75</td><td>75</td></tr> <tr><td>2005</td><td>85</td><td>80</td><td>85</td></tr> <tr><td>2006</td><td>95</td><td>85</td><td>95</td></tr> <tr><td>2007</td><td>105</td><td>90</td><td>108</td></tr> <tr><td>2008</td><td>115</td><td>-</td><td>115</td></tr> <tr><td>2009</td><td>125</td><td>-</td><td>125</td></tr> <tr><td>2010</td><td>135</td><td>-</td><td>135</td></tr> <tr><td>2011</td><td>145</td><td>-</td><td>145</td></tr> <tr><td>2012</td><td>155</td><td>-</td><td>160</td></tr> </tbody> </table> </div>	FY ending June	Forecast (Controllable) \$m	Decision (Controllable) \$m	Actual (Controllable) \$m	2002	65	65	65	2003	70	70	70	2004	75	75	75	2005	85	80	85	2006	95	85	95	2007	105	90	108	2008	115	-	115	2009	125	-	125	2010	135	-	135	2011	145	-	145	2012	155	-	160
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<b>Q</b>	<b>Forecast is 38% above actual opex incurred between 2001/02 and 2005/06</b>
<b>A</b>	<p>Same issues as above. Comparatives need to be done on an “apples vs apples” basis, using controllable opex. In addition, the sharp increases in input costs in the latter years makes it inappropriate to use an average which covers both those years, and the years preceding the sharp increases.</p>

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<b>Q</b>	<b>Is there evidence of double dipping?</b>
<i>A</i>	<p>Corporate 'finance' costs do not relate to financing costs per se, but rather the internal costs associated with the provision of services from the finance group within Powerlink. Similarly with accounting services, administration, employee relations etc.</p> <p>The true costs associated with financing debt and equity are discussed in the Cost of Capital chapter. Due to the framework applied by the AER under the SRP, the debt margin is defined as a margin for credit risk. Therefore, the costs associated with debt-raising and interest rate risk management are not included in the debt-margin. Given the AER's preference to treat debt-raising, equity-raising and hedging costs as cash flow items, Powerlink has included these items as opex allowances as opposed to an adjustment to the WACC parameters.</p>

<b>Q</b>	<b>AER should be aware of this type of regulatory gaming and be taking steps to prevent it.</b>
<i>A</i>	<p>Powerlink has spent more actual controllable opex than the revenue allowances in every year of the current regulatory period. Data for the final two years of the current period are forecasts and reflect the current environment for provision of these services. Sharp increases in costs have arisen in recent times. Powerlink will provide updated actual data for the 2005/06 financial year after its accounts have been audited. It is anticipated that actual expenditure may be even higher than the estimated expenditure in the revenue proposal. These increases are therefore real costs which reflect increases in the size of the network to be managed, and modern day labour rates and other input costs.</p> <p>Powerlink refutes any suggestion of gaming.</p>

**Opex/RAB (Slides 21,22)**

<b>Q</b>	<b>Based on its forecast opex and RAB, in 2007/08, opex/RAB will be 4%?</b>
<i>A</i>	<p>The opex/RAB ratios in the EUAA slides are not valid comparisons. The EUAA slides use different definitions of opex for forecast years vs historical years. In the EUAA table historic opex is based on nominal \$ and (correctly) <u>controllable</u> opex only. In the only future years, the opex used by EUAA is based on controllable opex <u>plus</u> all other allowances such as grid support, capex efficiency allowances, etc. The valid approach to opex/RAB is to use controllable opex only, and consistently use either nominal or real values.</p> <p>The comparative figures included in Powerlink's application are calculated in the same way as those determined by the ACCC in its revenue decisions. On this correct comparative basis, Powerlink will clearly continue to lead its peers.</p>

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*Opex (Slide 23)*

<b>Q</b>	<b>Powerlink have not specified any productivity/efficiency gains/targets for its operations.</b>
<b>A</b>	<p>The revenue proposal submitted by Powerlink shows the impact on the controllable opex forecast of efficiencies and economies of scale which will result in lower forecast opex than would otherwise be required.</p> <p>In addition, correctly calculated comparisons of controllable opex/RAB continue to demonstrate that Powerlink has low opex levels compared with other NEM transmission businesses.</p>

<b>Q</b>	<b>→ cost plus approach to pricing? How do industries in competitive sectors of the economy manage these cost increases? Do they simply increase prices or do they seek to increase productivity, manage cost pressures and absorb some cost increases?</b>
<b>A</b>	<p>Powerlink is a regulated business. As such all revenues associated with provision of regulated services are in accordance with the allowances determined by its regulator the AER.</p> <p>Businesses in competitive industries which need to acquire construction and maintenance services are experiencing the same cost pressures as Powerlink. Two major mining companies recently reported major blowouts in operating costs to shareholders and cited the same underlying drivers as Powerlink. Rio Tinto is reported as having experienced an increase in annual operating costs of 135%.</p> <p>For operating expenditure, rising operating costs in competitive industries are generally outweighed by higher revenues. Many competitive companies are experiencing much larger increases in revenues (eg. Mining companies associated with the current resources boom) than the increases in their operating costs. Powerlink's revenue is regulated and hence Powerlink must make its regulator aware of these rising costs and recognition of them by the regulator is necessary to ensure Powerlink remains a viable business.</p> <p>As with all businesses, Powerlink continues to seek efficiencies to offset rising costs while still meeting our obligations.</p>



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*Performance Standards (Slide 24)*

<b>Q</b>	<b>However, 1% revenue at risk simply too small an incentive to do much.</b>
<b>A</b>	<p>The 1 per cent revenue at risk is equivalent to about 5 per cent of Powerlink's opex.</p> <p>The service standards framework is explicitly aimed at operational measures to improve service standards performance. As such it is not intended to be associated with capital investments. It is therefore appropriate to consider the revenue at risk as a comparison with the opex allowance. 5% of controllable opex is a large number, particularly for a low opex business such as Powerlink and appropriately incentivises Powerlink to strive for gains in service levels.</p>

*Revenue adjustments ... Pass Through (Slide 25)*

<b>Q</b>	<p><b>Terrorist Events &amp; Increased Security Measures</b></p> <ul style="list-style-type: none"><li>▪ <b>How is such an event defined?</b></li><li>▪ <b>Cost for self insurance are included in opex (p. 107)</b></li><li>▪ <b>How would customers know if an event has occurred that would allow a pass through of reduced costs?</b></li><li>▪ <b>Are customers allowed to apply when there are lower costs?</b></li></ul>
<b>A</b>	<p>Powerlink will deal with these events in accordance with the rules.</p> <p>Powerlink's current revenue decision includes a pass through arrangement for grid support costs. The pass through is symmetric, i.e. Costs lower than the allowance are returned to customers through a reduction in the following year's MAR. Costs higher than the allowance are subject to approval of the AER and a pass through consultation is undertaken. This experience clearly demonstrates that costs lower than allowances can be effectively managed through the revenue reporting arrangements between the regulated business and the regulator.</p>

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***Demand Management (Slide 26)***

<b>Q</b>	<b>Little evidence in application to address any of the demand management and embedded generation opportunities. Powerlink has undertaken some such measures in the past (to its credit) and been relatively transparent about it. Disappointing that there is little evidence of this in the Application.</b>
<b>A</b>	<p>Powerlink and the Queensland electricity distributors have a comprehensive program of demand management in place through control of hot water systems. This has been in place for many years and is automatically taken into account in the demand forecast used for the capital expenditure forecast.</p> <p>Powerlink has considered whether <u>additional</u> grid support (in any form including demand management) can be used to defer capital expenditure as part of its system analysis in determining the network development plans for each of the 40 scenarios used in the revenue proposal. Two major grid support arrangements have been determined as very likely to be effective and have been included in the revenue proposal through deferral of capital expenditure and inclusion of grid support forecasts.</p> <p>Powerlink will continue to consider grid support solutions (including demand management) in its future augmentations. This will be done in the transparent manner already in use, using the Regulatory Test evaluation process.</p> <p>The regulatory framework which has an ex ante allowance for capital expenditure naturally incentives Powerlink to seek non-network solutions if they can be implemented at lower cost than the capital expenditure allowances.</p>

***Customer Impact (Slides 27,28)***

<b>Q</b>	<b>Proposed revenue will result in average TUOS of over 10% in 2007/08 based on the Qld demand forecast published in NEMMCO's 2005 SOO.</b>
<b>A</b>	<p>This statement is not correct.</p> <p>As noted in the Revenue Proposal, there is a "one off" increase of 10% in average TUOS in 2007/08 due to the AER's change in accounting treatment for capex.</p> <p>Powerlink's capex and opex requirements will result in a 5.5% (nominal) increase p.a. in average TUOS over the next regulatory period. Since TUOS is only about 8% of the total delivered price of electricity for most customers, the overall impact is about 0.5% p.a. (nominal) – much less than CPI.</p>